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Take the First Exit!
Defenses That Can Win a Case Early

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"TAKE THE FIRST EXIT:
DEFENSES THAT CAN WIN A CASE EARLY"

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TAKE THE FIRST EXIT: DEFENSES THAT CAN WIN A CASE EARLY[1]

I. Overview/Scope of Actions Discussed.

Panel will discuss adversary proceedings in two categories—avoidance actions, and actions prosecuting estate claims under section 541. Most of the defensive matters we discuss are preemptive responses that would end the case or provide significant advantages to the defendant. We do not generally deal with responses to claims objections, and various motions in connection with sales, plan confirmation, claims objections, etc. (although some of the issues may be similar). We deal with dispositive motions as well as actions which defendants believe will have a significant value if successful. We do not deal with discovery matters.

II. Procedural and Substantive Defenses.

A. Failure to comply with pleading standards of Bell Atlantic and Iqbal.

1. Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007): This is a pleading case in which the Supreme Court tightened pleading standards; rejected Conley v. Gibson; held that the complaint must be "plausible on its face" and that the claims must come "across the line from conceivable to plausible"). See also Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499 (2007) (pleading standards under PSLRA require a "strong" inference of scienter; court must consider whether all facts alleged give rise to such a strong inference and also consider plausible non-culpable explanations; overall, complaints will survive only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any plausible opposing inference); Stoneridge Inc. Partners, LLC. v. Scientific-Atlanta, Inc., 128 S. Ct 761 (2008) (limiting 10(b) actions against aiders and abettors because, *inter alia*, extensive discovery and

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uncertainty could "allow plaintiffs with weak claims to extort settlements from innocent companies").

Bell Atlantic was a class action against local exchange carriers alleging a Sherman Act conspiracy to prevent competitive entry in local phone and Internet markets and avoid competition. The basis of the claim was parallel conduct of the carriers and no other facts were pleaded supporting the existence of a conspiracy. The district court dismissed for failure to state a claim and the court of appeals reversed. On appeal, the Supreme Court initially held that, although Rule 8(a)(2) required a short and plain statement of the claim, proper pleading requires a sufficient factual basis to provide plausibility to the allegations of an agreement. Here, however, the complaint simply alleged parallel conduct which was inadequate to show the existence of a conspiracy. And, significant, there were independent business reasons why the defendants might have acted in parallel fashion absent a conspiracy including the compartmentalized nature of the markets and the fact that monopoly had previously existed in the communications market. Thus, the complaint did not contain a sufficient factual basis for the existence of a conspiracy.

2. Ashcroft v. Iqbal, 556 U.S. 662 (2009): Plaintiff, a Muslim pretrial detainee, claimed the defendants improperly confined him and took various other actions because of his race, religion or national origin, and did not act for a legitimate penological interest. To assert such a claim, plaintiff must plead that each defendant acted not for a neutral investigative reason, but for the purpose of discrimination. The Court held that Bell Atlantic was applicable and, under Bell Atlantic, the complaint was not sufficient if supported only by conclusory statements, since such statements were not entitled to an assumption of truth. Instead, the legal conclusions must be supported by well pleaded factual allegations. Here, Iqbal's allegations that defendants acted for discriminatory reasons and no legitimate penological interest were conclusory, and his allegation that many Arab Muslim men had been subject to detention did not support the allegation of discrimination since the detention might have been warranted in light of the September 11 attack. Although the claims alleged a policy of holding these prisoners as persons "of high interest," there were no allegations suggesting that the policy was based on discriminatory factors. The pleading thus failed to plausibly allege discrimination and the Court specifically rejected the argument that Bell Atlantic was limited to the antitrust context.

3. The Take Away Points:

    a. Claim must be "plausible on its face." Bell Atlantic at 570.

    b. A pleading has facial plausibility when "the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." Iqbal at 678.

    c. A claim is plausible on its face when it contains sufficient facts to raise "a reasonable expectation that discovery will reveal evidence of illegal agreement." Bell Atlantic at 556.

    d. A pleading that offers "labels and conclusions" and a "formulaic recitation of the elements of a cause of action will not do." *Id.* at 555. And, the court is "not bound to accept as true a legal conclusion couched as a factual allegation" *Id.*; Iqbal at 678.

    e. A complaint does not suffice if it offers "naked assertion[s]" devoid of "further factual enhancement." Iqbal at 678. It must plead facts that "[nudge] their claims across the line from conceivable to plausible." Bell Atlantic at 570.

    f. Factual allegations must "raise a right to relief above the speculative level", Bell Atlantic at 555, and requires "more than a sheer possibility" that the defendant is liable. Iqbal at 678.

    g. Conley v. Gibson, the Supreme Court's 1957 notice pleading case, held that a complaint should be dismissed only if "no set of facts" possible under the complaint would justify relief. The Court, in Bell Atlantic, says that this standard has "earned its retirement." Bell Atlantic at 563.

4. Application to Bankruptcy Cases.

    a. In re Hydrogen, L.L.C., 431 B.R. 337 (Bk. SDNY 2010) was an action by the committee against current and former officers and directors of the debtor LLC and its parent objecting to proofs of claim and asserting claims for breach of fiduciary duty, avoidance of constructive fraudulent transfers, unjust enrichment, breach of employment agreements, deepening insolvency, equitable subordination, and avoidance of preferences. The debtor was a development stage company that was allegedly undercapitalized and needed additional capital, knew that asset sales would be necessary, had limited prospects of further financing but still spent large amounts, and defendants saddled the debtor with debts it allegedly would be unable to pay and insider defendants took significant bonus payments and other amounts and benefits. As to the various claims, the Court held the complaint inadequate and granted leave to amend.

i. Claimed breach of fiduciary duty by permitting the Debtor to continue operating, increasing spending, taking on additional debt and paying increasing compensation. Held, complaint failed to allege sufficient facts that defendants who were officers and directors of parent had fiduciary relationship, and when the fiduciary relationship with the Debtor began. Also, the complaint hasn't identified obligations that shouldn't have been incurred.

ii. Claimed aiding and abetting breach of fiduciary duty. Held, complaint failed to allege factual basis that the primary party's conduct was a breach of duty, and facts showing that there was substantial assistance to the primary party.

iii. Claimed constructive fraudulent transfer. Held, complaint simply alleged the elements in summary fashion, and failed to allege the facts supporting the allegation that the debtor received less than a reasonably equivalent value for various payments.

iv. Claimed state constructive fraudulent transfer. Held, no factual basis for allegations that bonus and other payments were not for a reasonably equivalent value to the debtor.

v. Claimed preferences. Held, complaint simply alleged elements without details such as date, amount or type of transfer, and failed to allege the debt for which the transfers were made.

vi. Claimed deepening insolvency (not recognized as a cause of action in some jurisdictions). Held, inadequate pleading that life of corporation was prolonged and debts were increased.

vii. Claimed breach of employment agreements. Held, complaint failed to identify agreements breached or provisions of unspecified agreements breached.

viii. Claimed unjust enrichment. Held, complaint contained conclusory allegations that debtor received no benefit in connection with payments. Also, general allegations of insolvency and financial crisis causing the problem with the payments are inadequate.

ix. Claimed equitable subordination. Held, complaint failed to designate the inequitable conduct, and specifically, the fraud, illegality or breach of fiduciary duty involved, and failed to allege the use of the debtor as a mere instrumentality.

b. <u>In re JMK Construction Group, Ltd.</u>, 502 B.R. 396 (Bk. S.D.N.Y. 2013): The Trustee of a construction company sued customer for breach of contract and unjust enrichment. The customer counterclaimed and asserted third party claims, and the president-shareholder moved to dismiss the third party claims. The Court adopted a two part test, accepting factual allegations as true but discounting legal conclusions in factual garb; and then, determining if the well-pleaded facts stated a plausible claim. According to the Court, a claim is plausible when the court can draw a reasonable inference that the defendant has acted unlawfully, and a complaint pleading facts that are merely consistent with liability or that simply recite elements of the cause of action is not adequate. The court concluded that the third-party complaint (a) failed adequately to allege a veil-piercing claim by allegations that the third party defendant made decisions on transfers of funds, failed to observe proper corporate formalities, commingled funds and had no separate identity, and failed to adequate allege complete domination; also, general allegations of personal use of funds, misrepresentation of workmanship and quality, and use of subcontractor funds were too general to support a veil piercing claim; (b) failed adequately to plead a claim for conversion because it did not specifically identify the fund converted; and (c) failed adequately to assert a claim for unjust enrichment because it failed to allege that the third party defendant received something of value that belonged to defendant.

c. There are literally hundreds of reported cases deciding pleading motions in the post-Bell Atlantic era, although at least the reported litigation seems to have calmed down in the last few years. Some recent cases of interest are: In re Madison Williams & Co., 509 B.R. 791 (Bk. S.D.N.Y. 2014) (summarizing "take away points" as above, and largely sustaining complaint); In re Direct Response Media, Inc., 466 B.R. 626 (Bk. D. Del. 2012) (pleading claims for breach of fiduciary duty, waste and mismanagement, constructive fraud, and *in pari delicto*); In re Autobacs Strauss, Inc., 473 B.R. 525 (Bk. D. Del. 2012) (multiple avoidance, recharacterization, tort and other claims; pleading largely sustained); In re Harris Agency, LLC, 465 B.R. 410 (Bk. E.D. Pa. 2011) (suit against insiders; various claims dismissed, but pleading of breach of fiduciary duty and subordination ok); In re DBSI, 476 B.R. 413 (Bk. D. Del. 2012) (pleading various fraudulent conveyance claims ok); *Id.*, 445 B.R. 351 (Bk. D. Del. 2011) (pleading of multiple tort and bankruptcy claims inadequate); Aye v. Lone Star Fund V (U.S.), L.P., 453 B.R. 645, 670 (sustaining lengthy complaint; passage of more than 3 years doesn't show adequate capitalization); In re Tweeter Opco, 452 B.R. 150 (Bk. D. Del. 2011) (preference complaint failed to state claim when numerous facts relating to transaction were not included); In re C.R. Stone Concrete Contractors, Inc., 434 B.R. 208 (Bk. D. Mass. 2010) (for pleading preference, don't have to identify specifics of transfers—probably contra to other cases); In re USDigital, Inc., 443 B.R. 22 (Bk. D. Del. 2011) (pleading various avoidance, breach of fiduciary duty, subordination and recharacterization theories); In re NE 40 Partners, L.P., 440 B.R. 124 (B k. S.D. Tex. 2010) (no relaxed pleading standards for chapter 7 trustee who had to rely on second hand information since trustee could engage in fishing expedition under Rule 2004); Flannigan v. Vulcan Power Group, L.L.C., 712 F. Supp. 2d 63 (S.D.N.Y. 2010) (fraudulent conveyance claims pled with sufficient particularity); In re USA Detergents, Inc., 418 B.R. 533 (Bk. D. Del. 2009) (pleading of various bankruptcy and tort claims adequate); In re BHS&B Holdings LLC, 420 B.R. 112 (Bk. S.D.N.Y. 2009) (various bankruptcy and tort claims inadequately pled). See also Anderson News, LLC v. American Media, Inc., 680 F.3d 162, 185-95 (in Bell Atlantic situation, detailed factual allegations showing agreement and analysis of plausibility). It is generally agreed that based on Rule 9(b) allegations of actual fraud (and actual intent fraudulent conveyances) require more detail. See In re M. Fabrikant & Sons, Inc., 447 B.R. 170 (Bk. S.D.N.Y. 2011).

d. Perhaps only of historical interest, in In re Valley Media, Inc., 288 B.R. 189, 192) (Bk. D. Del. 2003), the Delaware Bankruptcy Court tightened pleading standards for preference (and presumably other avoidance) litigation. There were a flurry of motions to dismiss in avoidance actions as defendants tried to take advantage of the new ruling, but the issues seem to have been superseded by Bell Atlantic and Iqbal which imposed more rigorous standards.

B. Defenses From Prior Actions (In Case and Other Litigation).

1. Judicial Estoppel—Prior Statements. May be based on prior statements/admissions in documents filed in the case or the course of proceedings, including schedules, plan documents, and financing applications and related documents.

a. An important decision on judicial estoppel was Adelphia Recovery Trust v. Goldman Sachs & Co., 2014 WL 1327864 (2d Cir 2014). Adelphia was parent to a number of subsidiaries and unsecured creditors of all subsidiaries (but not of Adelphia itself) were paid in full pursuant to the plan. The Adelphia Recovery Trust ("ART") brought suit claiming that a payment of $63MM by Adelphia to Goldman from a concentration account in the name of its subsidiary Adelphia Cablevision ("Cablevision") was a fraudulent conveyance. The District Court granted summary judgment to Goldman on the ground that the payment had come from Cablevision and was not a transfer of the property of Adelphia, and the ART appealed. The Court of Appeals noted that throughout the reorganization case, the concentration account had been listed as the property of Cablevision, and Adelphia's claim of ownership "appeared for the first time late in the present litigation . . . and well after consummation of the plan of reorganization." Adelphia's prior position was thus inconsistent with its present claim, and thus the ART was estopped from pursuing a claim that would reattribute asset ownership after a plan of reorganization has been confirmed and substantially consummated.

The Court discussed the doctrine of judicial estoppel, finding it fact specific, but typically requiring (a) a change of position where the later position was inconsistent with the former, (b) the court to have accepted the position such that acceptance of the new position would create the perception that the first or second court was misled, and (c) the party asserting the new position would obtain an unfair advantage over the opposing party. It then reviewed the facts which were "shaped by the context" of the bankruptcy proceeding. The Court noted that numerous filings identified Cablevision (or another subsidiary, but not Adelphia), as the owner of the account, the plan had been confirmed, assets liquidated, and billions of dollars had been distributed, and that a determination of ownership of assets is "at the core of the bankruptcy process, and . . . the creation of a bankruptcy plan" binding on creditors and it is "crucial . . . that claims to ownership of various assets be determined in the bankruptcy process." Here, it was particularly critical because of uncertainties regarding the ownership of assets of various entities, and the ultimate resolution of that issue underpinned the plan. As a consequence, permitting a change of position would permit parties to play fast and loose with the bankruptcy process and create an unacceptable level of uncertainty in the results. Judicial estoppel prevented such a result.

