FBA

NEW VALUE

FEDERAL BAR ASSOCIATION—BANKRUPTCY SECTION NEWSLETTER

Summer/Fall 2013

BANKRUPTCY SECTION STEERING COMMITTEE

EDITOR'S NOTE

Benjamin M. White

If I could scrape together a flux capacitor and 1.21 gigawatts, I would go back to mid-June, 2013 to record your reaction when I explained that within the next couple months, Detroit will file the largest municipal bankruptcy in U.S. history, both Judge Gregg and Judge Hughes will announce their retirements from the bench, and the Federal Government will shut down. Your response? What else, "Hello? Anybody home? Think, McFly. Think!" And yet here we are. See, I told you so.

In late July, the FBA Bankruptcy Section held its 25th Annual Seminar in Traverse City with great success. Thank you to all those who worked so hard to make it happen (see Seminar details on pages 4-6).

This issue of New Value is stuffed with great information. Be sure to see the News & Announcements section for dates of upcoming events (see pg. 3). Also in this issue we have excellent articles on the absolute priority rule in individual chapter 11 cases (Daniel F. Gosch) and on the avoidance of mortgages due to faulty legal descriptions (Scott H. Hogan and Laura J. Genovich), as well as new case summaries and legal updates.

As always, members are encouraged to contact me (bwhite@kalawgr.com) with comments, suggestions or articles.

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New Value is published by the Federal Bar Association, Bankruptcy Section, for the Western District of Michigan.

LETTER FROM THE CHAIR

Andrew J. Gerdes

A big "Thank You" to everyone who worked to make our 25th Anniversary Seminar in Traverse City a success, including sponsors, panelists and attendees. Special thanks to Barb Foley, the seminar chair, for all the hard work in organizing the event, and to Judge Scott W. Dales, our educational chair, for another excellent program.

Judge James D. Gregg received the inaugural James D. Gregg Education Award, and Robert F. Wardrop II was the 2013 recipient of the Nims-Howard Civility Award. Congratulations to both of them.

We are actively planning next year's seminar which will take place July 31-August 2, 2014 at Boyne Highlands. The seminar will continue to provide excellent education and information as well as providing opportunities to socialize with your fellow practitioners. We welcome your comments on format, topics, etc. Do not hesitate to contact me or Barb Foley with your ideas.

Andrew J. Gerdes, Chairman

NEWS & ANNOUNCEMENTS

ANNOUNCEMENTS:

- **JUDGE GREGG AND JUDGE HUGHES ANNOUNCE THEIR RESPECTIVE RETIREMENTS**
  Judge Gregg and Judge Hughes have each announced their retirement from the bench. We will not attempt in this short announcement to describe either Judge's significant contributions to the Western District of Michigan and its bankruptcy bar. Judge James D. Gregg has served as Bankruptcy Judge in the Western District of Michigan since 1987. Judge Jeffrey R. Hughes has served as Bankruptcy Judge in our District since 2000. More to follow on both Judges in subsequent newsletters. As stated in the Events section below, the FBA will host a retirement party in honor of Judge Hughes on November 7, 2013 in Grand Rapids. A retirement party in honor of Judge Gregg will be announced when scheduled.

- Electronic Proofs of Claim (ePOC): The Clerk's office is excited to announce the implementation of ePOC. ePOC enables creditors without a CM/ECF login/password to electronically file proofs of claim via a link on the court's website; thereby eliminating the need to complete the paper copy of the official proof of claim form and mailing it to the court for filing. The ePOC module allows creditors to populate and electronically file the Official Form B10, attach supporting documentation (optional) and receive immediate verification of the filing. Creditors can electronically file amended claims as well. The court strongly encourages creditors to take advantage of this fast, free and efficient method of filing their proofs of claim. For more information and instructions on how to utilize this feature, please click here.

- Bankruptcy Rule and Form Changes Effective December 1, 2013: Please see the following links for Bankruptcy Rule Amendments and Form Changes. Also effective December 1, 2013, Item 19 of the Bankruptcy Court Miscellaneous Fee Schedule will be amended to include a fee in the amount of $176.00 to file a motion for the sale of property free and clear of liens under 11 U.S.C. Section 363(f).

- The FBA Bankruptcy Section is pleased to sponsor WIFI to its members at the Ledyard Building in Grand Rapids. There are two connections: one named "FBA-Attorney," for which the password is "FBAguest" (case sensitive), and another named "FBA-Guest," for which there is no password.

NEWS & ANNOUNCEMENTS CONTINUED

UPCOMING EVENTS:

- The 3rd annual State of the Court Luncheon will be held at noon, on Friday, October 11, 2013. The luncheon will be held at the JW Marriott International Ballroom, Grand Rapids, Michigan. RSVP is required by October 4, 2013. Please click on the following link for more information: http://www.miwb.uscourts.gov/cms/assets/Home/Court-News/FBA-State-of-the-Court-2013-Announcement.pdf.

