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Tackling Bankruptcy Issues in State Court

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TACKLING BANKRUPTCY ISSUES IN STATE COURT

Materials on General and Consumer Issues

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I. Bankruptcy Code Overview

A. Types of Bankruptcy Relief

The Bankruptcy Code, which is title 11 of the United States Code, is organized into chapters, mostly with odd numbers – chapter 12 is the current exception – and the types of bankruptcy relief are placed into the operative chapters as follows:

- Chapter 7 – Liquidation
- Chapter 9 – Municipal Bankruptcy (*famously concerning Detroit*)
- Chapter 11 – Reorganization
- Chapter 12 – Debt Adjustment for Family Farmers and Fishermen with Regular Income
- Chapter 13 – Debt Adjustment for Individuals with Regular Income
- Chapter 15 – Ancillary and Other Cross-Border Cases (*for insolvency proceedings based in foreign countries*)

B. The Non-Operative Chapters

The non-operative chapters, 1, 3 and 5, contain provisions that are intended to apply in all or most of the operative chapters, as follows:

- Chapter 1 – General Provisions (*applies throughout the Code*), including
    - Definitions
    - Eligibility Requirements for Relief in Operative Chapters
    - Applicability of Code Provisions in Various Chapters
    - Power of the Court
    - Waiver of Sovereign Immunity

- Chapter 3 – Case Administration (*applies completely in chapters 7, 11, 12 and 13, and selectively in chapters 9 and 15*), including
    - Commencement of a Case – voluntary and involuntary petitions
    - Officers
        - Role, capacity and qualification of the trustee
        - Retention and compensation of professionals
    - Administration
        - Meetings of creditors
        - Effects of dismissal of cases and conversion of cases from one operative chapter to another
    - Administrative Powers
        - Automatic stay
        - Use, sale and lease of property
            - Use of "cash collateral"
            - "Free and clear" asset sales
        - Obtaining credit
        - Executory contracts and unexpired leases

- Chapter 5 – Creditors, the Debtor and the Estate (*applies completely in chapters 7, 11, 12 and 13, and selectively in chapters 9 and 15*), including
  - Creditors and Claims
    - Filing of proofs of claims or (equity) interests
    - Allowance and disallowance of claims
    - Allowance of administrative expenses
    - Determination of secured status
    - Priority claims
  - Debtor's Duties and Benefits
    - Debtor's duties
    - Exempt property
    - Exceptions to discharge (non-dischargeable debts)
    - Effect of discharge
    - Protection against discrimination for debtors (in employment and governmental licensing)
    - Regulation of "debt relief agencies" – advisers to individual debtors
  - The Estate
    - Property of the estate
    - Turnover of property of the estate
    - Avoiding powers ("clawback actions")
      - Preferences
      - Fraudulent transfers
      - Unperfected interests (the "strong arm" power)
    - Setoff
    - Abandonment of property
    - Protection for certain financial contracts

C. Statutory Concepts Common to Chapters 7, 11 and 13

The following statutory concepts apply in bankruptcy cases under chapter 7, 11 and 13:

- Creation of the Bankruptcy Estate

  The filing of a bankruptcy petition – voluntary or involuntary – creates an estate, which, at a minimum, consists of all legal and equitable interests of the debtor as of the filing of the petition, wherever located and by whomever held. 11 U.S.C. § 541(a).

- The Trustee

  The trustee is the representative of the estate, with capacity to sue and be sued. 11 U.S.C. § 323. The trustee may compel the turnover of property of the estate. *Id.* § 542. Subject to restrictions, which may include court permission, the trustee may use, sell or lease property of the estate, borrow money on the credit of the estate, and assume or reject executory contracts or unexpired leases of the debtor.

Id. §§ 363-365. The trustee is empowered to prosecute the Bankruptcy Code's avoiding powers, and recover property for the benefit of the estate. *Id.* §§ 544-550.

Chapter 11 Modifications: In a chapter 11 case, a debtor in possession has the rights, duties and powers of a trustee. *Id.* § 1107(a). A chapter 11 plan of reorganization may designate a representative, such as a plan administrator or liquidating trustee, to prosecute a claim belonging to the debtor or the estate, such as an avoidance or "clawback" action. *Id.* § 1123(b)(3)(B).

Derivative Standing: The bankruptcy court may authorize an interested party, often a creditors' committee in a chapter 11 case, to prosecute a meritorious claim or cause of action belonging to the estate that the trustee or debtor in possession is unwilling or unable to prosecute. *Official Comm. of Unsecured Creditors v. Chinery*, 330 F.3d 548, 579 (3d Cir. 2003) (en banc); *Canadian Pac. Forest Prods., Ltd. v. J.D. Irving, Ltd. (In re The Gibson Grp., Inc.)*, 66 F.3d 1436, 1438 (6th Cir. 1995); *Unsecured Creditors Comm. v. Noyes (In re STN Enters.)*, 779 F.2d 901, 904 (2d Cir. 1985).

Chapter 13 Debtor: Although there is a trustee in chapter 13 cases, the trustee's role is a limited one. The chapter 13 debtor remains in possession of the property of the estate, 11 U.S.C. § 1306(b); and has the right, exclusive of the trustee, to use such property and operate any business the debtor has as a sole proprietor, *id.* §§ 1303-1304. The trustee's functions are essentially investigative and supervisory, with the obligation to be heard on the propriety of the chapter 13 debtor's plan. *Id.* § 1302(b). With respect to property, the chapter 13 trustee's principal role is to receive plan payments from the chapter 13 debtor (even before the plan is confirmed), and distribute them to creditors if the plan is confirmed or return them to the debtor if the plan is denied confirmation. *Id.* § 1326(a). Consequently, the right to prosecute a claim belonging to the chapter 13 estate belongs to the chapter 13 debtor. *Cable v. Ivy Tech State College*, 200 F.3d 467, 472-73 (7th Cir. 1999); *Olick v. Parker & Parsley Petroleum Co.*, 145 F.3d 513, 515-16 (2d Cir. 1998). This does not apply to the right to prosecute an avoiding power, such as a preference or fraudulent transfer, as to which the courts are divided. *See In re Binghi*, 299 B.R. 300, 302-04 (Bankr. S.D.N.Y. 2003) (collecting cases).

- The Automatic Stay

The filing of a bankruptcy petition – voluntary or involuntary – imposes the automatic stay. 11 U.S.C. § 362(a). The automatic stay is discussed at length in Part II.

- The Debtor's Schedules and Statement of Financial Affairs

  At the beginning of a bankruptcy case, the debtor is required to file with the court a comprehensive set of disclosures of assets and liabilities on official bankruptcy forms, called "Schedules," and responses to additional questions entitled a "Statement of Financial Affairs." Individual debtors, those who are natural persons, also file schedules of exempt property and income and expenses. 11 U.S.C. § 521(1)(B); FED. R. BANKR. P. 1007(b).

- Discharge

  One of the chief purpose of the bankruptcy laws is to give "the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discourage of preexisting debt." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). This purpose is accomplished through the bankruptcy discharge. A discharge has the effect of voiding any judgment at any time obtained to the extent it determines the personal liability of any discharged debt, 11 U.S.C. § 524(a)(1); and operates as an injunction against the commencement or continuation of any action, the employment of any process, or any act to collect, recover or offset any such debt as a personal liability of the debtor, *id.* § 524(a)(2). Any waiver of the discharge as to a particular debt is unenforceable. *Id.* § 524(a). The discharge applies in all operative chapters, including chapter 11 reorganization of artificial entities, although not all debtors are eligible for a discharge.

- Nondischargeable Debts

  Despite being granted a (general) discharge, certain kinds of debt are nondischargeable, and may be enforced after the discharge is granted or denied. *Id.* § 523(a). The kinds of dischargeable debts are different in different operative chapters.

D. Liquidation Under Chapter 7

The following is a brief overview of a chapter 7 case:

- Appointment of a Trustee

  A disinterested interim trustee is appointed by the United States Trustee (an official in the U.S. Department of Justice charged with supervision of bankruptcy cases). 11 U.S.C. § 701(a). Creditors have the right to elect a permanent trustee, *id.* § 702(b); but if, as in most cases, no election is requested, the interim trustee becomes the permanent trustee, *id.* § 702(d). The trustee reviews the debtor's Schedules and Statement of Financial Affairs, conducts any additional investigation of the debtor's assets, liabilities and financial affairs as may be

appropriate, takes custody of the property of the estate, and compels the turnover of property of the estate held by others. *Id.* §§ 542, 704(a).

- Cessation of Business

  In a chapter 7 case, all business operations cease, unless the trustee is authorized by the bankruptcy court to operate the business for a limited period, if such operation is in the best interest of the estate and is consistent with an orderly liquidation. 11 U.S.C. § 721.

- Reduction of the Estate to Cash

  The trustee is statutorily directed to "collect and reduce to money the property of the estate . . . and close such estate as expeditiously as is compatible with the best interests of parties in interest." 11 U.S.C. § 704(a)(1). Thus, the trustee collects debts owed to the debtor, *see id.* § 542(b); sells physical assets, *see id.* § 363(b); and prosecutes lawsuits belonging to the debtor, *see id.* § 541(a)(1), and avoidance actions, such as preferences and fraudulent transfers, *id.* §§ 544, 547, 548.

- Disposition of Secured Creditors' Collateral

  If a secured creditor has a valid, properly perfected, unavoidable lien on or security interest in property of the estate, the creditor may obtain relief from the automatic stay to recover such property or enforce such lien, 11 U.S.C. § 362(d); or the trustee may dispose of the property for the benefit of the secured creditor, recovering the expenses of such disposition, *see id.* § 506(c); or the trustee may abandon the estate's interest in the property, *id.* § 554(a); or the trustee may return the property to the secured creditor, *id.* § 725.

- Filing and Allowance of Claims

  To receive a distribution from unencumbered property of the estate, creditors must file proofs of claim. 11 U.S.C. §§ 501, 502(a). Filed claims are deemed allowed unless a party in interest, such as the trustee, objects. *Id.* § 502(a). If an objection is made, the bankruptcy court determines whether to allow or disallow the claim. Disallowance may be based on the unenforceability of such claim under applicable nonbankruptcy law, *id.* § 502(b)(1); or based on a limitation on allowance, or a required disallowance contained in the Bankruptcy Code, *id.* §§ 502(b)(2)-(9), 502(d), 502(e), 502(k).

- Distributions to Unsecured Creditors

  The unencumbered property of the estate, as reduced to cash is distributed in accordance with the priorities set by Congress. All claims of the same priority

must be satisfied before any claims with a junior priority may receive a distribution. 11 U.S.C. § 726(a). The priority claims are:

1. *Domestic support obligations*, generally, those in the nature of alimony, maintenance or support, *id.* § 101(14A), even come ahead of administrative expenses (the cost of the bankruptcy case, including compensation for professionals), except for the expenses, compensation and professional fees of an actual trustee (as opposed to a debtor in possession) to the extent the trustee administers assets that are otherwise available for the payment of domestic support obligations. *Id.* § 507(a)(1).

2. *Administrative expenses*, the costs of the bankruptcy case, including the commissions of the trustee and the compensation of professionals. *Id.* §§ 503(b), 507(a)(1).

3. *Involuntary "gap" creditors,* ordinary course obligations in an involuntary bankruptcy case incurred between the filing of the petition and the bankruptcy court order for relief determining to proceed with the bankruptcy case. *Id.* § 507(a)(3).

4. *Wages* of employees, subject to limitations and a statutory maximum that is adjusted every three years. *Id.* § 507(a)(4).

5. *Employee benefits*, subject to limitations and the same statutory maximum. *Id.* § 507(a)(5).

6. *Producers of grain* (against debtors that store grain) and *fishermen* (against debtors that store or process fish). *Id.* § 507(a)(6).

7. *Customer deposits* by individuals (against debtors that are retailers), subject to limitations and a statutory maximum adjusted every three years. *Id.* § 507(a)(7).

8. *Taxes*, most kinds of taxes. *Id.* § 507(a)(8).

- Discharge, the "Fresh Start" for Deserving Individuals

Individuals are presumptively eligible to receive a (general) discharge of their pre-bankruptcy debts. 11 U.S.C. § 727(a); FED. R. BANKR. P. 4004(a), (c). Corporations and other artificial entities are not. 11 U.S.C. § 727(a)(1); FED. R. BANKR. P. 4004(c)(1). An individual debtor may be denied a discharge for engaging in certain improper conduct, such as concealing property, destroying records, giving false testimony, disobeying bankruptcy court orders, or transferring property with actual intent to hinder, delay or defraud creditors within one year prior to bankruptcy. *Id.* § 727(a). Nevertheless, before the discharge is

granted, an individual may reaffirm an otherwise dischargeable debt, for example, a car loan, if approved by the bankruptcy court, or a certification containing the required disclosures is filed by the debtor's attorney. *Id.* § 524(c), (d), (k).

- Nondischargeable Debts

  For individuals in chapter 7 (and also chapter 11), there are currently 19 categories of nondischargeable debts, the most common of which are for certain taxes; debts to creditors who are not listed on the Schedules (or otherwise notified of the bankruptcy); domestic support obligations; fines, penalties or forfeitures owed to governmental agencies; most student loans (except where undue hardship is demonstrated); debts for causing personal injury while operating a vehicle, vessel or aircraft while impaired. *Id.* §§ 523(a), 1141(d)(2).

