# BANKRUPTCY

*Blake H. Bailey*[*]



* Associate, McKool Smith, P.C., Houston, Texas; J.D., Stanford Law School; B.A., Trinity University. Mr. Bailey is a member of the Order of the Coif and served as an Editor for the *Stanford Law and Policy Review* and the *Stanford Environmental Journal*. Before entering law school, Mr. Bailey worked as a research associate for three years at the Federal Reserve Board of Governors in Washington, D.C. After law school, Mr. Bailey served as a clerk to Chief Judge Edith H. Jones of the Fifth Circuit. Currently, Mr. Bailey is admitted to practice in all Texas federal districts and the Fifth Circuit. His practice includes complex commercial litigation and bankruptcy matters.

## I. INTRODUCTION

This Survey Article reviews twelve selected bankruptcy opinions of the United States Court of Appeals for the Fifth Circuit decided between July 1, 2011, and June 30, 2012, including the first en banc decision involving bankruptcy since 2006.[1] The Fifth Circuit addressed issues of first impression and clarified some of its earlier precedents. Of particular interest are cases addressing judicial estoppel's application to bankruptcy trustees, recharacterization under state law, accounts as property of the estate, inherited IRAs as exempt assets, arbitration awards as nondischargeable debts, public policy exceptions to the automatic stay, fraudulent transfers, and effective reservations of causes of action in plans of reorganization.

The decisions reported during the survey period will certainly have an impact on the bankruptcy bar and courts in the Fifth Circuit. Overall, the survey period was a good time for recovering assets for the estate. In its first en banc case on bankruptcy in five years, the Fifth Circuit confirmed that a bankruptcy trustee is not judicially estopped from pursuing a claim the debtor fails to schedule because any recovery would benefit creditors.[2] Similarly, the Fifth Circuit held in *In re Mirant* that a trustee could still pursue fraudulent transfer claims even when all creditors had been paid in full.[3] The Fifth Circuit also increased the estate's potential property.[4] The *In re IFS Corp.* court held

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1. Zaylor v. U.S. Dep't of Ag. (*In re* Supreme Beef Processors, Inc.), 468 F.3d 248 (5th Cir. 2006) (en banc).
2. Reed v. City of Arlington (*Reed III*), 650 F.3d 571, 579 (5th Cir. Aug. 2011) (en banc).
3. MC Assett Recovery LLC v. Commerzbank A.G. (*In re* Mirant Corp.), 675 F.3d 530, 537-38 (5th Cir. Mar. 2012).
4. Stettner v. Smith (*In re* IFS Fin. Corp.), 669 F.3d 255 (5th Cir. Jan. 2012).

that property of the estate could include money in an account when the debtor had only control but no legal title to the account.[5] In *In re McCombs*, the Fifth Circuit held that any homestead value in excess of the limits of § 522(p) flows to the estate for general distribution to all creditors.[6] However, it was not a perfect year. Inherited retirement funds from an inherited IRA are exempt assets under § 522(d)(12) according to *In re Chilton*.[7]

Creditors trying to make debts nondischargeable also had a good year. In *In re Bandi*, the Fifth Circuit held that fraudulent statements about specific debtor's assets are covered by § 523(a)(2)(A), which is an easier standard to prove than its counterpart § 523(a)(2)(B).[8] Also, arbitration awards can constitute "willful and malicious" debts under § 523(a)(6) if they arise out of bad faith litigation tactics according to *In re Shcolnik*.[9]

Finally, the Fifth Circuit addressed two issues of particular importance to the bankruptcy bar. In *In re Lothian Oil*, the Fifth Circuit held that a bankruptcy court can recharacterize debt into equity but, unlike all other circuits, grounded that power in state law and not § 105(a).[10] In *In re Texas Wyoming Drilling*, the Fifth Circuit clarified its ruling in *United Operating*, holding that a plan of reorganization can effectively reserve causes of action by describing the causes of action and potential defendants generally, even though a catch-all general reservation of all claims would not effectively reserve the causes of action.[11]

## II. Judicial Estoppel: Innocent Trustees Are Not Judicially Estopped from Pursuing Causes of Action That the Debtor Fails to Schedule (*Reed v. City of Arlington*)

In *Reed v. City of Arlington*, the en banc Fifth Circuit held that judicial estoppel did not prevent an innocent bankruptcy trustee from pursuing a cause of action that the debtor failed to schedule.[12]

In 2004, Kim Lubke won a million-dollar judgment against the City of Arlington (the City) under the Family and Medical Leave Act (FMLA) in federal district court.[13] The City appealed the judgment.[14] On June 10, 2005, while the appeal was pending, Lubke and his wife filed for bankruptcy under

5. *Id.* at 265.
6. Smith v. Smith Wholesale Drug Co. (*In re* McCombs), 659 F.3d 503, 512 (5th Cir. Oct. 2011).
7. Chilton v. Moser (*In re* Chilton), 674 F.3d 486, 490 (5th Cir. Mar. 2012).
8. Bandi v. Becnel (*In re* Bandi), 683 F.3d 671, 676 (5th Cir. June 2012).
9. Shcolnick v. Rapid Settlements, Ltd. (*In re* Shcolnick), 670 F.3d 624, 629-30 (5th Cir. Feb. 2012).
10. Grossman v. Lothian Oil, Inc. (*In re* Lothian Oil, Inc.), 650 F.3d 539, 544 (5th Cir. Aug. 2011).
11. Spicer v. Laguna Madre Oil & Gas II, L.L.C. (*In re* Tex. Wyo. Drilling, Inc.), 647 F.3d 547, 551-52 (5th Cir. July 2011).
12. *Reed III*, 650 F.3d 571, 574 (5th Cir. Aug. 2011) (en banc).
13. *Id.* at 573.
14. *Id.*

Chapter 7.[15] Lubke did not schedule the FMLA judgment nor did he inform his FMLA lawyer, Roger Hurlbut, of the bankruptcy.[16] The Lubkes received a no-asset discharge, and their bankruptcy case was closed in September 2005.[17]

In June 2006, unaware that Lubke had received a discharge, a Fifth Circuit panel upheld the FMLA judgment but remanded to the district court to recalculate damages.[18] The City proposed a settlement offer to Hurlbut under Rule 68.[19] Hurlbut took the offer to Lubke, who informed him for the first time that he had gone through bankruptcy.[20] Hurlbut informed the bankruptcy trustee, who reopened the case and substituted in for Lubke in the pending FMLA litigation.[21] The bankruptcy trustee attempted to accept the Rule 68 settlement offer, but the City refused.[22] Instead, the City petitioned for the panel to rehear the case to consider the defense of judicial estoppel.[23] The panel denied the petition for rehearing but ordered that the district court consider the judicial estoppel defense on remand in addition to the damage recalculation issue.[24]

To determine whether judicial estoppel bars an action, the court analyzes three elements: (i) the party against whom judicial estoppel is sought has asserted a legal position that is plainly inconsistent with a prior position; (ii) a court accepted the prior position; and (iii) the party did not act inadvertently.[25] Judicial estoppel is particularly important in bankruptcy settings because the process relies on debtors disclosing assets for distribution to creditors.[26] On remand, the City argued that the bankruptcy trustee was judicially estopped from pursuing the FMLA claim.[27] The district court disagreed and fashioned a specific remedy.[28] It held that Lubke was judicially estopped from benefiting from the FMLA judgment but that the trustee, representing Lubke's innocent creditors, was not.[29] Under the court order, the trustee was free to collect the FMLA judgment to satisfy Lubke's creditors, but any surplus would be returned to the City.[30] Because the FMLA includes an attorney's fee provision,

15. Reed v. City of Arlington (*Reed I*), 620 F.3d 477, 479 (5th Cir. 2010), *rev'd en banc*, 650 F.3d 571 (5th Cir. Aug. 2011).
16. *Id.*
17. *Id.*
18. Lubke v. City of Arlington, 455 F.3d 489, 500 (5th Cir. 2006).
19. *Reed I*, 620 F.3d at 480.
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. Lubke v. City of Arlington, 473 F.3d 571, 571 (5th Cir. 2006) (per curiam).
25. *Id.* at 574.
26. *Id.*
27. *Reed I*, 620 F.3d at 480.
28. *Id.*
29. *Id.*
30. *Id.*

the attorneys' fees spent litigating the judicial estoppel issue were added to the total judgment.[31] The City appealed.[32]

The appeal went back to the same Fifth Circuit panel.[33] The panel reversed the district court.[34] The panel noted that the Fifth Circuit case law was inconsistent on whether a bankruptcy trustee was barred by judicial estoppel from pursuing causes of action if the debtor was barred by judicial estoppel.[35] To reconcile the cases, the panel held that the "lowest common denominator appears to lie in a holistic, fact-specific consideration of each claim of judicial estoppel that arises from litigation claims undisclosed to a bankruptcy court."[36] Applying the doctrine, the panel ruled that a bankruptcy trustee assumes the cause of action from the debtor subject to all the available defenses, including judicial estoppel.[37] Further, the panel held that the equities favored applying judicial estoppel because most of the judgment's proceeds would go to the bankruptcy trustee and Hurlbut, not Lubke's unsecured creditors, and the City had already incurred significant additional fees prosecuting the case over and above the original verdict to address the novel area of law.[38]

The Fifth Circuit decided to hear the case en banc and reinstated the district court opinion.[39] The Fifth Circuit held that judicial estoppel should not be applied against an innocent trustee because of a debtor's post-petition misrepresentations to the court.[40]

First, the Fifth Circuit held that judicial estoppel did not apply against the bankruptcy trustee when the debtor failed to disclose assets.[41] Pursuant to 11 U.S.C. § 541, all causes of action became property of the estate on the petition date subject to all the defenses that existed on the petition date.[42] Lubke's misrepresentations occurred post-petition when the cause of action already belonged to the trustee.[43] Accordingly, Lubke's actions could not affect

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31. *Id.*
32. *Id.* at 479.
33. *Id.* at 480.
34. *Id.* at 483.
35. *See id.* at 482; *see also* Kane v. Nat'l Union Fire Ins. Co., 535 F.3d 380, 383 (5th Cir. 2008) (per curiam) (holding that a bankruptcy trustee was not judicially estopped from pursuing a personal injury action when the debtor failed to list the cause of action on his schedules); Superior Crewboats, Inc. v. Primary P & I Underwriters (*In re* Superior Crewboats, Inc.), 374 F.3d 330, 332-33 (5th Cir. 2004) (holding that a bankruptcy trustee's motion to intervene was moot after ruling that the debtor was judicially estopped from bringing a cause of action).
36. *Reed I*, 620 F.3d at 480.
37. *Id.* at 482.
38. *Id.* at 482-83.
39. Reed v. City of Arlington (*Reed II*), 634 F.3d 769, 770 (5th Cir. 2011); *Reed III*, 650 F.3d 571, 573 (5th Cir. 2011) (en banc).
40. *Reed III*, 650 F.3d at 579.
41. *See id.* at 574-75.
42. *Id.* at 575.
43. *Id.* at 576.

the bankruptcy trustee's ability to pursue the claim because the trustee was no longer bound by Lubke's actions.[44]

Second, the Fifth Circuit ruled that the equities favored not applying judicial estoppel.[45] Unsecured creditors would benefit from the FMLA judgment, which comported with the Bankruptcy Code's purpose.[46] Critically, the district court's unique remedy insured that the true wrongdoer, Kim Lubke, would not benefit.[47] The City complained that the biggest benefactor would be Hurlbut—Lubke's attorney.[48] The opinion agreed that Hurlbut was the largest creditor but held that this was not relevant to the issue of judicial estoppel.[49] Although Hurlbut's claim was large, he was a proper creditor, and the district court found he was not complicit in Lubke's wrongdoing.[50] The City also complained that the FMLA judgment had grown because of Lubke's misrepresentations.[51] The Fifth Circuit was unsympathetic.[52] The increased costs were due to the City's chosen litigation strategy, for which it only had itself to blame.[53]

Third, the opinion addressed the conflicting case law.[54] The opinion noted that the facts of this case were indistinguishable from those in *Kane v. National Union Fire Insurance Co*.[55] In that case, the Fifth Circuit did not apply judicial estoppel because the trustee had not abandoned the claim and assumed the cause of action *before* the debtor's misrepresentations giving rise to judicial estoppel occurred.[56]