- The Federal Bar Association for the Western District of Michigan has planned a retirement party in honor of Judge Jeffrey R. Hughes at the John Ball Zoo Bissell Tree House in Grand Rapids, Michigan, on Thursday, November 7, 2013. Please see the invitation and RSVP for further information.

- The following is a schedule of the dates and times for Holiday Parties (sites and times to follow):
  - Marquette: December 3, 11:00 - 2:00
  - Grand Rapids: December 5, 4:30 - 8:00
  - Kalamazoo: December 11, 4:00 - 7:00
  - Traverse City: December 12, evening (TBD)
  - Lansing: December 19, afternoon (TBD)

BANKRUPTCY COURT NOTICE TO THE PUBLIC REGARDING GOVERNMENT SHUTDOWN:

Pursuant to the direction of the Administrative Office of the United States Courts, the U.S. Bankruptcy Court for the Western District of Michigan will continue operations for an estimated 10 business days despite the federal government shutdown effective October 1, 2013. Court business will be conducted as usual. All proceedings and deadlines remain in effect as scheduled, unless otherwise advised. The Case Management and Electronic Filing (CM/ECF) system will remain in operation for the electronic filing of documents with the court. The intake department will be open for filing paper pleadings and court staff will also be available to answer questions and assist the public. If the government shutdown continues beyond the 10 days (on or around October 15, 2013) the court will issue a notice with updated operating status information.

Date: 01 October 2013

Daniel M. LaVille
Clerk of Court

A SPECIAL THANK-YOU TO SPONSORS OF THE 2013 FBA BANKRUPTCY SECTION SEMINAR

The FBA Bankruptcy Section expresses its sincere appreciation to the 2013 FBA Bankruptcy Seminar sponsors:

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CHAIRS

Educational Chair: **The Honorable Scott W. Dales**
United States Bankruptcy Judge

Seminar Chair: **Barbara Foley, Esq.**
Standing Chapter 13 Trustee

2013 AWARD WINNERS

- Congratulations to **The Honorable James D. Gregg**, who received the FBA Bankruptcy Section's inaugural James D. Gregg Education Award for his outstanding commitment and contributions to the continuing legal education of the bankruptcy bench and bar of the Western District of Michigan.

Judge Stosberg presents Judge Gregg with the James D. Gregg Education Award

- Congratulations to **Robert F. Wardrop II**, who received the FBA Bankruptcy Section's 2013 Nims-Howard Civility Award in recognition of his conduct, skill and advocacy that exemplifies the tradition of civility and excellence of the bench and bar of the Western District of Michigan.

Tim Hillegonds presents the Nims-Howard Civility Award to Robert F. Wardrop II.

PANELISTS

The FBA Bankruptcy Section extends its sincere gratitude and appreciation to Keynote Speaker **Kathy Bazoian Phelps, Esq.**, of Diamond McCarthy LLC, Award Presenters **The Honorable David T. Stosberg** and **Timothy Hillegonds**, as well as to the following panelists and participants:

Hon. Scott W. Dales

Hon. James D. Gregg

Hon. Barbara J. Houser

Hon. Jeffrey R. Hughes

Hon. Robert J. Jonker

Hon. Daniel S. Opperman

Hon. Steven W. Rhodes

Hon. Walter Shapero

Hon. Phillip J. Shefferly

Hon. Jo Ann C. Stevenson

Hon. David T. Stosberg

Kathy Bazoian Phelps, Keynote

Elizabeth T. Clark

Chad Coffman

Paul F. Davidoff

Thomas D. DeCarlo

John P. Gustafson

Richard B. Levin

Jeffrey D. Mapes

Susan Jill Rice

Brian P. Yoho

Judge Steven W. Rhodes and Kathy Bazoian Phelps discuss Ponzi Schemes

ARTICLES

Recent Decisions Hold Absolute Priority Rule Applies in Individual Chapter 11 Cases

By Daniel F. Gosch
Dickinson Wright, PLLC

As the economic recovery continues to wind along through the up and down financial cycles that have been the hallmark of the last four years, there can be little doubt that some individuals historically on the higher end of the economic spectrum have felt the impact of the crisis more than others. More than a few "high net worth individuals" have seen personal fortunes eroded to a degree that has caused them to consider what would have once been unthinkable—personal bankruptcy. However, many times, the bankruptcy relief utilized most often by individual debtors, Chapter 13, or Chapter 7, won't be quite the right fit. The debt ceilings in Chapter 13 preclude some from filing. Means testing, limited exemptions, and the fact that Chapter 7 is after all a *liquidation* proceeding create difficulty under that chapter. What's a poor high net worth debtor to do?