The lesson of Adelphia to defendants in litigation by debtors, trustees, litigation trustees and other representatives of the estate is to carefully look at prior activities and litigation in the case, especially as to factual and quasi-factual issues (it obviously helps if defense lawyers have been involved in the case all along since, in a complex case, it's almost impossible to go through the past record to find a literal needle in a haystack). Issues such as financial condition, value of assets, ownership of assets, actions of management, and claims of creditors are among those issues frequently raised in first day motions and supporting declarations, financing motions, prior settlements, plans of reorganization, disclosure statements, schedules and statements of affairs, other litigations, assumption/rejection motions, motions to terminate CBAs and health benefits, and many other matters. Also, for public companies or others issuing registered securities, prior SEC filings can contain a wealth of information. Finally, while the Adelphia case implies that the debtor could have changed its position on the ownership issue at some point, it also suggests that as more happens in the case, it is less likely that such change will be permitted.

b. A number of decisions involve the debtor's failure to schedule one or more legal claims, and then its attempts to prosecute these claims:

   i. A recent example is In Re Jackson, ___ F.3d ___ (5th Cir. 2014), where the debtor failed to schedule its right to a patent, a right to payment of $150,000, and a claim against his lawyers for breach of fiduciary duty and malpractice. After the bankruptcy, Jackson brought an action against the lawyers who asserted judicial estoppel based on Jackson's failure to schedule the lawsuit. The Fifth Circuit held that judicial estoppel applies when the debtor asserts a legal position inconsistent with a prior position, the bankruptcy court has accepted the prior position, and the debtor did not act inadvertently. The Court then affirmed the bankruptcy and district court decisions applying the doctrine, and specifically held that Jackson knew of his interest in these assets and had a motive not to report them. Undaunted, Jackson then sought to hold that his lawyers had "unclean hands," but the court rejected this defense on the ground that judicial estoppel is intended to protect the judicial system rather than the litigants.

   ii. A more ancient example is Krystal Cadillac-Oldsmobile GMC Truck, Inc. v. General Motors Corp., 337 F.3d 314 (3d Cir. 2003), cert. denied, 124 Sup. Ct. 2172 (2004). There, when the disclosure statement was approved, the debtor dealer was in litigation with the manufacturer regarding termination of its franchise, the debtor disclosed that the termination issue hadn't been resolved, but the debtor failed to disclose a claim against the manufacturer for a stay violation because it wanted to minimize assets so creditors would compromise their claims. The Court held the debtor judicially stopped from asserting the stay claim, and reasoned that this result was required by the bankruptcy policy requiring disclosure of all potential assets.

   iii. A similar case to those above is In re Coastal Plains, Inc., 179 F.3d 197 (5th Cir. 1999). There, the debtor brought an adversary proceeding against its largest unsecured creditor for breach of contract and various tortuous acts, its assets were sold and the successor substituted, the bankruptcy trustee who had apparently abandoned the claim intervened, and the district court held the claims were not barred by judicial estoppel. Ultimately, a multi-million dollar judgment was awarded, and the defendant appealed. The Fifth Circuit reversed and began its discussion by noting that section 521(1) required the debtor to provide a schedule of assets, this duty continued throughout the case, and the duty applied to all claims even if contingent or disputed. The Court rejected plaintiffs' argument that the claim was disclosed because the adversary proceeding had been started a week after the bankruptcy petition was filed on the basis that the initial adversary proceeding asserted a far different claim than the one on which judgment had been entered, and rejected the argument that the defendant's knowledge of the claim was relevant. Finally, the court held that the debtor's conduct might be excused as inadvertent where the debtor lacks knowledge of the undisclosed claims or has no motive for concealment, but here, the debtor had sufficient information and had a motive to conceal in trying to minimize creditor claims and keep the asset for itself.

iv. This nondisclosure issue has come up frequently in consumer cases where the debtor has a tort or statutory claim such as personal injury, employment discrimination, or violation of consumer credit laws and regulations. Courts have regularly estopped debtors who knew of the claim and failed to disclose it on the schedules or otherwise to the trustee. However, in such cases, most authorities have held that the trustee is not estopped because (i) s/he didn't know of the asset and had made a reasonable inquiry as to assets, and (ii) to estop the trustee would penalize creditors who clearly were not at fault. When thinking about this distinction, keep in mind that the "creditors" protected often include the lawyer prosecuting the claim, who is often on a contingency fee which constitutes the largest liability/claim. See <u>In re Flugence</u>, 732 F.3d 428 (5th Cir 2013) (debtor subject to judicial estoppel for not disclosing post-petition personal injury claims; but, trustee can prosecute, defendant must pay full amount awarded, and anything left over will be returned to the defendant); Reed v. City of Arlington, 650 F.3d 571 (5th Cir. 2011) (en banc) (same; dissent, under circumstances estoppel applied because of delays and fact that case was largely prosecuted for the benefit of lawyers); Kane v. Caillouet, 2008 WL 272157 (5th Cir 2008) (undisclosed personal injury claim; trustee not barred by judicial estoppel and creditors would be harmed by application of judicial estoppel); Love v. Tyson Foods, Inc., 677 F.3d 258 (5th Cir. 2012) (civil rights claim barred by nondisclosure; not inadvertent because motive to conceal); Jethroe v. Omnova Solutions, Inc., 412 F.3d 598 (5th Cir. 2005) (chapter 13 debtor estopped to assert undisclosed discrimination claim; court rejects advice of counsel defense); Lewis v. Weyerhaeuser Co., 141 Fed. Appx. 420 (6th Cir. 2005) (similar). Compare Biesek v. Soo Line R. Co., 440 F.3d 410 (7th Cir. 2006) (undisclosed FELA claim; court rejects judicial estoppel defense because it would penalize creditors and, instead, suggests the bankruptcy court should revoke the debtor's discharge and refer the matter to the U.S. Attorney for criminal prosecution).

v. The Ninth Circuit has recently thrown a wrinkle into the issue discussed above. In Ah Quin v. Kauai Dep't of Transportation, 733 F.3d 267 (9th Cir. 2013), an unlisted asset case, the court reversed a decision for the defendant on the ground that plaintiff had alleged her failure to list the claim as an asset as inadvertent, and therefore, further factual development was necessary. More recently, in Dzakula v. McHugh, 746 F.3d 399 (9th Cir. 2014) the debtor, in a similar situation, argued that Ah Quin required a hearing in such case, but the court held that the debtor had offered no possible explanation for failure to list the asset and no hearing was required. Taken together, these two cases suggest uncertainty as to the standard for applying judicial estoppel in unlisted asset cases and whether an evidentiary hearing is required.

c. The Third Circuit has recognized an important exception to general res judicata/collateral estoppel doctrine, which should be noted here as well. In Mullarkey v. Tamboer, 536 F.3d 215 (3d Cir. 2008), the Court held collateral estoppel was not applicable to findings in a prior lift-stay hearing, even though it was a final order (other decisions are to the same effect). The Court noted that the lift stay motion was a contested matter rather than an adversary proceeding, and is a "summary proceeding of limited effect" and is "not a proceeding for determining the merits of the underlying substantive claims, defenses, or counterclaims." In this regard, the question on lift stay was simply whether the creditor had a colorable claim that exceeded the value of the property, and the court did not consider questions of possible wrongdoing by the lender, possible avoidance actions, and the commercial reasonableness of the sale under state law. Compare <u>In re Ameriserve Food Distribution Inc.</u>, 267 B.R. 668 (D. Del. 2001) (question of estoppel of PACA claim based on decision in prior bankruptcy case; court held test was whether there was a full and fair opportunity to litigate and that a decision on a motion could be sufficient but wasn't in the case because an expert report had been produced much later than was reasonable).

2. <u>Equitable Estoppel.</u> Equitable estoppel requires (a) acts or conduct by a party causing another to believe in the existence of a fact or state of things, (b) willfulness or negligence with respect to the acts of conduct, and (c) detrimental reliance by the other party upon the state of things s/he was led to believe.

   a. <u>In re Vision Development Group</u>, 411 B.R. 768 (Bk SD Fla 2009) applied this defense against the debtors who asserted claims arising from loans by the lenders, to cancel the amounts owing based on the defense of usury, to recharacterize the debt as equity and for equitable subordination. The loans were apparently structured in a somewhat unusual manner with pledges of equity interests rather than the property itself, and also had high interest rates. The debtors made representations and warranties to the lenders that the agreements were legal, valid and binding, that the debtor was solvent and would not be undercapitalized, and that the debtor received a reasonably equivalent value. The debtors also furnished an opinion letter in which attorneys for the debtors opined that the loans documents were legal, valid and binding, and did not contravene any Florida law relating to the amount of interest. The court found that the lenders had met the standard for equitable estoppel—the opinion letter was furnished by the debtors, the debtors had acted willfully in that the debtors made the representation in the documents, and the lenders clearly had relied on the letter. It is not clear how far this doctrine extends to opinion letters generally since the court emphasized that the opinion letter was issued by counsel for the borrower.

b. A somewhat similar case is In re Garfinkle, 672 F.2d 1370 (11th Cir. 1982). There, the trustee conducted a bankruptcy sale of a hotel property, and prior to the sale, worked out a procedure with the ultimate purchaser for dealing with a 999 year lease on the property. The ultimate purchaser defaulted and then sued for return of its $500,000 deposit citing the title problem with the 999 year lease. The bankruptcy court, district court and Court of Appeals all found for the trustee, reasoning that (a) the trustee had described his proposed procedures for dealing with the lease problem, (b) the purchaser had contracted with reference to such terms and the trustee relied on the purchaser's willingness to accept the procedures, and the purchaser objected to the procedures, (c) the purchaser failed to object at the time the sale order was presented and, if it had, other purchasers would have contracted, and (d) the purchaser was equitably stopped by the apparent willingness of the purchaser, the purchaser's knowledge of the problem and process, and the trustee's reliance.

3. Disclosure in Plan Documents. Section 1123(b)(3)(B) states that a plan may provide for "the retention and enforcement by the debtor, the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest." Based on this section and for other reasons, courts generally require the debtor to disclose the existence of claims and proposed litigation in the plan, plan documents and/or the disclosure statement as a condition to bringing an action on the claim post-confirmation. Some courts see this, as articulated by the late Judge Eisenberg in Milwaukee, as essentially an "anti-sandbagging" rule on the theory that creditors should know they may be sued before voting on a plan. Other courts see it more in terms of control of the case and regulation of post-confirmation conduct, providing creditors with information about the prosecution of claims and sharing of recoveries, and still others, judicial estoppel. Regardless of the precise rationale, if the claim is not properly disclosed, it is lost.

a. In the first decade of the 21st Century, there was a substantial amount of litigation on whether particular disclosures were adequate, and

Courts in the Fifth and Sixth Circuits, and to a lesser extent other courts, adopted a requirement of specific litigation descriptions which required a considerable amount of detail and also required the disclosure to be sufficient to alert the prospective defendant of the lawsuit.

i. The Sixth Circuit decision is Browning v. Levy, 283 F.3d 761 (6th Cir. 2002) requiring detailed and specific disclosure. One can argue that the Browning case was driven more by the court's sympathy for the large law firm involved, but it wasn't so limited and led to a fair amount of litigation on issues such as adequacy of disclosure, whether the debtor knew about the claim, whether the debtor needed more information and had fully investigated the matter, whether nondisclosure was intentional or inadvertent, and whether the debtor had an "incentive" not to disclose. See, *e.g.*, Eubanks v. CBSK Fin. Group, Inc., 385 F.3d 894 (6th Cir. 2004) (lender liability, tort and contract claims; court held no judicial estoppel because debtor sought to amend schedules thereby disclosing claims and also raised claims in various proceedings thereby putting parties on notice; dissent that Browning required a contrary decision). The Fifth Circuit case is In re United Operating, L.L.C., 540 F.3d 351, 355 (5th Cir. 2008) (for plan to preserve claim, the plan must "expressly retain the right to pursue such actions. The reservation must be specific and unequivocal.") Research suggests that the Fifth Circuit cases are confused as to the specificity required (or at least the bankruptcy courts think so) and that more disclosure is better but, also, that the Fifth Circuit has pulled off its hard line approach. See In re Texas Wyoming Drilling, Inc., 647 F.3d 547 (5th Cir. 2011) (to decide whether plan preserved claim, should consult not only plan but disclosure statement; here disclosure statement disclosed existence, possible recoveries and basis for claims); In re MPF Holdings US LLC, 701 F.3d 449 (5th Cir. 2012) (exhibits stated basis for recovery and listed names of potential defendants; sufficient). Compare In re SI Restructuring Inc., 714 F.3d 860 (5th Cir. 2013) (reservation not specific as to non-avoidance claims against insiders and professionals for breach of fiduciary duty and torts). See also cases cited in 7 Collier on Bankruptcy ¶1123.02[3][b], at 1123-

20 nn. 17, 18; 5 Collier on Bankruptcy ¶548.02[6]. The latter suggests that "recovery must be for the benefit of creditors as a group," but section 550(a) provides that the trustee can recover for the "benefit of the estate" and this suggests that a benefit to the reorganized debtor or a secured creditor may suffice. *Id.* ¶550.02[3] (citing authorities).

ii. See also CCI Construction Co. v. Manufacturers & Traders Trust Co., 128 Fed. Appx. 273 (3d Cir. 2005) (debtor equitably estopped from pursuing claims relating to credit line when not disclosed or pursued during bankruptcy case even though the debtor knew there was a substantial chance it would pursue; looks like sandbagging); In re Hovis, 325 B.R. 158 (Bk. D.S.C. 2005) (debtor sold assets prepetition and brought various claims against purchaser prepetition; court held claims barred by judicial estoppel because debtor was aware of the claims and failed to disclose).

iii. Some courts intimate that there is a distinction between reservation of avoidance claims, and reservation of more general litigation claims. As to the avoidance claims, courts split on whether the reservation must include the names of the potentially affected parties, although most courts permit a reservation of avoidance claims by simply retaining all avoidance claims and specifying the categories of claims preserved, and saying they may be prosecuted post confirmation. See In re Bridgeport Holdings, Inc., 326 B.R. 312 (Bk. D. Del. 2005); In re Gulf States Long Term Acute Care, LLC, 487 B.R. 713 (Bk. E.D. La. 2013) (essentially adopts anti-sandbagging rule if creditor who voted was not put on notice that its treatment might be affected). However, careful debtors may want to list the recipients, and some debtors attach the list from the schedules identifying all payments w/in 90 days and one year for insiders. And, it appears that, without saying so as such, many courts require much more detailed disclosure including names and some description of the underlying claims, in proposed litigation involving serious wrongdoing seeking substantial damages. See SI Restructuring, *supra*; In re MPC Computers, LLC, 465 B.R. 384 (Bk. D. Del. 2012) (claims for breach of contract and unjust enrichment; actions disclosed as a means of implementing plan).