The opinion then distinguished cases in which the bankruptcy trustee was barred by judicial estoppel because of the debtor's misrepresentations.[57] In *In re Superior Crewboats*, the bankruptcy trustee was barred from pursuing a claim because of the unique procedural posture of the case.[58] In *Superior Crewboats*, the trustee abandoned the cause of action back to the debtor under 11 U.S.C. § 554.[59] The debtor had lied to the bankruptcy court and was barred by judicial estoppel from pursuing the claim while owning the claim.[60] Thus, if the trustee tried to reassume the claim, he would take the claim subject to the

44. *Id.*
45. *Id.*
46. *See id.* at 577.
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.* (citing Kane v. Nat'l Union Fire Ins. Co., 535 F.3d 380, 385 (5th Cir. 2008) (per curiam)).
56. *See id.*
57. *Id*. at 578.
58. *See id.* (citing Superior Crewboats, Inc. v. Primary P & I Underwriters (*In re* Superior Crewboats, Inc.), 374 F.3d 330, 336 (5th Cir. 2004)).
59. *Id.*
60. *Id.*

judicial estoppel defense.[61] In the present case, the trustee had not abandoned the claim.[62]

In *In re Coastal Plains*, the trustee was judicially estopped from pursuing an undisclosed claim because the debtor's legal successor (run by the same individual who ran the debtor) would receive 85% of the recovery, while the trustee (and creditors) would receive only 15% under a sharing agreement.[63] According to the en banc panel in *Reed III*, the *In re Coastal Plains* panel applied judicial estoppel because the "recovery would benefit the individual who actually perpetrated the bankruptcy fraud in great disproportion to the bankruptcy estate."[64] In contrast with *In re Coastal Plains*, Lubke would get nothing.[65]

Finally, the Fifth Circuit noted that its ruling accorded with other circuits. The Eleventh Circuit ruled that judicial estoppel should not be applied against an innocent trustee with standing to pursue a claim[66] and that other circuits had suggested a similar outcome in dicta.[67]

Chief Judge Jones, joined by Judge DeMoss and Judge Clement, dissented.[68] The dissent argued that the majority opinion focused its attention too narrowly on the bankruptcy process.[69] Instead, the Fifth Circuit should have considered the larger judicial process, including the multiple appeals and the judicial estoppel litigation itself.[70] If Lubke had not lied, according to the dissent, the bankruptcy trustee would have accepted the Rule 68 settlement offer, and no further litigation would have ensued.[71] Instead, Lubke's misrepresentations encouraged the City to continue litigation.[72]

Further, the opinion did not take into proper consideration the unfair burdens placed on the City due to Lubke's misrepresentations.[73] The dissent noted that when the litigation began, *Kane v. National Union Fire Insurance Co.* did not exist, and the Fifth Circuit jurisprudence supported the City's position.[74]

Finally, the dissent noted that the opinion's focus on innocent creditors "lack[ed] a certain depth of feeling."[75] The dissent noted that only $85,000 (or

61. *See id.*
62. *Id.*
63. *Id.* at 578 (citing Browning Mfg. v. Mims (*In re* Coastal Plains, Inc.), 179 F.3d 197, 204 (5th Cir. 1999)).
64. *Id.*
65. *Id.*
66. *Id.* (citing Parker v. Wendy's Int'l, Inc., 365 F.3d 1268, 1272 (11th Cir. 2004)).
67. *Id.* (citing Eastman v. Union Pac. R.R., 493 F.3d 1151 (10th Cir. 2007); Biesek v. Soo Line R.R., 440 F.3d 410 (7th Cir. 2006)).
68. *Id.* at 579 (Jones, C.J., dissenting).
69. *Id.*
70. *Id.* at 580.
71. *Id.*
72. *Id.*
73. *Id.*
74. *Id.* at 580 n.2.
75. *Id.* at 580.

one-third) of Lubke's unsecured creditors had refiled their claims and would be entitled to a distribution from the FMLA award.[76] To recover $85,000 of unsecured claims, the estate incurred expenses of $450,000 for Hurlbut and a six-figure expense for the bankruptcy trustee.[77] In the commercial world, the dissent noted, "The transactional costs of such creditor recovery are wildly disproportionate."[78]

## III. FRAUDULENT TRANSFERS: BANKRUPTCY TRUSTEES CAN RECOVER FRAUDULENT TRANSFERS FOR EQUITY INTERESTS (*IN RE MIRANT CORP.*)

In *In re Mirant Corp.*, the Fifth Circuit held that a bankruptcy trustee can pursue fraudulent transfers under state law even if all unsecured creditors have been paid in full.[79] Also, the Fifth Circuit held that a bankruptcy trustee cannot pursue a Federal Debt Collection Practices Act (FDCPA) claim under 11 U.S.C. § 544.[80] Finally, the Fifth Circuit ruled that, in a choice of law conflict on fraudulent transfers, when the harm and assets are intangible, the court should apply the law that best achieves the policy purpose of recovery for creditors.[81]

Mirant Corporation (Mirant) sought to purchase power islands from General Electric through a subsidiary, Mirant Asset Development and Procurement B.V. (MADP).[82] Several lenders (the Lenders) financed MADP's acquisition.[83] Mirant guaranteed the debt (the Guaranty) and later made payments on the Guaranty when the deal fell through.[84] Soon after making the payments, Mirant filed for bankruptcy.[85]

The bankruptcy court confirmed a plan of reorganization in which all unsecured creditors were eventually paid in full and transferred all causes of action into a litigation trust for the litigation trustee—the MC Asset Recovery, LLC (MCAR)—to pursue.[86] During the bankruptcy, the debtor-in-possession (and then MCAR after confirmation of the plan) sued the Lenders to avoid the Guaranty and all payments made under the Guaranty as fraudulent transfers under New York state law as applied by § 544(b).[87] MCAR also sued under the FDCPA as applied by § 544(b).[88] The Lenders filed a motion for summary

76. *Id.*
77. *Id*
78. *Id.* at 580-81.
79. MC Asset Recovery, LLC v. Commerzbank A.G. *(In re* Mirant Corp.), 675 F.3d 530, 537-38 (5th Cir. Mar. 2012).
80. *Id*. at 534-35.
81. *Id.* at 537.
82. *Id.* at 532.
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.* at 532-33.
87. *Id.* at 532.
88. *Id.*

judgment, asserting that MCAR lacked standing to pursue state fraudulent transfer claims and FDCPA claims.[89] Additionally, the Lenders asserted that Georgia fraudulent transfer law, not New York fraudulent transfer law, applied and that the Georgia law barred MCAR from avoiding the Guaranty.[90]

The bankruptcy court filed proposed findings of fact and conclusions of law, which the district court revised.[91] First, the district court held that MCAR could bring fraudulent transfer actions under state law even though all unsecured creditors were paid in full.[92] Second, the district court found that MCAR did not lack standing to bring a FDCPA claim.[93] Third, the district court found that Georgia law applied and that the Georgia fraudulent transfer law in effect at the time did not permit MCAR to avoid guarantees.[94] MCAR and the defendants both appealed.[95] The Fifth Circuit reversed the district court's holding that Georgia law applied but affirmed the other parts of the opinion.[96]

First, the panel addressed whether MCAR had Article III standing to bring fraudulent transfer claims under state law.[97] The Lenders argued that MCAR could not bring state fraudulent transfer claims because any recovery would be distributed to equity interests.[98] Outside of bankruptcy, state fraudulent transfer law did not allow *equity* interests to avoid fraudulent transfers.[99] Thus, according to the Lenders, the bankruptcy trustee could not avoid fraudulent transfers if the recovery would benefit equity interests.[100] The Fifth Circuit noted that federal courts were divided on the issue.[101] The Southern District of New York had held that a bankruptcy trustee lacked standing when all creditors were paid in full.[102] In contrast, the Eighth and Ninth Circuits had ruled that a bankruptcy trustee had standing to avoid fraudulent transfers under state law even if all unsecured creditors were paid in full.[103] Both circuits noted that § 550 allowed a trustee to avoid fraudulent transfers to recover for the "benefit [of] the estate," whoever that might be.[104]

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89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id*. at 534-36.
97. *Id.* at 533.
98. *Id.* at 532.
99. *Id.* at 533.
100. *Id.*
101. *Id*. at 533-34.
102. *Id.* at 533 (citing Adelphia Recovery Trust v. Bank of America, N.A., 390 B.R. 80, 91-97 (S.D.N.Y. 2008)).
103. *Id.* at 533-34 (citing Stalnaker v. DLC, Ltd., 376 F.3d 819 (8th Cir. 2004), and Acequia, Inc. v. Clinton (*In re* Acequia, Inc.), 34 F.3d 800 (9th Cir. 1994)).
104. *Id.* (emphasis omitted).

The Fifth Circuit adopted the Eighth and Ninth Circuits' position.[105] Under Fifth Circuit case law, the court evaluated the trustee's avoidance power at the petition date.[106] The panel held that "[o]nce a trustee's avoidance rights are triggered at the time of filing, they persist until avoidance will no longer benefit the estate under § 550."[107] The only relevant issue was whether avoiding the transfer would benefit the estate, even if that benefit might reach equity interests.[108]

Second, the Fifth Circuit addressed whether MCAR could bring FDCPA claims.[109] The court noted that the FDCPA states that it will not "supersede or modify the operation . . . of title 11."[110] In *In re Volpe*, the Fifth Circuit interpreted similar language under ERISA to mean that ERISA's provisions did not apply in bankruptcy.[111] Applying the *Volpe* ruling to the present case, the panel ruled that "28 U.S.C. § 3003(c) does not permit the FDCPA to be used as applicable law under § 544(b)."[112] This ruling was consistent with the legislative history, where Committee Chairman Brooks clarified that Congress intentionally inserted the language to ensure that other statutes did not modify the Bankruptcy Code.[113]

Third, the Fifth Circuit addressed which fraudulent transfer law applied.[114] MCAR argued that New York law applied.[115] The Lenders argued that Georgia's pre-2002 law applied because it was the law in effect when the Guaranty was made and Mirant made payments on the Guaranty.[116] Before 2002, Georgia's fraudulent transfer law did not permit a creditor to avoid guarantees.[117] Notably, Georgia repealed that law and adopted the Uniform Fraudulent Transfers Act (UFTA) in 2002, which does permit creditors to avoid guaranties.[118] Thus, the Lender was calling for the application of a now-repealed statute.

The Fifth Circuit noted that it had not determined which rule to use to determine the choice of law: "the independent judgment test or the forum state's choice-of-law rules."[119] In this case, Texas's choice-of-law rules (the forum state) and the independent judgment test were identical because both

105. *Id.* at 534.
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.* at 535.
110. *Id.* (emphasis omitted) (quoting 28 U.S.C. § 3003(c) (2006)).
111. *Id.* (citing NCNB Tex. Nat'l Bank v. Volpe (*In re* Volpe), 943 F.2d 1451, 1451-53 (5th Cir. 1991)).
112. *Id.*
113. *Id.* at 535-36.
114. *Id.* at 536.
115. *Id.*
116. *See id.* at 532, 536-38.
117. *See id.* at 537.
118. *See* GA. CODE ANN. §§ 18-2-70 to -80 (2002).
119. *In re Mirant Corp.*, 675 F.3d at 536.

applied § 6 and § 145 of the Restatement (Second) of Conflict of Laws.[120] Thus, the Fifth Circuit left the issue unresolved.