For some the answer has been an individual chapter 11 case. Individual chapter 11 cases have historically not been the norm, because they required that the individual debtor comply with the same requirements to confirm a plan of reorganization that were applicable to corporations and businesses. To confirm a plan of reorganization, all classes of claims not paid in full in cash on the effective date of the plan have to agree to the alternative treatment the plan proposes. If they do not, the only way to confirm the plan over their dissent is through what is called "cram down"—the process of confirming a plan *notwithstanding* the dissent of an impaired class of creditors. In order to "cram down" a plan on unsecured creditors, the plan must comply with the so-called "Absolute Priority Rule".

The Absolute Priority Rule has been part of bankruptcy jurisprudence since at least 1939. It mandates that in a chapter 11 case no junior class of claims or interests can receive or retain anything under the plan of reorganization, unless senior classes of claims or interests are either paid in full or consent (by voting yes on the plan) to the treatment that pays them less than in full. In a corporate context, this means that shareholders/equity (the lowest priority interest) cannot retain their shares in the debtor if they pay unsecured creditors less than 100% of their claims (unless the creditors agree to take less). While there are some "exceptions" to this general rule (they aren't critical here) for an individual chapter 11 debtor, who plainly has no shareholders, this rule meant that the debtor could not retain the property owned when the case was filed unless unsecured creditors were paid in full. Effectively then, the Absolute Priority Rule provided unsecured creditors with a "blocking vote" in an individual chapter 11 case, as the creditors could demand that the debtor either pay the unsecured creditors in full, or give up all of his or her pre-petition property to fund the plan. From the debtor's perspective, giving up all of one's pre-petition property would have the effect of rendering the whole "reorganization" process meaningless, as a practical matter.

However, in 2005, Congress amended the Bankruptcy Code through a set of amendments commonly referred to as "BAPCPA" (the "Bankruptcy Abuse Prevention and Consumer Protection Act" of 2005). One of the numerous BAPCPA changes altered the part of Section 1129 of the Bankruptcy Code that implements the Absolute Priority Rule. What the change appeared to do was to permit an individual debtor to confirm a plan of reorganization over the dissent of a senior class of unsecured creditors even while retaining some or even all of his or her property. Depending on how the new language was interpreted a debtor could either retain all of his property or just additional property obtained by the debtor after the commencement of the bankruptcy case (typically a much more limited amount). If the correct interpretation of the changed language was that a debtor could keep all property (the so-called "broad view"), the effect would be that the Absolute Priority Rule was effectively gone as it related to individual chapter 11 debtors. Alternatively, if the correct view was that only the more limited amount of post-petition property could be retained (the so-called "narrow view"), then the Absolute Priority Rule would still be alive and well.

After BAPCPA, the bankruptcy courts split over which of these two interpretations was correct. There were a number of arguments either way. Some courts that adopted the "broad view" concluded that the statutory language plainly and unambiguously abolished the Absolute Priority Rule. Others found the language ambiguous, but still found that the amendment abolished the Absolute Priority Rule because such a conclusion was consistent with what they perceived as a Congressional desire to make individual chapter 11 cases more like chapter 13 cases. On the other hand, the courts adopting the "narrow view" found the language of the amendment ambiguous, and concluded that Congress could not have intended to abrogate such a longstanding concept as the Absolute Priority Rule through ambiguous language. Recently, the Circuit Courts of Appeal in the United States are starting to weigh in on the issue, and some consistency is starting to appear in the analysis.

In *In re Maharaj* 681 F. 3d 558 (4th Cir. 2012) was a prototypical example of the criticality of adopting the "narrow" vs. the "broad" view. In this case the debtors ran a small business (an auto body shop), and fell into debt through their exposure to a fraud scheme. Because their debts exceeded the chapter 13 debt limitations, and they desired to continue their business, they filed an individual chapter 11 case. Their chapter 11 plan proposed to refinance or continue to pay most of their secured debt, and proposed to pay their unsecured creditors roughly two cents on the dollar over five years. The plan would be funded by the debtors retaining and continuing to operate the existing pre-petition business. However, if the Absolute Priority Rule applied, the debtors would be unable to retain the pre-petition business assets unless each of the classes of creditors under the plan voted to accept the plan. The secured creditors accepted the plan, but only one small unsecured creditor voted on the plan—and they voted no.

The result was that the Absolute Priority Rule applied, and that the debtors could only confirm their plan if they liquidated their business—which of course would have resulted in their having no future business, and no means to fund the plan—a classic individual chapter 11 "catch-22". While sympathetic to this outcome, the bankruptcy court rejected the debtors' arguments that the court should adopt the "broad view" of the BAPCPA amendments, held that the plan could not be confirmed because of the application of the Absolute Priority Rule, and certified the case for appeal directly to the Fourth Circuit Court of Appeals. The Fourth Circuit Court of Appeals affirmed the ruling of the Bankruptcy Court, and held that the BAPCPA amendments did not abrogate the Absolute Priority Rule. In doing so, the Fourth Circuit concluded:

1. The specific BAPCPA amendments at issue were ambiguous because they were susceptible to multiple interpretations (as evidenced by the varying decisions of the bankruptcy courts);
2. BAPCPA did not evidence a Congressional intent to effect an "implied repeal" of the Absolute Priority Rule or "alter longstanding bankruptcy practice" in the context of individual chapter 11 cases; and
3. If Congress had intended to abrogate the Absolute Priority Rule, it could have done so in a much clearer fashion.