4. <u>Confirmation Objections Not Raised.</u>

   a. Are creditor v. creditor disputes barred by plan confirmation? Three cases illustrate the problem.

      i. <u>CoreStates Bank v. Huls America, Inc.</u>, 176 F.3d 187, 202 (3d Cir. 1999) involved a subordination agreement between the bank and a seller of goods, a confirmed plan calling for a payment of $600,000 to the seller, and a post-confirmation action by the bank against the seller for the $600,000. The Court held that the issue was sufficiently raised and considered in the confirmation process, and the bank was barred. The Court noted that the bank knew of the proposed $600,000 plan distribution, the bank demanded payment before the confirmation order was issued, the bank's claim had accrued before confirmation was finalized, and the bank had essentially raised its claim in objecting to the plan provision for payment of the $600,000. Even though this was clearly a creditor v. creditor dispute and the debtor was not affected, the bank was barred. For creditors, the message is that once your toe is in you're in.

      ii. <u>In re Piper Aircraft</u>, 244 F.3d 1289 (11th Cir. 2001), involved an alleged agreement between two parties who sought to acquire the debtor, and one who failed. In the case, there was a pre-confirmation cooperation agreement between two proponents of a prior plan to buy the debtor's assets which provided various remedies. But, only one of the proponents was a buyer under the actually confirmed plan and, pre-confirmation and pre-filing of the plan, the disappointed prior proponent brought an action against the successful proponent for breach of the cooperation agreement, and the successful proponent sought dismissal on the ground that the matter should have been raised in connection with plan confirmation. The Court of Appeals disagreed on the ground that the plan and cooperation agreement claims were not the same cause of action, the dispute between the two proponents couldn't have been brought in the bankruptcy proceeding, and the issues had not been raised or discussed in the confirmation process. Close call, but the key here seems to be that the plaintiff proponent stayed out of the confirmation process (and, arguably, had it tried to raise the claims, the bankruptcy court would have held them irrelevant to confirmation issues).

iii. The third example is In re Atlanta Retail, Inc., 456 F.3d 1277 (11th Cir. 2006), a case involving the provisions of a subordination agreement between two creditors and a post-confirmation attempt by one creditor to enforce the subordination. Thus, after confirmation, Kodak brought an action to subordinate claims of Wachovia, and Wachovia got an injunction from the bankruptcy court which was affirmed by the district court. The Court of appeals reversed on the ground that Kodak was not required to resolve an independent claim against a co-creditor unless the issue is an essential part of the plan. Here, the court found it wasn't and Kodak couldn't have received full relief in the bankruptcy case. Nevertheless, Kodak's strategy was high risk and other cases, some of which are cited in the opinion, might have led to a contrary conclusion.

iv. A number of cases on this issue involve suits by creditors or equity against parties involved in the bankruptcy process. And, findings which are basic to plan confirmation generally bar a post-confirmation action. See, *e.g.*, In re National Century Fin. Enterprises, Inc., 2012 WL 3740685 (6th Cir. 2012) (bank's indemnity claims against financier of debtor were within the jurisdiction of the bankruptcy and could have been litigated in a prior action); In re V&M Management, Inc., 321 F.3d 6 (1st Cir. 2003) (finding of no equity bars shareholder who participated in the confirmation process from later action against trustee and counsel). Other cases of interest include Hope v. Acorn Financial, Inc., 731 F.3d 1189 (11th Cir. 2013) (trustee granted creditor a secured position under plan even though he knew of a defect in the security interest; trustee barred by plan); In re Winn-Dixie Stores, Inc., 639 F.3d 1053 (11th Cir. 2011) (landlord's rejection claim was liquidated before plan confirmation without objection; post-confirmation amendment barred); In re Notre Dame Investors, Inc., 306 Fed. Appx. 693 (5th Cir. 2009) (court valued claim in connection with confirmation process and creditor did not object to confirmation); In re Mega-C Power Corp., 460 Fed. Appx. 693 (9th Cir 2011) (ownership rights to battery device were transferred to debtor under plan, which had both an injunction and release of claims; claims barred); In re High voltage Eng'g Corp., 360 B.R. 369 (D. Mass 2007) (trustee barred from objection to compensation of professionals on the ground they should have known that plan projections were unreliable and exit financing was inadequate); In re Genesis Health Ventures, Inc., 355 B.R. 438 (Bk. D. Del. 2006) (action against debtor, CFO, and three senior secured creditors claiming manipulation of financial information to obtain plan confirmation; court holds confirmation barred known claims which should have been raised in the confirmation process but did not bar concealed claims); In re Insilco Technologies, 480 F.3d 212 (3d Cir. 2007) (plan provided both for full release and allowance to Term C Lenders and limitation of release; Court found full allowance of claims took precedence); In re Earned Capital Corp., 331 B.R. 208 (Bk. W.D. Pa. 2005) (plan confirmation providing for substantive consolidation based on collective insolvency barred malpractice claims against advisors on the ground they incorrectly determined the debtors were insolvent and sold assets below value); *Id.*, 393 B.R. 362 (Bk. W.D. Pa. 2008) (malpractice claims asserted post-confirmation on the ground that debtors were not insolvent and equity should not be stripped barred by plan; contentions were asserted in confirmation process and rejected, and claimants were active participants); In re Target Ind., 328 B.R. 99 (Bk. D.N.J. 2005) (post-confirmation action against DIP lender largely barred by confirmation order).

5. Post-Confirmation Jurisdiction Over Claims. Post confirmation jurisdiction over post-confirmation claims begins with the contours of subject matter jurisdiction in bankruptcy cases as set forth in 28 U.S.C. §1334. Although the words of section 1334 are general, the most widely accepted test is that the outer limit of jurisdiction in a civil proceeding is whether the "outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy." Pacor, Inc. v.

Higgins, 743 F.2d 984 (3d Cir. 1985); 1 Collier on Bankruptcy ¶3.01[3][e][ii].

Beyond this, there are more questions than answers. First, is post-confirmation jurisdiction narrower than pre-confirmation jurisdiction? Second, is post-confirmation jurisdiction narrower (or broader) in liquidation and reorganization cases than pre-confirmation jurisdiction? See In re Boston Regional Medical Center, Inc., 410 F.3d 100 (1st Cir. 2005) (in liquidation case, post-confirmation jurisdiction is similar to pre-confirmation jurisdiction because the debtor is simply liquidating and is not in the marketplace, and matters before the court are similar to pre-confirmation matters). Third, is there a special rule for cases where the debtor is an operating entity after confirmation? Fourth, do the jurisdiction provisions in the plan make any difference? As to the latter, it is conceptually impossible for the provisions to expand jurisdiction beyond that set forth in section 1334. But, at least in close cases, courts seem to regard the existence of specific jurisdictional provisions covering the proceeding or type of proceeding before the court to be of some significance (*e.g.*, court will have jurisdiction over litigation of all avoidance matters v. court will have jurisdiction over all matters affecting the administration of the estate or the post-confirmation debtor).

a. Retention of Jurisdiction Provisions of Plan. Although subject matter jurisdiction cannot, at least theoretically, be expanded by the plan, it can be limited. In deciding whether a proceeding is within the post-confirmation jurisdiction, courts often look to the jurisdiction provisions of the plan. *E.g.*, In re Park Avenue Radiologists, P.C., 450 B.R. 461 (Bk. S.D.N.Y. 2011) (plan had limited post-confirmation jurisdiction); In re Fairchild Corp., 2011 WL 3267764 (Bk. D. Del. 2011) (general retention provisions not adequate).

b. Provisions of Plan or Assets Distributed Under Plan. Parties seeking to assert post-confirmation jurisdiction do best when they can point to specific plan provision that are implicated or an issue that was otherwise dealt with by the plan. See In re General Growth Property, Inc., 460 B.R. 592 (Bk. S.D.N.Y. 2011) (action to hold indenture trustee liable for recovery fee notwithstanding contrary plan provision; court always has power to interpret, construe and enforce plan and confirmation order); In re Consolidated Meridian Funds, 2014 WL 2208411 (W.D. Wash 2014) (claims against perpetrator of Ponzi scheme; plan provided for exclusive jurisdiction over the claims as potential assets of estate; and litigation required interpretation of plan relating to a statute of limitations issue); In re CD Liquidation Co., 2011 WL 5278308 (Bk. D. Del. 2011) (enjoining action by former shareholder because claim belonged to liquidating trustee; trustee had power to protect confirmation order and exclusive jurisdiction under the plan); Pathfinder Pompano Bay v. Compass Financial, 396 B.R. 602 (S.D.N.Y. 2008) (post-confirmation jurisdiction over actions by lender's successor against purchaser of assets based on obligations arising under plan); In re Senango Group Inc., 501 F.3d 338 (3d Cir. 2007) (jurisdiction over claim by retirees that plan required debtor to fund pension plan because close nexus between question and plan, and issue involved interpretation, implementation and administration of plan); In re Midstate Mtg. Investors, Inc., 105 Fed. Appx. 420 (3d Cir. 2004) (creditors brought state court action on guaranties; bankruptcy court has jurisdiction over claim that guaranties were released under the plan); Valley Historic L.P. v. Bank of New York, 486 F.3d 831 (4th Cir. 2007) (no jurisdiction over indenture trustee of bond issue for interfering with debtor's relationship with tenants; claims not related to bankruptcy case, no bankruptcy administrative purpose, and plan made no provision for recovery); In re Metro-Goldwyn-Mayer Studios Inc., 459 B.R. 550 (Bk. S.D.N.Y. 2011) (no post confirmation jurisdiction to authorize transaction involving purchasing of some sub debts and releasing others; had nothing to do with interpretation or implementation of plan); In re Heritage Organization, L.L.C., 454 B.R. 353 (Bk. N.D. Tex 2011) (no jurisdiction over claims of liquidating trustee who obtained avoidance judgment against downstream transferees).

c. Litigation Claims. Many courts seem to distinguish cases where recoveries go to creditors or the reorganized operating debtor from those which don't. See In re Railworks Corp., 325 B.R. 709 (Bk. D. Md. 2005) (avoidance claims; recoveries to creditors); In re Reliant Exploration Ltd., 336 B.R. 286 (Bk. S.D. Tex 2005) (claim was not property of the estate and had no impact on the estate); In re General Media, Inc., 335 B.R. 66 (Bk. S.D.N.Y.2005) (dispute between debtor's successor and former director about assets; claims didn't arise under plan and proceeds would not go to unsecured creditors).

d. The Third Circuit has given a narrow reading to post-confirmation jurisdiction in In re Resorts Int'l, Inc., 372 F.3d 154 (3d Cir. 2004), suggesting post-confirmation jurisdiction may be more limited than pre-confirmation jurisdiction. There, the Court said that section 1334 jurisdiction was limited to "whether there is a close nexus to the bankruptcy plan or proceeding sufficient to uphold bankruptcy court jurisdiction" over the proceeding. Applying this test, the court held there was no jurisdiction over a litigation trustee's malpractice claim for post-confirmation accounting malpractice because it was incidental to the bankruptcy process and would have no substantial effect on the success of the plan. *Id.* at 170; see also In re Pegasis Gold Corp., 394 F.3d 1189 (9th Cir. 2005) (similar); 1 Collier on Bankruptcy ¶3.02[7].

e. In In re Craig's Stores, Inc., 266 F.3d 388 (5th Cir. 2001), the Fifth Circuit recognized a further limit on post-confirmation jurisdiction for an operating chapter 11 debtor. The court held that there was no jurisdiction over a debtor's claim arising from operations against a non-debtor, on the theory that the post-confirmation debtor should not obtain a market advantage over a competitor not in bankruptcy. In other words, post-confirmation jurisdiction was narrower that pre-confirmation. The Boston Regional case is to the same effect. However, although Boston Regional recognized that the operating reorganized debtor should be bound by marketplace rules as for other marketplace participants, this "marketplace competition" test was not applicable to liquidating plans so pre- and post-confirmation jurisdiction were the same. Accord, In re DPH Holdings Corp., 437 B.R. 88 (S.D.N.Y. 2010), aff'd, 448 Fed. Appx. 134 (2d Cir. 2011), cert denied, 133 Sup. Ct. 51 (2012).

f. Third Party Litigation. See Newby v. Enron Corporation, 2008 WL 2689248 (5th Cir. 2008) (state securities lawsuits removed pre-confirmation based on pre-confirmation actions; court has jurisdiction; rejected Craig's Stores which called for limited post-confirmation jurisdiction); In re Fruehauf Trailer Corp., 369 B.R. 817 (Bk. D. Del. 2007) (post confirmation jurisdiction over breach of contract claims against liquidating trustee of trust established under plan); In re Insilco Technologies, Inc., 394 B.R. 747 (D. Del. 2008) (claims by liquidating trust based on improper use of controls, unjust enrichment and breach of fiduciary duty not within subject matter jurisdiction).

g. An important recent decision perhaps illustrating the flexibility of the concepts is Wilshire Courtyard v. California Franchise Tax Board, 729 F.3d 1279 (9th Cir. 2013). In this case, the debtor's limited partners sought relief in the bankruptcy court from the assertion of state tax claims—the issue was whether the plan resulted in capital gains (state's position) or forgiveness of debt (partners' position). The Court held there was post-confirmation jurisdiction over the taxation issue because it was affected by plan provisions, required an interpretation of the plan, confirmation order and settlement agreement among the parties, and the debt cancellation question was "central to the conceptual framework of the plan" and also implicated section 346. The court also noted that the tax consequences of a plan are "fundamental to virtually any corporate bankruptcy" and here, if the partners knew of the attempt to reclassify the discharged debt as capital gains "they may never have consented to the reorganization plan." *Id.* at 1292. Taken literally, these statements seem almost open ended, and certainly, an invitation to bankruptcy courts to revisit tax issues coming out of reorganizations. Whether or not this decision is limited to the specific factual situation presented in the case will be left to later cases, but the case certainly opens the door to expanded post-confirmation jurisdiction.