Applying both § 6 and § 145 of the Restatement (Second) of Conflict of Laws, the court found that both New York and Georgia had sufficient contacts to apply their respective fraudulent transfer laws.[121] The question became which state's law should apply. The court ruled that the § 145 analysis did not offer any guidance because it focused on the physical location of the parties and the injury.[122] Here, because the injury was intangible, the injury "location" could not be identified and would not be relevant to the inquiry.[123] Similarly, the parties' physical locations did not provide a clear answer.[124] Both the debtor and the defendants had relationships with both New York and Georgia, but neither party's operations were centered in either New York or Georgia.[125]

In contrast, the Fifth Circuit found that § 6 of the Restatement strongly favored the application of New York law.[126] First, applying New York law would best promote "the underlying policy of protecting creditors from fraudulent transfers regardless of the specific form of those transfers."[127] Unlike nearly all other states (including post-2002 Georgia), the pre-2002 Georgia statute protected certain kinds of transfers because they were structured as guarantees.[128] This minor technicality frustrated the basic policy purpose of recovering fraudulent transfers for creditors and favored applying New York law.[129] Second, applying New York law would better promote harmony between the states because the New York law represented the majority position adopted by nearly all other states.[130] Third, the panel noted that none of the Lenders were Georgia citizens.[131] As a policy matter, "Georgia ha[d] little interest in applying its now-repealed statute to this case where its citizens ha[d] nothing to gain from the application of that statute."[132] Accordingly, New York law applied.[133]

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120. *See id.*
121. *Id.* at 537.
122. *See id.*
123. *See id.*
124. *Id.*
125. *Id.*
126. *Id.*
127. *Id.*
128. *See id.*
129. *See id.* at 538.
130. *Id.*
131. *Id.*
132. *Id.*
133. *See id.*

## IV. EXEMPT ASSETS: INHERITED IRAS ARE EXEMPT ASSETS UNDER 11 U.S.C. § 522(d)(12) (*IN RE CHILTON*)

In *In re Chilton*, the Fifth Circuit held that inherited retirement funds in an inherited IRA are exempt assets in bankruptcy.[134]

Janice Chilton and Robert Chilton (the Chiltons) inherited an individual retirement account (IRA) worth $170,000 from Janice Chilton's deceased mother, Shirley Heil (the Heil IRA).[135] The Chiltons established an "inherited IRA" to receive the proceeds from the Heil IRA (the Chilton IRA).[136] The Chiltons filed for bankruptcy and claimed the Chilton IRA as exempt property under 11 U.S.C. § 522(d)(12).[137] The trustee objected that the § 522(d)(12) exemption did not apply, arguing that the money from the Heil IRA was "retirement funds" under § 522(d)(12) and that the Chilton IRA was not an "account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986."[138] The bankruptcy court ruled that the Chilton IRA was not exempt property, and the Chiltons appealed.[139] The district court reversed and ruled in favor of the Chiltons.[140] The trustee appealed and the Fifth Circuit affirmed.[141]

First, the panel held that funds received from the Heil IRA were retirement funds under § 522(d)(12).[142] The panel noted that the Bankruptcy Code did not define retirement funds to mean only the debtor's retirement funds.[143] Rather, the definition included any money within the debtor's possession that was set aside by some party for retirement.[144] Because Heil set aside the $170,000 for her own retirement, the money in the Heil IRA was retirement funds.[145] The money remained retirement funds when the Chiltons inherited the Heil IRA and when the Chiltons transferred the funds from the Heil IRA to the Chilton IRA.[146] The panel noted that nearly all courts agreed with this analysis and that the bankruptcy court's ruling otherwise was reversed on appeal.[147]

Second, the panel held that an inherited IRA is a tax-exempt account for purposes of § 522(d)(12).[148] The trustee argued that inherited IRAs, such as the

134. Chilton v. Moser (*In re* Chilton), 674 F.3d 486, 487 (5th Cir. Mar. 2012).
135. *Id.*
136. *Id.* at 487-88.
137. *Id.* at 488.
138. *Id.*
139. *Id.*
140. *See id.*
141. *See id.* at 487-88.
142. *Id.* at 489.
143. *Id.*
144. *Id.*
145. *Id.*
146. *Id.*
147. *Id.* at 489 n.1.
148. *Id.* at 489-90.

Chilton IRA, were tax exempt pursuant to 26 U.S.C. § 402(c)(11)(A).[149] Because § 522(d)(12) did not reference 26 U.S.C. § 402(c), § 522(d)(12) did not apply to inherited IRAs.[150] The panel disagreed and ruled that the Chilton IRA was tax-exempt under 26 U.S.C. § 408.[151] The court also ruled that 26 U.S.C. § 408 defined "individual retirement accounts" to encompass many types of IRAs, including inherited IRAs, and that 26 U.S.C. § 408 exempted any IRA from taxation.[152] The Fifth Circuit noted that nearly all courts agreed with this analysis and that the bankruptcy court's ruling otherwise was reversed on appeal.[153] Accordingly, the Chilton IRA qualified for the § 522(d)(12) exemption because it was a tax-exempt account under 26 U.S.C. § 408.[154]

## V. EXEMPT ASSETS: HOMESTEAD VALUES IN EXCESS OF 11 U.S.C. § 522(p) LIMITS GO TO UNSECURED CREDITORS, NOT SECURED CREDITORS WITH UNENFORCEABLE LIENS (*IN RE MCCOMBS*)

In *In re McCombs*, the Fifth Circuit ruled that homestead values in excess of the 11 U.S.C. § 522(p) limits go to unsecured creditors generally, not judgment creditors with unenforceable liens against the homestead.[155]

In 2004, Michael McCombs and his wife, Alicia Atkinson McCombs (Atkinson), purchased property in Katy, Texas, which they claimed as a homestead.[156] In March 2006, H.D. Smith Wholesale Drug Company (H.D. Smith) obtained a judgment against McCombs for $540,000 and filed the judgment in the real property records.[157] In November, McCombs filed for Chapter 7 bankruptcy, but Atkinson did not.[158] The Chapter 7 trustee sold the Katy property, which netted over $900,000 in proceeds.[159] Because McCombs acquired the property within 1,215 days of bankruptcy, he could only claim a homestead exemption of $125,000 pursuant to § 522(p).[160]

The trustee paid $125,000 to McCombs and Atkinson and held the remaining proceeds in escrow until the issue of priority was resolved.[161] Atkinson, H.D. Smith, and the trustee all quarreled over the remaining proceeds.[162] H.D. Smith asserted that it had a judgment lien against the Katy

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149. *Id.* at 490.
150. *See id.*
151. *Id.*
152. *Id.*
153. *Id.* at 490 n.2.
154. *Id.* at 490.
155. Smith v. H.D. Smith Wholesale Drug Co. (*In re* McCombs), 659 F.3d 503, 512 (5th Cir. Oct. 2011). This case was decided by a quorum due to the death of Judge William L. Garwood. *Id.*
156. *Id.* at 506.
157. *Id.*
158. *Id.*
159. *Id.* at 506-07.
160. *Id.* at 507.
161. *Id.*
162. *Id.*

property and the judgment lien was enforceable on the homestead beyond the § 522(p) limits.[163] Thus, the remaining proceeds belonged to H.D. Smith.[164] The trustee asserted that H.D. Smith's judgment lien was unenforceable against the Katy property and that any proceeds above the § 522(p) cap should go to the bankruptcy estate for distribution to unsecured creditors.[165] Atkinson asserted that she still held an unlimited homestead right under Texas law to all the proceeds because she did not file for bankruptcy.[166] Thus, the remaining proceeds were hers.[167] Alternatively, Atkinson argued that she was owed compensation for the loss of her homestead right and that failure to compensate her was an unconstitutional taking.[168]

The bankruptcy court ruled for H.D. Smith, holding that H.D. Smith had a secured claim against any proceeds beyond the § 522(p) cap.[169] The trustee and Atkinson both appealed to the district court and filed statements of issues under Federal Rule of Bankruptcy Procedure (FRBP) 8006.[170] Before the district court could rule, the bankruptcy court certified the issues for direct appeal to the Fifth Circuit.[171] The Fifth Circuit reversed the bankruptcy court.[172]

The Fifth Circuit held that although § 522(p) can limit the debtor's homestead exemption, it does not change the nature of the property.[173] Under Texas law, a judgment creditor cannot enforce a lien against a homestead.[174] Thus, on the petition date, H.D. Smith had no enforceable interest in the Katy property.[175] Critically, § 522(p) did not make H.D. Smith's judicial lien enforceable against the Katy property.[176] Instead, the Fifth Circuit ruled that the proceeds in excess of § 522(p)'s limit flowed to the bankruptcy estate for general distribution to unsecured creditors.[177]

Next, the Fifth Circuit held that Atkinson waived her appeal by failing to preserve her issues for appeal.[178] The panel began by holding that Atkinson was required to file a statement of issues.[179] Atkinson argued that she did not need to file a statement of issues because the case was certified for direct

163. *Id.* at 509.
164. *Id.*
165. *Id.* at 507.
166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.*
170. *Id.* at 510.
171. *Id.* at 507.
172. *Id.* at 509.
173. *Id.* at 508-09.
174. *Id.* at 508.
175. *Id.* at 509.
176. *Id.*
177. *Id.* The trustee also argued that enforcing H.D. Smith's lien would violate the automatic stay and 11 U.S.C. § 549. *Id.* Because the panel found that H.D. Smith's lien was unenforceable as a matter of law, it did not address these issues. *Id.*
178. *Id.* at 513.
179. *Id.* at 509-10.

appeal.[180] The panel disagreed.[181] Under 28 U.S.C. § 158(d)(2), the Federal Rules of Appellate Procedure (FRAP) applied to all bankruptcy appeals to the Fifth Circuit, including direct appeals from the bankruptcy court.[182] FRAP 6(b)(2)(B)(i) specifically required Atkinson to file a statement of issues to be presented on appeal.[183]

The panel noted that Atkinson did file a statement of issues to the district court under FRBP 8006 but failed to file the statement of issues with the Fifth Circuit.[184] Despite this oversight, the panel treated the FRBP 8006 statement of issues as if Atkinson had filed it with the Fifth Circuit.[185]

The panel found that Atkinson's statement of issues failed to properly preserve her issues for appeal.[186] Fatally, Atkinson's statement of issues was a direct copy of the trustee's statement.[187] The trustee's statement did not raise the issues of whether the wife of a debtor had an enforceable, unlimited homestead right in her husband's bankruptcy proceedings or whether the elimination of that right constituted an unconstitutional taking.[188] The bankruptcy court had specifically addressed those issues in its original order, and the trustee had no indication that Atkinson was raising those issues on appeal.[189] Accordingly, Atkinson waived those issues.[190]

## VI. ESTATE PROPERTY: ESTATE PROPERTY CAN INCLUDE FUNDS IN AN ACCOUNT WHEN THE DEBTOR HAS NO LEGAL INTEREST IN THE ACCOUNT BUT EXERCISES CONTROL OVER THE MONEY (*IN RE IFS FINANCIAL CORP.*)

In *In re IFS Financial Corp.*, the Fifth Circuit ruled that a debtor's property can include funds in an account that the debtor controls even if the debtor does not possess any formal or legal ownership rights in the account.[191]

IFS Financial Corporation (IFS) and several related entities (collectively the Interamericas) operated in the insurance, mortgage, and banking services industries.[192] A single advisory board controlled all the Interamericas entities.[193] Interamericas misled its investors into believing that their investments were safeguarded and segregated in several accounts at the "Integra

180. *Id.* at 510.
181. *Id.*
182. *Id.* at 510-11.
183. *Id.*
184. *Id.* at 511.
185. *Id.*
186. *Id.* at 512.
187. *Id.*
188. *Id.*
189. *Id.*
190. *Id.*
191. Stettner v. Smith (*In re* IFS Fin. Corp.), 669 F.3d 255, 264-65 (5th Cir. Jan. 2012).
192. *Id.* at 258.
193. *Id.*

Bank."[194] Instead, Interamericas deposited its investors' capital into several bank accounts, including one in the name of Integra Bank, at Southwest Bank of Texas (the Integra Account).[195] Integra Bank, controlled by the advisory board, never acted as a bank.[196]

In 1997, unrelated litigation revealed that the Interamericas enterprise was financially unsound.[197] Afterwards, the advisory board caused Interamericas to transfer money to advisory board members and caused Interamericas to sell several of the Interamericas subsidiaries.[198] By 2002, IFS was the only solvent Interamericas company.[199]

In 2002, IFS filed for Chapter 7 bankruptcy.[200] The IFS trustee sued to avoid $3 million in transfers from the Integra Account to the advisory board members under Texas law, as applied by § 544(b).[201] The trustee claimed fraud, aiding and abetting fraudulent transfers, and conspiracy.[202] After a series of trials, the bankruptcy court found the following: (i) the funds in the Integra Account were property of the IFS estate because IFS controlled the Integra Account; (ii) the funds were paid to the defendants as part of a fraudulent scheme; and (iii) the defendants knew or should have known about the fraudulent scheme.[203] The defendants appealed to the district court, which affirmed the bankruptcy court's ruling.[204] The Fifth Circuit affirmed.[205]