Maharaj is proving to be a leading case on the subject, and since the decision, the "narrow view" is clearly gaining the most traction with the courts. Another Circuit Court decision has now followed this reasoning (see *In re Stephens* 704 F. 3d 1279 (10th Cir. 2013)), and at least one other case is presently pending in the 5th Circuit Court of Appeals, from a bankruptcy court decision following the "narrow view". In the Sixth Circuit, which includes Michigan, there is at least one decision from the Bankruptcy Court in Tennessee which also adopts the "narrow view", which has now been affirmed on appeal by the United States District Court. Even in California, a state in which the 9th Circuit Bankruptcy Appellate Panel early on adopted the "broad view", a recent case, decided after the Maharaj decision has now concluded that it is not bound to apply the "broad view".

Thus clearly the trend is towards the conclusion that the Absolute Priority Rule is alive and well in individual Chapter 11 cases. And, notwithstanding the "catch-22" experienced by the *Maharaj* debtors, the narrow view doesn't mean that things are hopeless for an individual Chapter 11 debtor. As one court indicated, when it rejected the argument that the Absolute Priority Rule made it impossible for an individual Chapter 11 debtor to confirm a plan unless it paid unsecured creditors in full: "To the contrary, such a plan may be confirmed if the holders of such claims vote in favor of the plan. They are likely to do so if a reasonable dividend is proposed and they conclude that they will receive no dividend in a chapter 7 case." *In re Gbadebo* 431 B.R. 222 (Bankr. N. D. Cal. 2010).

If you're a creditor, you're nodding your head up and down after reading that quote, and the *Maharaj* decision and the cases that have followed it now put some real weight on the scale in favor of creditors. Keep it in mind the next time you encounter an individual chapter 11 case.

AVOIDING AVOIDANCE:
HOW ERRORS IN MORTGAGE LEGAL DESCRIPTIONS LEAD TO AVOIDANCE BY BANKRUPTCY TRUSTEES

By Scott H. Hogan & Laura J. Genovich
Foster, Swift, Collins & Smith, P.C.

When a borrower files bankruptcy, the mortgage lender can usually expect that its perfected lien on the debtor's property will survive bankruptcy. But even seemingly minor errors in the legal description of the property can give a bankruptcy trustee grounds to avoid the mortgage. This article addresses the impact of legal description errors on the avoidability of mortgages based on several recent cases from Michigan's bankruptcy courts.

Strong-Arm Power under Section 544

Section 544 of the Bankruptcy Code, known as the "strong-arm" clause, allows a bankruptcy trustee to set aside certain obligations of the debtor that could have been avoided by a judgment lienholder or bona fide purchaser of real property. Specifically, Section 544(a)(3) allows a trustee to avoid unperfected or otherwise defective interests in the debtor's real property if the transfer of that interest would not be effective against a hypothetical bona fide purchaser under applicable state law. If avoided, the interest is automatically preserved for the benefit of the bankruptcy estate under Section 551. Bankruptcy trustees often use Sections 544 and 551 to avoid mortgages, particularly where errors or omissions are found in the property's legal description.

Platted Property: Omission of Plat

If the debtor's property is platted under Michigan law and the mortgage document fails to identify the plat, then the trustee may avoid the mortgage.

In *Richardson v. Wells Fargo Home Mortgage, Inc. (In re Brandt),* 421 B.R. 426 (Bankr. W.D. Mich. 2009), aff'd 2010 U.S. Dist. LEXIS 87845 (W.D. Mich. 2010), the recorded mortgage on the debtor's platted land included the correct street address and tax identification number. However, the bank failed to attach any legal description to the mortgage. The bankruptcy court held that the mortgage was avoidable because it failed to comply with the Michigan Land Division Act, which requires that all conveyances of platted land identify the plat. *See* MCL 560.255 and 560.212. Consequently, the bankruptcy court held that the mortgage failed to place bona fide purchasers on constructive notice of the bank's interest in the property. The district court affirmed the bankruptcy court's decision, reasoning that Michigan's recording statute requires compliance with other statutes, including the Land Division Act.

Platted Property: Incorrect Lot Number

When the debtor's property is platted, the mortgage is avoidable if it identifies the wrong lot number. In *Vandenbosch v. Edlund (In re Vandenbosch),* 405 B.R. 253 (Bankr. W. D. Mich. 2009), the mortgage listed the lot number of the vacant lot adjacent to the debtor's property. The bankruptcy court held that the mortgage was avoidable, reasoning that "no amount of inquiry into the Property's chain of title would have revealed the [bank's] mortgage, because the [bank's] mortgage had a different legal description."