  Exclusive bankruptcy jurisdiction: Certain categories of nondischargeable debts may be determined only by the bankruptcy court, and a complaint for such determination must be filed by the creditor within a brief, but extendable, limitations period. 11 U.S.C. § 523(c); FED. R. BANKR. P. 4007(c). These are debts for false pretenses, fraud, or false financial statements, 11 U.S.C. § 523(a)(2); embezzlement, larceny, or defalcation while acting in a fiduciary capacity, *id.* § 523(a)(4); or willful and malicious injury, *id.* § 523(a)(6).

- Exempt Property for Individuals

  Individuals may exempt a limited amount property from the estate. 11 U.S.C. § 522(b)(1). The Bankruptcy Code contains a list of 12 categories of property, subject to statutory maximums in value, which maximums are adjusted every three years. *Id.* § 522(d). Nevertheless, the Bankruptcy Code permits states to limit their citizens to exemptions specified in state law plus exemptions in non-bankruptcy federal statutes. *Id.* § 522(b)(1)-(2). Most states have enacted laws denying their citizens access to the Bankruptcy Code's exemptions. New York was one such state, N.Y. DEBT. & CRED. LAW § 284; until a 2010 enactment effectively countermanded such limitation without repealing it, *id.* § 285. In states that do not limit exemptions in bankruptcy, debtors may elect the exemptions specified in either the Bankruptcy Code or in state and non-bankruptcy federal law. 11 U.S.C. § 522(b)(1). In 2005, Congress added limitations on homestead exemptions for debtors who move their residences within 1215 days (approximately 3 years 4 months) prior to the filing in an attempt to take advantage of more generous exemptions in other states, or who have committed certain serious crimes, frauds or other wrongful acts. *Id.* §§ 522(p)-(q).

- Redemption of Certain Exempt or Abandoned Personal Property by Individuals

  An individual debtor has the right to redeem tangible personal property used primarily for personal, family or household purposes, from a lien securing a

dischargeable debt, if the property is exempt or abandoned by the trustee, by paying the creditor the value of the property. 11 U.S.C. § 722. To exercise this right, the debtor must timely file and perform a statement of intention concerning all secured property, as whether such property will be surrendered or retained, and the method of retention, such as redemption of the property, reaffirmation of the debt, *see id.* § 524(c), or in such other fashion, including a litigation claim. *Id.* § 521(a)(2). The debtor's statement of intention does not affect the trustee's rights in the property. *Id.*

- Limitation on Availability of Chapter 7 Relief for Certain Consumer Debtors

  In 2005, Congress curtailed the availability of chapter 7 to individuals whose debts are primarily consumer debts and are able to repay a portion of their debts from future income. The Bankruptcy Code now contains a "means test" for individuals whose debts are primarily consumer debts, and requires the dismissal of the chapter 7 cases prior to discharge for individuals who are statutorily declared to have sufficient means, absent special circumstances. 11 U.S.C. § 707(b). A description of the means test is beyond the scope of this discussion. What is important is that individuals with adequate means who seek bankruptcy relief must seek it in chapter 11 or chapter 13.

E. Reorganization Under Chapter 11

- Underlying Premises

The purposes of chapter 11 are to preserve going concern values of assets, as opposed to liquidation values, which are much lower, so that creditors receive an enhanced recovery, and to preserve jobs. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 220 (1977). For businesses, rehabilitation can be achieved only if the operation of the assets generates revenue in excess of ongoing expenses. If not, and the business continues to lose money, the rehabilitation should be discontinued, and an orderly liquidation pursued instead. Although chapter 11 is designed for businesses, individuals are eligible for chapter 11, whether or not they are sole proprietors of a business. *Toibb v. Radloff*, 501 U.S. 157, 166 (1991).

- Debtor in Possession and Creditors' Committee

In a chapter 11 case, no trustee is appointed automatically. Instead, the debtor remains in possession of property of the estate, and has all the rights, powers and duties of a trustee, except for the right to compensation. 11 U.S.C. § 1107(a). The debtor in possession therefore has the right to operate the debtor's business. *Id.* § 1108. An actual chapter 11 trustee may be appointed, for cause, including fraud or gross mismanagement, after a hearing in the bankruptcy court, *id.* § 1104(a); but this is viewed as an extraordinary remedy. To monitor and counterbalance the debtor in possession, the Bankruptcy Code provides for the appointment of an official creditors' committee, *id.* § 1102(a), which has the ability to investigate the debtor,

negotiate a reorganization plan with the debtor, and retain professionals compensated from the estate, *id.* § 1103(a), (c).

- Chapter 11 Plan

The plan is the legal document that, if confirmed by the bankruptcy court, becomes binding on the debtor and the creditors, *id.* § 1141(a); directs the distribution of property of the estate, and replaces pre-existing debts and business structures with new obligations and structures as set forth in the plan. Among other things, sets forth the creditors' and equity holders' recovery, if any, by dividing them into classes, and proposing treatments for these classes (what percentage recovery, when provided, and in what form). *Id.* § 1122-1123. The plan must include adequate means for its implementation, such as by selling or otherwise transferring assets; merging or consolidating with other entities; satisfying, modifying or canceling liens; curing defaults; changing maturity dates and interest rates; or issuing new debt or equity securities. *Id.* § 1123(a)(5). At the beginning of a chapter 11 case, the debtor has the exclusive right to propose a plan for a limited period of time, which may be extended or shortened for cause; after which, any party in interest may propose a plan. *Id.* § 1121.

- Confirmation Process

Creditors and equity interest holders whose legal, equitable and contractual rights are altered by the plan – called "impaired" – generally have the right to vote on the plan, unless their claims and interests are in dispute and have not received court permission to vote despite the dispute. *Id.* § 1126(a). Voting is on a class-by-class basis. A class of creditors accepts a plan, if of the voting creditors, creditors holding 2/3 in dollar amount and simple majority in number vote to accept. A class of equity holders accepts a plan, if 2/3 of the percentage of voting equity holders vote to accept. A class where the legal, equitable and contractual rights of the holders are unchanged – called "unimpaired" – is presumed to accept and does not vote. A class that receives nothing is presumed to reject and is not required to vote. *Id.* § 1126(c)-(d), (f)-(g). Prior to voting, to enable the voters to make an informed decision, the voters must be provided with a court-approved disclosure statement containing adequate information. *Id.* § 1125. After the voting, the court holds a hearing to consider whether the plan meets the statutory requirements for confirmation. *Id.* § 1128. These requirements include that the plan contains the required provisions, is proposed in good faith and not by any means forbidden by law, provides a recovery to each class at least as good as the recovery provided by a hypothetical liquidation (unless the class unanimously agrees to accept less), and is feasible. *Id.* § 1129(a). One of the other requirements is that each class accepts the plan or is unimpaired. *Id.* § 1129(a)(8). If a class rejects, the plan can still be confirmed, or "crammed down," on such class, if the treatment of such class is "fair and equitable" and there is no "unfair discrimination." *Id.* § 1129(b). "Fair and equitable" includes adherence to the "absolute priority rule," which essentially provides that the class must be satisfied before any junior class may participate. *See Bank of Am. Nat'l Trust & Sav. Ass'n v.*

203 N. LaSalle St. P'ship, 526 U.S. 434, 442 (1999). Nevertheless, the plan may not be crammed down on every impaired class. Another requirement of confirmation is that at least one impaired class of claims must accept the plan, not counting the acceptances of insiders. 11 U.S.C. § 1129(a)(10).

- Discharge and Nondischargeable Debts

Unless the plan is a liquidating plan or the debtor is an individual, confirmation of the plan grants the debtor a discharge. *Id.* § 1141(d). For artificial entities, there is no discharge if the debtor is liquidated. *Id.* § 1141(d)(3). For individuals, the granting of the discharge is postponed until the plan is completed, unless after appropriate efforts, the debtor is unable to complete or modify the plan, and the debtor qualifies for a "hardship discharge." *Id.* § 1141(d)(5). For artificial entities receiving a chapter 11 discharge, the usual categories of nondischargeable debts are inapplicable. Instead, only certain kinds of debts for fraud owed to certain governmental units are nondischargeable. *Id.* § 1141(d)(6). For individuals receiving a chapter 11 discharge, the same debts that are nondischargeable in chapter 7 are nondischargeable in chapter 11. *Id.* § 1141(d)(2).

F. Debt Adjustment Under Chapter 13

- Underlying Premise

Chapter 13 provides individuals or married couples with a regular income an opportunity to obtain a discharge, while retaining much of their property, by proposing and confirming a plan that would pay creditors over five years in full or what is available from their projected disposable income. *See Ransom v. FIA Card Servs., N.A.*, 131 S. Ct. 716, 721 (2011); *Hamilton v. Lanning*, 130 S.Ct. 2464, 2468-69 (2010).

- Voluntary Nature of Relief

Unlike chapters 7 and 11, a chapter 13 case may only be commenced voluntarily. 11 U.S.C. § 303(a). The chapter 13 debtor has the right to convert the case to chapter 7 at any time. *Id.* § 1307(a). Unless the case has been previously converted, the chapter 13 debtor has the right to dismiss the case at any time. *Id.* § 1307(b). Although the right to dismiss may not be waived, *id.*; the court may nevertheless prevent dismissal and insist on conversion, if the court finds that the chapter 13 debtor has acted in a fraudulent or abusive manner. *See Marrama v. Citizens Bank*, 549 U.S. 365, 375 & n.11 (2007).

- Eligibility – Debt Limits

Only individuals and married couples with a regular income are eligible (except for stockbrokers and commodity brokers), provided that their fixed unsecured debts do

not exceed $383,175, and their fixed secured debts do not exceed $1,149,525. 11 U.S.C. § 109(e). The amounts are adjusted every three years. *Id.* § 104.

- Debtor and Trustee

  Like a chapter 11 debtor in possession, the chapter 13 debtor remains in possession of the property of the estate, *id.* § 1306(b); and has the right, exclusive of the trustee, to use such property and operate any business the debtor has as a sole proprietor, *id.* §§ 1303-1304. The trustee's functions are essentially investigative and supervisory, with the obligation to be heard on the propriety of the chapter 13 debtor's plan. *Id.* § 1302(b). With respect to property, the chapter 13 trustee's principal role is to receive plan payments from the chapter 13 debtor (even before the plan is confirmed), and distribute them to creditors if the plan is confirmed or return them to the debtor if the plan is denied confirmation. *Id.* § 1326(a). There is no creditors' committee in a chapter 13 case.

- Chapter 13 Plan and Confirmation Process

  The debtor must propose a plan with the petition or shortly thereafter. *Id.* § 1321; FED. R. BANKR. P. 3015(b). The plan must provide for the submission of future earnings and other future income of the debtor to supervision and control of the trustee, provide for deferred payment in full of priority claims, and unless creditors are paid in full, devote all of the debtor's projected disposable income for five years to make plan payments. *Id.* § 1322(a). A plan may provide for the curing of defaults such as on home mortgages. *Id.* § 1322(a)(3), (5). Unlike chapter 11, there is no voting by unsecured creditors, and no disclosure statement. Secured creditors' rights, except for mortgages on principal residences (as to which defaults may be cured), may be modified, *id.* § 1322(a)(2), (c); and such creditors may vote to accept such modifications, *id.* § 1325(a)(5)(A). If such secured creditors do not accept, the plan be nevertheless be confirmed if the secured creditor retains its lien and the debtor makes payments that meet certain criteria, including providing a present value equal to the value of the collateral, or the debtor surrenders the collateral. *Id.* § 1325(a)(5)(B)-(C). The plan must also be proposed in good faith and not by any means forbidden by law, be feasible, and provide creditors with at least as good a recovery as a hypothetical liquidation. *Id.* § 1325(a). The court must hold a confirmation hearing and trustee or any party in interest may object to confirmation. *Id.* § 1324.

- Discharge and Nondischargeable Debts

  The debtor who successfully completes the chapter 13 plan receives a discharge, called a "completion discharge," and the categories of nondischargeable debts are more limited than in a chapter 7 or 11 case, which is to say, the "completion discharge" offers more debt relief. *Id.* § 1328(a). The principal nondischargeable debts for a "completion discharge" are the most common categories, namely,

debts for certain taxes; debts to creditors who are not listed on the Schedules (or otherwise notified of the bankruptcy); domestic support obligations; fines, penalties or forfeitures owed to governmental agencies; most student loans (except where undue hardship is demonstrated); debts for causing personal injury while operating a vehicle, vessel or aircraft while impaired. *Id.* § 1328(a)(2)-(4). In addition, a debt that is cured under the plan for which the installment payments last beyond the plan's duration is not discharged. *Id.* § 1328(a)(1). There is also a "hardship discharge" in chapter 13 for certain debtors who, after appropriate efforts, are unable to complete or modify their plans. *Id.* § 1328(b). The nondischargeable debts for these debtors are the same as for chapter 7 and 11 debtors, plus any debt that is cured under the plan for which the installment payments last beyond the plan's duration is not discharged. *Id.* § 1328(c).

II. The Automatic Stay, Generally

The automatic stay is considered "one of the fundamental debtor protections provided by the bankruptcy laws." *Midlantic Nat'l Bank v. N.J. Dep't of Envtl. Prot.*, 474 U.S. 494, 503 (1986) (quoting S. Rep. No. 95-989, 95th Cong., 2d Sess. 54 (1978); H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 340 (1977)). Not only does it protect the debtor, it also protects the estate and enables its orderly administration.