First, the panel considered whether the funds in the Integra Account were property of the IFS estate.[206] The defendants argued that no fraudulent transfers occurred because the money in the Integra Account was not property of the estate.[207] IFS could not be the owner of the Integra Account because IFS did not have any legal title to the accounts.[208] The trustee agreed that IFS had no legal ownership interests because (i) IFS did not legally own the account or possess any formal control over the Integra account; (ii) IFS had no ownership interests in Integra Bank; (iii) no one at IFS was an officer, director, or employee of Integra Bank; and (iv) IFS had no formal authority over Integra Bank.[209] Instead, the trustee argued that IFS had de facto control over the

194. *See id.*
195. *Id.*
196. *Id.*
197. *Id.* at 259.
198. *Id.*
199. *Id.*
200. *Id.*
201. *Id.* at 257, 259.
202. *Id.* at 259.
203. *Id.* at 260.
204. *Id.*
205. *Id.* at 265.
206. *Id.* at 261-62.
207. *See id.* at 262.
208. *Id.*
209. *See id.*

Integra Account and that this control was sufficient to find that IFS owned the funds in the Integra Account.[210]

The Fifth Circuit was confronted with the following issue of first impression: Did the bankruptcy estate include accounts over which the debtor had no legal ownership but controlled through other means?[211] The court concluded that control was sufficient by itself; a bankruptcy estate could include accounts when it had no legal ownership but did exercise de facto control.[212]

After reviewing Texas and federal case law, the Fifth Circuit concluded that "control is the primary determinant of ownership of bank accounts."[213] The court noted that in *In re Southmark* the Fifth Circuit held that a debtor's property included all commingled money in a joint account because the debtor could exercise unfettered control over that money.[214] Similarly, the Texas Supreme Court ruled that the legal owner of an account was not the actual owner when an unknown third party withdrew money from the account on the same day money was deposited.[215] Thus, Texas law required that the court consider the particular facts when determining ownership of an account.[216]

The panel was careful to say that the inquiry was fact specific.[217] Control over the account was the primary factor, but legal ownership was not irrelevant.[218] A key factor was the presence of fraud.[219] Technical legal ownership might be less persuasive if there is evidence of a fraudulent scheme but might be critical when no fraud occurred.[220]

The court then turned to the facts in the case. The bankruptcy court found that IFS exercised control over the funds in several ways: (i) the Interamericas subsidiaries controlled the Integra Account at IFS's direction; (ii) a single advisory board controlled all the various entities; (iii) IFS used the Integra Account as its general operating fund; and (iv) the entire corporate structure was a sham to perpetrate a fraud.[221] The Fifth Circuit held that the bankruptcy court did not clearly err when making these findings and supported the finding that IFS owned the Integra Account.[222]

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210. *See id.*
211. *Id.*
212. *See id.*
213. *Id.* at 264.
214. *Id.* at 262-63 (citing Southmark Corp. v. Grosz (*In re* Southmark Corp.), 49 F.3d 1111, 1116-17 (5th Cir. 1995)).
215. *Id.* at 262 (citing Silsbee State Bank v. French Mkt. Grocery Co., 132 S.W. 465, 466 (Tex. 1910)).
216. *See id.*
217. *Id.*
218. *Id.* at 264.
219. *See id.*
220. *Id.*
221. *Id.*
222. *Id.*

Next, the panel affirmed the bankruptcy court's findings that the defendants received fraudulent transfers.[223] The court noted that the defendants failed to raise any argument that would merit reversal.[224] In contrast, the trustee successfully proved several badges of fraud that suggested actual fraudulent transfers: (i) IFS made transfers to insiders; (ii) IFS concealed the transfers; (iii) the transfers were made during litigation; (iv) IFS transferred substantially all of its assets; (v) IFS concealed assets during litigation; and (vi) IFS did not receive reasonably equivalent value from the defendant.[225] Thus, the record supported the bankruptcy court's findings that the transfers were actual fraudulent transfers.[226]

## VII. NONDISCHARGEABLE DEBTS: ARBITRATION AWARDS ARISING OUT OF MERITLESS LITIGATION CAN BE NONDISCHARGEABLE DEBTS UNDER 11 U.S.C. § 523(a)(6) BECAUSE THEY MAY BE "WILLFUL AND MALICIOUS" (*SHCOLNIK V. RAPID SETTLEMENTS, LTD.*)

The Fifth Circuit reversed the district court's granting a motion for summary judgment on whether an arbitration award for attorney's fees was a nondischargeable debt under 11 U.S.C. § 523(a)(6) because there was a genuine issue of material fact as to whether the debt was the result of the debtor's "willful and malicious" acts.[227]

Scott Shcolnik worked for Capstone Associated Services and Rapid Settlements, Ltd. (collectively Rapid).[228] In 2004, Rapid offered an ownership interest to Shcolnik, but he rejected the offer.[229] Afterwards, Shcolnik claimed to be a partial owner of Rapid, and he was fired.[230] According to Rapid, Shcolnik stole various documents from Rapid as he left.[231] Later, he sent e-mails to Rapid threatening to disclose certain "criminal . . . violations" if Rapid did not buy out his "interest[]" for over $1 million.[232] He also threatened Rapid employees with a massive series of legal attacks that would leave them "disbarred, broke, professionally disgraced, and rotting in a prison cell."[233]

Rapid sued Shcolnik and initiated arbitration proceedings seeking a declaratory judgment that Shcolnik did not have any ownership interest in Rapid or any related entity.[234] The arbitrator ruled for Rapid and awarded it

223. *Id.* at 264-65.
224. *Id.* at 265.
225. *Id.*
226. *See id.*
227. Shcolnik v. Rapid Settlements, Ltd. (*In re* Shcolnik), 670 F.3d 624, 626 (5th Cir. Feb. 2012).
228. *Id.*
229. *Id.*
230. *Id.*
231. *Id.*
232. *Id.* at 627.
233. *Id.*
234. *Id.*

$50,000 in attorney's fees (the Arbitration Award).[235] A state court confirmed the award, and Shcolnik filed for bankruptcy.[236] In the bankruptcy proceeding, Rapid filed a complaint alleging that the Arbitration Award was nondischargeable on two grounds.[237] The Arbitration Award was a debt for fraud or defalcation while acting in a fiduciary capacity and nondischargeable under § 523(a)(4).[238] Alternatively, the Arbitration Award was a debt for willful and malicious injury to another entity and nondischargeable under § 523(a)(6).[239]

Both parties moved for summary judgment.[240] The bankruptcy court granted Shcolnik's motion for summary judgment without opinion.[241] The district court affirmed and Rapid appealed.[242] The Fifth Circuit reversed the district court, holding that there was a genuine issue of material fact as to whether the Arbitration Award was a debt for willful and malicious injury.[243]

First, the court held that the Arbitration Award was not nondischargeable under § 523(a)(4).[244] Under § 523(a)(4), a debt is nondischargeable if it is "*for* fraud or defalcation *while acting* in a fiduciary capacity."[245] Although Shcolnik was an officer of Rapid and acting in a fiduciary capacity, the Arbitration Award did not arise because of Shcolnik's actions as an officer.[246] Rather, the panel found that the Arbitration Award arose out of Shcolnik's false claims of being a partial owner of Rapid.[247]

Second, the Fifth Circuit held that the Arbitration Award was nondischargeable under § 523(a)(6).[248] The panel first addressed the district court's ruling.[249] The district court, interpreting *Kawaauhau v. Geiger*, ruled that a debt is nondischargeable under § 523(a)(6) only if the debtor intended that "the alleged injury itself" actually occur.[250] The district court found that Rapid never alleged that Shcolnik intended to cause the Arbitration Award; rather, Shcolnik intended to cause Rapid to pay $1 million.[251]

The Fifth Circuit reversed.[252] The panel noted that the district court failed to consider Fifth Circuit precedent interpreting *Kawaauhau*.[253] In *In re Miller*,

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235. *Id.*
236. *See id.*
237. *See id.*
238. *See id.*
239. *See id.*
240. *Id.*
241. *Id.*
242. *Id.*
243. *Id.* at 630.
244. *See id.* at 628.
245. *Id.* (quoting 11 U.S.C. § 523(a)(4) (2011)).
246. *See id.*
247. *See id.*
248. *See id.*
249. *Id.* at 629.
250. *Id.* (citing Kawaauhau v. Geiger, 523 U.S. 57, 64 (1998)).
251. *Id.*
252. *Id.* at 630.

the Fifth Circuit ruled that an injury is "willful and malicious" under § 523(a)(4) if there is either an objective, substantial certainty that the act will cause harm or a subjective motive by the debtor to cause harm.[254] Here, both elements potentially existed.[255] Shcolnik's hostile e-mails demonstrated a clear intent to cause harm to Rapid.[256] Further, Shcolnik's behavior had a substantial certainty of causing harm to Rapid because it was foreseeable that Rapid would file litigation to prevent Shcolnik from claiming to be an owner of Rapid.[257] In either case, there was a genuine issue of material fact as to whether Shcolnik's acts were willful and malicious.[258]

Further, in *In re Keaty*, the Fifth Circuit held that sanctions arising from bad faith litigation tactics were nondischargeable debts because bad faith litigation tactics were willful and malicious.[259] The panel applied *In re Keaty*, holding that the costs of filing a declaratory action to defend against meritless litigation would be nondischargeable as well:

> It would make no sense for the infliction of expense in litigating a meritless legal claim to constitute willful and malicious injury to the creditor, as in *Keaty*, while denying the same treatment here to the infliction of expense by a debtor's attempt to leverage an equally baseless claim through a campaign of coercion.[260]

Next, the panel addressed the fact that the arbitrator did not make a specific finding that Shcolnik acted in bad faith.[261] The panel found that the absence of a bad faith finding was not conclusive.[262] Under Texas law, the arbitrator had authority to award attorneys' fees without such a finding.[263] Absent an explicit finding of good faith, there was a fact question as to whether Shcolnik acted in good faith.[264]

After reviewing the record, the panel held that there was still a genuine issue of material fact as to whether Shcolnik's "claims of ownership were made in bad faith as a pretense to extract money from the Appellants."[265] Accordingly, the bankruptcy court erred in granting the motion for summary judgment.[266]

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253. *Id*. at 629.
254. *Id.* (citing Miller v. J.D. Abrams Inc. (*In re* Miller), 156 F.3d 598, 606 (5th Cir. 1998)).
255. *See id.*
256. *See id.* at 629-30.
257. *See id.*
258. *Id.* at 630.
259. *Id.* at 629 (citing Raspanti v. Keaty (*In re* Keaty), 397 F.3d 264, 273 (5th Cir. 2005)).
260. *Id.*
261. *See id.*
262. *See id.* at 629 n.4.
263. *See id.*
264. *See id.*
265. *Id.* at 630.
266. *Id.*

Judge Haynes dissented, arguing that the majority opinion effectively transformed the costs of losing legal positions into nondischargeable debts because of some hostile e-mails.[267] While Shcolnik's hostile e-mails were insulting and demeaning, they did not make Shcolnik's claim that he had an ownership interest in Rapid a bad faith argument.[268]

In addition, Judge Haynes argued that the majority opinion misapplied the holding in *Keaty*.[269] In *Keaty*, the state judge made an explicit finding that the attorneys violated Louisiana law.[270] Here, the arbitrator made no such finding.[271] Rather, the arbitrator, Judge Haynes argued, implicitly found that Shcolnik had a good faith legal argument.[272] Critically, Judge Haynes noted that the arbitrator made no finding of "coercion, contempt, fraud, or any other of the allegedly bad acts."[273] Further, the arbitrator did not award Rapid their full attorneys' fees but reduced them by $20,000, which was inconsistent with a finding of willful and malicious conduct.[274] Additionally, the arbitrator noted that Rapid held Shcolnik out as an owner of the company and that this conduct was an "excusable mistake[]."[275] Thus, according to Judge Haynes, the arbitrator found that Shcolnik's claims had *some* basis, even if he ultimately lost and could not be willful and malicious.[276]

Finally, Judge Haynes argued that there was no causal connection between Shcolnik's hostile e-mails and the Arbitration Award.[277] Shcolnik sent his hostile e-mails on May 25, and 27, 2005.[278] On May 27, 2005, the state district court granted a temporary injunction against Shcolnik from carrying out his threats until the litigation concluded.[279] The parties did not enter arbitration until six months later.[280] Accordingly, the Arbitration Award was not a debt caused by Shcolnik's hostile behavior.[281]