6. Section 546(e)-Settlement Payments.

a. Section 546(e) provides a defense to avoidance actions for a margin payment, settlement payment, or a payment by, to, or for the benefit of a forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency in connection with a securities contract. The definitions are longer and have cross references to other Code sections. These provisions were originally intended to protect the public securities markets but, as discussed below, have been expanded to protect transactions far removed from that limited purpose and the courts of appeals have interpreted this defense very broadly.

b. Initial litigation tended to focus on arguments that the definition should not be applied to transactions not involving public markets (such as an LBO of a private company), transactions in which the financial institution or stockbroker was a simple intermediary and had no financial interest (and even, was not involved) and transactions not involving a purchase and sale. Four relatively recent decisions of courts of appeal rejected these arguments. See In re Plassein Int'l Corp., 590 F.3d 252 (3d Cir. 2009), cert denied, 559 U.S. 1093 (2010) (citing prior authorities). Compare Munford v. Valuation Research Corp., 98 F.3d 604 (11th Cir. 1996) (LBO not covered).

c. Historically, preference law was said to be structural or analytical and not transactional, so parties could not "transform" a preferential transfer into a non-avoidable transaction. Recent caselaw has seriously undermined this assumption. Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011) (premature redemption of commercial paper protected by 546(e) as settlement payment; dissent said this would undermine preference law and could include simple payment on a note); In re Quebecor World (USA) Inc., 719 F.3d 94 (2d Cir. 2013) (preference payment protected because it involved the purchase of securities by the debtor and was a transfer to or from a financial institution). Significantly, apart from section 546(e), each of these cases was a garden variety preference involving a classic improvement of position at the expense of unsecured creditors

d. Some courts have said enough is enough and refused to expand the defense. See In re Appleseed's Intermediate Holdings, LOLC, 470 B.R. 289 (D. Del. 2012) (not applicable to dividends; waste claims survive); In re Qimonda Richmond, LLC, 467 B.R. 318 (Bk. D. Del. 2012) (neither prepetition deposit into bank account nor bank's application of funds in the account to satisfy letter of credit reimbursement obligation was not a settlement payment protected from avoidance). But, courts have applied these safe harbors to Ponzi cases. *E.g.*, SIPC v. BLMIS, 505 B.R. 135 (S.D.N.Y. 2013).

e. After the broad construction of 546(e) discussed above, plaintiffs began trying to avoid the 546(e) defense by, in addition to alleging state fraudulent transfer type claims, alleging causes of action for unjust enrichment, conversion, and other torts. For a discussion of the overlap, see In re Lehman Bros. Holdings Inc., 469 B.R. 415 (Bk.

S.D.N.Y. 2012) (holding 546(e) should not be read to broadly preempt overlapping state claims).

f. Section 546(e) is generally applicable to avoidance claims, but does not apply to intentional fraudulent conveyance claims under section 548, and claims of creditors under state law. As to the latter, a number of recent confirmed bankruptcy plans provide for unsecured creditors to transfer their individual state law fraudulent conveyance claims to a trustee who will prosecute for the benefit of all creditors. Such an arrangement was upheld in In re Lyondell Chemical Co., 503 B.R. 348 (Bk. S.D.N.Y. 2014) with a significant limitation—the assigned claims could not include claims by junior lenders who participated in the offending transfer transaction and the junior lender claims were subject to the defense of ratification. See also In re Tribune Co. Fraudulent Conveyance Litigation, 499 B.R. 310 (S.D.N.Y. 2013) (same holding, but different result because separate trustee action superseded creditor actions; not clear if trustee could waive). In each of these cases, the courts rejected the defendants' claim of preemption, finding there was no basis to assume that Congress had intended to preempt the field and that the statutory provisions were straight forward as to when section 546(e) did and did not apply.

g. Although the section 546(e) issue has received the lion's share of attention, there has been a smattering of cases involving some of the other safe harbors. *E.g.*, In re Clear Peak Energy, Inc., 488 B.R. 647 (Bk. D. Ariz. 2013) (renewable power purchase and sales agreement between power company and debtor for the sale of electricity was a protected forward contract); In re MBS Management Services, Inc., 90 F.3d 352 (5th Cir. 2012) (agreement between property manager and power company to purchase electricity requirements was a protected forward contract; made no difference that the contract didn't specify quantities and delivery dates); In re Magnesium Corp., 460 B.R. 360 (Bk. S.D.N.Y. 2011) (gas supply contract protected). Again, some courts have said enough is enough. See SIPC v. Lehman Bros. Inc., 433 B.R. 127 (Bk. S.D.N.Y. 2010) (date for unwinding petition is date of petition, and is not changed by safe harbors); In re Lehman Bros. Holdings Inc., 432 B.R. 31 (Bk. S.D.N.Y. 2011) (termination provision contain distribution waterfall which was different in bankruptcy and resulted in a lower priority for the debtor; held, invalid ipso facto clause).

C. Forum Related Defenses.

Our program has emphasized substantive defenses to claims which can lead to an early end to the litigation. However, a related tactical course is for the defendants to seek to move the case to an alternative forum. Such tactical defenses may not lead to an absolute win, but can dramatically alter the litigation dynamics and are widely thought as a "win" by successful defendants (and losing plaintiffs too since plaintiffs are deprived of their forum of choice). They are discussed very briefly below.

1. Jurisdiction. Bankruptcy subject matter jurisdiction is very broad, but it is not unlimited. In cases where the relation to the bankruptcy case is peripheral or involves largely parties other than the debtor, a jurisdictional defense may be a possibility. See Pacor, *supra*. There is nationwide personal jurisdiction, but in some cases involving foreign parties, such a defense may be available especially if the defendant has little or no connection with the United States.

2. Venue. Bankruptcy courts are generally not receptive to venue motions, but one should never say never. Keep in mind that a venue transfer motion may involve the case itself or an adversary proceeding. See 28 U.S.C. §1412. The strongest argument for the case itself may be if venue was manufactured or recently "created." The decision in In re Patriot Coal Corp., 482 B.R. 718 (Bk. S.D.N.Y. 2012) is a very good example. See also In re Houghton Mifflin Harcourt Publishing Co., 474 B.R. 122 (Bk. S.D.N.Y. 2012) (delaying transfer until plan three weeks after the effective date of the plan or 3 weeks after the confirmation order). Some courts also are somewhat more receptive to transferring the case of a real estate debtor to the court in which the property is located, especially if state law issues are likely to arise—perhaps a vestige of the old "local action" rule of Livingston v. Jefferson. See In re Dunmore Homes, Inc., 380 B.R. 663 (Bk. S.D.N.Y. 2008) (California developer with properties largely in California); In re Palmer Lake Plaza, LLC, 470 B.R. 511 (Bk W.D. Wis. 2012) (transfer when case primarily involves building in another district); see also In re Buffets Holdings, Inc., 397 B.R. 725 (Bk.D. Del. 2008) (dispute between landlord and debtor regarding failure to repair roof and unpaid rent transferred to location of building). The existence of a forum selection clause may help especially if the case is non-core. See, *e.g.*, In re Manchester, Inc., 51 BCD ¶206 (Bk. N.D. Tex 2009); but cf. In re

Spillman Development Group, Ltd., 710 F.3d 299 (5^{th} Cir. 2013) (strong policy to permit the bankruptcy court to resolve core proceedings involving asset purchaser overcomes forum selection clause).

3. Abstention. Related to venue is a request that the court abstain, generally in favor of an action pending in a state or non-bankruptcy federal court. These motions are largely discretionary. See 28 U.S.C. §1334(c), although section 1334(c)(2) seems to require abstention in certain cases arising under State law if an action has been commenced in the state court and can be timely adjudicated in such forum. Some early cases seemed to suggest that this provision only applied to state actions commenced prepetition, but a decision of the Second Circuit (which did not discuss the issue) implied otherwise.

4. Withdrawal of Reference. 28 U.S.C. §157(d) permits the district court to withdraw the reference at any time, and requires withdrawal of the reference in certain proceedings involving the regulation of organizations or activities affecting interstate commerce. There is no time limit but it generally is good practice to make such a motion sooner rather than later and before the bankruptcy court has become heavily involved. The district court has almost complete discretion. It is fair to say that such motions are more often denied than granted, but also, that the strongest case for withdrawal is a complex case involving non-bankruptcy issues and, especially, numerous parties other than the debtor and movant. In cases involving a right to jury trial, parties sometimes seek withdrawal on the ground the district court would have to try the case anyway, although it is common for the district court to deny the withdrawal on the ground that the bankruptcy court should pre-try the case until it's ready for trial. A recent case along these lines is In re Northeast Dev. Corp., 2014 WL 2253322 (S.D.N.Y. 2014). More recently, parties have also sought withdrawal of the reference on the basis of Stern v. Marshall considerations.

5. Jury Trial. There is much jurisprudence on this issue. In general, there is a right to jury trial on noncore claims (and presumably Stern Claims), as well as avoidance claims (at least if the defendant hasn't filed a proof of claim). Much of the jury trial jurisprudence overlaps with jurisdictional and Stern v. Marshall issues and is presently somewhat in a state of flux. For litigants, it is most important that they assert the right to a jury timely—usually no later than the filing of an answer.

6. Stern v. Marshall. There is little question that Stern/Arkison issues will probably dominate this NCBJ conference in terms of effort, interest, and time allocated. The issues are extremely complicated and still in a state of flux after the recent Arkison decision, and involve basic issues of bankruptcy court adjudicatory authority, the relative roles of the bankruptcy and district court, and issues of express or implied (or deemed) consent. On July 1, 2014, the Supreme Court granted limited certiorari in Wellness Int'l Network Ltd. v. Sharif, 727 F.3d 721 (7^{th} Cir. 2013) which raises many of these issues. For our purpose, it is simply important for litigants to keep these issues in mind and observe Bankruptcy Rules, local rules and chambers rules requiring the timely raising of such issues. One can anticipate that, after Arkison, bankruptcy courts will write opinions designed to serve both as final orders and findings and conclusions in proceedings involving any doubt. Also, parties ought to consult Bankruptcy Rule 9033 which arguably applies to such situations.

D. Standing Defenses.

1. Ownership of Claims. Estate or individual creditors.

Under section 541 of the Bankruptcy Code, the estate includes causes of action held by the debtor as of the filing date. *In re Jackson*, 593 F.3d 171, 176 (2d Cir. 2010); *Sierra Switchbd. Co. v. Westinghouse Elec. Corp.* 789 F.2d 705, 707 (9th Circuit 1986). The trustee or debtor-in-possession has the capacity to sue and be sued under section 323 of the Bankruptcy Code and has standing to bring any suit the debtor could have instituted on the eve of bankruptcy. *Smith v. Arthur Andersen LLP,* 421 F.3d 989, 1002 (9th Cir. 2005). The trustee's standing with respect to the debtor's causes of action is exclusive. *In re Mktg. Serv., LLC,* 309 B.R. 783, 788 (Bankr. S.D. Cal. 2004).

Plaintiffs lacking standing are not entitled to litigate claims in federal court. *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 117 (2d Cir. 1991). Standing requires (a) a concrete and particularized injury in fact; (b) that can be fairly traced to the defendant's conduct; and (c) that can be redressed by the court. *Denney v. Deutsche Bank*, 443 F.3d 253, 263 (2d Cir. 2006). Critically, a party must assert its own legal right, not the rights or interests of third parties. *Warth v. Seldin*, 422 U.S. 490, 499 (1975). In bankruptcy litigation, standing often turns on whether the rights or claims asserted belong to the debtor, which the trustee liquidates on behalf of the estate for the benefit of creditor, or to a particular creditor. *See Smith*, 421 F.3d at 1002. The trustee has no standing to pursue a cause of action that belongs to a creditor. *In re Cannon*, 277 F.3d 838, 853 (6th Cir. 2002). A creditor has standing when the harm alleged is specific to the creditor. The trustee has standing when the harm alleged is general and common to the debtor and all creditors. *See, e.g.*, *Kalb Voorhis & Co. v. Am. Fin. Corp*., 8 F.3d 130, 132 (2d Cir. 1993); *Koch Ref. v. Farmer's Union Cent. Exch. Inc.* 831 F.2d 1339, 1349 (7th Cir. 1987). For example, the trustee lacks standing to bring Securities Investor Protection Act claims and related common law claims on behalf of customers of a defunct brokerage firm. *Picard v. HSBC Bank PLC*, 454 B.R. 25, 36-37 (S.D.N.Y. 2011). Similarly, if the debtor was a participant in fraudulent conduct, the doctrine of *in pari delicto* may deprive the trustee of standing to sue other participants. *See Shearson Lehman Hutton, Inc.*, 944 F.2d at 118; *see also* section II.d.(i) below. On the other hand, the trustee and not any individual creditor has standing to bring alter ego, successor liability, shareholder derivative claims, and other claims for damages general to the estate. *In re Emoral, Inc.*, 740 F.3d 875, 882 (3d Cir. 2014); *In re Ambac Fin. Grp.*, 487 F. App'x. 663, 665 (2d Cir. 2012); *In re Cabrini Med. Ctr.* 489 B.R. 7, 21-22 (S.D.N.Y. 2012).