A. What Is Stayed

The filing of a bankruptcy petition – voluntary or involuntary – as well as the filing of an application for relief under the Securities Investor Protection Act of 1970, as in *Bernard L. Madoff Investment Securities LLC* and *Lehman Brothers Inc.* – operates as a stay, applicable to all entities, of –

> (1) the commencement or continuation, including the issuance or employment of process, or a judicial, administrative, or other action or proceeding against the debtor [with respect to a debt that arose before the filing of the petition];
>
> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before [the filing of the petition];
>
> (3) any act to obtain possession of property of the estate or property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce any lien against property of the estate;

> (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent such lien secures a claim that arose before [the filing of the petition]
>
> (6) any act to collect, assess, or recover a claim against the debtor that arose before [the filing of the petition]
>
> (7) the setoff of any debt owing to the debtor that arose before [the filing of the petition] against any claim against the debtor; and
>
> (8) the commencement or continuation of a proceeding before the United States Tax Court [with respect to certain kinds of tax liability].

11 U.S.C. § 362(a).

B. What Is Not Stayed

The Bankruptcy Code currently contains 28 enumerated exceptions to the automatic stay. 11 U.S.C. § 362(b). The most relevant are:

- criminal actions and proceedings against the debtor – *Id.* § 362(b)(1)

- most domestic relations actions, such as
  - paternity
  - child custody or visitation
  - enforcement or modification of alimony and child support (***but not*** collection from property of the estate)
  - separation and divorce (***but not*** the division of property that is property of the estate) – *Id.* § 362(b)(2)

- perfecting certain liens within statutory relation-back periods – *Id.* § 362(b)(3)

- governmental "police power" actions, ***but not*** the enforcement of money judgments – *Id.* § 362(b)(4)

- certain remedies against real property – discussed in Part III below

C. When the Stay Automatically Ends

The automatic stay terminates on the occurrence of certain events, as follows:

- The stay of an act against property of the estate terminates when the property is no longer property of the estate – 11 U.S.C. § 362(c)(1).

- The stay of any other act terminates on the earliest of:

    - when bankruptcy case is closed
    - when bankruptcy case is dismissed
    - for an individual chapter 7 debtor, or in a chapter 9, 11, 12 or 13 case, when the discharge is granted or denied – *Id.* § 362(c)(2).

- If a second case is file by or against an individual or a married couple whose first case was dismissed within one year (except when the first case was a chapter 7 dismissed because of the "means test" and the second case is not a chapter 7 case), the stay terminates in 30 days, unless the court orders it continued. *Id.* § 362(c)(3).

- If the debtor is an individual in a chapter 7 case, the debtor's assets include property secured by a lien, and the debtor has not timely filed and performed the debtor's intention (*see* 11 U.S.C. § 521(a)(2)) to retain (via redemption, *see id.* § 722; or reaffirmation of the debt, *see id.* § 524(c)) or surrender such property, or if the debtor has not assumed a lease of personal property, *see id.* § 365(p), the stay of an act against any such property terminates, unless the court, on motion by the trustee, finds that the property is of consequential value to the estate, and orders "adequate protection" (as described below) of the creditor's interest – *id.* §§ 362(h), 521(a)(6).

- On request of a party in interest, the bankruptcy shall issue an order confirming that the automatic stay has been terminated – 11 U.S.C. § 362(j).

D. Relief from the Stay

There are several grounds upon which the bankruptcy court shall grant relief from the automatic stay, as follows:

- For "cause," 11 U.S.C. § 362(d)(1), including

    - Lack of "adequate protection": "Adequate protection" is not defined in the Bankruptcy Code, but is generally understood to be lacking if a secured party's collateral "is depreciating during the bankruptcy." *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 370 (1988). The Bankruptcy Code offers examples of adequate protection, namely, making a cash payment or a series of periodic cash payments, providing an additional or replacement lien, or granting such other relief (***but not*** an administrative expense claim) as results in the realization of the "indubitable equivalent" of the interest in the property. 11 U.S.C. § 361. In addition, adequate protection is present when there is an adequate equity cushion, in which the value of the property exceeds the amount of the secured debt at issue, taking into account the increase in the secured debt due to unpaid interest. *See Pistole v. Mellor (In re Mellor)*, 734 F.3d 1396, 1400, 1402 (9th Cir. 1984); *Wilmington Trust Co. v AMR Corp. (In re AMR Corp.)*, 490 B.R. 470, 478 (S.D.N.Y. 2013).

- Other "cause": In situations not involving secured creditors, especially a request to litigate a claim or cause of action in a non-bankruptcy forum, such as a state court, a 12-factor analysis is generally employed. The factors are: (1) whether the relief would result in partial or complete resolution of the issues; (2) lack of any connection with or interference with the bankruptcy case; (3) whether the claim involves the debtor as a fiduciary; (4) whether a specialized tribunal with necessary expertise has been established to hear the cause of action; (5) whether the debtor's insurer has assumed full responsibility for defending it; (6) whether the action primarily involves third parties; (7) whether the litigation in another forum would prejudice the interests of other creditors; (8) whether any judgment obtained is subject to equitable subordination; (9) whether the movant's success in other forum would result in a judicial lien avoidable by the debtor; (10) the interests of judicial economy and the expeditious and economical resolution of the litigation; (11) whether the parties are ready for trial in the other forum; and (12) the impact of the stay on the parties and the balance of harms. *Sonnax Indus., Inc. v. Tri Component Prods. Corp. (In re Sonnax Indus., Inc.)*, 907 F.2d 1280, 1286 (2d Cir. 1990) (citing *In re Curtis*, 40 B.R. 795, 799-800 (Bankr. D. Utah 1984)).

- With respect to a stay of an act against property, under 11 U.S.C. § 362(d)(2),
  - The debtor lacks equity in the property (the value of the property is less than the amount of liens on the property); and
  - The property is not necessary to an effective reorganization (which, by definition, cannot occur in a chapter 7 case). To resist relief from the stay on this ground, there must be a demonstration that the property "is essential for an effective reorganization that is *in prospect,* " which means that there must be "a reasonable possibility of a successful reorganization within a reasonable time." *Timbers of Inwood*, 484 U.S. at 376 (emphasis in original).
- Special provisions regarding real estate – discussed in Part III below
- Automatic termination upon a request for relief, after
  - 30 days, unless the court orders the stay to continue pending a final determination of the request – 11 U.S.C. § 362(e)(1)
  - 60 days, if the debtor is an individual and a final determination of the request has not been made, unless
    - the parties agree, or
    - the court extends the stay for cause, upon findings made by the court – *id.* § 362(e)(2).

E. Inapplicability of Stay to Serial Filers

- For individuals: The automatic stay does not go into effect when a case is filed by an individual or a married couple and two or more previous cases were pending in the previous year and dismissed (not counting a previous case that was a chapter 7 dismissed because of the "means test" and the later case is not a chapter 7 case). The court may under certain circumstances order the stay imposed. *Id.* § 362(c)(4).

- For small business cases (fixed debts of not more than $2,490,925, adjusted every three years, excluding debts to insiders – *see id.* § 101(51C)-(51D)):

  The automatic stay does not apply in a small business case if the debtor was also a debtor in a small business in the previous two years, or acquired the assets of such a debtor, unless

  - the small business case was commenced involuntarily without collusion between the debtor and the petitioners, or

  - the debtor establishes unforeseeable circumstances and is likely to confirm a plan, other than a liquidating plan, within a reasonable period of time

  Id. § 362(n).

F. Actions in Violation of the Stay

Most courts, including the Second Circuit, hold that actions taken in violation of the automatic stay are void *ab initio*. *48th St. Steakhouse, Inc. v. Rockefeller Grp., Inc. (In re 48th St. Steakhouse, Inc.)*, 835 F.2d 427, 431 (2d Cir. 1987); *accord Soares v. Brockton Credit Union (In re Soares)*, 107 F.3d 969, 976 (1st Cir. 1997); *Schwartz v. United States (In re Schwartz)*, 954 F.2d 569, 571 (9th Cir. 1992); *Maritime Elec. Co. v. United Jersey Bank*, 959 F.2d 1194, 1206-07 (3d Cir. 1991); *Albany Partners Ltd. v. Westbrook (In re Albany Partners, Ltd.)*, 749 F.2d 670, 675 (11th Cir. 1984). A minority of courts holds that such actions are merely voidable. *Jones v. Garcia (In re Jones)*, 63 F.3d 411, 412 & n.3 (5th Cir. 1995), *cert. denied*, 517 U.S. 1167 (1996); *Easley v. Pettibone Mich. Corp.*, 990 F.2d 905, 911 (6th Cir. 1993). The difference is which party has the burden of sustaining the action taken in violation of the stay. Because the stay relief expressly includes "annulling," 11 U.S.C. § 362(d), retroactive relief is permitted. *Soares*, 107 F.3d at 976.

G. Enforcement of the Stay

- **Statutory Remedy for Individuals**

An "individual" who is injured as a result of a willful violation of the stay is entitled to actual damages, including attorneys' fees, and in appropriate circumstances, punitive damages. 11 U.S.C. § 362(k)(1). The exposure of a creditor that acted in a good faith belief that the stay

had been terminated under *id.* § 362(h), because of the debtor's failure to fail and perform the debtor's statement of intention with respect to secured property is limited to actual damages. *Id.* § 362(k)(2). Although in other provisions of the Bankruptcy Code, the word "individual" refers solely to a natural human being, courts are divided as to whether "individual" in this provision is similarly restricted. *See Spookyworld, Inc. v. Town of Berlin (In re Spookyworld, Inc.)*, 346 F.3d 1, 7-8 & n.3 (1st Cir. 2003) (collecting cases).

- **Contempt**

In cases where the statutory damage remedy is not available, the automatic stay is enforceable through civil contempt. *Maritime Asbestosis Legal Clinic v. LTV Steel Co., Inc.*, 920 F.2d 183, 186-87 (2d Cir. 1990); *Mountain Am. Credit Union v. Skinner (In re Skinner)*, 917 F.2d 444, 450 (10th Cir. 1990).

III. Special Issues Regarding the Automatic Stay and Real Property

A. Protection for Holders of Real Property Liens from Serial Filers

The automatic stay does not apply to the enforcement of liens against real property of so-called "serial" debtors who previous filed bankruptcy petitions in which:

- secured parties were granted relief from the stay under a special *in rem* provision (described in Part III(D) below) – 11 U.S.C. § 362(b)(20); or
- the debtors were prevented by a court order from re-filing. – *Id.* § 362(b)(21).

B. Protection for Landlords

The automatic stay does not apply to landlords' actions to recover possession of real property for:

- nonresidential property upon expiration of the stated term of the lease either prior to or during the bankruptcy case – *Id.* § 362(b)(10)
- residential property as to which the landlord obtained a judgment of possession prior to the bankruptcy case – this provision is effective 30 days after the bankruptcy filing, subject to the debtor's ability to prevent this exception to the automatic stay from taking effect by
    - filing a certification with the petition that under applicable nonbankruptcy law, there are circumstances that allow the debtor to cure the default that gave rise to the judgment of possession after it was entered; and
    - depositing with the bankruptcy court any rent that would come due during the 30 days following the bankruptcy petition; and

- filing a second certification within 30 days of the petition that the entire monetary default has been cured; subject to
- the landlord's ability to challenge such certifications – *Id.* § 362(b)(22) & (*l*)

C. Protection for Mortgagees in Single Asset Real Estate Cases

In a single asset real estate case (substantially all of the debtor's income is generated by a single property or project, other than residential real property with fewer than four units – *see id.* § 101(51B)), the mortgagee may obtain stay relief after 90 days (subject to extension for cause), unless:

- the debtor has filed a plan of reorganization that has a reasonable prospect of being confirmed within a reasonable time; or
- the debtor has commenced monthly payments of non-default contract rate interest on the amount of the secured claim (which may be paid from the rent collected even if the mortgagee has an assignment of rents). *Id.* § 362(d)(3)

D. *In Rem* Protection for Holders of Real Property Liens from Abusive Practices

The bankruptcy court may grant relief from the stay with respect to actions against real property if the debtor was part of a scheme to delay, hinder or defraud creditors that involved either

- the transfer of property without consent of the lienors or a court order, or
- multiple bankruptcy filing concerning the real property.

Such relief from the stay may be binding on subsequent filings affecting the real property within two years. *Id.* § 362(d)(4).

IV. The Co-Debtor Stay in Chapter 13 Cases

In chapter 13 cases, in addition to the general automatic stay, there is automatically imposed a co-debtor stay, which prevents the debtor's creditors from taking any action, including commencing or continuing any civil action, to collect a ***consumer debt*** owed by the debtor from any ***individual*** (the co-debtor) that is also liable to the creditor or has secured the debt to the creditor. *Id.* § 1301(a).

The co-debtor stay does not apply if the co-debtor became liable on or secured the debtor's debt in the ordinary course of the co-debtor's business. *Id.* § 1301(a)(1).

The co-debtor stay terminates when the chapter 13 case is closed, dismissed, or converted to a case under chapter 7 or 11. *Id.* § 1301(a)(2).