267. *See id.*at 630-32 (Haynes, J., dissenting).
268. *Id.* at 630-31.
269. *Id.* at 631 (citing Raspanti v. Keaty (*In re* Keaty), 397 F.3d 264, 273 (5th Cir. 2005)).
270. *See In re Keaty*, 397 F.3d at 273.
271. *In re Shcolnick*, 670 F.3d at 632.
272. *See id.*
273. *Id.*
274. *Id.*
275. *Id.*
276. *Id.*
277. *Id.* at 632-33.
278. *Id.* at 632.
279. *Id.* at 632-33.
280. *Id.* at 633.
281. *Id.*

## VIII. NONDISCHARGEABLE DEBTS: THE TERM "STATEMENTS RESPECTING THE DEBTOR'S OR INSIDER'S FINANCIAL CONDITION" IN 11 U.S.C. § 523(a)(2)(B) REFERS TO STATEMENTS OF THE DEBTOR'S OVERALL FINANCIAL CONDITION (*IN RE BANDI*)

In *In re Bandi*, the Fifth Circuit held that the term "statement[s] respecting the debtor's or insider's financial condition" in 11 U.S.C. § 523(a)(2)(B) refers to statements of the debtor's overall financial condition.[282]

At the behest of Stephen and Charles Bandi (the Bandis), Christopher Becnel loaned $150,000 to RSB Companies (RSB), which in turn executed a promissory note to him.[283] The Bandis each personally guaranteed the note.[284] RSB defaulted, and Becnel obtained judgments against both Bandi brothers (the RSB Debt).[285] The Bandis each filed for Chapter 7 and sought a discharge of the RSB Debt.[286] Becnel sued in bankruptcy court, asserting that the RSB debts were nondischargeable pursuant to § 523(a)(2)(A) and § 523(a)(2)(B) because the debt was obtained through fraud.[287] Becnel alleged that the Bandis defrauded him by lying about owning certain real estate and presenting him a false list of RSB's accounts receivable.[288] Becnel asserted that he would never have made the loan to RSB if he had known about the misrepresentations.[289]

After a consolidated trial, the bankruptcy court found that the RSB Debt was procured through actual fraud and denied the Bandis a discharge on the RSB Debt under § 523(a)(2)(A).[290] The Bandis appealed to the district court, which affirmed the bankruptcy court's ruling.[291] The Bandis appealed to the Fifth Circuit, and the Fifth Circuit affirmed.[292]

First, the Fifth Circuit addressed the definition of "statement respecting the debtor's or an insider's financial condition."[293] The *In re Bandi* court explained that debts obtained by fraud are nondischargeable under § 523(a)(2) but that the statute treats different types of fraud differently.[294] Section 523(a)(2)(A) deals with money obtained by "false pretenses, false representations, or actual fraud" but does not cover money obtained by "a statement respecting the debtor's or an insider's financial condition."[295]

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282. Bandi v. Becnel (*In re* Bandi), 683 F.3d 671, 674 (5th Cir. June 2012), *cert. denied*, 133 S. Ct. 845 (2013).
283. *Id.* at 673.
284. *Id.*
285. *Id.*
286. *Id.*
287. *Id.*
288. *Id.*
289. *Id.*
290. *Id.*
291. *Id.* at 674.
292. *Id.*
293. *Id.*
294. *Id.*
295. *Id.* at 673-74.

Instead, § 523(a)(2)(B) deals with this particular kind of fraud.[296] Section 523(a)(2)(B) makes debt obtained from "a statement respecting the debtor's or an insider's financial condition" nondischargeable only if (i) the statement was materially false; (ii) the creditor reasonably relied on the writing; and (iii) the debtor caused the document to be made or published with the intent to deceive.[297] Accordingly, proving fraud based on "a statement respecting the debtor's or an insider's financial condition" under § 523(a)(2)(B) is more difficult than proving fraud generally under § 523(a)(2)(A).[298]

The Bandis argued that the statements about real estate and the accounts receivable list were statements respecting the debtor's financial condition and that § 523(a)(2)(A) did not apply.[299] The court disagreed, and the panel held that the term "statement respecting the debtor's or an insider's financial condition" meant statements that described the "general overall financial condition of an entity or individual, that is, the overall value of property and income as compared to debt and liabilities."[300] Statements regarding specific assets or debt did not qualify.[301]

The panel found support for this interpretation in Supreme Court jurisprudence and the Bankruptcy Code.[302] First, in *Field v. Mans*, the Supreme Court equated the term with a debtor's statement about his bank balance and explained that the legislative history suggested that § 523(a)(2)(B) dealt with false financial statements of general conditions to specifically address the fear that *creditors* might misuse false financial statements.[303] Second, the Bankruptcy Code used the term "financial condition" to define insolvency in three separate locations.[304] Because insolvency described the debtor's status generally, this suggested that "financial condition" described a general evaluation of all the debtor's debts and assets.[305]

The Bandis asserted that the Fifth Circuit interpreted the term more broadly in *In re Mercer*.[306] The panel disagreed.[307] If anything, the *In re Mercer* decision supported the panel's interpretation because the *In re Mercer* court indicated that the Fifth Circuit believed that the term "financial condition" meant overall financial condition of the debtor.[308]

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296. *Id.*
297. *Id.*
298. *Id.*
299. *Id.*
300. *Id.* at 676.
301. *Id.*
302. *Id.* at 675-76.
303. *Id.* (citing Field v. Mans, 516 U.S. 59 (1995)).
304. *Id.* at 676 (quoting 11 U.S.C. § 523(a)(2)(A), (B) (2011)).
305. *Id.*
306. *Id.* at 678.
307. *Id.*
308. *Id.* (citing AT&T Universal Card Servs. v. Mercer (*In re* Mercer), 246 F.3d 391, 399 (5th Cir. 2001) (en banc)).

The *In re Bandi* court recognized that there is a circuit split on the issue.[309] The Eighth and Tenth Circuits reasoned that the term applied to statements "that purport to present a picture of the debtor's overall financial health."[310] In contrast, the Fourth Circuit held that a representation, which pledged collateral was unencumbered by other liens, was a "statement respecting the debtor's or an insider's financial condition."[311]

Applying the term to the present case, the panel ruled that the Bandis' statements regarding real estate and accounts receivable did not qualify as "statement[s] respecting the debtor's or an insider's financial condition" because they did not provide an overall picture of debts and assets.[312] Accordingly, § 523(a)(2)(A) applied.[313]

Second, the panel held that the bankruptcy court did not clearly err by finding that the Bandis obtained the money by actual fraud.[314] The panel found that there was sufficient evidence to show that the Bandis made misrepresentations and that Becnel relied on those misrepresentations.[315] The panel noted that the evidence was weakest on whether the Bandis had intent to deceive.[316] Fatally, the Bandis failed to present any evidence to support their case.[317] Accordingly, the weak evidence was uncontroverted.[318] As a result, the bankruptcy court did not clearly err.[319]

Third, the Fifth Circuit addressed whether the bankruptcy court's rulings prejudiced the Bandis.[320] The Bandis asserted that the bankruptcy court changed its interpretation of the term "a statement respecting the debtor's or an insider's financial condition" over the course of the adversary proceeding after the Bandis chose their defensive strategy, which prejudiced their defense.[321] After reviewing the entire record, the Fifth Circuit held that the Bandis were not prejudiced by the bankruptcy court's interpretation of "statement respecting the debtor's . . . financial condition."[322] First, the panel noted that although Stephen Bandi attempted to raise the issue before trial, he did not do so effectively until after trial on a post-trial motion.[323] Second, the panel found that the bankruptcy court did not take inconsistent positions on the term because it never definitely ruled on the interpretation of the term until the post-

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309. *Id.* at 677.
310. *Id.* (quoting Cadwell v. Joelson (*In re* Joelson), 427 F.3d 700, 706-07 (10th Cir. 2005)).
311. *Id.*
312. *Id.* at 678-79.
313. *Id.*
314. *Id.* at 679.
315. *Id.*
316. *Id.*
317. *Id.* at 679-80.
318. *See id.* at 680.
319. *Id.*
320. *See id.*
321. *Id.*
322. *Id.*
323. *Id.*

trial motion.[324] Third, the panel found that the Bandis had no reasonable basis to believe that the bankruptcy court adopted their interpretation of "a statement respecting the debtor's . . . financial condition" because the adversary proceeding went to trial.[325]

## IX. Conflicts of Interest: A Secured Creditor Paying the Debtor's Lawyers' Retainer Is Not a Per Se Disqualifying Conflict of Interest (*In re American International Refinery, Inc.*)

In *In re American International Refinery, Inc.*, the Fifth Circuit ruled that when evaluating an adverse interest between a professional and the estate, the bankruptcy court must consider the totality of the circumstances to determine whether the adverse interest rises to the level of a disqualifying conflict of interest.[326] Applying this rule, the Fifth Circuit held that a secured creditor paying the debtor's lawyers' retainer is not a per se disqualifying interest.[327]

Adams & Reese, LLP (A&R) represented American International Petroleum Company and American International Refinery, Inc. (the debtors) during their bankruptcy.[328] Throughout the bankruptcy, A&R failed to disclose two conflicts of interest.[329]

First, A&R failed to disclose that it had performed work for the debtors pre-petition.[330] Before the bankruptcy, the debtors sold a corporate asset for $5 million and used the proceeds to pay back wages and benefits to the debtors' officers.[331] A&R advised the debtors on the accounting treatment of the payments to insiders.[332] Second, A&R failed to disclose its relationship with GCA Strategic Investment Fund Limited (GCA), the largest secured creditor.[333] A&R had represented the debtors in pre-petition negotiations with GCA in an effort to stave off bankruptcy.[334] Also, GCA loaned the debtor $200,000 and wired the proceeds directly to A&R to pay the debtors' retainer.[335]

During the bankruptcy, GCA's secured claim was a hotly litigated issue.[336] Eventually, the parties settled the dispute so that all unsecured creditor's claims would be paid in full and the equity holders would receive a distribution.[337]

324. *Id.*
325. *See id.*
326. Waldron v. Adams & Reese, LLP (*In re* Am. Int'l Refinery, Inc.), 676 F.3d 455, 462 (5th Cir. Mar. 2012).
327. *See id.*
328. *Id.* at 459-60.
329. *Id.* at 459.
330. *Id.*
331. *Id.* at 459 & n.1.
332. *Id.* at 459.
333. *Id.*
334. *Id.*
335. *Id.* at 460.
336. *Id.*
337. *Id.*

The bankruptcy court awarded A&R nearly $680,000 in fees and over $63,000 in costs.[338] A&R, however, failed to disclose GCA's payment of its retainer in three separate applications for compensation.[339]

The trustee sued A&R for disgorgement based on the conflicts of interest and the failure to disclose.[340] After amending its complaint two times, the trustee moved for leave to amend his complaint a third time to "add claims for fraud, fraudulent inducement, conspiracy, and breach of fiduciary duty."[341] The bankruptcy court denied the motion as to all counts except breach of fiduciary duty.[342] The bankruptcy court granted a motion for partial summary judgment dismissing the breach of duty claim.[343] The disgorgement claim went to trial.[344]

The bankruptcy court found that A&R did not have a disqualifying conflict of interest but that its failure to disclose warranted sanctions.[345] The bankruptcy court sanctioned A&R $135,000 or approximately twenty percent of its fee.[346]

First, the Fifth Circuit evaluated whether the bankruptcy court erred when finding that A&R did not have a disqualifying conflict of interest. The "Bankruptcy Code requires that any professional [employed] by the debtor in possession not 'hold . . . an interest adverse to the estate.'"[347] A professional has an adverse interest to the estate if he "possess[es] or assert[s] any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or . . . possess[es] a predisposition under circumstances that render such a bias against the estate."[348] Under § 328(c), the court may deny all compensation to a professional that has an adverse interest to the estate.[349] The court, however, does not need to deny all compensation if the professional has an adverse interest but otherwise acts in a disinterested manner.[350]

The trustee asserted that A&R had disqualifying conflicts of interest because A&R was biased against the estate in two ways.[351] First, A&R favored GCA over the estate because GCA paid A&R's retainer and worked with A&R