In some cases, the trustee and an individual creditor both may have standing to bring the same or overlapping claims. *See In re Torcise*, 116 F.3d, 860, 866 (11th Cir. 1997) (allowing independent actions to proceed against bank by secured creditors alleging tort and conspiracy and by a committee asserting bankruptcy causes of action on behalf of estate). A common example is when a creditor is pursuing a fraudulent transfer claim against the debtor's transferee under state law when the debtor files bankruptcy. Most courts have held that the estate's right to avoid fraudulent transfers under sections 544 and 548 of the Bankruptcy Code preempts individual creditor claims. *See Honigman v. Comerica. Bank In re Van Dresser Corp.)*, 128 F.3d 945, 949 (6th Cir. 1997). Some courts conclude that the fraudulent transfer claim is estate property and section 362(a)(3) stays exercise and control by a creditor. *In re Mortg. Am. Corp.*, 714 F.2d 1266, 1275 (5th Cir. 1983). Other courts point out that the estate's property is the recovery on the claim, not the claim itself. *In re Colonial Realty Co*., 980 F.2d 125, 132 (2d Cir. 1992). The debtor does not own or control a fraudulent transfer claim under state law; rather, the trustee's avoidance power arises on behalf of the estate under the Bankruptcy Code itself. *See in re Teleservs. Grp., Inc.* 463 B.R. 28, 34 (Bankr. W.D. Mich. 2012).

A trustee and a creditor may have independent claims arising from the same transaction. *See Honigman*, 128 F.3d at 949 (state law, not bankruptcy law, prohibited multiple recoveries). But the creditor still only may pursue claims based on injury to the particular creditor. *In re Teleservs. Grp., Inc.*, 463 B.R. at 34. Fraudulent transfer claims focus on harm to creditors in general. In fact, a fraudulent transfer action is an effort to recover a claim against the debtor's property in the hands of a third party transference. Accordingly, the creditor's state law claims are stayed regardless of the estate's interest in the property. *Id*. at 34-35 (also enjoining recovery under similar state law theories such as unjust enrichment and constructive trust).

2. Standing of Creditors or Committees to Bring Estate Claims.

Courts are split on whether a creditor or committee can gain derivative standing to sue on behalf of a bankrupt debtor. Some courts do not recognize derivative standing to pursue claims the Bankruptcy Code vests in the trustee. *See, e.g., Ahcom, LTD. v. Smeding*, 623 F.3d 1248, 1250 (9th Cir. 2010) (standing of trustee is exclusive and divests creditors of power to bring claim); *Surf N Sun Apts., Inc. v. Dempsey*, 253 B.R. 490, 494-95 (M.D. Fla. 1999) (bankruptcy court may not confer standing on creditor to pursue fraudulent transfer claim absent authority from Congress).

Other courts have granted derivative standing to creditors and committees in certain situations. *See, e.g., Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 567-68 (3d Cir. 2003) (finding congressional authorization under sections 1109(b), 1103(c)(5), 503(b)(3)(B),` and bankruptcy court's equitable powers). Granting derivative standing, however, is an extraordinary remedy that courts should apply sparingly. *Southtrust Bank N.A. v. Jackson (In re Dur Jac Ltd.)*, 254 B.R. 279, 286

(Bankr. M.D. Ala. 2000). In a leading case on the topic, the Sixth Circuit Court of Appeals held that Congress did not prohibit courts from granting derivative standing to creditors, but a creditor can only gain such standing if the creditor:

> 1) has alleged a colorable claim that would benefit the estate, if successful based on a cost-benefit analysis performed by the bankruptcy court; 2) has made a demand on the debtor-in-possession to file the avoidance action; 3) the demand has been refused; and 4) the refusal is unjustified in light of the statutory obligations and fiduciary duties of the debtor-in-possession in a Chapter 11 reorganization.

Canadian P. Forest Prods. Ltd., v. J.D. Irvin, Ltd. (In re Gibson Group, Inc.), 66 F.3d 1436, 1438 (6th Cir. 1995). Nearly every court that allows derivative standing for creditors applies some form of the *Gibson Group* test. *See, e.g., Maxfield v. Quarles & Brady LLP (In re Jennings)*, 378 B.R. 678, 684-85 (Bankr. M.D. Fla. 2006); *In re iPCS, Inc.*, 297 B.R. 283, 289-91 (Bankr. N.D. Ga. 2003); *In re Dur Jac Ltd.*, 254 B.R. at 285-86.

In any event, a creditor or committee must receive court authorization to bring a derivative suit on behalf of the debtor. *In re Trailer Source, Inc.*, 555 F.3d 231, 245 (6th Cir. 2009); *La. World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 247 (5th Cir. 1988); *Infinity Investors Ltd. ex rel. Estate of Yes! Entm't Corp. v. Kingsborough (In re Yes! Entm't Corp.)*, 316 B.R. 141, 145 (D. Del. 2004); *see* section II.g.(v) below (discussing courts authorizing committees to pursue certain actions waived or released by debtor in financing or cash collateral order).

For a creditor or committee to recover a preference, fraudulent transfer, or other chapter 5 claim, the court must find the recovery is for the benefit of the estate under section 550 of the Bankruptcy Code. *See, e.g., In re Tronox Inc.*, 464 B.R. 606, 614 (Bankr. S.D.N.Y. 2012) (finding benefit to the estate under section 550 can be direct or indirect, including increasing the probability of reorganization); *see also Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003) (finding benefit to the estate under section 550(a) because avoidance actions assigned to creditors as adequate protection allowed debtor to continue operating); *In re Huntsville Small Engines, Inc.*, 228 B.R. 9, 10, 13 (Bankr. N.D. Ala. 1998) (granting defendant summary judgment on avoidance action assigned to secured creditor because recovery did not benefit estate).

3. Assignment of Claims.

A common feature of chapter 11 plans is the creation of a litigation or liquidation trust to pursue causes of action for the benefit of creditors. *See* 11 U.S.C. § 1123(b)(3)(B) (plan may provide for retention and enforcement of any claim or interest of debtor or estate "by a representative of the estate appointed for such purpose"). In addition to succeeding to the bankruptcy trustee's standing, a liquidation trustee, as a creature of the chapter 11 plan rather than the Bankruptcy Code itself, may have broader standing by consent or ratification of the parties. *See, e.g.*, *Zazzali v. Hirschler Fleischer, P.C.*, 482 B.R. 495, 509 (D. Del. 2012). As discussed in section II.c.(i) above, bankruptcy trustee's may assert claims of the estate, not claims of creditors. *See Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 431-34 (1972). However, the parties may define the power of a plan trustee by agreement and are not limited to the statutory power of a bankruptcy trustee. *See Grede v. Bank of N.Y. Mellon*, 598 F.3d 899, 902 (7th Cir. 2010); *Semi-Tech Litig., LLC v. Bankers Trust Co.* 272 F. Supp. 2d 319, 323-24 (S.D.N.Y. 2003). Without limitation, creditors may assign individual claims to a litigation trust pursuant to a plan. In such circumstances, the litigation trustee has standing to pursue the claims of assigning creditors. *Zazzali*, 482 B.R. at 509-510; *see also In re Lyondell Chem. Co.*, 503 B.R. 348, 383 n.173 (Bankr. S.D.N.Y. 2014).

E. <u>Right to Arbitration. Timing; right to appeal denial.</u>

The Federal Arbitration Act, 9 U.S.C. §§ 1, et seq. (the "FAA"), provides that arbitration agreements "involving commerce" shall be "valid, irrevocable, and enforceable, save upon such grounds as exist in law or in equity for the revocation of any contract." 9 U.S.C. § 2. A court may stay litigation that is subject to an enforceable arbitration clause and order the parties to arbitrate in accordance with the agreement. 9 U.S.C. §§ 3 and 4. The court first must find that the parties agreed to submit the claims to arbitration and that the subject contract involves commerce. *See. e.g., Zeigler v. Whale Sec. Co*., 786 F.Supp. 739, 741 (N.D. Ind. 1992) (arbitration clauses enforced unless clause cannot be interpreted to cover dispute under ordinary contract principles); *In re Quigley Co*., 361 B.R. 723, 740 (Bankr. S.D.N.Y. 2007) (in deciding whether dispute is arbitrable, court must find parties agreed to arbitrate and that agreement to arbitrate covers dispute at hand). The "commerce" qualification has broad application, consistent with the full exercise of congressional powers under the Commerce Clause, including all contracts relating to interstate commerce. *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 273 (1985)

The United States Supreme Court has recognized in the FAA a strong federal policy in favor of arbitration that requires rigorous enforcement of arbitration agreements. *See, e.g., Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 200 (1985); *Moses H. Cone Mem'l.*

Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983). Without limitation, the enforcement of arbitration clauses under the FAA may extend beyond contract rights to include claims arising under federal statute. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987). However, a court may override the application of the FAA to federal statutory claims if a litigant can establish that Congress intended an exception to the FAA mandate. The court may find congressional intent "to preclude a waiver of judicial remedies for the statutory rights at issue" from the text of the statute, the legislative history of the statute, or "an inherent conflict between arbitration and the statute's underlying purposes." *Id*. at 227; *see also Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc*., 473 U.S. 614, 628 (1985).

Litigants have argued an inherent conflict between the FAA and the Bankruptcy Code should render arbitration agreements unenforceable in bankruptcy cases. Some courts have been sympathetic to the idea that bankruptcy policy favoring centralization of disputes involving the estate directly contravenes the FAA. *See Societe Nationale Algerienne Pour La Recherche v. Distrigas Corp.,* 80 B.R. 606, 610 (D. Mass. 1987) (FAA and Bankruptcy Code present a policy conflict "of near polar extremes"). Earlier case law tended to resolve the conflict in favor of bankruptcy, providing bankruptcy courts with the discretion to decline to enforce arbitration agreements based on factors such as protection of estate assets, the interests of creditors and others not party to the arbitration agreement, the need for efficient estate administration, and expertise on specific issues. *See, e.g., Zimmerman v. Cont'l Airlines, Inc*., 712 F.2d 55, 59-60 (3d Cir. 1983); *In re Charles P. Young Co*., 111 B.R. 410, 417 (Bankr. S.D.N.Y. 1990).

After the Supreme Court's decision in *McMahon*, and the 1984 amendments to the Bankruptcy Code (indicating that Congress did not intend that all bankruptcy matters must be litigated in a single forum), courts moved away from a discretion standard and found an irreconcilable conflict between arbitration and bankruptcy only when arbitration deprives parties of statutory rights and protections under the Bankruptcy Code. *See In re Gurga*, 176 B.R. 196, 200 (B.A.P. 9th Cir. 1994). In *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., the United States Court of Appeals for the Third Circuit held that a court has discretion to deny enforcement of an arbitration clause only when the party objecting to enforcement shows that arbitration conflicts with the text, legislative history, or purpose of the Bankruptcy Code. *Hays & Co*., 885 F.2d 1149, 1156-57 (3d Cir. 1989); *see also In re Nat'l Gypsum*, 118 F.3d 1056, 1067 (5th Circuit 1997) (discretion to deny arbitration exists only where bankruptcy proceeding meets *McMahon* standard for nonenforcement). *Hays* involved non-core claims, leading some to argue that bankruptcy courts retain discretion to decline to enforce arbitration clauses with respect to core proceedings. *See In re Farmland Indus*., 309 B.R. 14, 19 (Bankr. W.D. Mo. 2004). However, most courts have held the same "irreconcilable conflict" standard applies to core and non-core proceedings under *McMahon*. *See, e.g., In re Mintze*, 434 F.3d 222, 230-31 (3d Cir. 2006); *In re Winimo Realty Corp*., 270 B.R. 108, 118 (S.D.N.Y. 2001).

Accordingly, a bankruptcy court lacks authority to override an otherwise enforceable and applicable arbitration clause "*unless* the party opposing arbitration can establish congressional intent, under the *McMahon* standard, to preclude waiver of judicial remedies for the statutory rights at issue." *Mintze*, 434 F.3d at 231 (emphasis in original). The debtor in *Mintze* asserted claims against a finance company under the Truth in Lending Act, and other federal and state consumer protection laws. The *Mintze* court found the debtor failed to raise any statutory claims under the Bankruptcy Code, or its underlying purposes, that conflicted with federal arbitration policy. *Id*. at 231-32; *see also Winimo Realty*, 270 B.R. at 124 (bankruptcy court improperly failed to enforce arbitration clause with respect to contract claims that did not arise from rights conferred or obligations imposed by the Bankruptcy Code). *But see In re Brown*, 354 B.R. 591, 603 (D.R.I. 2006) (bankruptcy court properly denied enforcement of arbitration agreement in debtor's TILA suit).