Upon request, creditors must be granted relief from the co-debtor stay to the extent that:

- as between the debtor and the co-debtor, the co-debtor received consideration for the creditor's claim;
- the debtor's plan does not propose to pay the creditors' claim in full; or
- the creditor's interest would be irreparably harmed by the continuation of the stay.

Id. § 1301(c).

The rationale for the co-debtor stay has been expressed in a manual written by three bankruptcy judges and a law clerk as follows:

> The codebtor stay may be of special importance to the Chapter 13 debtor because it is common practice for lenders in consumer loan transactions to require that a friend or relative of the debtor cosign or other guaranty the debt and sometimes the cosigner is not fully aware of the legal consequences of doing so. When the debtor is unable to pay the debt because of financial reverses, lender is in a position to use the threat of collection against the cosigner as leverage to extract preferential payments from the debtor. Thus, moral and social pressure placed on the debtor to protect a friend or relative often results in an unfair advantage to a particular lender over others. . . . The stay results only in a procedural delay and does not affect the creditor's right to full satisfaction from the debtor and codebtor. In essence, the lender is required to wait for payment until the conclusion of the Chapter 13 plan before pursuing remedies against the codebtor. In this way, the codebtor benefits from payments made by the debtor during the Chapter 13 case.

2 NANCY C. DEHER, JOAN N. FEENEY, MICHAEL C. WILLIAMSON, MICHAEL J. STEPAN, BANKRUPTCY LAW MANUAL, § 13:8, at 1052 (5th ed. 2014)

V. Bankruptcy and Matrimonial Law in New York

A. The Automatic Stay

As discussed above in Part II(B), the automatic stay does not interfere with most actions or proceedings relating to the dissolution of a marriage or the determination, modification, or enforcement of spousal and child support obligations and rights. 11 U.S.C. § 362(b)(2). The major exceptions to this general rule are:

- Division of marital property – *id.* § 362(b)(2)(A)(iv)
- Enforcement of domestic support obligations from property of the estate – *id.* § 362(b)(2)(B)

These are blocked by the automatic stay.

B. The Bankruptcy Estate and Equitable Distribution

As stated above, division of marital property in state court is automatically stayed by the filing of a bankruptcy petition. If the division of property occurred pursuant to a judgment entered prior to the filing of the petition, the property awarded to the non-debtor spouse does not become property of the estate. Otherwise, the debtor's property becomes property of the estate, irrespective of its status as marital property. Significantly, the crucial factor is the entry of a judgment, not the issuance of a state court decision. As summarized by the Second Circuit:

> Four relevant premises require this result. First, under New York law an equitable distribution award is a remedy, and the enforcement of that remedy is no different than the enforcement of any other judgment. Second, New York adheres to the bright line rule that the priority of judgment creditors is determined on the basis of the order in which judgments are docketed or entered. Third, 11 U.S.C. § 544 – the so-called "strong arm" provision of the Bankruptcy Code – gives the bankruptcy trustee the rights of a hypothetical perfected judgment lien creditor as of the petition date. Finally, while [the state court decision] determined the rights to marital assets as between husband and wife, the decision did not purport to determine the rights to assets as between [the non-debtor spouse] and all other judgment lien creditors.

Musso v. Ostashko, 468 F.3d 99, 102 (2d Cir. 2006). As to the first premise, the Second Circuit elaborated on N.Y. DOM. REL. LAW § 236(B) stating that "neither spouse obtains an equitable interest in property held by the other merely because the property falls within the definition of 'marital property.' Nor do such rights vest on the commencement of a matrimonial action." *Id.* at 105. Furthermore, "[A]t *no point prior to judgment* does [section 236] create any contingent or present vested interests, legal or equitable, by virtue of the parties' marital status or prior to a judgment dissolving their union." *Id.* (quoting *Leibowits v. Leibowits*, 93 A.D.2d 434, 549 (2d

Dep't 1983) (O'Connor, J. concurring) (alteration and emphasis in 2d Cir. decision); *accord Hallsville Capital, S.A. v. Dobrish*, 87 A.D.3d 933, 934 (1st Dep't 2011).

C. Domestic Support Obligations and Property Settlement Claims

1. Priority

Domestic support obligations (alimony, maintenance and support) are first priority claims. 11 U.S.C. § 507(a)(1). Property settlement claims are not entitled to priority.

2. Dischargeability

Domestic support obligations are not dischargeable. *Id.* §§ 523(a)(5). Property settlement claims are generally not dischargeable, *id.* § 523(a)(15); except for chapter 13 debtors who complete their plans and receive the "completion discharge," *id.* § 1328(a).

3. Enforceability against Exempt Assets

Domestic support obligations may be enforced against exempt property, *id.* § 522(c)(1); property settlement claims may not, *id.* § 522(c).

VI. Effect of Non-Disclosure in Bankruptcy on Causes of Action against Third Parties

An obvious abuse of the bankruptcy system arises when a debtor has an asset prior to bankruptcy that is not disclosed during the bankruptcy, where the asset could be exploited for the benefit of creditors, and the debtor seeks to exploit that asset for itself after the bankruptcy. Two principal legal doctrines have been employed to prevent such abuse.

A. The Doctrine of Judicial Estoppel

The doctrine of judicial estoppel involves the taking of a litigation position that is inconsistent with a prior one upon which a litigant was granted relief. As described most recently by the Supreme Court:

> [W]here a party assumes a certain position in a legal proceeding, and succeeds in maintaining that position, he may not thereafter, simply because his interests have changed, assume a contrary position, especially if it be to the prejudice of the party who has acquiesced in the position formerly taken by him.

New Hampshire v. Maine, 532 U.S. 742, 749 (2001) (*quoting Davis v. Wakelee*, 156 U.S. 680, 689 (1895)); *see Pegram v. Herdrich,* 530 U.S. 211, 228 n.8 (2000). Although the Court described the purpose of the doctrine as protecting the integrity of the judicial process and to prevent abuse of the process by litigants, it did not itself establish "inflexible prerequisites or an

exhaustive formula," and concluded that the doctrine is discretionary. *New Hampshire v. Maine*, 523 U.S. at 750-51. In federal courts, no uniform set of requirements exists. *See generally,* 18B C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4477 at 555-61 (2002); 18 MOORE'S FEDERAL PRACTICE § 134.32 (3d ed. 2001). The doctrine has been applied frequently in bankruptcy cases. *See, e.g., Moses v. Howard Univ. Hosp.*, 606 F.3d 789, 800 (D.C. Cir. 2010); *Hamilton v. State Farm Fire & Cas. Co.*, 270 F.3d 778, 785 (9th Cir. 2001); *Browning Mfg. v. Mimms (In re Coastal Plains, Inc.),* 179 F.3d 197, 208 (5th Cir. 1999); *Payless Wholesale Distribs., Inc. v. Alberto Culver (P.R.), Inc.*, 989 F.2d 570, 571-72 (1st Cir.), *cert. denied*, 510 U.S. 931 (1993); *Oneida Motor Freight, Inc. v. United Jersey Bank*, 848 F.2d 414, 416-18 (3d Cir.), *cert. denied*, 488 U.S. 967 (1988).

B. The Doctrine of Lack of Standing by the Post-Bankruptcy Debtor

The lack of standing by the post-bankruptcy debtor derives from two bankruptcy concepts, property of the estate and abandonment of property upon the closing of the case. The statute governing property of the estate states that such property consists of, among other things, "all legal and equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The statute governing the abandonment of property of the estate, *id.* § 554, provides in the two relevant subsections as follows:

> (c) Unless the court orders otherwise, any property scheduled under section 521(a)(1) of this title [on the debtor's official Schedules] and not otherwise administered at the time of the closing of a case is abandoned to the debtor and administered for purposes of section 350 of this title [requiring a fully-administered estate to be closed].
>
> (d) Unless the court orders otherwise, property of the estate that is not abandoned under this section and that is not administered in the case remains property of the estate.

Thus, under subsection (c), if the asset is scheduled by the debtor and not otherwise disposed of by the trustee when the case is closed, it is abandoned to the debtor; but under subsection (d), if the asset is not scheduled, it remains property of the estate even after the case is closed. *See Chartschlaa v. Nationwide Mut. Ins. Co.*, 538 F.3d 116, 122 (2d Cir. 2008); *Jeffrey v. Desmond*, 70 F.3d 183, 186 (1st Cir. 1995); *Hutchins v. IRS*, 67 F.3d 40, 43 (3d Cir. 1995); *Vreugdenhill v. Navistar Int'l Transp. Corp.*, 950 F.2d 524, 525-26 (8th Cir. 1991). Consequently, if the after the closing of the case, the debtor attempts to exploit an unscheduled (or otherwise disclosed) asset, such as a lawsuit, courts treat the asset as remaining with the closed estate and the post-bankruptcy debtor as lacking standing. *See Kunica v. St. Jean Fin., Inc.*, 223 B.R. 46, 53 (S.D.N.Y. 1999).

C. Clear Application of the Doctrines: A Closed Chapter 7 Case or Chapter 11 Case with a Confirmed Plan and a Discharged Debtor

A closed chapter 7 case or a confirmed chapter 11 with a discharged debtor case presents the clearest application of these doctrines to bar the pursuit of undisclosed pre-bankruptcy assets. As discussed in Part VI(B) above, a closed chapter 7 provides a simple application of the lack of standing of the post-bankruptcy debtor to pursue an asset that remains in the closed estate.

In a confirmed chapter 11 case, the lack of standing doctrine loses its statutory grounding. Prior to the closing of the case, which triggers the relevant parts of the abandonment statute, the Bankruptcy Code provides that confirmation vests "all of the property of the estate in the debtor," unless the plan or the order confirming the plan provides otherwise. 11 U.S.C. § 1141(b). Consequently, the proper determination of standing to pursue an undisclosed asset requires construing the plan or the order confirming the plan.

Nevertheless, in confirmed chapter 11 cases which the corporate debtor emerges (as opposed to being liquidated), the debtor receives a discharge. *Id.* § 1141(d)(1), (3). Since 2005, confirmed individual chapter 11 debtors must complete their plans or show that, despite appropriate efforts they cannot, to receive a discharge. *Id.* § 1141(d)(5). Although the receipt by a litigant of a benefit from an inconsistent position is not universally required for the application of judicial estoppel, when a substantial benefit is received, such application is on the firmest ground. In such chapter 11 cases, judicial estoppel prevents such a debtor's post-bankruptcy exploitation of undisclosed pre-bankruptcy assets, especially lawsuits. *Oneida Motor Freight*, 848 F.2d at 416-18; *see Payless Wholesale Distribs.*, 989 F.2d at 571-72 (no discussion of official status of debtor's chapter 11 case); *Cafferty v. Thompson*, 223 A.D.2d 99, 102 (3d Dep't 1996) (pre-2005 case with confirmed chapter 11 plan of an individual).

It should be observed that the foregoing does not apply in a pending bankruptcy case. That an asset is undisclosed by the debtor should not prevent a trustee, or even a debtor in possession, for pursing such asset as a current representative of the estate. Similarly, a chapter 13 debtor should not be disabled from pursuing an undisclosed pre-bankruptcy asset while the case is pending, since the chapter 13 debtor has the rights of a trustee, exclusive of the actual chapter 13 trustee, to use property of the estate, 11 U.S.C. §§ 1303, 1304(b); and the chapter 13 debtor remains in possession of property of the estate, *id.* § 1306(b). *Olick v. Parker & Parsley Petroleum Co.*, 145 F.3d 513, 515-16 (2d Cir. 1998) (sustaining right to chapter 13 debtor to maintain undisclosed pre-petition claim for compensation in a class action lawsuit); *see Cable v. Ivy Tech State College*, 200 F.3d 467, 472-73 (7th Cir. 1999) (sustaining right of chapter 13 debtor to prosecute appeal of dismissal of pre-petition claim for employment discrimination).

D. Application of the Doctrines in a Reopened Case: Trustee Pursuit and Debtor Pursuit

The abandonment provisions discussed above relate to a closed case, which occurs when the estate is fully administered. 11 U.S.C. § 350(a). Another provision of the same statute, permits a closed case to be reopened, and provides as follows:

> (b) A case may be reopened in the court in which such case was closed to administer assets, to accord relief to the debtor, or for other case.

Id. § 350(b). When a case is reopened the court may direct the appointment of a trustee. FED. R BANKR. P. 5010.

If a case with undisclosed assets is closed, and then reopened, and a trustee is appointed in the reopened case, the trustee has the ability to administer the previously undisclosed asset, and even formally abandon it back to the debtor. Thus, with a reopened case to administer a previously undisclosed asset, the lack of standing argument loses force, if the asset is pursued by the trustee or, after formal abandonment, by the debtor. Nevertheless, there is no statutory impediment to the consideration of judicial estoppel.

Moses v. Howard Univ. Hosp., 606 F.3d at 792-94, involved a civil rights retaliation lawsuit that was undisclosed in two bankruptcy cases, a chapter 7 case, followed by a failed chapter 13 case. When the defendant uncovered the bankruptcies, it sought dismissal of the lawsuit on the grounds of judicial estoppel. While the dismissal motion was pending the debtor successfully moved to reopen the chapter 7 case to administer the lawsuit, and the chapter 7 trustee was reappointed. The district court nevertheless dismissed the case, and the debtor and the chapter 7 trustee appealed. While the appeal was pending, the chapter 7 trustee formally abandoned the lawsuit to the debtor. The court of appeals affirmed the dismissal on judicial estoppel grounds. The court held that although the debtor had standing to pursue the lawsuit, he should not be permitted to "back up, reopen the bankruptcy case, and amend his filings" and be revested with authority to exploit his assets "only after he is caught concealing them." *Id.* at 800.