Similarly, in *Tibble v. Wells Fargo Bank, N.A. (In re Hudson),* 455 B.R. 648 (Bankr. W.D. Mich. 2011), the trustee successfully avoided a mortgage where the legal description described "Lot 6," but the debtor owned Lot 5. The court, citing *Vandenbosch,* reasoned that because the bank's mortgage was not in the chain of title for Lot 5, it could not provide constructive notice to a bona fide purchaser on that lot. The bank unsuccessfully argued that a potential purchaser could have examined the grantor-grantee index and observed that the debtor granted a mortgage on Lot 6. The purchaser could have then found the mortgage on Lot 6 and discovered that it identified the address of Lot 5. The court rejected the bank's argument, noting that such an inquiry is beyond what Michigan law requires of a bona fide purchaser. Thus, as in *Vandenbosch,* the lot identification error in the legal description allowed the trustee to avoid the mortgage under § 544(a)(3).

Unplatted Property

Although errors in the legal description of platted property generally lead to avoidance, mortgages on unplatted property may be treated differently. In a 2010 bench opinion, the bankruptcy court did not allow the trustee to avoid a mortgage based on an error in the metes-and-bounds description of the debtor's property. *Richardson v.*

Macatawa Bank (In re George), No. 09-10738 (Bankr. W.D. Mich. 2010). Although there are no published opinions in this district, minor errors in metes-and-bounds descriptions likely will not lead to avoidance because the mortgages are not required to comply with the Michigan Land Division Act, and Michigan law does not require mortgages to include precise legal descriptions of unplatted land.

Conclusion

This case law illustrates the importance of reviewing mortgages carefully at the execution stage (by the mortgage lender), before filing (by the debtor's attorney), and after filing (by the trustee). Even seemingly minor errors in the legal description of platted property can lead to avoidance by a bankruptcy trustee.

A SUMMARY OF THE BANKRUPTCY JUDGE APPOINTMENT PROCESS

By Benjamin M. White
Keller & Almassian, PLC

The process is underway to appoint two new Bankruptcy Judges for the Western District of Michigan. The following is a short summary of the appointment process.

The 6th Circuit Court of Appeals appoints Bankruptcy Judges for the Western District of Michigan. The deadline to submit applications for appointment to fill the two vacancies in our District was August 8th, 2013.

The 6th Circuit first appoints a Merit Selection Panel to review the applications, check references, and schedule interviews. The Merit Selection Panel has been appointed and it consists of 6 members. Within 90 days of the application deadline, the Merit Selection Panel will select approximately 5 to 10 applicants, which the Panel recommends to the Judicial Council of the 6th Circuit. Upon receipt of the Merit Selection Panel's recommended applicants, the Judicial Council will publish the list of recommended applicants and make a request for public comments. The public-comment period lasts two weeks. From the 5-10 recommended applicants, the Judicial Council of the 6th Circuit will select its finalists, and submit those finalists to the 6th Circuit Court of Appeals for recommended appointment.

And voilà, there you have it. For more detail on the process generally (it varies from Circuit to Circuit), see this recent report by the Institute for the Advancement of the American Legal System (IAALS) at the University of Denver.

Debtor:

A Motown Guide to the Detroit Bankruptcy

By Benjamin M. White
Keller & Almassian, PLC

First, please know that my references to Motown songs is not meant to make light of Detroit's struggles, which may have serious effects for many Michiganders and their families, but is rather to invoke an enduring symbol of the City's greatness.

What's Going On? (by Marvin Gaye): On July 18, 2013, the City of Detroit filed the largest municipal bankruptcy in U.S. history. The City's debt is estimated at approximately $18 billion, which dwarfs the second largest municipal bankruptcy by amount of debt – Jefferson County, Ala., filed in 2011 with $4 billion in debt. Detroit's population of 700,000 is more than double that of Stockton, California (2012), which had been the largest municipal filer by population.

My Guy (by Mary Wells): The Chief Judge of the U.S. 6th Circuit Court of Appeals selected Eastern District of Michigan Bankruptcy Judge Steven Rhoades to oversee Detroit's Chapter 9 bankruptcy proceeding. Judge Rhoades is one of Detroit's most experienced judges, having been a bankruptcy judge in the Eastern District since 1985. He is a graduate of the University of Michigan Law School.

Let's Get It On (by Marvin Gaye): The Court set August 19, 2013 deadline for any party to file objections to the City's eligibility for Chapter 9 bankruptcy, and also set October 23, 2013 as the trial date for any such objections. 109 objections were filed, including objections by the Retired City Employees Association and Joint Retired Detroit Police and Fire Fighters Association, the UAW, and the American Federation of State, County and Municipal Employees (AFSCME). In other municipal bankruptcy cases, questions of eligibility have caused significant delays. As demonstrated by the relatively quick dates mentioned above, Judge Rhoades appears determined not to let that happen in the Detroit case. Several creditors have indicated that they plan to challenge the City's eligibility. The Court also proposed a March 1, 2014 deadline for the City to file a Plan of Adjustment.