On the other hand, while acknowledging that bankruptcy courts do not have automatic discretion to deny arbitration in core proceedings, in *In re United States Lines, Inc*., the United States Court of Appeals for the Second Circuit deferred to the bankruptcy court's determination that arbitration of core proceedings to recover insurance proceeds would seriously jeopardize the trustee's efforts to preserve and distribute the estate. Accordingly, the court upheld the bankruptcy court's denial of arbitration. *In re United States Lines, Inc*., 197 F.3d 631, 641 (2d Cir. 1999); *see also In re White Mountain Mining Co*., 403 F.3d 164, 171 (4th Cir. 2005) (inherent conflict between Bankruptcy Code and FAA precluded enforcement of arbitration agreement in suit to recharacterize debt as equity).

To enforce an arbitration clause, a litigant must file a motion under Bankruptcy Rule 7056, which provides that Rule 56 of the Federal Rules of Civil Procedure apply in adversary proceedings. Bankruptcy Rule 9014 provides that Bankruptcy Rule 56 also applies to contested matters. The standard for summary judgment under Rule 56(c) generally applies to a motion to enforce an arbitration agreement and to compel arbitration. The party seeking arbitration must show the existence of a valid and binding agreement to arbitrate. The court may take evidence if it finds a question of fact as to the enforceability or scope of the agreement, but, in accordance with summary judgment standards, must consider all evidence presented and construe all reasonable inferences in favor of the party opposing arbitration. *See In re Turner v. Frascella Enters. (In re Frascella Enters.)* 349 B.R. 421, 426-27 (Bankr. E.D. Pa. 2006). However, whether the bankruptcy court has discretion to deny enforcement of the arbitration agreement is a question of law. *Hays*, 885 F.2d at 1152. Rule 56(b) of the Federal Rules of Civil Procedure provides that unless the local rules or an order of the court set a different time, a party may file a motion at any time until 30 days after the close of discovery.

With respect to a pending arbitration proceeding, the litigant may seek relief from the automatic stay to allow claims to be liquidated by the arbitrator. In addition, the litigant may seek remand or abstention in favor of the arbitration proceeding. *See* 28 U.S.C. §§ 1334(c), 1452; Fed. R. Bankr. P. 9027. Bankruptcy Rule 9019(c) provides that the court may authorize arbitration on the stipulation of the parties. The bankruptcy court has no authority to compel arbitration if the parties do not consent.

Section 16 of the FAA provides a party may appeal from an order denying a petition to compel arbitration under section 4 of the FAA and an order refusing a stay of litigation pending arbitration under section 3 of the FAA. Such orders are immediately appealable. *Ansari v. Qwest Communications Corp*., 414 F.3d 1214, 1217 (10th Cir. 2005*); Microchip Tech. Inc. v. U.S. Philips Corp*., 367 F.3d 1350, 1355 (Fed. Cir. 2004). In contrast, orders granting a stay or compelling arbitration are interlocutory and are not immediately appealable, except as otherwise provided in 28 U.S.C. § 1292(b). *Boomer v. AT&T Corp*., 309 F.3d 404, 412 (7th Cir. 2002).

F. <u>Defenses based on prior proceedings.</u>

1. Res Judicata and Collateral Estoppel.

Under the doctrine of *res judicata*, a final judgment on the merits of an action precludes the parties from relitigating claims that were or could have been raised in that action. *Federated Dep't Stores v. Moitie*, 452 U.S. 394, 398 (1981). The doctrine is applicable when (a) the prior decision was rendered by a court of competent jurisdiction; (b) the judgment on the merits is final; (c) both cases involve the same parties or their privies; and (d) both cases involve the same causes of action. *See In re Piper Aircraft Corp.,* 244 F.3d 1289, 1296 (11th Cir. 2001). If the new claim was or could have been raised in the prior action, *res judicata* applies and bars the new claim. *See id.*

Collateral estoppel bars relitigation of a previously decided issue when the parties are the same (or in privity), if the party against whom the issue was decided had a full and fair opportunity to litigate the issue. *Allen v. McCurry,* 449 U.S. 90, 95 (1980). Collateral estoppel applies when (a) the issue at stake is identical to one decided in the prior litigation; (b) the issue was actually litigated in the prior proceeding; (c) the prior determination of the issue was a critical and necessary part of the judgment in that earlier decision; and (d) the standard of proof in the prior action was at least as stringent as the standard of proof in the later case. *In re Se. Banking Corp.*, 69 F.3d 1539, 1552 (11th Cir. 1995).

Res judicata constitutes "claim preclusion" and collateral estoppel "issue preclusion," but the two doctrines are difficult to distinguish in application. *See Allen v. McCurry*, 449 U.S. at 94 (under *res judicata*, final judgment on merits precludes parties from relitigating issues that were or could have been raised in the action; under collateral estoppel, a decision of fact or law necessary to a prior judgment precludes relitigation of the issue in a different cause of action involving party to the first case). The two doctrines relieve parties and the courts of the cost and vexation of multiple lawsuits, prevent inconsistent rulings, and encourage reliance on adjudication. *Id*.

The Full Faith and Credit Act, 28 U.S.C. § 1738, requires federal courts to give state court judgments the same preclusive effect the judgment would have under the law of the state in which the judgment was rendered. *Migra v. Warren City Sch. Dist. Bd. of Educ*., 465 U.S. 75, 81 (1984); s*ee also Marrese v. Am. Acad. of Orthopaedic Surgeons*, 470 U.S. 373, 380 (1985) (state law of preclusion applies even when claim is subject to exclusive federal jurisdiction). Federal judgments have similar preclusive effect (subject to state law of preclusion in diversity cases). *See Semtek Int'l Inc. v. Lockheed Martin Corp*., 531 U.S. 497, 506-07 (1976). Accordingly prior state or federal judgments may bind parties attempting to revisit in bankruptcy court issues previously litigated. Similarly, bankruptcy court judgments have preclusive effect in subsequent litigation. 11 U.S.C. § 1141(a); *see, e.g., Travelers Indem. Co. v. Bailey*, 557 U.S. 137, 151-55 (2009); *In re Optical Techs., Inc.*, 425 F.3d 1294, 1300 (11th Cir. 2005). For example, parties with notice or knowledge of the bankruptcy case are bound by the terms of a confirmed plan and are precluded from relitigating claims or issues resolved by the confirmation order. *See Optical Techs., Inc.*, 425 F.3d at 1301; *In re Am. W. Airlines, Inc.*, 179 B.R. 893, 897-98 (Bankr. D. Ariz. 1995) (arguments in support of proof of claim were actually objections to plan that should have been raised at confirmation hearing) (disallowing proof of claim based on *res judicata* effect of confirmation order). Without limitation, claim and issue preclusion applies only to parties that had the chance to fully and fairly litigate the same issues. *See Levi Strauss & Co. v. Abercrombie & Fitch Trading Co.,* 719 F.3d 1367, 1371-72 (Fed. Cir. 2013).

Claim and issue preclusion may apply even where the bankruptcy court exceeds its jurisdiction in entering judgment. In *In Travelers Indem. Co. v. Bailey*, the Supreme Court reversed a decision of the Second Circuit that invalidated part of a bankruptcy court order from 1986. *Bailey,* 557 U.S. 137, 155-56 (2009). The Court held that a litigant that was party to the proceedings (or in privity with a party) and had a fair chance to challenge jurisdiction at the time could not defend enforcement of the order for lack of jurisdiction. *Id.* at 153.

2. Rooker Feldman

The lower federal courts lack jurisdiction to hear collateral attacks on state court judgments or to review state court rulings. *D.C. Ct. of App. v. Feldman*, 460 U.S. 462, 483 (1983); *Rooker v. Fidelity Trust Co*., 263 U.S. 413, 414-17 (1923). The Rooker-Feldman doctrine applies to "cases brought by state-court losers complaining for injuries caused by state-court judgments rendered before the district court proceedings and inviting district court review and rejection of those judgments." *Exxon Mobil Corp. v. Saudi Basic Indus. Corp*., 544 U.S. 280, 284 (2005).

Rooker-Feldman applies to bankruptcy courts and may deprive the bankruptcy court of subject matter jurisdiction over proceedings related to prior state court judgments. *See, e.g., In re Singleton*, 230 B.R. 533, 536 (B.A.P. 6th Cir. 1999); *In re Audre, Inc*., 216 B.R. 19, 32 (B.A.P. 9th Cir. 1997); *In re Nugent*, 254 B.R. 14, 31 (Bankr. D.N.J. 1998). Essentially, Rooker-Feldman stands for the proposition that lower federal courts cannot hear appeals from state court judgments. The doctrine is broader that *res judicata* or collateral estoppel because it is not dependent upon finality of the prior order. *Dubinka v. Judges of Super. Ct.*, 23 F.3d 218, 219 (9th Cir. 1994). When a litigant loses in a state court, its remedy is to pursue an appeal to a higher state court, not to ask a federal court to relieve it of the judgment*. See E.B. v. Verniero*, 119 F.3d 1077, 1091-92 (3d Cir. 1997); *In re Besing*, 981 F.2d 1488, 1496 (5th Cir. 1993); *In re Nugent*, 254 B.R. at 31. Rooker-Feldman does not affect the United States Supreme Court's jurisdiction over rulings by state supreme courts. *Verniero*, 119 F.3d at 1092.

For example, the Rooker-Feldman doctrine prevents a bankruptcy court from reconsidering a state court judgment concerning the debtor's liability under a franchise agreement, and a state court's award of damages for fraud. *See In re Nugent*, 254 B.R. at 31; *In re Keenan*, 201 B.R. 263, 266 (Bankr. S.D. Cal. 1996). The doctrine applies even where the state court judgment may be in error. *In re Audre, Inc.*, 216 B.R. at 29. The bankruptcy court must respect the judgment, and the litigant's only remedy is by way of appeal through the state court system.

However, the doctrine is not unlimited in application. Rooker-Feldman does not apply to judgments procured by fraud, deception, accident, or mistake. *In re Sun Valley Foods Co.,* 801 F.2d 186, 189 (6th Cir. 1986). Rooker-Feldman does not bar federal suits by litigants not a party to the state court action. *Snider v. City of Excelsior Springs*, 154 F.3d 809, 812 (8th Cir. 1998). Other courts have held the doctrine will not apply to parties that had no reasonable opportunity to raise federal claims in state court. *Wood v. Orange Cnty.*, 715 F.2d 1543, 1547 (11th Cir. 1983).

Most notably, Rooker-Feldman may not apply where the state court judgment is void *ab initio* due to lack of jurisdiction. *In re James*, 940 F.2d 46, 52 (3d Cir. 1991). For example, because a judgment in violation of the automatic stay is void under federal law, some courts have held that a bankruptcy judge may review a state court's determination of whether a particular action violated the automatic stay. *In re Dunbar*, 245 F.3d, 1058, 1062-63 (9th Cir. 2001). Other courts have not allowed collateral attacks on the non-bankruptcy court's determination of its own jurisdiction. *NLRB v. Edward Cooper Painting, Inc.*, 804 F.2d 934, 939 (6th Cir. 1986). Similarly, some courts have held that Rooker-Feldman does not prevent bankruptcy courts from reconsidering state judgments concerning matters within exclusive federal jurisdiction, such as the scope or enforceability of a discharge. *In re McGhan*, 288 F.3d 1172, 1179-80 (9th Cir. 2002). Other courts have been less willing to limit Rooker-Feldman so expansively. *GASH Assocs. v. Vill. of Rosemont*, 995 F.2d 726, 728 (7th Cir. 1993); *Picco v. Global Marine Drilling Co*., 900 F.2d 846, 850 (5th Cir. 1990).

As a result of the confused application of Rooker-Feldman to bankruptcy issues, parties favoring bankruptcy court jurisdiction—to enforce the stay or to enforce a discharge, for example—are well-advised to apply for relief to the bankruptcy court before seeking a ruling from a state court. On the other hand, litigants with a favorable ruling from a state court judge have ample opportunity to challenge the re-litigation of any claim linked or inextricably intertwined with the state court judgment. *See In re Goetzman*, 91 F.3d 1173, 1177 (8th Cir. 1996); *In re Morrow*, 189 B.R. 793, 808-09 (Bankr. C.D. Cal. 1995).

3. Law of the Case.

The law of the case doctrine provides that the resolution of an issue decided at one stage of a case is binding at later stages of the same case. *Schiavo ex rel. Schiavo v. Schiavo*, 403 F.3d 1289, 1291 (11th Cir. 2005). The doctrine applies in bankruptcy cases and promotes finality and efficiency by encouraging courts to follow their own decisions within a case. *In re Pilgrim's Pride Corp.*, 442 B.R. 522, 529 (Bankr. N.D. Tex. 2010); *see also Litman v. Mass. Mut. Life Ins. Co.*. 825 F.2d 1506, 1511 (11th Cir. 1987) (failure to honor law of the case results in chaos). A court should not revisit its decisions in a case, except in extraordinary circumstances. *In re Pilgrim's Pride Grp.,* 442 B.R. at 529 n.14. Accordingly, prior rulings in a bankruptcy case may be determinative of various issues in subsequent litigation. *See In re Moye*, 437 F. App'x 338, 342 (5th Cir. 2011) (prior ruling on perfection of security interest was conclusive in subsequent claim litigation under law of case doctrine).