In contrast, in *Reed v. City of Arlington*, 650 F.3d 571 (5th Cir 2011) (en banc), the debtor, Kim Lubke, a firefighter, had obtained a judgment for more than $1 million in federal district court against the City of Arlington, Texas for violation of the Family Medical Leave Act, a judgment which the City appealed to the Fifth Circuit. While the appeal was pending the debtor and his wife filed for chapter 7 bankruptcy, but did not disclose the existence of the judgment during the bankruptcy case. The debtor obtained a discharge, and bankruptcy case was closed as a "no asset" case. The Fifth Circuit then decided the appeal, affirming the verdict of liability, but reversing the judgment and remanding for a recalculation of damages. At this point, the debtor disclosed his prior bankruptcy to his counsel in the lawsuit, who then contacted the trustee's counsel. The trustee, Diane Reed, obtained orders reopening the bankruptcy case and consensually revoking Lubke's discharge. The City sought dismissal of the case on the grounds of judicial estoppel. When the case reached the Fifth Circuit a second time, the court granted the dismissal, but the case was reheard en banc, and the dismissal was vacated. The en banc court held that the blameless trustee, who would recover a judgment for the benefit of creditors, could not be barred by virtue of the debtor's bad conduct. *Id.* at 574-79.

Other circuits support the proposition that the innocent trustee should not be judicially estopped by virtue of the debtor's wrongful conduct. *Parker v. Wendy's Int'l, Inc.*, 365 F.3d 1268, 1272 (11th Cir. 2004); *see Eastman v. Union Pac. R.R.Co.*, 493 F.3d 1151, 1155 n.3 (10th Cir. 2007); *Biesek v. Soo Line R.R. Co.*, 440 F.3d 410, 413 (7th Cir. 2006).

E. Application of the Doctrines in a <u>Dismissed</u> Case

Dismissing a bankruptcy case, rather than closing it, invokes a different statute, 11 U.S.C. § 349, which is entitled, "Effect of dismissal," the relevant part of which provides:

> (b) Unless the court, for cause, orders otherwise, a dismissal of a case other than under section 742 of this title [dismissing a chapter 7 case of a stockbroker with a SIPC liquidation of the debtor is pending] –
>
> * * * * * * * *
>
> (3) revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case.

In *Crawford v. Franklin Credit Mgmt. Corp.*, 758 F.3d 473 (2d Cir. 2014), the Second Circuit considered and rejected both doctrines in a dismissed case. The individual debtor failed to disclose in her chapter 13 case that she had a claim against a financial intermediary for among other things, violations of the Truth in Lending Act. The lawsuit was brought following the dismissal of her chapter 13 case on the ground of unreasonable delay that was prejudicial to creditors, based on her failure to appear at the plan confirmation hearing and her failure to make payments to the chapter 13 trustee. The defendant sought dismissal of the lawsuit based on the non-disclosure in the bankruptcy of the potential claim. Although the district court granted the dismissal for lack of standing and collateral estoppel, the court of appeals reversed in relevant part. The court of appeals held that in a dismissed bankruptcy case, the effect of dismissal statute, 11 U.S.C. § 349(b)(3), which revested the estate in the debtor, was not overridden by the abandonment statute, *id.* § 554(d). 758 F.3d at 484. Notably, it rejected the contrary reasoning of *Kunica v. St. Jean Fin., Inc.*, 223 B.R. at 57, in which the district court refused to apply the dismissal revesting provision bccause the debtor had received substantial relief in the bankruptcy case that was the functional equivalent of a discharge. 758 F.3d at 485; *accord B.N. Realty Assocs. v. Lichtenstein*, 21 A.D.2d 793, 797-98 (1st Dep't 2005) (similarly applying § 349 and distinguishing *Kunica*). On the estoppel issue, which the Second Circuit held was properly characterized as judicial estoppel, rather than collateral estoppel, the court held that there had been no adoption by the bankruptcy court of her non-disclosure, since the dismissal resulted in no ruling by the bankruptcy court on the debtor's assets. 758 F.3d at 486; *accord B.N. Realty Assocs. v. Lichtenstein*, 21 A.D.2d at 799 (similarly refusing to apply judicial estoppel, since no bankruptcy relief had been granted based on the nondisclosure).

In *Hamilton v. State Farm Fire & Cas. Co.*, 270 F.3d at 780-82, the court reached the same result on standing, but a different one on judicial estoppel. The debtor in a chapter 7 case in which he received a discharge failed to disclose a claim against his insurance carrier for failure to pay a vandalism loss, although he had disclosed the loss. Prior to the closing of the case, the trustee inquired about any insurance claims regarding the loss, and the debtor failed to inform the trustee of the unpaid insurance claim. The trustee then successfully sought dismissal of the case,

based on bad faith and lack of cooperation by the debtor, and the bankruptcy court additionally vacated the discharge. The court of appeals sustained the dismissal of the lawsuit against the carrier on judicial estoppel grounds, observing that the debtor had obtained benefits from the bankruptcy case, including the automatic stay and the discharge, even though the latter was vacated. *Id.* at 784-85.

F. Application of the Doctrines to Undisclosed Post-Petition Assets

1. Chapter 11 Debtors

Avoidance actions, such as preferences and fraudulent transfers, can be brought by a debtor in possession only because it has the rights and powers of a trustee. *See* 11 U.S.C. §§ 544, 547, 548, 1107. Therefore, these actions cannot be undisclosed pre-petition assets of a debtor. Such actions can, of course, be brought, after the confirmation of a plan, if the plan appropriately so provides. *Id.* § 1123(b)(3)(B). Another application of judicial estoppel can be found in chapter 11 cases involving post-confirmation avoidance actions against creditors that had not been disclosed in a disclosure statement. It has been held that a debtor may not state in a court-approved disclosure statement a belief that no avoidable transfers had occurred, and then, post-confirmation, sue a creditor to avoid a transfer. *Galerie des Monnaies of Geneva, Ltd. v. Deutsche Bank (In re Galerie des Monnaies of Geneva, Ltd.)*, 55 B.R. 253, 256, 259-60 (Bankr. S.D.N.Y. 1985), *aff'd*, 62 B.R. 22 (S.D.N.Y. 1986).

2. Individual Chapter 7 Debtors

Individual chapter 7 debtors, unlike corporate chapter 7 debtors, have a life apart from their respective bankruptcy estates. Any assets acquired post-petition by a corporate chapter 7 debtor become property of the estate. 11 U.S.C. § 541(a)(6)-(7). For individuals, the estate consists of the debtor's property "as of the commencement of the case," *id.* § 541(a)(1), and property acquired by the debtor thereafter does not enter the estate, with the exception of inherited property, property settlements with a spouse, or life insurance benefits received within 180 days of the petition date. *Id.* § 541(a)(5). Indeed, the Bankruptcy Code expressly provides an exception from inclusion in the estate of "[p]roceeds, product, offspring, rents, or profits of or from property of the estate" for "earnings from services performed by an individual debtor after the commencement of the case." *Id.* § 541(a)(6). Although this provision is applicable in chapters 11 and 13, these chapters each have provisions that specifically include post-petition earnings in the estate, so long as the case remains in such chapters, and permit the chapter 11 and 13 debtors generally to remain in possession of such earnings. *Id.* §§ 1115(a)(2), 1306(a). The chapter 11 provision was added in 2005. For an individual chapter 7 debtor, however, except for inheritances, spousal property settlements and life insurance benefits received within 180 days, the rule is "property acquired post-petition by the debtor does not enter the estate; it remains separate property of the debtor." *Bell v. Bell (In re Bell)*, 225 F.3d 203, 215 (2d Cir. 2000). Consequently, an individual chapter 7 debtor should not be precluded by lack of standing or judicial estoppel from exploiting undisclosed post-petition asset, such as a lawsuit.

3. Chapter 13 Debtors

a. With Pending Cases

As discussed above in Part VI(C), chapter 13 debtors, while their cases are pending, have the rights of a trustee, exclusive of the actual chapter 13 trustee, to use property of the estate. 11 U.S.C. §§ 1303, 1304(b); and therefore, are not precluded from pursuing undisclosed pre-petition claims. *Olick v. Parker & Parsley Petroleum Co.*, 145 F.3d at 515-16; *see Cable v. Ivy Tech State College*, 200 F.3d at 472-73. This principle should be equally applicable to undisclosed post-petition claims, which, unlike the situation in chapter 7, become property of a chapter 13 estate. 11 U.S.C. § 1306(a)(1).

b. With Closed Cases (and Discharges)

Because the estates of chapter 13 debtors include assets acquired after the petition, 11 U.S.C. § 1306(a)(1); chapter 13 debtors have a continuing obligation to disclose such assets during the pendency of their cases. *Robinson v. Tyson Foods, Inc.*, 595 F.3d 1269, 1274 (11th Cir. 2010). A chapter 13 debtor with a closed case and a discharge who does not disclose a post-petition asset should be treated the same as a chapter 7 debtor with an undisclosed pre-petition asset. Such a debtor should not be permitted to pursue the asset post-closing of the case, based on judicial estoppel. *Gray v. City of New York*, 58 A.D.3d 448, 449 (1st Dep't 2009) (reaching the correct result, based on the facts set forth in the lower court opinion, but containing *dicta* incorrectly suggesting that there is no difference between filing for chapter 13 and chapter 7).

c. With Cases Converted to Chapter 7

As discussed above, the estates for chapter 13 debtors include all post-petition assets, but the estates of chapter 7 debtors do not. In cases converted from chapter 13 to chapter 7, the question is raised with respect to the inclusion of post-petition assets in the chapter 7 estate. That question is answered in 11 U.S.C. § 348, which is entitled, "Effect of conversion," subsection (f) of which provides in relevant part as follows:

> (f)(1) Except as provided in paragraph (2), when a case under chapter 13 of this title is converted to a case under another chapter under this title –
>
> (A) property of the estate in the converted case shall consist of property of the estate, as of the filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion[.]
>
> * * * * * *
>
> (2) If the debtor converts a case under chapter 13 of this title to a case under another chapter of this title in bad faith, the

> property of the estate in the converted case shall consist of the property of the estate as of the date of the conversion.

Significantly, Section 348(f) was amended by Congress in 1994 to resolve a split of authority on the contents of the estate after the conversion from Chapter 13 to Chapter 7. As the Second Circuit has observed:

> Congress' purpose in enacting this section was to eliminate the disincentive that section 1306(a)(1) placed on a party that wanted to file under Chapter 13 but also wanted the option to convert to Chapter 7. Without the 1994 amendment, the converted Chapter 7 estate would include property acquired by the debtor after he filed the original Chapter 13 petition, even though the after-acquired rule did not apply to cases originally filed under Chapter 7.

Bell v. Bell (In re Bell), 225 F.3d at 227 (citation omitted).

Therefore, the critical question about whether an asset, such as a cause of action, acquired by a chapter 13 debtor after the filing of the petition, but prior to the conversion to chapter 7, and not disclosed in the bankruptcy case belongs to the chapter 7 estate or to the debtor, is answered by the determination whether the chapter 13 case was converted in bad faith. In the absence of bad faith, such property reverts to the debtor, *see Stamm v. Morton (In re Stamm)*, 222 F.3d 216, 217-18 (5th Cir. 2000); but with bad faith, the property belongs to the chapter 7 estate.

In *In re Easley-Brooks*, 487 B.R. 400 (Bankr. S.D.N.Y. 2013), the bankruptcy court decided that a chapter 13 debtor who had suffered potential malpractice (after the filing of the petition), converted to chapter 7, did not disclose the potential claim during the bankruptcy, and brought a malpractice suit following her chapter 7 discharge and the closing of her chapter 7 case, had sufficient pre-conversion knowledge of the potential claim to require its disclosure during the chapter 13 case and rendered the conversion to chapter 7 in bad faith. *Id.* at 406. Nevertheless, the court granted the debtor's motion to reopen the closed chapter 7 case to enable the trustee to pursue the malpractice claim, and stated that the decision, including the finding of bad faith, did not preclude the debtor from recovering a surplus from the malpractice claim, after the administrative expenses of the bankruptcy and the creditors have been fully paid. *Id.* at 406 & n.4.

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TACKLING BANKRUPTCY ISSUES IN STATE COURT

Materials on Commercial Law

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TACKLING BANKRUPTCY ISSUES IN STATE COURT

Materials on Commercial Law

<u>ISSUE 1</u>: Who May Determine the Applicability of the Automatic Stay?