Stop! In the Name of Love (by Supremes): Michigan Attorney General Bill Schuette filed a statement that his office does not contest Detroit's eligibility for Chapter 9, but does object, and will continue to object, to Detroit's ability through the bankruptcy process to diminish its retiree pension benefits in light of the Michigan state constitutional prohibition against impairment of these vested obligations. Notably, bondholder representatives and municipal bond insurance companies chose not to file an objection to eligibility.

Aint No Mountain High Enough (by Marvin Gaye & Tammi Terrell): Lawyers in Detroit's bankruptcy case are breaking a gender barrier of sorts. As noted by the Wall Street Journal on August 6th, "[t]he main parties squaring off in Detroit's $18 billion bankruptcy case will be led by women, an unusual feat in a legal field typically dominated by men [bankruptcy law]," the. "Women hold leadership roles in fewer than one-fifth of the 100 biggest U.S. law firms' bankruptcy practices, according to data compiled by Dow Jones. But in the hotly contested case in Detroit, the names to know are Heather Lennox, Sharon Levine and Babette Ceccotti. Lennox is representing Detroit, which is trying to shed billions of dollars in obligations, including to retired city workers on pensions. Levine and Ceccotti are on the other side of the table representing two unions that dispute Detroit's eligibility to seek bankruptcy protection: the American Federation of State, County and Municipal Employees and the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America."

Going To a Go-Go (by Smokey Robinson & the Miracles): Judge Rhodes ordered that initial arguments on the purely legal issues of Detroit's eligibility for Chapter 9 be advanced to October 15-16, rather than the October 23rd date of the full trial on eligibility. Judge Rhodes explained that early consideration of the purely legal issues, such as Detroit's authorization under state law for the bankruptcy filing, would expedite determination of eligibility under the Bankruptcy Code.

CASE SUMMARIES AND LEGAL UPDATES

By Benjamin M. White
Keller & Almassian, PLC

CASE SUMMARIES

***Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754 (U.S. 2013)**

In this case, the Supreme Court held that "defalcation" under 11 U.S.C. § 523(a)(4) includes "a culpable state of mind ... involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior."

The case involved an inter-family conflict in which the father of five siblings had created a life insurance trust naming one of his sons as the trustee. Later, the father wished to borrow money from the life insurance policy's cash value, and approached his son the trustee to arrange the loan, at which time the trustee/son first learned that such a trust existed, and further that he was the trustee of the trust. Three loans issued from the policy over the next 10 or so years, all of which were paid back to the trust in full with 6% interest. The dispute centered on the trustee/son's profits from the transactions, which amounted to roughly $250,000.00.

Here in the WD of Michigan, the "defalcation" exception to discharge often arises in connection with the Michigan Builders Trust Fund Act. In *Patel v. Shamrock Floorcovering Servs., (In re Patel)*, 565 F.3d 963, 970 (2009), the 6th Circuit stated, quoting a previous 6th Circuit opinion, that "'the objective fact that monies paid into the building contract fund were used for purposes other than to pay laborers, subcontractors or materialmen first is sufficient to constitute a defalcation under section [523](a)(4) so long as the use was not the result of mere negligence or a mistake of fact.'" The 6th Circuit in *Patel* went on to hold that there is no such thing as "defalcation per se" in the 6th Circuit. Rather, the *Patel* Court stated, the debtor must "have been <u>objectively reckless</u> in failing to properly account for or allocate funds." *Id.* (emphasis added).

Likewise, in its decision that was appealed to the Supreme Court in *Bullock*, the 11th Circuit Court of Appeals wrote that "defalcation requires a known breach of a fiduciary duty, such that the conduct can be characterized as <u>objectively reckless</u>." 670 F.3d at 1166.

In the final paragraph of the *Bullock* opinion, the Supreme Court states, "[i]n this case the Court of Appeals applied a standard of 'objectiv[e] reckless[ness]' to facts presented at summary judgment. We consequently remand the case to permit the court to ... apply the heightened standard that we have set forth.

... stay tuned.

***Grant, Konvalinka & Harrison, PC v. Banks (In re McKenzie)*, 716 F.3d 404 (6th Cir. Tenn. 2013).**

In this case, the Chapter 7 Trustee filed three actions against one of the Debtor's creditors (two adversary proceedings and one state-court action), all of which were dismissed. Thereafter, the creditor brought three actions against of its own against the Trustee and its counsel alleging malicious prosecution and abuse of process. The bankruptcy court dismissed the actions, the district court affirmed, and the creditor appealed to the 6th Circuit, which affirmed.