338. *Id.*
339. *Id.*
340. *Id.*
341. *Id.*
342. *Id.*
343. *Id.*
344. *Id.*
345. *Id.*
346. *Id.*
347. *Id.* at 461 (quoting 11 U.S.C. § 327(a) (2006)).
348. *Id.* (quoting I.G. Petrol., L.L.C. v. Fenasci (*In re* W. Delta Oil Co.), 432 F.3d 347, 356 (5th Cir. 2005)).
349. *Id.* at 462 (citing *In re W. Delta Oil Co.*, 432 F.3d at 354-55).
350. *Id.*
351. *Id.*

in pre-petition negotiations.[352] Second, A&R favored itself by failing to challenge the legal work it did for the debtor pre-petition.[353]

First, the Fifth Circuit considered whether A&R had a disqualifying conflict of interest because GCA paid A&R's retainer.[354] The panel noted that some courts "found that payment of a retainer by a third party is a per se disqualification" that warranted denying all compensation.[355] The court declined to adopt this test because it was inconsistent with Fifth Circuit case law in *In re West Delta Oil Co.*[356] Rather, the court held that *In re West Delta Oil Co.* required the court to consider the totality of the circumstances when evaluating a conflict of interest.[357] Pursuant to that case law, a bankruptcy court should evaluate the totality of the circumstances to determine whether the payment of a retainer by a third party creates a disqualifying conflict of interest.[358]

Even though there was no per se rule, the trustee argued that the totality of the circumstances demonstrated how A&R favored GCA at the expense of the debtor's estate: (i) A&R submitted bankruptcy plans favorable to GCA; (ii) A&R decided to not litigate against GCA's secured claim; and (iii) A&R drafted a motion for relief of stay on behalf of GCA during the bankruptcy.[359] According to the trustee, these facts showed that A&R had a disqualifying conflict of interest.[360] The panel disagreed.[361] The Fifth Circuit opined that this evidence might support a finding that A&R had a disqualifying conflict of interest.[362] Nonetheless, the panel also stated that the evidence also supported a more innocent interpretation.[363] The bankruptcy court—considering all the evidence—adopted the more innocent interpretation, finding that (i) A&R submitted bankruptcy plans favorable to GCA because the debtors needed GCA's support; (ii) A&R decided to not litigate GCA's claim because of the costs involved; and (iii) A&R drafted a relief motion as part of a negotiation strategy.[364] Because the evidence supported both interpretations, the bankruptcy court's fact findings were not in clear error.[365]

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352. *Id.* at 462-63.
353. *Id.* at 463-65.
354. *Id.* at 462-63.
355. *Id.* at 462 (citing *In re* Lotus Props. LP, 200 B.R. 388, 391-96 (Bankr. C.D. Cal. 1996)).
356. *Id.* (citing I.G. Petrol., L.L.C. v. Fenasci (*In re* W. Delta Oil Co.), 432 F.3d 347, 356 (5th Cir. 2005)).
357. *Id.*
358. *Id.*
359. *Id.* at 463-64.
360. *Id.* at 464.
361. *Id*. (quoting 11 U.S.C. § 327(a) (2006)).
362. *Id.*
363. *Id.*
364. *Id.*
365. *Id.*

Next, the panel considered whether A&R had a disqualifying conflict of interest because of the pre-petition work it did for the debtors.[366] The panel held that "earlier legal work can require disqualification of counsel under certain circumstances."[367] The bankruptcy court found that A&R never represented the debtor pre-petition and that there was no conflict.[368] The panel found that the bankruptcy court clearly erred in its finding.[369] The evidence demonstrated that A&R advised the debtors on the accounting treatment of several transfers to insiders.[370] The trustee asserted that A&R's pre-petition work represented a disqualifying conflict because A&R failed to avoid the transfers it had helped structure.[371] The panel found that there was no evidence to support this allegation.[372] Rather, the evidence showed that A&R counseled against disputing the transfers because of the costs.[373] Thus, the pre-petition work was not a disqualifying conflict of interest.[374]

Second, the Fifth Circuit reviewed the bankruptcy court's sanctions against A&R for its failure to disclose.[375] FRBP 2014(a) requires professionals applying for compensation to disclose all connections to the parties in the bankruptcy, whether or not they might rise to the level of a disqualifying interest.[376] Courts may deny some or all compensation to professionals who fail to make a full disclosure.[377] Further, courts should punish intentional nondisclosure more harshly than inadvertent nondisclosure.[378]

The trustee argued that the record showed that A&R intentionally failed to disclose its adverse interests and that the bankruptcy court should have sanctioned A&R more than $135,000.[379] The panel found that the record supported the bankruptcy court's findings.[380] The bankruptcy court found that A&R's non-disclosure was inadvertent.[381] A&R's attorneys believed they had made full disclosure during the initial proceedings and only failed to do so because of negligence caused by an inexperienced associate and poor

366. *Id.* at 464.
367. *Id.* at 465 (citing I.G. Petrol., L.L.C. v. Fenasci (*In re* W. Delta Oil Co.), 432 F.3d 347, 355 (5th Cir. 2005)).
368. *Id.* at 464.
369. *Id.* at 464-65.
370. *Id.* at 464.
371. *Id.*
372. *Id.* at 465.
373. *Id.*
374. *Id.*
375. *Id.*
376. *Id.* (citing I.G. Petrol., L.L.C. v. Fenasci (*In re* W. Delta Oil Co.), 432 F.3d 347, 355 (5th Cir. 2005), and Herzog v. Stopol, Inc. (*In re* Cornerstone Prods., Inc.), 416 B.R. 591, 608 (E.D. Tex. 2008)).
377. *Id.* at 465-66.
378. *Id.* at 466.
379. *Id.* at 465-66.
380. *Id.*
381. *Id.*

management.[382] Because this was a reasonable interpretation, the bankruptcy court did not clearly err by sanctioning only $135,000.[383]

Finally, the Fifth Circuit considered whether the bankruptcy court abused its discretion by denying the trustee's motion to amend his complaint to add fraud claims.[384] The panel noted that a trial court can deny a motion to amend if the litigant fails to assert the new claim promptly and if the motion to amend would "fundamentally alter the nature of the case" at a late stage.[385] Here, the trustee's motion to amend did both.[386] The record showed that the trustee possessed the evidence forming the basis of its fraud claims years before filing the motion to amend.[387] Further, the motion to amend from a disqualification suit into a fraud suit would have required expansive discovery and delayed resolution of the case.[388] Accordingly, the bankruptcy court did not abuse its discretion in denying the motion to amend.[389]

## X. ESTATE CLAIMS: DUE DILIGENCE FEES APPROVED FOR REIMBURSEMENT UNDER 11 U.S.C. § 363 DO NOT NEED TO MEET THE ADMINISTRATIVE EXPENSE STANDARD OF 11 U.S.C. § 503 (*IN RE ASARCO LLC*)

In *In re ASARCO LLC*, the Fifth Circuit held that because a bidder's due diligence fees were approved for reimbursement under 11 U.S.C. § 363, the bidder did not need to meet the higher "actual and necessary" standard for administrative expenses under 11 U.S.C. § 503.[390]

In 1999, Grupo Mexico, S.A.B. de C.V. purchased ASARCO LLC, a mining conglomerate that owned shares in Southern Peru Copper Company (SCC).[391] Grupo Mexico organized ASARCO under two subsidiaries: Americas Mining Corporation (AMC) and ASARCO Incorporated (collectively Parent).[392] Grupo Mexico caused ASARCO to transfer the SCC shares to AMC in 2003.[393] In 2005, ASARCO filed for Chapter 11 bankruptcy.[394]

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382. *Id.*
383. *Id.*
384. *Id.*
385. *Id.* at 466-67 (quoting Mayeaux v. La. Health Serv. & Indem. Co., 376 F.3d 420, 427 (5th Cir. 2004)).
386. *Id.* at 467.
387. *Id.*
388. *Id.*
389. *Id.*
390. ASARCO Inc. v. Elliot Mgmt. (*In re* ASARCO LLC), 650 F.3d 593, 597 (5th Cir. Aug. 2011) (quoting Total Minatome Corp. v. Jack/Wade Drilling, Inc. (*In re* Jack/Wade Drilling, Inc.), 258 F.3d 385, 387 (5th Cir. 2001)).
391. *Id.*
392. *Id.*
393. *Id.*
394. *Id.*

While in bankruptcy, ASARCO sued AMC for fraudulent transfers, breach of fiduciary duty, and conspiracy.[395] After a bench trial, the district court found AMC liable and awarded damages of 260 million shares of SCC and $1.4 billion in damages for past dividends and interest (the SCC Judgment).[396] The Parent appealed.[397]

During the appeal, ASARCO submitted a reorganization plan that contemplated selling the company.[398] Valuing the company was difficult because the SCC Judgment was subject to appeal.[399] To encourage bidders, ASARCO requested authorization under § 363 from the bankruptcy court to reimburse bidders expenses related to the "sophisticated legal analysis" in valuing the SCC Judgment.[400] The Parent objected to the request.[401] The bankruptcy court granted the request and entered the order (the Reimbursement Order).[402]

The Parent appealed the Reimbursement Order and moved for a stay pending appeal.[403] Two weeks after entering the Reimbursement Order, the bankruptcy court stayed the order.[404] During that two-week window, two bidders (the Bidders) incurred reimbursable expenses.[405] While the district court considered the Reimbursement Order appeal, the Parent proposed a different reorganization plan under which the Parent would regain control over ASARCO and eliminate the SCC Judgment.[406] The bankruptcy court recommended—and the district court confirmed—the Parent's reorganization plan.[407]

Because the district court confirmed the Parent's reorganization plan, the Reimbursement Order was moot.[408] Nonetheless, there was still the issue of the two-week window during which the Bidders incurred reimbursable expenses.[409] The Bidders intervened to replace ASARCO in the appeal.[410] The district court affirmed the Reimbursement Order, and the Parent appealed to the Fifth Circuit.[411] The Fifth Circuit affirmed.[412]

395. *Id.*
396. *Id.*
397. *Id.*
398. *Id.* at 597-98.
399. *Id.* at 598.
400. *Id.*
401. *Id.*
402. *Id.*
403. *Id.*
404. *Id.*
405. *Id.*
406. *Id.*
407. *Id.*
408. *Id.*
409. *Id.*
410. *Id.*
411. *Id.*
412. *Id.*

First, the Parent argued that the Fifth Circuit lacked jurisdiction over the Reimbursement Order because it was not a "final, appealable order of the bankruptcy court."[413] The panel disagreed and noted that "'[o]ur approach to determining whether an order is . . . appealable in a bankruptcy case is flexible' and we view 'finality in bankruptcy proceedings . . . in a practical, less technical light.'"[414] The court would consider a bankruptcy order final if it "constitute[d] either a final determination of the rights of the parties to secure the relief they [sought], or a final disposition of a discrete dispute within the larger bankruptcy case."[415]

Here, the Reimbursement Order decided the "discrete dispute" of whether ASARCO was permitted, in its business judgment, to reimburse a potential bidder's due diligence expenses related to valuing the SCC Judgment.[416] Thus, it was a final order subject to review.[417]

Next, the Parent argued that the bankruptcy court abused its discretion when granting the Reimbursement Order.[418] To determine whether the bankruptcy court abused its discretion, the Fifth Circuit first determined whether the Reimbursement Order should be evaluated under the § 363 standard or the § 503(b) standard.[419] Section 363 addresses the debtor's use of property of the estate and incorporates a business judgment standard.[420] Under § 363, the bankruptcy court considers the diverse interests of the debtor, creditors, and equity holders.[421] In contrast, § 503 affords the debtor much less flexibility.[422] Under § 503, parties can only recover administrative expenses that are actual and necessary to the estate.[423]

The Parent argued that the bankruptcy court erred by applying the § 363(b) standard and that the panel should apply the stricter § 503 standard.[424] The Parent argued that due diligence fees are administrative expenses.[425] Applying the § 503 standard, the Parent argued that the due diligence fees were not actual and necessary for the reorganization because the district court confirmed its alternate reorganization plan.[426] The Parent noted that two Third Circuit cases found that § 503(b) applied to bidders' requests for break-up

413. *Id.* at 599.
414. *Id.* at 599-600 (alterations in original) (quoting Tax Ease Funding, L.P. v. Thompson (*In re* Kizzee-Jordan), 626 F.3d 239, 242 (5th Cir. 2010)).
415. *Id.* at 600 (quoting *In re Kizzee-Jordan*, 626 F.3d at 242).
416. *Id.*
417. *Id.*
418. *Id.* at 601.
419. *Id.*
420. *Id.*
421. *Id.*
422. *Id.*
423. *Id.*
424. *Id.* at 601-02.
425. *Id.* at 602.
426. *Id.*

fees.[427] In both cases, the bankruptcy court refused to approve break-up fees for bidders.[428] The Third Circuit applied § 503(d) to review the bankruptcy court's decisions and found that the bidders had not proven that the fees were actual and necessary.[429]

The Fifth Circuit disagreed and decided that the § 363 standard was more appropriate.[430] The panel held that the Third Circuit cases were inapplicable because those cases differed from the ASARCO case in two critical respects.[431] First, the Third Circuit cases involved break-up fees paid only to losing bidders, which would have deterred competition by chilling the bidding process.[432] In contrast, the ASARCO Reimbursement Order reimbursed any and all second-round bidders, which increased the potential number of bidders and the competitive process.[433] Second, in the Third Circuit cases, the bidders failed to obtain bankruptcy court pre-approval for the break-up fees.[434] Thus, the bidders could only seek reimbursement after the fact as administrative expenses.[435] In contrast, in *In re ASARCO LLC*, the bidders obtained the bankruptcy court's approval *before* incurring any fees.[436]

Applying the § 363 standard, the panel affirmed the district court's findings.[437] The district court determined that (i) there was no evidence of self-dealing or manipulation between bidders and ASARCO; (ii) the Reimbursement Order facilitated the auction process; and (iii) the maximum reimbursable expenses were reasonable in comparison to the size of the SCC Judgment.[438] The district court also noted that the auction process was valuable because it encouraged the Parent to offer a more generous plan of reorganization.[439] Given these findings, and those of the bankruptcy court, the bankruptcy court did not err in issuing the Reimbursement Order.