- Circuits are split regarding whether a bankruptcy court has the exclusive jurisdiction to determine whether the automatic stay applies to a pending state or federal court action.
- **Majority Approach: Bankruptcy Courts Do Not Have The Exclusive Jurisdiction To Determine Whether Automatic Stay Applies**
  - The Second Circuit has adopted the majority view that state courts in which the litigation claimed to be stayed is pending have concurrent jurisdiction with bankruptcy courts to determine the applicability of the automatic stay. *See, e.g., United States v. Colasuonno*, 697 F.3d 164, 172 n.4 (2d Cir. 2012) ("[a]lthough 'relief for a violation of the [automatic] stay must be sought in the Bankruptcy Court,' . . . '[w]hether the stay applies to litigation otherwise within the jurisdiction of a district court or court of appeals is an issue of law within the competence of . . . the court within which the litigation is pending[.]'") (internal citations omitted); *Erti v. Paine Webber Jackson & Curtis, Inc. (In re Baldwin-United Corp. Litig.)*, 765 F.2d 343, 347 (2d Cir. 1985) (holding that the issue of whether the automatic stay applies to litigation pending in a non-bankruptcy court is within the jurisdiction of both the court in which the litigation is pending and the bankruptcy court supervising the reorganization); *In re Ivani*, 308 B.R. 132, 135 (Bankr. E.D.N.Y. 2004) (holding that, under Second Circuit law (which has adopted the majority position), "where a prepetition action is pending in a federal district court [or a state court], that court has concurrent jurisdiction with the bankruptcy court to determine whether the automatic stay applies to the prepetition action."); *Siskin v. Complete Aircraft Servs., Inc. (In re Siskin)*, 258 B.R. 554, 562 (Bankr. E.D.N.Y. 2001) (same).
    - These courts have held that "the exclusivity of jurisdiction provision [in 28 U.S.C. § 1334] . . . does not apply, because the determination of the applicability of the automatic stay is not a bankruptcy 'case' within the meaning of the statute" and bankruptcy courts have "original *but not exclusive* jurisdiction" over matters that are "related to" a bankruptcy, including determinations of whether the automatic stay applies. *In re Ivani*, 308 B.R. at 136 (citations omitted; emphasis added); *see also In re Siskin*, 258 B.R. at 563 ("the only aspect of a bankruptcy proceeding over which district courts and their bankruptcy units have exclusive jurisdiction is the bankruptcy petition itself; in other matters arising in or relating to bankruptcy cases, unless the Bankruptcy Code provides otherwise, state courts have concurrent jurisdiction. . . .").

- These courts have also held that the *Rooker-Feldman* doctrine—which provides that "lower federal courts lack subject matter jurisdiction over a case if the exercise of jurisdiction over that case would result in the reversal or modification of a state court judgment"—bars any attempt by a bankruptcy court to enforce the automatic stay after a determination by a state court that the stay does not apply. *In re Ivani*, 308 B.R. at 136-37 (citations omitted); *In re Siskin*, 258 B.R. at 563 (holding that bankruptcy courts are prohibited from re-litigating matters relating to the automatic stay if a state court has already resolved such matters).

- However, some of these courts have held (similar to the Ninth Circuit in *Gruntz*) that, to the extent of a disagreement between the state court and the bankruptcy court, the bankruptcy court's determination regarding stay applicability governs. *See, e.g., In re Killmer*, 501 B.R. 208, 214 (Bankr. S.D.N.Y. 2013) ("[e]ven assuming that the state courts have concurrent jurisdiction over stay violations, those judgments must bow to the plenary power vested in the federal courts over bankruptcy proceedings."); *Mokuba New York LLC v. Pitts (In re Pitts),* No. 808-74860-reg, 2009 WL 4807615, at *4 (Bankr. E.D.N.Y. Dec. 8, 2009) ("the ultimate determination of whether the automatic stay applies to a non-bankruptcy action lies with the bankruptcy court, which originally issued the injunction.")

  - According to these courts, the *Rooker-Feldman* doctrine does not prohibit a bankruptcy court from reviewing a state court decision regarding the stay if the state court judgment is void *ab initio*. *See In re Killmer*, 501 B.R. at 213. In other words, "state court judgments are subject to collateral attack in a federal court if the state court acted beyond its power." *Id.* When a state court's determination regarding the automatic stay "is erroneous, the parties [therefore] run the risk that the entire action later will be declared void *ab initio*." *Id.* at 215 (quoting *Chao v. Hosp. Staffing Servs., Inc.*, 270 F.3d 374, 384 (6th Cir. 2001)).

- **Minority Approach: Bankruptcy Courts Have Exclusive Jurisdiction To Determine Applicability of Stay**

  - The Ninth Circuit and certain lower courts in other circuits have held that a bankruptcy court has the exclusive jurisdiction to determine whether the automatic stay applies to a certain action.

  - *Gruntz v. County of Los Angeles (In re Gruntz)*, 202 F.3d 1074 (9th Cir. 2000)

    - Holding: "by virtue of the power vested in them by Congress, the federal courts have the final authority to determine the scope and applicability of the automatic stay. 'The States cannot, in the exercise of control over local laws and practice, vest State courts with power to violate the supreme law of the land.' Thus, the *Rooker-Feldman* doctrine is not implicated by collateral challenges to the automatic stay in bankruptcy. A bankruptcy court simply does not conduct an improper appellate review of

a state court when it enforces an automatic stay that issues from its own federal statutory authority. In fact, a reverse *Rooker-Feldman* situation is presented when state courts decide to proceed in derogation of the stay, because it is the state court which is attempting impermissibly to modify the federal court's injunction." *Id.* at 1083 (internal citations omitted).

- "The automatic stay is an injunction issuing from the authority of the bankruptcy court, and bankruptcy court orders are not subject to collateral attack in other courts." *Id.* at 1082 (citations omitted).
- "Any state court modification of the automatic stay would constitute an unauthorized infringement upon the bankruptcy court's jurisdiction to enforce the stay." *Id.*
- "[M]odifying the automatic stay is not the act of a state court merely interpreting federal law; it is an intervention in the operation of an ongoing federal case, the administration of which is vested exclusively in the bankruptcy court." *Id.* at 1084.
- "[N]othing in [28 U.S.C. § 1334(b)] vests the *states* with any jurisdiction over a core bankruptcy proceeding, including 'motions to terminate, annul, or modify the automatic stay.'" *Id.* at 1083 (citations omitted).
- "[E]ven assuming that the states had concurrent jurisdiction, their judgment would have to defer to the plenary power vested in the federal courts over bankruptcy proceedings." *Id.*

<u>ISSUE 2</u>: The Automatic Stay and Bankruptcy Code Section 105 Injunctions in Non-Bankruptcy Litigation Against Directors and Officers

- The automatic stay protects property of the estate, which in general consists of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The stay "prevents dismemberment of the estate, ensures orderly liquidation, and grants the trustee time to familiarize himself with the various rights and interests involved and the property available for distribution." *In re Granite Partners, L.P.*, 194 B.R. 318, 336 (Bankr. S.D.N.Y. 1996) (citation omitted). The automatic stay is "limited to debtors and do[es] not encompass non-bankrupt co-defendants." *Teachers Ins. & Annuity Ass'n v. Butler*, 803 F.2d 61, 65 (2d Cir. 1986) (citations omitted) (declining to extend stay against debtor partnership to co-defendant non-debtor individual partners). Accordingly, "courts in this circuit regularly refuse to extend a debtor corporation's [automatic] stay to its non-debtor officers and principals." *Gray v. Hirsch*, 230 B.R. 239, 242 (S.D.N.Y. 1999) (citing cases, declining to stay a shareholders action against the corporate debtor's principal for alleged securities law violations); *see also Granite Partners,* 194 B.R. at 338-39 (reasoning that "the mere threat to the [insurance] policy does not implicate the automatic stay, and [] the Court should not extend the automatic stay if that is the only "injury" that the debtor can show" and declining to enjoin litigation of a creditor's claims against the debtor's insiders and advisors).

- While not directly protecting directors and officers, the automatic stay will prevent creditors from pursuing derivative claims on the estate's behalf or other claims belonging to the estate against directors or officers. *See, e.g., St. Paul Fire & Marine Ins. Co. v. PepsiCo, Inc.*, 884 F.2d 688, 701 (2d Cir. 1989). In addition, in limited circumstances "the automatic stay can apply to [protect] non-debtors, but . . . only when a claim against the non-debtor will have an immediate adverse economic consequence for the debtor's estate." *Queenie, Ltd. v. Nygard Int'l*, 321 F.3d 282, 287-88 (2d Cir. 2003) (affirming applicability of automatic stay to debtor's wholly-owned corporation when "adjudication of a claim against the corporation will have an immediate adverse economic impact on [the debtor]"); *McCartney v. Integra Nat'l Bank North*, 106 F.3d 506, 510-11 (3d Cir. 1997) (affirming applicability of automatic stay to deficiency action against a non-debtor third party with no assets where the debtor was the guarantor and was the "real party in interest").

- Non-bankruptcy litigation against directors and officers may also implicate the automatic stay if there is underlying insurance liable to pay claims or defense costs. Insurance policies often provide coverage for directors and officers as well as the debtor, and a debtor's insurance policy is property of the estate. *See, e.g., In re Downey Fin. Corp.*, 428 B.R. 595, 603 (Bankr. D. Del. 2010). However, "whether the proceeds of a liability insurance policy are property of the estate [is determined] by the language and scope of the specific policies at issue." *Id.* (citing cases).

  - In determining whether the policy proceeds are property of the estate, courts look to whether the directors and offers have direct payment rights under the policy, the priority of payment rights under the policy, and whether the estate has or is likely to incur costs above any retention amount that would covered by the insurance policy. *Downey Fin. Corp.* at 603-08 (holding that the policy at issue providing Side A, B and C coverage was not property of the estate under the debtor's circumstances); *see also, e.g., In re Allied Digital Techs. Corp.*, 306 B.R. 505, 512 (Bankr. D. Del. 2004) (policy proceeds are not property of the estate when the policy provides direct coverage only to the directors and officers, or when the policy provides the debtor with coverage for indemnification expenses that have not been incurred or are hypothetical or speculative, but the proceeds are property of the estate if payable only to the debtor or, if the proceeds are from a policy covering directors and officers and the debtor, if depletion of the proceeds would have an adverse effect on the estate). As directors and officers become increasingly aware of the bankruptcy risks to their D&O policies and take protective steps, this may become an increasingly uncommon issue.

  - If the insurance policy proceeds are held to be property of the estate, the directors and officers will be prevented from accessing such proceeds unless the automatic stay is lifted. *See, e.g., Downey Fin. Corp.*, 428 B.R. at 608-09 (after holding that the insurance policy proceeds were not property of the estate, holding in the alternative that cause existed to lift the stay, using a three-prong test (1) whether any great prejudice to either the bankrupt estate or the debtor will result from a lifting of the stay; (2) "[w]hether the hardship to the non-bankrupt party by maintenance of the stay considerably outweighs the hardship to the debtor;" and

(3) "[t]he probability of the creditor prevailing on the merits."); *Allied Digital*, 306 B.R. at 513 (discussing cases, noting that "[i]t is not uncommon for courts to grant stay relief to allow payment of defense costs or settlement costs to directors and officers, especially when there is no evidence that direct coverage of the debtor will be necessary.").

- Non-debtor litigation against directors and officers may also be enjoined by the bankruptcy court under its general equitable powers. The Bankruptcy Code empowers courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code. 11 U.S.C. § 105(a). This provision "is an omnibus provision phrased in such general terms as to be the basis for a broad exercise of power in the administration of a bankruptcy case." *Casse v. Key Bank N.A. (In re Casse)*, 198 F.3d 327, 336 (2d Cir. 1999) (citing legislative history and noting Congress's intent that section 105 be similar in in effect to the All Writs Act) (internal marks and qoutation omitted). However, when exercising its general equitable powers, "a bankruptcy court may not contravene specific statutory provisions" of the Bankruptcy Code. *Law v. Siegel*, 134 S.Ct 1188, 1194-95, 571 U.S. -- (2014).

  - Bankruptcy courts look to the standards for a preliminary injunction in considering requests for a section 105 injunction, and evaluate (1) whether the debtor is faced with imminent irreparable harm without the injunction; (2) whether there is a reasonable likelihood of a successful reorganization; (3) whether the balance of harms weighs in favor of the debtor; and (4) whether the public interest weighs in favor of the injunction. *See In re Calpine Corp.*, 365 B.R. 401, 409 (S.D.N.Y. 2007) (affirming bankruptcy court's section 105 injunction against continuation of suit by creditor against surety); *A.H. Robins Co., Inc. v. Piccinin*, 788 F.2d 994 (4th Cir. 1986) (extending the automatic stay using section 105 to enjoin actions against nondebtor codefendants because of the potential impact on the estate and the availability of insurance proceeds to satisfy the claims).