The 6th Circuit held that the bankruptcy court did not err in finding as a matter of law that the Trustee and his attorneys are entitled to quasi-judicial immunity from the creditor's claims. In affirming, the 6th Circuit noted that "[j]udges enjoy absolute immunity from suit for money damages for actions taken in their judicial capacity, except when taken in the complete absence of jurisdiction. *Bush v. Rauch*, 38 F.3d 842, 847 (6th Cir. 1994). Extension of such immunity to officials performing quasi-judicial duties has been recognized for 'those persons performing tasks to integral or intertwined with the judicial process that these persons are considered an arm of the judicial officer who is immune.' *Id.* (extending immunity to probate court administrator). This determination is made using a 'functional' approach, under which courts look to the nature of the function being performed rather than the identity of the actor performing it." *Grant, Konvalinka & Harrison, PC v. Banks (In re McKenzie)*, 716 F.3d at 412. The Court reasoned that "[t]he function, filing suit on behalf of the estate in seeking to avoid a potentially fraudulent transfer, is authorized by statute, and exposure to potential liability for doing so would have a negative effect on the appropriate exercise of that function." *Id.* at 418. The Court further noted that quasi-judicial immunity, however, does not extend to claims against a trustee for breach of fiduciary duty brought by beneficiaries of the estate, but no such breach was alleged in this case.

***Richardson v. Checker Acquisition Corp. (In re Checker Motors Corp.)*, 2013 Bankr. LEXIS 2438, 2013 WL 3279791 (Bankr. W.D. Mich. June 10, 2013).**

In this case before Judge Hughes, the Chapter 11 liquidating Trustee brought an adversary proceeding seeking to recover alleged prepetition fraudulent transfers. The Trustee relied on Section 548 of the Bankruptcy Code as well as the Michigan Fraudulent Transfer Act ("MFTA") by way of Section 544(b) of the Code.

At issue in the case was the Debtor's solvency at the time of the transfers, which hinged on the inclusion or exclusion of a large liability associated with the Debtor's withdrawal from a multiemployer retirement plan. Under ERISA, when an employer withdraws from a multiemployer pension plan, the withdrawing employer is responsible for a portion of the plan's unfunded liabilities, referred to as a "withdrawal liability." The twist in this case was that the Debtor did not actually withdraw from the multiemployer retirement plan until after it had filed its bankruptcy case. Nevertheless, the Trustee contended that the possibility of the Debtor's withdrawal always existed prepetition, and therefore the "withdrawal liability" associated with its possible withdrawal should be included for calculating insolvency at the time of the transfers.

With regard to Section 548, the Court followed *CPT Holdings, Inc. v. Indus. & Allied Employees Union Pension Plan, Local 73*, 162 F.3d 405 (6th Cir. 1998). In so doing, the Court held "(1) that insolvency for purposes of Section 548 (a)(1)(B)(ii)(I) permits only claims as defined by Section 101(5) to be included in that calculation; and (2) that a debtor's withdrawal liability from a multiemployer plan does not become a 'claim' within the meaning of Section 101(5) until the debtor has actually withdrawn from the plan." *Richardson v. Checker Acquisition Corp. (In re Checker Motors Corp.)*, 2013 Bankr. LEXIS 2438, 27, 2013 WL 3279791 (Bankr. W.D. Mich. June 10, 2013).

With regard to the MFTA, however, the Court found *CPT Holdings* less persuasive. At the Defendant's urging, the Court looked to Judge Posner's analysis of the inclusion of contingent debts in calculating insolvency in *In re Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988), which stated that it was for the court in each case to decide whether a contingent liability's "present, or expected, value" is to be face, zero, or somewhere in between. *Id.* at 200. The Defendants asserted that no amount of the withdrawal liability should count because the contingency upon which it is premised – the cessation of the Debtor's business – did not occur until after the transfers were made. The Court reasoned that, "what Defendants ignore is that the cessation of a debtor's business is implicitly assumed whenever a transfer is challenged as being constructively fraudulent.... As such it necessarily follows that whatever the debtor would owe upon liquidation, including its withdrawal liability, must be included in assessing the debtor's solvency for avoiding purposes."

***Daley v. Mostoller (In re Daley)*, 717 F.3d 506 (6th Cir. Tenn. 2013).**

In this case, the 6th Circuit reversed the district court's ruling that the Debtor's IRA had lost its exempt status when the Debtor signed a Merrill Lynch Client Relationship Agreement which granted a lien to Merrill Lynch.

Two years prior to filing bankruptcy, the Debtor opened an IRA with Merrill Lynch by rolling over $64,646.00 from another financial institution. In connection with the rollover, the Debtor signed a Client Relationship Agreement with Merrill Lynch which stated:

> All of your securities and other property in any account – margin or cash – in which you have an interest, or which at any time are in your possession or under your control, shall be subject to a lien for the discharge of any and all indebtedness or any other obligations you may have to Merrill Lynch.