Finally, the Parent also argued that the bankruptcy court abused its discretion by approving reimbursement procedures without sufficient judicial oversight or notice to the Parent.[440] The panel held that the Parent waived this issue by failing to raise it to the district court.[441]

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427. *Id.* at 602 (citing *In re* Reliant Energy Channelview LP, 594 F.3d 200, 208-09 (3d Cir. 2010); Calpine Corp. v. O'Brien Envtl. Energy, Inc. (*In re* O'Brien Envtl. Energy, Inc.), 181 F.3d 527, 537-38 (3d Cir. 1999)).
428. *Id.*
429. *Id.*
430. *Id.*
431. *Id.*
432. *Id.*
433. *Id.*
434. *Id.*
435. *Id.*
436. *Id.*
437. *Id.* at 603.
438. *Id.*
439. *Id.* at 603 n.10.
440. *Id.* at 600.
441. *Id.*

## XI. RECHARACTERIZATION: BANKRUPTCY COURTS CAN RECHARACTERIZE DEBT INTO EQUITY USING STATE LAW (*IN RE LOTHIAN OIL INC.*)

In *In re Lothian Oil Inc.*, the Fifth Circuit created a minor circuit split, ruling that a bankruptcy court can recharacterize debt into equity—but only under state law, not under 11 U.S.C. § 105(a).[442]

Israel Grossman was a creditor to Lothian Oil, which filed for bankruptcy.[443] Among other loans, Grossman made two loans to Lothian Oil whereby he would receive a 1% royalty interest in certain properties and payment from equity placement proceeds.[444] These loans became claims 164 and 171, respectively.[445]

Grossman settled most of his other claims with the estate for $1.03 million.[446] Grossman went to trial on the remaining claims, which the bankruptcy court denied on two grounds.[447] First, the bankruptcy court equitably recharacterized several of the remaining claims (including claims 164 and 171) as equity.[448] Second, the bankruptcy court found that the other remaining claims (including claim 174) were not debts of Lothian Oil.[449]

Grossman and several other parties appealed the bankruptcy court's rulings.[450] Grossman (not an attorney) personally signed the notice of appeal.[451] The trustee moved to dismiss all the parties except Grossman, arguing that Grossman had no authority to sign on anyone else's behalf.[452] After giving time for the other parties to correct their pleadings and them failing to do so, the district court dismissed all parties except Grossman.[453]

The district court affirmed the bankruptcy court rulings on all matters except recharacterization.[454] The district court reversed the recharacterization of claims 164 and 171, holding that the Fifth Circuit had a per se rule that only insider debt could be recharacterized into equity.[455] The debtor, Grossman, and the other parties appealed.[456] The Fifth Circuit reversed the district court's ruling on recharacterization but affirmed the remainder of the opinion.[457]

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442. Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 544 (5th Cir. Aug. 2011), *cert. denied*, 132 S. Ct. 1573 (2012).
443. *Id.* at 541.
444. *Id.*
445. *Id.*
446. *Id.*
447. *Id.*
448. *Id.* at 541-42.
449. *Id.*
450. *Id.* at 542.
451. *Id.*
452. *Id.*
453. *Id.*
454. *Id.*
455. *Id.*
456. *Id.*
457. *Id.* at 543-44.

First, the panel recognized that the Fifth Circuit had not ruled on whether bankruptcy courts had the power to recharacterize debt into equity.[458] The court held that the bankruptcy court did have this power, but only if state law allowed for such recharacterization.[459] Citing 11 U.S.C. § 502(d) and *Butner v. United States*, the panel explained that state law defined and limited a claimant's property interest.[460] Thus, if state law permitted courts to recharacterize debt into equity, then the bankruptcy court had the same authority to do so by applying state law.[461]

The panel recognized that the Third, Fourth, Sixth, and Tenth Circuits had found that bankruptcy courts could recharacterize debt into equity using its equitable powers under § 105(a).[462] The Fifth Circuit declined to adopt this approach for two reasons.[463] First, because § 502(d) and state law provided authority for recharacterization, there was no reason to look to § 105(a)'s equitable powers for authority.[464] Second, the panel noted that the Fifth Circuit adopted a "cautious view of § 105(a)" and declined to extend § 105(a)'s powers in this context.[465] Ultimately, the panel agreed "with [the] sister circuits' results but not necessarily their reasoning."[466]

Next, the court held that Texas law did not have a per se rule that only insider debt could be recharacterized.[467] Rather, Texas law applied a multifactor test based in federal tax law (similar to other circuit's recharacterization tests) to determine whether debt should be treated as equity.[468] The court held that the bankruptcy court's fact findings supported recharacterizing Grossman's debt into equity.[469] Specifically, Grossman would be paid from equity placements and royalties, meaning that the "debt" would only be repaid if Lothian succeeded, all of which supported recharacterization.[470] Thus, the bankruptcy court did not err by recharacterizing claims 164 and 171 from debt into equity.

Second, the Fifth Circuit affirmed the district court's dismissal of all the non-Grossman parties' appeals because they had not signed the notice of

458. *Id.* at 543.
459. *Id.* at 542-43.
460. *Id.* at 543.
461. *Id.*
462. *Id.* (citing Cohen v. KB Mezzanine Fund II, LP (*In re* SubMicron Sys. Corp.), 432 F.3d 448, 454 n.6 (3d Cir. 2006); Fairchild Dormier GMHB v. Official Comm. of Unsecured Creditors (*In re* Dornier Aviation (N. Am.), Inc.), 453 F.3d 225, 231 (4th Cir. 2006); Bayer Corp. v. MasoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726, 748-49 (6th Cir. 2001); Hedged-Sec. Assocs., LP v. Bronze Grp., Ltd. (*In re* Hedged-Invs. Assocs.), 380 F.3d 1292, 1298 (10th Cir. 2004)).
463. *Id.*
464. *Id.*
465. *Id.*
466. *Id.*
467. *Id.* at 544.
468. *Id.*
469. *Id.*
470. *Id.*

appeal.[471] The court ruled that the non-Grossman parties had ample opportunity to correct the signature mistake but did not do so.[472]

Third, the panel next addressed claim 174.[473] Both the bankruptcy court and district court found that claim 174 was not owed by the debtor and disallowed the claim.[474] Grossman conceded that a non-debtor owed the amounts in claim 174 but argued that the debtor owed claim 174 under an "implied contract" theory.[475] The panel found that the record did not support Grossman's new argument and held that the bankruptcy court correctly disallowed the claim.[476]

Finally, Grossman raised a new argument regarding his earlier settlement that had not been raised to the bankruptcy court or district court.[477] The panel held that Grossman waived the argument by failing to raise it to either the bankruptcy or district courts.[478]

## XII. REORGANIZATION PLANS: A PLAN OF REORGANIZATION CAN EFFECTIVELY RESERVE CAUSES OF ACTION BY DESCRIBING THE CAUSES OF ACTION AND THE POTENTIAL DEFENDANTS GENERALLY (*IN RE TEXAS WYOMING DRILLING, INC.*)

In *In re Texas Wyoming Drilling*, the Fifth Circuit clarified that a court can consider the disclosure statement when evaluating whether a plan effectively reserves a cause of action under 11 U.S.C. § 1123(b)(3).[479] In addition, the Fifth Circuit ruled that a plan does not need to identify each defendant by name to make an effective reservation.[480]

Texas Wyoming Drilling, Inc. (TWD) filed for bankruptcy.[481] The bankruptcy court confirmed a plan of reorganization when TWD emerged from bankruptcy after cancelling all of TWD's pre-petition equity interests.[482] The plan reserved all causes of action in the reorganized TWD.[483] Soon after confirmation, TWD sued several former shareholders (the Shareholders) for $4 million in fraudulent transfers in the form of dividend payments (the Avoidance Actions).[484]

471. *Id.* at 544-45.
472. *Id.*
473. *Id.* at 545.
474. *Id.*
475. *Id.*
476. *Id.*
477. *Id.* at 542.
478. *Id.*
479. Spicer v. Laguna Madre Oil & Gas II, L.L.C. (*In re* Tex. Wyo. Drilling, Inc.), 647 F.3d 547, 550-51 (5th Cir. July 2011).
480. *Id.* at 552.
481. *Id.* at 549.
482. *Id.*
483. *Id.*
484. *Id.*

The Shareholders moved for summary judgment, arguing that TWD lacked standing to sue because the plan did not effectively reserve the Avoidance Actions.[485] The bankruptcy court found that the plan did effectively reserve the Avoidance Actions.[486] The Shareholders appealed, and the bankruptcy court certified the issue for appeal directly to the Fifth Circuit.[487]

The Fifth Circuit affirmed the bankruptcy court's holdings.[488] Pursuant to Fifth Circuit case law and § 1123(b)(3), a reorganized debtor only has standing to bring a claim that is retained by the confirmed plan of reorganization.[489] The reservation must be specific and unequivocal.[490] The purpose of the reservation requirement is to ensure that potential defendants are fully informed about the consequences of voting for or objecting to a plan.[491]

First, the Fifth Circuit ruled that, when evaluating whether a plan effectively reserves a cause of action, the court should consider the disclosure statement in conjunction with the plan itself.[492] The Shareholders asserted that the court should consider the plan alone.[493] The panel reasoned that the purpose of the reservation requirement was to provide notice to parties before confirmation.[494] Disclosure statements, the panel noted, provide this precise form of notice.[495] Accordingly, it was appropriate to consider the disclosure statement when determining whether a plan of reorganization reserved causes of action.[496]

Next, the panel found that the language in the plan and the disclosure statement did successfully reserve the Avoidance Actions.[497] The panel agreed that a general "any and all claims" reservation was not an effective reservation under *In re United Operating*.[498] Nonetheless, the TWD plan and disclosure statement provided far greater detail, including (i) the existence of the Avoidance Actions; (ii) the factual basis for the Avoidance Actions; (iii) the legal basis for the Avoidance Actions; (iv) the potential recovery on the Avoidance Actions; and (v) the requirement that the reorganized debtor would

485. *Id.*
486. *Id.* TWD defaulted on the plan and converted to a Chapter 7. *Id.* The bankruptcy court also held that the conversion of the case from Chapter 11 to Chapter 7 conferred standing on the trustee. *Id.* The Fifth Circuit affirmed on alternate grounds and did not address the issue. *Id.* at 549 & n.3.
487. *Id.*
488. *Id.* at 548.
489. *Id.* at 550.
490. *Id.*
491. *Id.*
492. *Id.* at 551.
493. *Id.* at 550.
494. *Id.* at 551.
495. *Id.*
496. *Id.*
497. *Id.* at 551-52.
498. *Id.* at 552 (referencing and quoting Dynasty Oil & Gas, L.L.C v. Citizens Bank (*In re* United Operating, L.L.C.), 540 F.3d 351, 356 (5th Cir. 2008)).