- Applying these standards, bankruptcy courts have exercised their section 105 authority to enjoin non-bankruptcy litigation against directors and officers in many cases. *See, e.g., Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 443 B.R. 295, 316-17 (Bankr. S.D.N.Y. 2011) (extending stay under section 105 to third-party actions against debtor principals); *In re Adelphia Commc'ns Corp.*, 302 B.R. 439, 450-51 (Bankr. S.D.N.Y. 2003) (enjoining suits against directors and officers threatening insurance policies necessary to the debtors' reorganization efforts); *In re United Health Care Org.*, 210 B.R. 228, 233-35 (S.D.N.Y. 1997) (enjoining action against officers that would interfere with their ability to implement a consensual reorganization plan); *In re Continental Airlines, Inc.*, 177 B.R. 475 (D. Del. 1993) (affirming injunction of suits against debtor corporation's officers because of the identity of interest between the debtor and the non-debtor defendants, the debtor was the real defendant in the suits, and those suits would impair the debtor's assets and its ability to pursue a successful reorganization); *In re Lazarus Burman Assocs.*, 161 B.R. 891, 899-900 (Bankr. E.D.N.Y. 1993) (enjoining guaranty actions against nondebtor principals of debtor partnerships were "owned and controlled solely by the [principals]" who were "clearly the only

persons who can effectively formulate, negotiate and carry out" any reorganization plan); *In re Third Eighty-Ninth Assocs.*, 138 B.R. 144 (S.D.N.Y. 1992) (affirming injunction of guaranty action against manager where the record established that his "involvement in the Debtor's business and reorganization would be sufficiently impeded by the [state court guaranty action] to constitute a burden on the estate" and lifting injunction as to persons without a similarly-sufficient supporting record); *In re North Star Contracting Corp.*, 125 B.R. 368, 371 (S.D.N.Y. 1991) (enjoining state court action against debtor's president upon finding that president was "a principal player in the corporation's reorganization process" and that action would adversely affect debtor's assets); *In re Lomas Fin. Corp.*, 117 B.R. 64, 67-68 (S.D.N.Y. 1990) (affirming injunction of suit against debtor corporation's key officers as a "transparent attempt . . . to end run the automatic stay" that would saddle the debtor with the burden of litigating prepetition claims, force the debtor to incur indemnification costs, would impair reorganization efforts by distracting the key officers and forcing the debtor to respond to discovery requests, and have collateral estoppel consequences for the underlying claims against the debtor).

ISSUE 3: Post-Confirmation Jurisdiction of Bankruptcy Courts

- While it is true that "bankruptcy jurisdiction shrinks post-confirmation, . . . it 'does not disappear entirely.'" *Harrison v. Rabinovici (In re Jesup & Lamont, Inc.)*, No. 10 B 14133 (AJG), 2012 WL 3822135, at *3 (Bankr. S.D.N.Y. Sept. 4, 2012) (citations omitted).

- Post-confirmation, a bankruptcy court retains jurisdiction over matters that have a close nexus to the bankruptcy plan or proceeding. *In re Jesup & Lamont*, 2012 WL 3822135 at *3.

- Courts within the Second Circuit have held that "a party invoking the bankruptcy court's post-confirmation jurisdiction must satisfy two requirements." *Penthouse Media Grp. v. Guccione (In re General Media, Inc.)*, 335 B.R. 66, 73 (Bankr. S.D.N.Y. 2005); *Ace Am. Ins. Co. v. DPH Holdings Corp. (In re DPH Holdings Corp.)*, No. 10-4170-bk, 2011 WL 5924410, at *2 (2d Cir. Nov. 29, 2011) (listing two requirements).

    - First, "the matter must have a '**close nexus to the bankruptcy plan or proceeding**, as when a matter affects the interpretation, implementation, consummation, execution, or administration of the confirmed plan or incorporated litigation trust agreement.'" *In re General Media, Inc.*, 335 B.R. at 73 (quoting *Binder v. Price Waterhouse & Co., LLP (In re Resorts Int'l, Inc.)*, 372 F.3d 154, 168-69 (3d Cir. 2004)) (emphasis added); *In re DPH Holdings Corp.*, 2011 WL 5924410 at *2 (same).

        - To that end, courts have consistently held that bankruptcy courts have jurisdiction to interpret and enforce their own orders post-confirmation. *See Baker v. Simpson*, 613 F.3d 346, 352 (2d Cir. 2010) (holding that "a bankruptcy court retains post-confirmation jurisdiction to interpret and enforce its own orders."); *In re Motors Liquidation Co.*, 457 B.R. 276, 287

(Bankr. S.D.N.Y. 2011) ("it's well established . . . that bankruptcy courts, like other federal courts, have the jurisdiction to enforce their earlier orders, even after confirmation."). *See also In re Portrait Corp. of Am.*, 406 B.R. 637, 641 (Bankr. S.D.N.Y. 2009) (holding that bankruptcy court has core jurisdiction to interpret and enforce its own order, notwithstanding fact that the dispute occurred post-confirmation and was between two non-debtors).

- This jurisdiction stems from 28 U.S.C. § 1334, which confers subject matter jurisdiction on bankruptcy courts where the claims at issue arise under the Bankruptcy Code, arise in proceedings under the Bankruptcy Code, or are related to cases under the Bankruptcy Code. *See NWL Holdings, Inc. v. Eden Center, Inc. (In re Ames Dept. Stores, Inc.)*, 317 B.R. 260, 268-69 (Bankr. S.D.N.Y. 2004).

- A bankruptcy court's jurisdiction to interpret and enforce its own orders "exists by reason of 'arising in' jurisdiction. . . ." *Id.* at 269. *See also Universal Oil Ltd. v. Allfirst Bank (In re Millenium Seacarriers, Inc.)*, 419 F.3d 83, 96-97 (2d Cir. 2005) (holding that adversary proceeding to determine priority of liens on assets sold under sale order in chapter 11 case was within "core" jurisdiction of bankruptcy court); *Luan Inv. S.E. v. Franklin 145 Corp. (In re Petrie Retail, Inc.)*, 304 F.3d 223, 230 (2d Cir. 2002); *Lothian Cassidy, LLC v. Lothian Exploration & Dev. II, L.P.*, 487 B.R. 158, 162-64 (S.D.N.Y. 2013) ("certain actions between non-debtors are core proceedings based on the principle . . . that a bankruptcy court retains jurisdiction to interpret and enforce its own orders.").

    - Recently, in *In re Motors Liquidation Co.*, certain ignition defect plaintiffs asserted that the bankruptcy court lacked subject matter jurisdiction to enforce the sale order, arguing that "[b]ecause New GM's claims are not 'related to' any proceedings before th[e] [bankruptcy] [c]ourt, th[e] [c]ourt lacks jurisdiction to stay their lawsuit. . . ." No. 09-50026 (REG), 2014 WL 3882417, at *2 (Bankr. S.D.N.Y. Aug. 6, 2014). The court, citing "nearly a dozen cases[,]" disagreed, holding that it had "arising in" jurisdiction because it was interpreting its own prior order. *Id.* (citing cases). According to the court, plaintiffs' argument that "the outcome of the sale order interpretation would have no effect on the debtor's estate . . . misses the point" because "[e]ffect on the estate is the standard for 'related to' jurisdiction, not 'arising in.'" *Id.* at *3 (citations omitted). And case law makes abundantly clear that a bankruptcy

court has "arising in" jurisdiction "when it comes to construing or enforcing its earlier orders. . . ." *Id.*

  - *See also In re Motors Liquidation Co.*, 513 B.R. 467, 477 (Bankr. S.D.N.Y. 2014) ("*GM I*") ("it need hardly be said that [the bankruptcy court] ha[s] jurisdiction to interpret and enforce [its] own orders").

- Second, "**the plan must provide for the retention of jurisdiction** over the dispute." *In re General Media, Inc.* 335 B.R. at 74 (citing *Hosp. and Univ. Prop. Damage Claimants v. Johns Manville Corp. (In re Johns-Manville Corp.)*, 7 F.3d 32, 34 (2d Cir. 1993)) (emphasis added); *In re DPH Holdings Corp.*, 2011 WL 5924410 at *2.

ISSUE 4: Collateral Attacks to Bankruptcy-Issued Injunctions or Stays

- *Celotex Corp. v. Edwards*, 514 U.S. 300, 115 S.Ct. 1493,131 L.Ed.2d 403 (1995)
  - Holding: bankruptcy court ordered injunctions cannot be collaterally attacked in other courts.
    - "[i]t is for the court of first instance to determine the question of the validity of the law, and until its decision is reversed for error by orderly review, either by itself or by a higher court, its orders based on its decision are to be respected." *Id.* at 313 (quoting *Walker v. Birmingham*, 388 U.S. 307, 314, 87 S.Ct. 1824, 1828 (1967)).
    - Thus, if a party feels that an injunction is improper, it must challenge it in the bankruptcy court. *Id.* If that challenge fails, the remedy is to appeal that decision "to the district court for the judicial district in which the bankruptcy judge is serving" and then to higher courts if necessary. *Id.*
    - Collaterally attacking a bankruptcy court decision in another court "seriously undercut[s] the orderly process of the law." *Id.*
- Courts within the Second Circuit have followed the ruling in *Celotex*, consistently holding that collateral attacks of a bankruptcy court's prior orders are impermissible.
  - *See, e.g.*, *GM I*, 513 B.R. at 478 (holding that ignition plaintiffs remained enjoined under the sale order "until and unless" the bankruptcy court ruled otherwise because, under *Celotex*, "persons subject to an injunctive order issued by a court with jurisdiction are expected to obey that decree until it is modified or reversed, even if they have proper grounds to object to the order.").

- *See also LTV Corp. v. Back (In re Chateaugay Corp.)*, 201 B.R. 48, 57-58, 68 (Bankr. S.D.N.Y. 1996) (holding that state court actions constituted improper collateral attacks on bankruptcy court sale order).

ISSUE 5: Bankruptcy Trustee Standing To Sue Third Parties On Behalf Of Creditors

- Under Second Circuit jurisprudence, a bankruptcy trustee lacks standing to sue third parties on behalf of the estate's creditors; he may only assert claims held by the bankrupt corporation itself. *See Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 428-32, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972); *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991).
  - *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972)
    - Issue: whether Chapter X trustee had standing to sue an indenture trustee on behalf of debenture holders?
      - District Court had previously held that trustee lacked standing, and Second Circuit had affirmed
    - Holding: Chapter X trustee lacks standing to assert claims on behalf of debenture holders
      - First, nothing in the "elaborate system of controls" that Congress has established "enables [the trustee] to collect money not owed to the estate" or "gives him th[at] authority. [The trustee's] task is simply to 'collect and reduce to money the property of the estates for which (he is trustee).'" *Id.* at 428-29 (citations omitted).
      - Second, the suit would not affect the interests of other parties to the reorganization. *Id.* at 430-31.
      - Third, a suit by the trustee "may be inconsistent with any independent actions that [the debenture holders] might bring themselves." *Id.* at 431-32.
- While a bankruptcy trustee does not have standing to pursue the individual claims of creditors and "may assert only the claims that belong to the bankruptcy estate, those claims may include the interests of creditors in the sense that the trustee has the duty to marshal the assets of the estate so that they can be distributed to creditors on a *pro rata* basis." *Bondi v. Grant Thornton Int'l (In re Parmalat Sec. Litig.)*, 377 F.Supp.2d 390, 420 (S.D.N.Y. 2005) (emphasis added).
  - To that end, courts within the Second Circuit have consistently held that the bankruptcy trustee is the proper party to assert "a claim [of a creditor, if it] is a

general one, with no particularized injury arising from it, and if that claim could be brought by any creditor of the debtor. . . ." *St. Paul Fire & Marine Ins. Co. v. Pepsico, Inc.*, 884 F.2d 688, 701 (2d Cir. 1989) ("*St. Paul Fire & Marine*").

  - In *St. Paul Fire & Marine*, the Second Circuit affirmed the dismissal of a complaint against a non-debtor third party on the basis that the plaintiff/guarantor lacked standing to assert the alter ego claims against non-debtor third party outside of the bankruptcy proceeding. According to the court, the bankruptcy trustee was the appropriate party to assert the claims, which were generalized, with no particularized injury to any individual creditor. While "the claims raised by [plaintiff] [were] not against the debtor[,] . . . if proved, [they] would have the effect of bringing the property of the third party into the debtor's estate, and thus would benefit all creditors." *Id.*

- The determination of "[w]hether the rights [in question] belong to the debtor or the individual creditors is a question of state law." *Id.* at 700 (citing *Morton v. Nat'l Bank (In re Morton)*, 866 F.2d 561, 563 (2d Cir. 1989)); *In re 1031 Tax Grp., LLC*, 397 B.R. 670, 679 (Bankr. S.D.N.Y. 2008) ("[t]he Court looks to state law to determine which claims are direct and belong to creditors, and which claims are derivative and belong exclusively to the trustee.") (citations omitted).

- Generally, "[a] claim is personal to the creditor '[w]hen a third party has injured not the bankrupt corporation itself but a creditor of that corporation. . . .'" *Mannucci v. Cabrini Med. Ctr. (In re Cabrini Med. Ctr.)*, 489 B.R. 7, 17 (S.D.N.Y. 2012) (internal citations omitted).

  - *See also In re Emoral, Inc.*, 740 F.3d 875 (3d Cir. 2014)

    - Holding: state court personal injury causes of action against non-debtor corporation were generalized claims constituting property of the bankruptcy estate. *Id.* at 879-82.

    - To be property of the bankruptcy estate:

      claim must be a 'general one, with no particularized injury arising from it.' On the other hand, if the claim is specific to the creditor, it is a 'personal' one and is a legal or equitable interest only of the creditor. A claim for an injury is person to the creditor if other creditors generally have no interest in the claim.

      Id. at 879 (quoting *Bd. of Trustees of Teamsters Local 863 Pension Fund v. Foodtown, Inc.*, 296 F.3d 164, 170 (3d Cir. 2002)).

- If it is property of the estate, a cause of action is "properly pursued by the bankruptcy trustee because it inures to the benefit of all creditors." *Id.*

- Plaintiffs in *Emoral* failed to demonstrate how the claims were "unique" to them or how recovery on such claims would not inure to the benefit of all creditors of the debtor. Thus, the claims were "'general' rather than 'individualized'" and should be asserted by the bankruptcy trustee on behalf of all of the creditors. *Id.* at 880.