4. Plan releases and discharge.

Generally, confirmation of a plan discharges all debts that arose before confirmation. 11 U.S.C. § 1141(d) (exceptions listed in subsection (d)(2)). The discharge converts the automatic stay, which is a temporary injunction against collection of pre-petition claims, into a permanent injunction binding on all creditors and parties in interest. 11 U.S.C. § 1141(a); *see also Celotex Corp v. Edwards*, 514 U.S. 300, 313 (1995) (a party cannot challenge a bankruptcy court's injunction by collateral attack in another forum). As discussed above, confirmation orders have preclusive effect under the doctrines of *res judicata* and collateral estoppel, and also may give rise to other defenses, such as waiver. *See* section II.i. below. Subject only to the hazards of the Rooker-Feldman doctrine, and a judge who does not understand the effect of discharge or does not care, parties should enjoy protection from relitigation of issues and claims resolved in chapter 11 plans and confirmation orders. *See, e.g., D&K Props. Crystal Lake v. Mut. Life Ins. Co*., 112 F.3d 257, 259-62 (7th Cir. 1997); *In re Laing*, 31 F.3d 1050, 1051 (10th Cir. 1994); *Eubanks v. FDIC*, 977 F.2d 166, 170-71 (5th Cir. 1992). The *res judicata* effect of confirmation orders may extend to rulings that are erroneous for which the bankruptcy court lacked subject matter jurisdiction. *Stoll v. Gottlieb*, 305 U.S. 165, 172 (1938); *see also Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1052-53 (5th Cir. 1987) (absent objection to confirmation, *res judicata* barred enforcement of guaranty released under plan). Common challenges to a plan discharge include lack of notice and arguments that the claim arose post-confirmation. *See generally In re Arch Wireless*, 534 F.3d 76, 79 (1st Cir. 2008); *Lemelle v. Universal Mfg. Corp*., 18 F.3d 1268, 1271 (5th Cir. 1994); *In re Chateaugay Corp*., 944 F.2d 997, 999 (2d Cir. 1991).

In addition to discharge, chapter 11 plans commonly feature releases of third parties. Although section 524 of the Bankruptcy Code provides that the discharge does not apply to non-debtors, debtors have argued that third party releases are not an extension of the discharge but rather may be reasonable and necessary to implement a plan. Nothing in the Bankruptcy Code specifically authorizes or prohibits third party releases in plans. *See Genesis Health Ventures, Inc*., 266 B.R. 591, 603 (Bankr. D. Del, 2001). Bankruptcy courts in various jurisdictions have found that the courts' broad equitable powers authorize third party releases as necessary to effectuate the purposes of chapter 11. Of course, any party can release claims against the debtor and non-debtors as part of a consensual settlement. The circuit courts are split on whether non-consensual releases of third parties are valid. Case law from the Fifth, Ninth, and Tenth Circuits appear to bar non-consensual third party releases per se. *See In re Pac. Lumber Co*., 584 F.3d 229, 252 (5th Cir. 2009); *In re Lowenschuss*, 67 F.3d 1394, 1401-02 (9th Cir. 1995); *In re Zale Corp*., 62 F.3d 746, 760 (5th Cir. 1995); *In re W. Real Estate Fund, Inc*., 922 F.2d 592, 600 (10th Cir. 1990). The Second, Fourth, Sixth, and Seventh Circuits have upheld non-consensual third party plan releases. *See In re Airadigm Commc'ns, Inc*., 519 F.3d 640, 657-58 (7th Cir. 2008); *In re Dow Corning*, 280 F.3d 648, 663 (6th Cir. 2001); *In re Drexel Burnham Lambert Grp., Inc*., 960 F.2d 285, 293 (2d Cir. 1992); *In re A.H. Robins Co*., 880 F.2d 694, 702 (4th Cir. 1989). The Third Circuit has been at war with itself but has not established a per se rule barring such releases. *See In re Cont'l Airlines*, 203 F.3d 203, 211-12 (3d Cir. 2000). Courts considering non-debtor third party releases often apply the following factors: (a) whether the debtor and the third party share an identity of interest; (b) substantial contribution by the non-debtor of assets to the reorganization as consideration for the release; (c) how essential the release is to the reorganization; (d) the level of support among affected classes; and (e) the treatment of the affected classes. *See, e.g., In re Transit Grp. Inc*., 286 B.R. 811, 817 (Bankr. M.D. Fla. 2001); *In re Zenith Elecs. Corp*., 241 B.R. 92, 110 (Bankr. D. Del. 1999); *In re Master Mortgage Investment Fund, Inc.*, 168 B.R. 930, 934-35 (Bankr. W.D. Mo. 1994). The United States Court of Appeals for the Fourth Circuit recently applied the foregoing factors in holding that the release of non-debtor officers and directors of a nonprofit charitable organization was not warranted. Although the officers and directors had an identity of interest with the debtor, the court found the third parties did not make a substantial contribution to the reorganization and the releases were not essential to the reorganization. Further, the court would not infer creditor support because the donor class most affected by the proposed release was unimpaired and did not vote on the plan. Finally, the plan did not provide a mechanism to pay or treat the released claims. *See National Heritage Foundation Inc. v. Highbourne Foundation*, ___ F.3d ___, 2014 WL 2900933 (4th Cir., June 27, 2014); see also *In re J.C. Householder Land Trust #1*, 501 B.R. 441 (Bankr. M.D. Fla. 2013) (enjoining claims against principals under section 105 based on identity of interest, depletion of personal assets to support debtor, and other factors); *In re Charles Street AME Church of Boston*, 499 B.R. 66 (Bankr. D. Mass. 2013) (refusing to enjoin guaranty claims against ecclesiastic authorities); *In re Indianapolis Downs*, LLC, 486 B.R. 286 (Bankr. D. Del. 2013) (releases approved based on wide approval by creditors, opt-out provisions, and other factors).

Applying these factors in the *ResCap* case, the United States Bankruptcy Court for the Southern District of New York approved third-party releases of Ally Financial, Inc. and certain affiliates ("AFI") in consideration of AFI's contribution of $2.1 billion to the debtor's estate. *See In re Residential Capital, LLC*, 508 B.R. 838, 845 (Bankr. S.D.N.Y. 2014). The *ResCap* court subsequently enforced the release (and the debtor's discharge) against plaintiffs seeking to "sidestep the confirmed chapter 11 plan" by asserting counterclaims against the debtor and AFI in a foreclosure action in a state court in Oregon. *Id.* at 847. Among other things, the plaintiff could not establish cause to modify the automatic stay because the discharge and release in the plan rendered litigation of the claims futile in any forum. *Id.* at 848. Moreover, the plaintiff failed to object to the third party release, which the bankruptcy court approved as a "key component" to AFI's $2.1 billion contribution, which was "a significant factor to achieving … confirmation and a global resolution" of the chapter 11. *Id.* at 850. Accordingly, the plaintiff was bound by the release and enjoined from pursuing the claims. The court ordered the plaintiff to dismiss the claims under threat of contempt. *Id.* at 850-51; *see In re Residential Capital, LLC*, 2014 WL 2809113 (Bankr. S.D.N.Y. June 20, 2014) (enforcing third party plan releases and injunction against litigants in California, finding grounds to impose sanctions, but denying sanctions, without prejudice, due to insufficient evidence to determine reasonableness of fees).

An effective injunction of claims against non-debtor third parties arises under section 363(f) of the Bankruptcy Code, which most courts interpret broadly to allow the sale of assets free and clear of all claims, including successor liability claims. The implications of sales free and clear under section 363(f) has become a major policy discussion in the General Motors case. On June 26, 2009, the United States Bankruptcy Court for the Southern District of New York entered an order approving the sale of assets by General Motors Corp. (Old GM) to General Motors LLC (New GM), free and clear of all claims other than assumed liabilities. In April 2014, New GM returned to the bankruptcy court to seek an injunction against litigation arising out of defective ignition switches. New GM did not seek to enjoin claims for personal injury, death, and property damages arising from the defect because New GM specifically assumed such liabilities in the sale. However, New GM sought to enjoin lawsuits to collect economic damage claims for lost value, replacement costs, lost wages, etc. New GM points out in its motion that several interested parties, including Old GM vehicle owners, consumer groups, and several State Attorneys General objected to the sale free and clear of such economic claims. The bankruptcy court overruled their objections. *See Burton v. Chrysler Grp., LLC,* 492 B.R. 392, 394 (Bankr. S.D.N.Y. 2013) (enjoining similar claims on similar grounds in the Chrysler bankruptcy).

Plaintiffs in pending ignition switch cases have countered various legal and equitable arguments, seeking to conflate New GM with Old GM especially with respect to evidence that Old GM failed to disclose its knowledge of the liabilities. The plaintiffs also have argued fraud on the court. The essential legal point of their arguments, however, seems to be that the injunction is unenforceable as a matter of due process because the plaintiffs did not receive notice of applicable bar dates for filing claims. *See In re Trans World Airlines*, 96 F.3d 687, 689-90 (3d Cir. 1996) (due process vitiates discharge for claimants with insufficient notice); *In re Grumman Olson Indus.*, 467 B.R. 694, 706 (S.D.N.Y. 2012) (refusing to enforce sale order injunction against claimants that did not receive notice).

5. Waiver.

Waiver is the intentional relinquishment of a known right. *Kontrick v. Ryan*, 540 U.S. 443, 458 n.13 (2004). Generally, a litigant must plead waiver as an affirmative defense under Fed. R. Civ. P. 8(c), which applies in adversary proceedings under Bankruptcy Rule 7008 but does not apply in contested matters under Bankruptcy Rule 9014.

The Bankruptcy Code includes numerous provisions concerning waiver of substantive rights and defenses. *See, e.g.*, 11 U.S.C. §§ 106 (waiver of sovereign immunity), 365(d)(3) (lessor does not waive rights by accepting performance of trustee), 365(n)(2)(C) (licensee electing to retain rights following rejection of licensing agreement deemed to waive rights of set off and administrative claims), 553(e) (waiver of exemptions), and 1307 (waiver of right to convert or dismiss).

In addition, parties may waive rights otherwise available under the Bankruptcy Code by agreement or conduct. A common example is the waiver of rights, claims, and defenses by the debtor or the estate in adequate protection agreements, cash collateral agreements, or DIP financing orders. For example, the debtor may waive the right to surcharge collateral under section 506(c) of the Bankruptcy Code, the right to challenge the amount of the creditor's claim or the perfection of liens, and other defenses to payments and counter-claims. Such waivers are not enforceable without a court order on proper notice and hearing and may not apply to subsequent trustees, or to creditors with insufficient notice, or to committees appointed later in the case. *See, e.g., In re Precision Concepts, Inc.*, 305 B.R. 438, 445 (Bankr. M.D. N.C. 2004); *In re UNR Indus.*, 71 B.R. 467, 477 (Bankr. N.D. Ill. 1987). Courts may decline to approve blanket waivers as contrary to the debtor's fiduciary duties to the estate and creditors. *See In re Roblin Indus.*, 52 B.R. 241, 243 (Bankr. W.D.N.Y. 1985). Courts routinely approve waivers that allow affected parties a reasonable time to investigate and pursue the rights or defenses waived. *See In re Nat'l Forge*, 304 B.R. 214, 222-23 (Bankr. W.D. Pa. 2004). A debtor's waiver that preserves the rights of an official committee may be enforceable against a subsequent trustee if the committee is dissolved upon conversion to chapter 7. *In re MS55, Inc.*, 477 F.3d 1131, 1135 (9th Cir. 2007). Under Bankruptcy Rule 4001(c)(1)(B), a motion to authorize post-petition financing specifically must describe any proposed waivers.

Courts may find implied waivers based on conduct or inaction of a party, such as failure to object to lack of adequate protection upon notice, or assertion of rights contrary to a confirmed plan. *See, e.g., In re Varat Enters., Inc.*, 81 F.3d 1310, 1317 (4th Cir. 1996); *In re E-Z Serve Convenience Stores, Inc.*, 318 B.R. 631, 636 (M.D.N.C. 2004); *In re Twins, Inc.,* 318 B.R. 90, 96 (Bankr. D.S.C. 2004); *see also In re Am. W. Airlines, Inc.*, 179 B.R.

893, 897-98 (Bankr. D. Ariz. 1995) (arguments in support of proof of claim were actually objections to plan that should have been raised at confirmation hearing).

However, due process requires notice and hearing before a party may be deemed to have waived rights through failure to object. *See In re Olde Prairie Block Owner, LLC*, 448 B.R. 482, 496 (Bankr. N.D. Ill. 2011). Courts may be reluctant to find waiver if the party has made a good faith effort to assert its rights, but avoiding a waiver may require attention to proceedings other than the primary litigation in which a party is involved. *See In re LandSource Cmtys. Dev. LLC*, 476 B.R. 454, 461-62 (Bankr. D. Del. 2012) (refusing to find waiver for failure to file objection to DIP financing in accordance with court notice where competing lienholders had filed notice of mechanics lien under section 546(b)).

Section 558 of the Bankruptcy Code provides that the estate shall have the benefit of any defense available to the debtor and that the waiver of any such defense by the debtor after commencement of the case does not bind the estate. Accordingly, pre-petition waivers by the debtor may provide a defense to causes of action asserted by the debtor or the estate, and may provide a basis for a motion to dismiss or motion for summary judgment. Waivers based on pre-petition conduct normally will be determined in accordance with applicable non-bankruptcy law. Although parties may waive important rights in bankruptcy cases by ignoring notices or failing to object to relief sought by other parties, silence or inaction is less likely to be an adequate basis for implied waiver under non-bankruptcy law. *See In re Calore Express Co*., 288 F.3d 22, 38 (1st Cir. 2002).

Borrowers commonly waive or release claims and defenses in loan extension, forbearance, or workout agreements. Generally, such waivers are enforceable if voluntary and knowing and supported by valid consideration*. See, e.g., BancBoston Mortg. Corp. v. Harbor Estates P'ship*, 768 F. Supp. 170, 172-74 (W.D.N.C. 1991); *Freedlander, Inc. v. NCNB Nat'l Bank*, 706 F. Supp. 1211, 1215-17 (E.D. Va. 1988), *aff'd*, 921 F.2d 272, 272 (4th Cir. 1990). A borrower also may waive the lender's alleged breach of a loan agreement by continuing to accept advances. *Nat'l Westminster Bank v. Ross*, 130 B.R. 656, 675 (S.D.N.Y. 1991), *aff'd*, 962 F.2d 1,1 (2d Cir. 1992).