pursue the Avoidance Actions.[499] This reservation was sufficient to properly reserve the claim.[500]

The Shareholders argued that the plan failed to effectively reserve the claims because it failed to identify *any* prospective defendants by name.[501] The panel disagreed.[502] First, the panel held that a confirmed plan did not need to identify prospective defendants by name.[503] Rather, a general identification was sufficient.[504] Second, the panel found that the disclosure statement made a general identification of "'[v]arious pre-petition shareholders of the Debtor' who might be sued for 'fraudulent transfer and recovery of dividends paid to shareholders.'"[505] This language was sufficient to identify potential defendants to effectively reserve a claim.[506]

Interestingly, the panel refused to rule on whether a plan must identify potential defendants at all.[507] Instead, it simply held that the plan's language met whatever standard might exist.[508] Therefore, it is an open question whether a plan must identify defendants to properly reserve a claim.[509]

Next, the Shareholders asserted that the trustee was judicially estopped from pursuing the Avoidance Actions because the debtor-in-possession took inconsistent positions during the bankruptcy.[510] The court rejected this argument because the debtor-in-possession did not take inconsistent positions.[511] Rather, the debtor-in-possession consistently asserted that it would pursue the Avoidance Actions in the plan and disclosure statement.[512]

Finally, the Shareholders asserted that the confirmation order barred the Avoidance Actions.[513] The panel rejected this argument.[514] "Res judicata does not apply where a claim is expressly reserved by the litigant in the earlier bankruptcy proceeding."[515] Because the plan did expressly reserve the Avoidance Actions, res judicata did not apply.[516]

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499. *Id.*
500. *Id.*
501. *Id.* at 551-52.
502. *Id.* at 552.
503. *Id.*
504. *Id.*
505. *Id.* at 549.
506. *Id.* at 552.
507. *Id.*
508. *Id.*
509. *See id.*
510. *Id.*
511. *Id.* at 552-53.
512. *Id.* at 553.
513. *Id.*
514. *Id.*
515. *Id.* (quoting Browning v. Levy, 283 F.3d 761, 774 (6th Cir. 2002)).
516. *Id.*

## XIII. AUTOMATIC STAY: LAWSUITS BROUGHT BY PRIVATE PARTIES THAT ARE SIMILAR TO A REGULATORY ACTION BROUGHT BY A GOVERNMENT AGENCY CAN BE EXEMPT FROM THE AUTOMATIC STAY UNDER 11 U.S.C. § 362(b)(4) (*IN RE HALO WIRELESS, INC.*)

In *In re Halo Wireless, Inc.*, the Fifth Circuit held that lawsuits to enforce telecommunications law before state public commissions were exempt from the automatic stay under 11 U.S.C. § 362(b)(4).[517]

Halo Wireless, Inc. provided wireless phone and data service pursuant to a license from the Federal Communications Commission (FCC).[518] Halo contended that "it provide[d] wireless Commercial Mobile Radio Service ('CMRS'), as defined by . . . the Federal Telecommunication Act" (FTA).[519] In a series of lawsuits before state public utility commissions (PUCs), several local telecommunication companies (the Plaintiffs) asserted that Halo was violating telecommunications law (the PUC actions).[520] Generally, the Plaintiffs asserted that Halo was regulated by state PUCs—as opposed to the FCC—and that Halo failed to obey PUC regulations.[521] According to the Plaintiffs, Halo owed them money under applicable state laws and regulations.[522]

As a result of these suits, Halo filed for bankruptcy, and the automatic stay stayed the PUC actions.[523] The Plaintiffs filed motions requesting that the PUC actions be exempt from the automatic stay under § 362(b)(4) because each PUC action was "an action or proceeding by a government unit . . . to enforce such governmental unit's or organization's police and regulatory power."[524] The bankruptcy court granted the motion but held that the PUCs could not issue any ruling or order to collect against Halo or take any action that modified the relationship between Halo and any creditor or potential creditor.[525] Halo appealed the order, and the bankruptcy court certified the issue for a direct appeal to the Fifth Circuit.[526] The Fifth Circuit affirmed.[527]

First, the Fifth Circuit addressed whether the PUC actions involved a governmental entity. Halo asserted that § 362(b)(4) did not apply to the PUC actions because they were brought by private telecommunications companies,

517. Halo Wireless, Inc. v. Alenco Commc'ns, Inc. (*In re* Halo Wireless, Inc.), 684 F.3d 581, 588-89 (5th Cir. June 2012).
518. *Id.* at 584.
519. *Id.* at 584-85.
520. *Id.* at 585.
521. *Id.*
522. *Id.*
523. *Id.*
524. *Id.* at 586 (alteration in original) (quoting 11 U.S.C. § 362(b)(4) (2006)).
525. *Id.* at 584-85.
526. *Id.* at 585-86.
527. *Id.* at 586.

not governmental agencies.[528] According to Halo, to be exempt under § 362(b)(4), the action must be commenced by a state agency.[529]

The panel disagreed.[530] The court noted that the statute's text exempted any "'commencement or *continuation of*' an action or proceeding by a government unit."[531] Here, the state PUC actions were being continued by governmental units because they were ongoing before the state PUCs.[532]

The panel noted that a few cases held that "an action must be *brought by* the governmental unit in order for it to be exempt from the automatic stay under § 362(b)(4)."[533] The panel noted, however, that other courts had applied § 362(b)(4) to situations in which a private party initiated the case but a governmental unit later intervened.[534] For example, the panel cited employment cases in which employees began unfair labor practices proceedings at the National Labor Relations Board (NLRB), the NLRB heard the issue and ruled, and then the NLRB sued to enforce its own adjudication.[535] The court "recognized that though these actions may have similarities to private litigation, they also promote the public interest by enforcing state laws and regulations."[536] Similarly, other cases held that § 362(b)(4) applied in situations in which the governmental agency had the discretion to intervene in the case.[537]

In addition, the court noted that some courts have held that actions brought by private citizens were exempt from the automatic stay under § 362(b)(4) if they served a public policy interest.[538] For example, both the Seventh and Ninth Circuits held that sanctions for frivolous litigation were exempt from the automatic stay because the purpose of such sanctions was to further public policy and enforce the court's rulings.[539] Similarly, courts have held that qui tam actions are exempt from the automatic stay as well.[540]

Thus, the PUC actions could qualify for § 362(b)(4) if either the state PUC intervened in the action or the PUC action served a public policy interest similar to a regulatory action by a state PUC.[541] The Fifth Circuit noted that the bankruptcy court did not make any findings as to how each state's PUC actually

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528. *Id.* at 588-89.
529. *Id.* at 589.
530. *Id.*
531. *Id.* (quoting § 362(b)(4)).
532. *Id.*
533. *Id.* at 590 (citing *In re* Nortel Networks, Inc., 669 F.3d 128 (3d Cir. 2011); Diaz v. State (*In re* Gandy), 327 B.R. 796 (Bankr. S.D. Tex. 2005); New York v. Exxon Corp., 932 F.2d 1020 (2d Cir. 1991)).
534. *Id.* at 589-92.
535. *Id.* at 589-90 (citing NLRB v. Evans Plumbing, 639 F.2d 291, 292 (5th Cir. Unit B 1981); D.M. Barber, Inc. v. Valverde (*In re* D.M. Barber, Inc.), 13 B.R. 962, 963 (Bankr. N.D. Tex. 1981)).
536. *Id.* at 589.
537. *Id.* at 590 (citing U.S. Int'l Trade Comm'n v. Jaffe, 433 B.R. 538, 541 (E.D. Va. 2010)).
538. *Id.* at 591.
539. *Id.* (citing Alpern v. Lieb, 11 F.3d 689, 690 (7th Cir. 1993); Berg v. Good Samaritan Hosp. (*In re* Berg), 230 F.3d 1165, 1168 (9th Cir. 2000)).
540. *Id.* at 591 n.9 (citing U.S. *ex rel.* Doe v. X, Inc., 246 B.R. 817 (E.D. Va. 2000)).
541. *Id.* at 591.

handled their respective PUC actions.[542] Nonetheless, the Plaintiffs presented some evidence that the PUCs themselves became involved in some PUC actions.[543] For example, the Georgia PUC and Missouri PUC became parties to the PUC actions once the Plaintiffs filed it.[544] Alternatively, the PUC actions were substantively identical to actions initiated by the state commissions themselves.[545] For example, the Wisconsin PUC initiated an action against Halo on the same issues as the Plaintiffs.[546] Thus, there was evidence that the PUC actions were identical to actions filed by PUCs themselves and that the PUCs became involved with the PUC actions.[547] This was sufficient to find that a governmental unit was continuing the PUC actions.[548]

Second, the Fifth Circuit considered whether the PUC actions furthered a public policy interest instead of the Plaintiffs' own pecuniary interests.[549] The court noted that there were two related, overlapping tests to determine whether proceedings fall within the police or regulatory power exception to the automatic stay: the pecuniary purpose test and the public policy test.[550] Under either test, the bankruptcy court considered the totality of the circumstances to determine whether the regulatory proceeding was primarily to protect the public safety and welfare or whether it was an attempt to recover property from the estate for the government.[551]

Here, the Fifth Circuit held that the PUC actions served the public welfare under both the public policy test and the pecuniary test.[552] The court noted that the FTA indicated that regulation of telecommunications carriers serves the public interest by ensuring access to effective telecommunications at fair prices without any unlawful discrimination.[553] Further, the FTA contemplated that state regulations would further this same public policy.[554] Similarly, the state laws creating the PUCs demonstrated their public purpose.[555] In case law, the state PUCs protected the public interest by *inter alia* ensuring access and equality to service and preventing unfair price competition.[556] The court also noted that the bankruptcy court's order limiting the effect of any monetary

542. *Id.* at 591-92.
543. *Id.* at 592.
544. *Id.*
545. *Id.*
546. *Id.*
547. *Id.*
548. *Id.*
549. *Id.*
550. *Id.* at 588.
551. *Id.*
552. *Id.* at 593.
553. *Id.* at 593-94.
554. *Id.* at 594.
555. *Id.*
556. *Id.* at 594-95.

judgment issued by the PUC ensured that the PUC actions would serve the public policy interests.[557]

Halo also argued that the PUC actions involved federal questions of law that needed to be addressed by a federal court.[558] Thus, the automatic stay should not be lifted.[559] The panel disagreed.[560] The panel noted that the FTA erected a scheme of "cooperative federalism" whereby PUCs would address certain issues subject to review by a federal court.[561] While this scheme created inefficiencies, it was consistent with congressional intent.[562] Thus, lifting the automatic stay would not violate the regulatory scheme established by the FTA.[563]

Third, the Fifth Circuit considered Halo's motion to strike a brief filed by the Missouri Public Service Commission (MoPSC).[564] MoPSC was not a party to the original motion to lift the stay and did not request permission to file an amicus brief.[565] The court noted that it had the discretion to consider the brief as an amicus brief.[566] Nonetheless, the panel granted the motion to strike because MoPSC failed to comply with FRAP 29(a) and because the MoPSC brief did not add anything consequential to the decision.[567]

Fourth, the panel considered the motion by several Plaintiffs for the Fifth Circuit to take judicial notice of publicly available orders and proceedings in some of the ongoing PUC actions.[568] Halo objected, arguing that the Plaintiffs were trying to supplement the record on appeal.[569] The panel noted that appellate courts had discretion to supplement the record on appeal, although they usually did not do so.[570] Further, the court had authority "to take judicial notice of information 'capable of accurate and ready determination by resort to a source whose accuracy on the matter cannot reasonably be questioned,'" such as the publicly available orders and proceedings referenced by the Plaintiffs.[571] The panel granted the motion but noted that the materials did not add anything material to the decision.[572]

557. *Id.* at 595.
558. *Id.* at 592.
559. *Id.*
560. *Id.*
561. *Id.* at 593 (quoting Budget Prepay, Inc. v. AT&T Corp., 605 F.3d 273, 281 (5th Cir. 2010)).
562. *Id.*
563. *Id.*
564. *Id.* at 595.
565. *Id.*
566. *Id.* at 596.
567. *Id.*
568. *Id.*
569. *Id.*
570. *Id.* at 596-97.
571. *Id.* at 597 (quoting Kitty Hawk Aircargo, Inc. v. Chao, 418 F.3d 453, 457 (5th Cir. 2005)).
572. *Id.*