- *Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC)*, 721 F.3d 54 (2d Cir. 2013)[1]

  - Issue: whether trustee (who stood in debtor's shoes, where debtor had participated in the wrongdoing) could assert common law claims against financial institutions on behalf of customers?

  - Holding: No. Trustee lacked standing because, in his capacity as trustee, he had no legal rights and interests in the particular claims. Court held that a trustee may only "'assert his own legal rights and interests, and cannot rest his claim to relief on the legal rights or interests of third parties.'" *Id.* at 58 (citations omitted).

    - Trustee himself could not bring the claims due to *in pari delicto* because, under New York law:

      - "debtor's misconduct is imputed to the trustee. . . ." *Id.* at 63.

      - "one wrongdoer may not recover against another." *Id.*

      - "[a] 'claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation.'" *Id.* (quoting *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 120 (2d Cir. 1991)).

    - Because trustee himself could not bring the claims on behalf of debtor, trustee lacked standing to bring the claims on behalf of creditors:

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[1] *See also Picard v. HSBC Bank PLC*, 454 B.R. 25 (S.D.N.Y. 2011) (Rakoff, *J.*) (trustee does not have standing to pursue common law claims on behalf of Madoff's customers); *Picard v. JPMorgan Chase & Co.*, 460 B.R. 84 (S.D.N.Y. 2011) (McMahon, *J.*) (same).

- Under *Caplin v. Marine Midland*, Supreme Court held that trustee is not empowered to "collect money owed to creditors." *Id.* at 67 (citing *Caplin*, 406 U.S. at 428-29).

- The Second Circuit, in *Wagoner*, has similarly held that "'[i]t is well settled that a bankruptcy trustee has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankruptcy corporation itself.'" *Id.* (quoting *Wagoner*, 944 F.2d at 118).

- Trustee had attempted to rely upon, *inter alia*, the holding in *St. Paul Fire & Marine* that a "trustee may assert creditors' claims if they are generalized in nature, and not particular to any individual creditor." *Id.* at 70.

  - Court held that the *St. Paul Fire & Marine* ruling was not applicable because:

    - Madoff trustee sought to bring claims that were the property only of creditors, not of the debtor;

    - Madoff trustee's argument would conflict with Supreme Court and Second Circuit precedent which clearly provide that "a trustee may not assert creditors' claims against third parties." *Id.*

    - *St. Paul Fire & Marine* stands for the proposition that "only a trustee, not creditors, may assert claims that belong to the bankrupt estate." *Id.*

      - Distinction between derivative claims (where creditors have an interest in the claims of the corporation against a third party) and direct creditor claims (claims which only the creditor himself can enforce). *Id.* at 70-71.

      - Bankruptcy trustee only has standing to bring derivative claims—not direct creditor claims.

    - The common law claims trustee sought to bring were not "general" because they would not augment the fund of customer property and affect all creditors in the same way. *Id.* at 71.

ISSUE 6: Permissibility of Third Party Releases

- **Majority Approach: Third Party Releases Are Permissible In Certain Limited Circumstances**

  - The Second, Third, Fourth, Sixth and Seventh Circuits have permitted third party releases, but only in limited circumstances.

    - *See S.E.C. v. Drexel Burnham Lambert Grp., Inc. (In re Drexel Burnham Lambert Grp., Inc.)*, 960 F.2d 285, 293 (2d Cir. 1992) ("a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan."); *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 212 (3d Cir. 2000) (non-consensual releases by a non-debtor of non-debtor third parties are to be granted only in "extraordinary cases."); *Menard-Sanford v. Mabey (In re A.H. Robins Co., Inc.)*, 880 F.2d 694, 702 (4th Cir. 1989) (holding that section 546(e) must not be "literally applied in every case as a prohibition on the power of the bankruptcy courts" to approve a third party release); *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 656-57 (6th Cir. 2002) (holding that section 546(e) merely "explains the effect of a debtor's discharge" and "does not prohibit the release of a non-debtor."); *In re Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993) ("[w]hile a third party release . . . may be unwarranted in some circumstances, a per se rule disfavoring all releases in a reorganization plan would be similarly unwarranted, if not a misreading of [section 546(e)].").

  - Courts have differed regarding the appropriate standard for evaluating whether a third party release is permissible, but generally have approved such releases only in "extraordinary circumstances." *See Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 141 (2d Cir. 2005) ("it is clear that . . . [a third party] release is proper only in rare cases."); *In re Washington Mutual, Inc.*, 442 B.R. 314, 351 (Bankr. D. Del. 2011) (third party releases "are the exception, not the rule").

    - With Consent: courts have generally held that third party releases are permissible where the third party consents to the release, including consent by voting affirmatively in favor of a plan containing the releases.

      - *See Specialty Equip. Cos.*, 3 F.3d at 1047 ("releases that are consensual and non-coercive . . . [are] in accord with the strictures of the Bankruptcy Code."); *In re Cent. Jersey Airport Servs., LLC*, 282 B.R. 176, 182 (Bankr. D. N.J. 2002); *In re Monroe Well Serv., Inc.*, 80 B.R. 324, 334-35 (Bankr. E.D. Pa. 1987).

      - Two bankruptcy courts in the District of Delaware have recently issued conflicting decisions concerning the type of the "consent"

needed for third party releases. *Compare Washington Mutual*, 442 B.R. at 354-55 with *In re Indianapolis Downs, LLC*, 486 B.R. 286, 304-06 (Bankr. D. Del. 2013)

   - In *Washington Mutual*, Judge Walrath held that "affirmative consent" is required for a party to be bound by a third party release contained in a plan. 442 B.R. at 354-55. In that case, after amendments by the debtors to satisfy the concerns of the court, the ballot contained an "opt out" provision, where affected parties needed to check the opt-out box in order for the release provisions not to apply. *Id.* Judge Walrath held that consent could not be implied if a party failed to return its ballot, returned a blank ballot, or voted against the plan. *Id.* at 355. Instead, the only way for a party to "consent" to the release was to return the completed ballot voting in favor of the plan and not check the opt-out box. *Id.* ("any third party release is effective only with respect to those who affirmatively consent to it by voting in favor of the Plan and not opting out of the third party releases.").

   - In contrast, Judge Shannon in *Indianapolis Downs* (another third party release case where there was an "opt-out" box on the ballot) held that affirmative consent is not required for a party to be bound. 486 B.R. at 304-05. Instead, consent could be implied if a creditor merely failed to return its ballot (or does not otherwise check the "opt-out" box). *Id.* "[T]hose who fail to opt out [by checking the opt-out box], or to vote, are 'deemed' to consent to the Third Party Release." *Id.* at 305. Thus, a creditor will be bound by the third party release if it (i) does not return its ballot, (ii) votes to accept the plan but does not check the "opt-out" box, (iii) returns a blank ballot, or (iv) votes to reject the plan but does "not otherwise opt out of the releases[.]" *Id.* at 304-06.

- <u>Second Circuit Test</u>: *Metromedia Fiber Network, Inc.*

  - In disapproving non-debtor release, holding that "nondebtor release[s] in a plan of reorganization should not be approved absent the finding <u>that truly unusual circumstances</u> render the release important to the success of the plan. . . ." 416 B.R. at 143 (emphasis added).

  - In determining whether the release is permissible, the court noted that focus should be paid to the following factors:

- Whether estate received substantial consideration;
- Whether enjoined claims are channeled to a settlement fund rather than extinguished
- Whether enjoined claims would indirectly impact debtor's reorganization "by way of indemnity or contribution";
- Whether plan otherwise provides for full payment of enjoined claims; and/or
- Whether there is consent of affected creditors. *Id.* at 142-43.

- Court noted, however, that whether a non-debtor release is permissible is "not a matter of factors and prongs" and that "[n]o case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique." *Id.* at 142.

- Involuntary Third Party Release: Multi-Factor Test
    - **5-Factor Test**
        - Identity of interest between debtor and non-debtor such that a suit against the non-debtor will deplete estate resources;
        - Substantial contribution to the plan by non-debtor;
        - Necessity of release to the reorganization;
        - Overwhelming acceptance of the plan and release by creditors and interest holders; and
        - Payment of all or substantially all of the claims of the creditors and interest holders under the plan.
            - *See In re Master Mortg. Inv. Fund, Inc.*, 168 B.R. 930, 934-35 (Bankr. W.D. Mo. 1994) (citing cases applying a variety of the five factors); *Indianapolis Downs*, 486 B.R. at 303 (applying *Master Mortg.* test); *In re Zenith Elecs. Corp.*, 241 B.R. 92, 110 (Bankr. D. Del. 1999) (same).
        - "No court has set out a rigid 'factor test' to be applied in every circumstance. Rather, the courts have engaged in a fact specific review, weighing the equities of each case. The courts seem to have balanced the five listed factors most often. However, these factors do not appear to be an

exclusive list of considerations, nor are they a list of conjunctive requirements." *Master Mortg. Inv. Fund*, 168 B.R. at 935; *see also Indianapolis Downs*, 486 B.R. at 303 ("[t]hese factors are neither exclusive nor are they a list of conjunctive requirements.").

- **6-Factor Test**
  - The Sixth Circuit, in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002) adopted a variation of the five-factor test, adding one additional factor, namely:
    - the plan provides an opportunity for those claimants who choose not to settle to recover in full.
  - The Fourth Circuit recently adopted this 6-factor test. *See Nat'l Heritage Found., Inc. v. Highbourne Found.*, No. 13-1608, 2014 WL 2900933, at *1-2 (4th Cir. June 27, 2014).

- Even if all of the factors enumerated above have been met, a bankruptcy court must have subject matter jurisdiction over the third party dispute in order to grant the non-debtor release. *See Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.)*, 517 F.3d 52 (2d Cir. 2008) ("*Manville III*"), *rev'd and remanded sub nom Travelers Indem. Co. v. Bailey*, 557 U.S. 137, 129 S.Ct. 2195, 174 L.Ed.2d 99 (2009) ("*Travelers*"). *See also In re Dreier*, 429 B.R. 112, 132 (Bankr. S.D.N.Y. 2010) ("before the Bankruptcy Court decides whether . . . the 'unusual circumstances' mandated by *Metromedia* [are present], it must first decide whether it has subject matter jurisdiction. . . .").
  - In *Manville III*, the Second Circuit held that "a bankruptcy court only has jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate." 517 F.3d at 66. Unless the third party has "derivative liability for the claims against the debtor[,]" a channeling injunction is inappropriate. *Id.* at 68. Because the claims at issue were "not derivative of [the debtor's] liability, but rather seek to recover directly from [a third party] for its own alleged misconduct[,]" the court found that the district court lacked subject matter jurisdiction to enjoin such claims. *Id.*
  - The Supreme Court in *Travelers* reversed and remanded *Manville III* on "narrow" grounds, finding that the Second Circuit had improperly permitted a collateral attack on the District Court's subject matter jurisdiction. 557 U.S. at 152-53 (holding that "[e]ven subject-matter jurisdiction . . . may not be attacked collaterally.") (citations omitted). Once the 1986 Order became final without any party having raised the jurisdictional issue, res judicata precluded the Court from addressing it.

Id. at 152 ("once the 1986 Orders became final on direct review (whether or not proper exercises of bankruptcy court jurisdiction and power), they became res judicata to the "'parties and those in privity with them. . . ."). It is notable, however, that the court expressly stated that it was "not resolv[ing] whether a bankruptcy court . . . could properly enjoin claims against nondebtor insurers that are not derivative of the debtor's wrongdoing." *Id.* at 155. It was merely holding that the issue of whether the court had subject matter jurisdiction was barred by res judicata and not subject to collateral attack.

- On remand, the Second Circuit in *Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.)*, 600 F.3d 135, 148-49 (2d Cir. 2010) ("*Manville IV*"), held that because Chubb was denied due process, its assertion of lack of subject matter jurisdiction was timely (and therefore not an impermissible collateral attack). The court then held that the order enjoining non-derivative claims by Chubb that sought to impose separate liability on a third-party non-debtor "exceed[ed] the bounds of the bankruptcy court's *in rem* jurisdiction." *Id.* at 153. According to the court, Bankruptcy Code section 524(g), which permits certain channeling injunctions, "does not authorize injunctions of . . . [non-derivative] claims against non-debtor third parties." *Id.*

- **Minority Approach: Third Party Releases Are Impermissible As A Matter Of Law**
  - The Fifth, Ninth and Tenth Circuits have held that non-debtor third party releases are impermissible as a matter of law.
    - *See Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 760-61 (5th Cir. 1995) (where permanent injunction "provided no alternative means . . . to recover from [third party] . . . [it] improperly discharged a potential debt of [third party]" and "the bankruptcy court exceeded its powers under § 105."); *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401-02 (9th Cir. 1995) (holding that third party release violates section 524(e), which "precludes bankruptcy courts from discharging the liabilities of non-debtors."); *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) ("the bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan."); *Landsing Diversified Properties-II v. First National Bank and Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600-01 (10th Cir. 1991) ("Congress did not intend to extend such benefits [of discharge] to third-party bystanders.").
  - These courts have narrowly interpreted Bankruptcy Code section 524(e), which provides that "the discharge of a debt of the debtor does not affect the liability of any other third entity on, or the property of any other entity for such debt."

- According to these courts, third party releases effectively allow the bankruptcy process to discharge non-debtors, a result clearly inconsistent with section 524(e).