No such indebtedness or obligations ever arose. Two years later, the Debtor filed a Chapter 7 proceeding, and exempted the IRA under 522(b)(3)(C). The Chapter 7 Trustee objected to the claimed exemption, asserting that the IRA had lost its exempt(able) status when the debtor signed the agreement granting a lien to Merrill Lynch.

The Court initially noted that generally a debtor may exempt retirement funds if they are held in an account that is exempt from taxation under Section 408 of the Tax Code, which includes IRA's. But an IRA loses its tax-exempt status if the owner engages in any of six different kinds of transactions, one of which is "any direct or indirect" "lending of money or other extension of credit" between the IRA and its owner. 26 U.S.C. § 4975(c)(1)(B).

The Court held that the Debtor had not used his IRA to obtain credit from Merrill Lynch, and therefore the IRA remained tax exempt and exemptible. The Court reasoned that "[t]he salient reality is that [the Debtor] never borrowed from the IRA, and Merrill Lynch never extended credit to [the Debtor] based on the existence of the IRA. That a lien in some settings may be granted in connection with an extension of credit does not establish that any loan or other extension of credit occurred here. It did not." *Daley v. Mostoller*, 717 F.3d at 508-509. The Court continued, "[t]he lien provision was contingent on an event that never occurred, and above all could not occur until Daley opened a separate account. It is one thing to say that Merrill Lynch extends credit any time a customer opens a margin-trading account (and thus that a lien on an IRA acts as an extension of credit between the IRA and its owner), even in the absence of actual margin trading; it is quite another to say that Merrill Lynch extended credit to a nonexistent margin-trading account." *Id.* at 509.

***Maas v. Northstar Educ. Fin., Inc. (In re Maas)*, 2013 Bankr. LEXIS 2836, 2013 WL 3872183 (Bankr. W.D. Mich. July 8, 2013).**

In this case before Judge Gregg, the Debtor filed an adversary proceeding alleging that certain loans he received while enrolled at the Thomas M. Cooley Law School were not educational benefit loans under § 523(a)(8), and that therefore the loans were dischargeable in the Debtor's Chapter 7 proceeding. Notably, the Debtor did not assert that repayment of the loans would constitute an "undue hardship," but asserted only that the loans were extended to him to provide cash for general living expenses during law school and immediately after graduation, and thus the loans did not constitute an "educational benefit" under § 523(a)(8). The Debtor's loan applications included statements referring to "this education assistance loan..." and defined "Student" as "the student whose education this loan is being made to finance."

The Court held that the loans were nondischargeable both as educational-benefit loans funded by nonprofit institutions under § 523(a)(8)(A)(i) and as obligations to repay funds received as an educational benefit under § 523 (a)(8)(A)(ii).

In so holding, the Court noted that "a majority of courts determine whether a loan qualifies as an 'educational benefit' by focusing on the stated purpose for the loan when it was obtained, rather than on how the loan proceeds were actually used." *Maas v. Northstar Educ. Fin., Inc.*, 2013 Bankr. LEXIS at 16. (citing *Busson-Sokolik v. Milwaukee School of Eng'g (In re Sokolik)*, 635 F.3d 261, 266 (7th Cir. 2011), cert. denied, 131 S. Ct. 3039 (2011); *Murphy v. Penn. Higher Educ. Assistance Agency (In re Murphy)*, 282 F.3d 868, 870 (5th Cir. 2002); *Tift County Hospital Authority v. Nies (In re Nies)*, 334 B.R. 495, 501 (Bankr. D. Mass. 2005); *contra In re Ealy*, 78 B.R. 897, 898 (Bankr. D.D. Ill. 1987)). The Court further noted, "§ 523(a)(8) 'does not expressly state that only loans used for tuition are nondischargeable. Nor does it define educational loans a excluding living or social expenses.' *In re Murphy*, 282 F.3d at 871. Loans that enable a student to pay for room, board, and other living expenses while attending school facilitate the student's education and 'certainly [have] educational benefits.' *Id.* at 871-72." *In re Maas*, pp. 12-13.

LEGAL UPDATES

- Bankruptcy Rule and Form Changes Effective December 1, 2013: Please see the following links for Bankruptcy Rule Amendments and Form Changes. Also effective December 1, 2013, Item 19 of the Bankruptcy Court Miscellaneous Fee Schedule will be amended to include a fee in the amount of $176.00 to file a motion for the sale of property free and clear of liens under 11 U.S.C. Section 363(f).
- Nationwide Bankruptcy Filings Have Fallen 13% From 2012 Through the First Three Quarters of 2013, Commercial Filings Down 23%, as recently reported by the ABI per the numbers from Epiq Systems, Inc.
- Student Loan Defaults High. A recent Department of Education report showed that the official student loan default rate has hit a 16-year high. Of loans that went into repayment in 2011, one out of every ten borrowers defaulted within 2 years. The total default rate across institutions is 14.7%.