Similarly, a lender may waive enforcement rights by failure strictly to enforce default remedies. *Compare In re Kids Creek Partners, L.P*., 212 B.R. 898 (Bankr. N.D. Ill. 1997), *aff'd*, 233 B.R. 409, 932-35 (N.D. Ill. 1999), *aff'd*, 200 F.3d 1070, 1075 (7th Cir. 2000) (lender did not waive defaults by advancing funds post-default) *with Hildago Props., Inc. v. Wachovia Mortg. Co*., 617 F.2d 196, 199 (10th Cir. 1980) (lender's failure to demand timely performance created waiver issue for jury). Express anti-waiver clauses, providing that failure to enforce rights or remedies shall not constitute waiver thereof, are enforceable. *See Monarch Coaches, Inc. v. ITT Indus. Credit,* 818 F.2d 11, 13 (7th Cir. 1987). However, some courts have held that anti-waiver clauses, like any other provision of a contract, are themselves subject to waiver or modification by course of conduct. *Westinghouse Credit Corp. v. Shelton*, 645 F.2d 869, 873-74 (10th Cir. 1981). Even with anti-waiver provisions, parties forbearing from strict exercise of remedies are well advised to reserve all rights and disclaim waiver.

G. <u>Defenses based on the actions of other parties.</u>

1. The Doctrine of *In Pari Delicto* and Exceptions to the Defense

The *in pari delicto* doctrine is an equitable rule. The name finds its roots in the Latin sentence, *in pari delicto potior est conditio defendantis*, which means "where the wrong of both parties is equal, the position of the defendant is stronger". *Knauer v. Jonathon Roberts Financial Group, Inc.*, 348 F.3d 230, 236 (7th Cir. 2003). The doctrine generally "prohibits a plaintiff from maintaining a claim if the plaintiff himself bears equal fault for the alleged injury." *Knauer v. Jonathan Roberts Fin. Group, Inc.*, 348 F.3d 230, 233 (7th Cir. 2003).

The defense is based on (1) the equitable principle that a party should not profit from its own misconduct, and (2) the fundamental principle of agency law that the acts and knowledge of an agent are imputed to the principal where the agent is acting within the scope of its agency. *In re Bennett Funding Group, Inc.,* 336 F.3d 94, 100 (2d. Cir. 2003). In order to assert *in pari delicto* against a corporation, the defendant must show that the conduct of the employees acting on behalf of the company can be imputed to the corporation (or a trustee stepping into the corporation's shoes). *See Cenco v. Seidman & Seidman*, 686 F.2d 449, 454 (7th Cir. 1982). Thus, in this context *in pari delicto* and imputation are essentially part and parcel of the same defense. Imputation serves to attribute individuals' actions to the corporation for purposes of determining whether the corporation's claims are barred by the *in pari delicto* rule. *Id.*

(a) The "Adverse Interest" Exception

Under the "adverse interest" exception to the *in pari delicto* defense, the tortious acts of an agent will not be imputed to the principal, and the defense of *in pari delicto* will not apply, where the agent is acting solely for its own benefit. This exception is based on the principle that imputation is not justified where the agent is acting adverse to the principal. *Grassmueck v. American Shorthorn Ass'n,* 402 F.3d 883, 837 (8th Cir. 2005). There appears to be some disagreement among courts with respect to the extent to which the complained of conduct must be harmful to the company for the so-called "adverse interest" exception to apply. In the First Circuit, "imputation may be avoided where the wrongdoing is done *primarily* for personal benefit of the officer and is 'adverse' to the interest of the company." *Baena v. KPMG LLP*, 453 F.3d 1, 7 (1st Cir. 2006) (emphasis added). The Second Circuit, applying New York law, holds that the adverse interest exception "applies only when the agent has 'totally abandoned' the principal's interests." *In re Mediators, Inc.*, 105 F.3d 822, 827 (2d Cir. 1997); *accord Kirschner v. KPMG LLP*, 938 N.E.2d 941, 952-54 (N.Y. Ct. App. 2010).

(b) The "Sole Actor Rule"

Some circuits, including the Second and Third Circuits, recognize a limitation to the adverse interest exception called the "sole actor" exception. *Id.*; *see also Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 360 (3d Cir. 2001). Under the "sole actor" exception, when the agent who committed the fraud was also the sole shareholder of the corporation or "dominated" the corporation, the adverse interest exception will not apply. *Lafferty*, 267 F.3d at 280 (applying sole actor exception and imputing conduct to creditors' committee where the Shapiro family, who dominated the debtors, participated in the fraud). The rationale for this rule is that the sole agent has no one else to whom he can transfer his knowledge, and from whom he can hide it, and therefore the corporation must shoulder the responsibility for allowing this agent to act without accountability. *Id.* at 359.

(c) The "Innocent Director Exception"

The sole actor rule is sometimes limited by the "innocent director exception." Under this exception, the sole actor rule is inapplicable, where at least one decision maker is innocent and could have stopped the wrongful conduct if aware of such conduct. *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P.,* 212 B.R. 34, 36 (S.D.N.Y. 1997); *In re CBI Holding Co., Inc.,* 311 B.R. 350, 371 (S.D.N.Y. 2004), *on reh'g,* 318 B.R. 761 (S.D.N.Y. 2004) ("The innocent insider exception…focuses on whether some part of the management was innocent of the misconduct, unaware of it, and able to prevent it had the misconduct been known"). In *Wechsler,* the court found that the complaint failed to allege the "existence of an innocent member of [debtor's] management who would have been able to prevent the fraud had he known about it," and therefore decided that the adverse interest exception precluded imputation. *Wechsler,* 212 B.R. at 38.

(d) Application of *In Pari Delicto* to Bankruptcy Trustees

(i) 7th Circuit *Scholes* Decision

The Seventh Circuit, in *Scholes v. Lehmann,* held a receiver could not be *in pari delicto* with other participants in a fraudulent scheme. 56 F.3d 750, 754-55 (7th Cir. 1995). In *Scholes*, an individual named Michael Douglas masterminded a Ponzi scheme through three corporations he created. *Id.* at 752. After the SEC brought an enforcement action, Steven Scholes was appointed receiver for Douglas and the corporations. *Id.* Scholes sought to recover assets transferred to investors in the Ponzi scheme as fraudulent transfers, and the defendants asserted that the claim belonged to the investors and not the receiver and, in any event, that the claims were barred by *in pari delicto*. *Id.* at 753-54.

With respect to whether these were claims that belonged to the receiver, the court held that the transfers made by Douglas through his three shell corporations "removed assets from the corporations for an unauthorized purpose and by doing so injured the corporations." *Id.* at 754. Thus, the receiver was a proper plaintiff to seek redress for those injuries. *Id.*

With respect to *in pari delicto*, the court held that the defense did not apply, because the "appointment of the receiver removed the wrongdoer from the scene" and "[f]reed from [Douglas'] spell [the corporations] became entitled to the return of the moneys – for the benefit not of Douglas but of innocent investors – that Douglas had made the corporations divert to unauthorized purposes." *Id.* at 754. "Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated . . . . Now that the corporations created and initially controlled by Douglas are controlled by a receiver whose only object is to maximize the value of the corporations for the benefit of their investors and any creditors, we cannot see an objection to the receiver's bringing suit to recover corporate assets unlawfully dissipated by Douglas." *Id.* at 755.

Similarly, in *FDIC v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995), the court held that *in pari delicto* did not apply to a receiver's claims against a law firm. The court reasoned that "there is little reason to impose the same punishment on *a trustee*, receiver or similar entity that steps into the party's shoes pursuant to court order or operation of law . . . . A receiver, *like a bankruptcy trustee* and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes." *Id.* (emphasis added).

(ii) Application of *Scholes* to Bankruptcy Trustees

O'Melveny and *Scholes* have not been extended to bankruptcy trustees. In *Peterson v. McGladrey & Pullen LLP*, 676 F.3d 594 (7th Cir. 2012), the Seventh Circuit held that there was no bankruptcy exception to the doctrine notwithstanding its ruling in *Scholes*. The Peterson decision involved unique facts: the debtor began as a legitimate business and only became a Ponzi scheme when the fund's manager learned it had been the victim of a larger Ponzi scheme. To cover up the debtor's shortfalls, the fund's owner conducted his own Ponzi scheme. The Seventh Circuit reinstated the trustee's complaint on the basis that the Trustee sued the auditors for audits conducted during time periods when the trustee alleged the fund manager was not engaged in fraud. In reaching its conclusion that *in pari delicto* could bar the suit depending on how the facts developed, the Seventh Circuit held that the question is one of state law, suggesting that if state law recognized an exception for bankruptcy trustees, then the doctrine would not apply. *Id*. at 598-99.

Eight other Circuit Courts of Appeal (the First, Second, Third, Sixth, Eighth, Ninth, Tenth and Eleventh) agree and all have allowed a defendant to rely upon the *in pari delicto* defense to claims brought by a bankruptcy trustee: *USACM Liquidating Trust v. Deloitte & Touche*, LLP, Case No. 11-15626, 2014 U.S. LEXIS 10685 (9th Cir. June 6, 2014); *Nisselson v. Lernout*, 469 F.3d 143, 153 (1st Cir. 2006); *Official Committee of Unsecured Creditors v. Coopers & Lybrand LLP,* 322 F.3d 147, 158-66 (2d Cir. 2003); *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 356-57 (3rd Cir. 2001); *Dublin Secs. Inc*., 133 F. 3d 277 (6th Cir. 1997); *Grassmueck v. Am. Shorthorn Ass'n*, 402 F.3d 833, 836-37 (8th Cir. 2005); *Sender v. Buchanan (In re Hedged-Investments Assocs., Inc.)*, 84 F. 3d 1281 (10th Cir. 1996); *Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards,* 437 F.3d 1145, 1150-51 (11th Cir. 2006).

(e) The *Wagoner* Rule

In the context of suits brought by bankruptcy trustees, some courts frame these issues not in terms of *in pari delicto* but in terms of standing. *See Picard v. HSBC Bank PLC*, 454 B.R. 25, 37 (S.D.N.Y. 2011). The Second Circuit has adopted a distinct approach to whether conduct by the debtor's principals can be imputed to the bankruptcy trustee. Under what has become known as the *Wagoner* rule: (1) a trustee only has standing to bring claims the debtor could have brought before bankruptcy and (2) generally, misconduct by debtor's principals is imputed to the trustee. Despite the different label, the first prong is essentially the issue discussed in *Lafferty* regarding whether *in pari delicto* applies to bankruptcy trustees and the second prong is an imputation analysis.

The *Wagoner* rule comes from the Second Circuit's decision in *Shearson Lehman Bros. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991), which applied New York state law. In *Wagoner*, Herbert Kirschner formed HMK Management Corporation through which he sold useless notes to his friends and used the proceeds to make stock trades in the name of HMK, which subsequently went bankrupt. *Id.* at 116. Shearson Lehman took commissions on the trades executed by HMK. *Id.* The trustee for HMK sued Shearson, claiming they breached their fiduciary duties. *Id.* The court first addressed Shearson's argument that the trustee "lacks standing because the claims he alleges on behalf of HMK's estate are really those of the noteholders." *Id.* at 117. In assessing that argument the court considered "whether in the case at hand there is any damage to the *corporation*, apart from that done to the third-party creditor noteholders" and whether HMK possessed claims against Shearson before it went bankrupt. *Id.* at 118. Applying that test, the court held that the trustee could maintain claims for churning, but not for dissipating corporate funds. *Id.* at 119. The court reasoned that a "claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation." *Id.* at 120.

Following *Wagoner*, courts in the Second Circuit have rejected claims by bankruptcy trustees against third parties who participated in fraudulent schemes with insiders of the debtor, even where New York law does not apply. *See, e.g., Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1093 (2d Cir. 1995) (trustee did not have standing under Connecticut law to pursue claims regarding distribution of misleading PPMs to investors and claims regarding deficient professional services were barred because debtor's principals were involved in fraudulent Ponzi scheme).

Strict application of the second prong of the *Wagoner* rule would appear to bar claims by the trustee even if the fraud hurt the company. *See Mediators*, 105 F.3d at 827 (explaining that in *Wagoner* the trustee's claims were barred even though the insider's misconduct in that case was "entirely adverse" to the debtor). In other words, although the "adverse interest" exception does apply to the *Wagoner* rule, it is narrow and only applies when the insider has "totally abandoned" the principal's interest. *Id.*

(f) Damage allocation

Bar orders are increasingly used to encourage partial settlement of litigation involving multiple defendants by barring contribution claims against settling defendants by non-settling defendants. *Eichenholtz v. Brennan*, 52 F.3d 478, 486 (3d Cir. 1995). "Without the ability to limit the liability of settling defendants through bar orders it is likely that no settlements could be reached." *In re Worldcom, Inc. ERISA Litig.*, 339 F. Supp. 2d 561, 568 (S.D.N.Y. 2004); *see also Cullen v. Riley (In re Masters Mates & Pilots Pension Plan and IRAP Litig.)*, 957 F.2d 1020, 1028 (2d Cir. 1992). Bankruptcy courts have the ability to enter such orders. *Matter of Munford, Inc.*, 97 F.3d 449, 455 (11th Cir. 1996). Such orders are often included in confirmation orders that settle litigation. *See In re Tribune Co.*, 464 B.R. 126, 176-80 (Bankr. D. Del. 2011).

There are three basic methods for judgment reductions to ensure that non-settling defendants obtain a judgment credit reduction that is at least equal to the settling defendant's proven share of liability: (1) *pro rata* (which apportions an equal share of liability to each defendant, without regard to culpability); (2) proportionate fault method (under which the finder of fact assesses the relative culpability of both settling and non-settling defendants and the non-settling defendants pay only a commensurate share of the judgment); and (3) *pro tanto* (which reduces a non-settling defendant's liability for a judgment in the amount paid by the settling defendant). *Id*. at 1028-29. The Supreme Court has acknowledged the fairness of the proportionate fault method. *See McDermott, Inc. v. AmClyde*, 511 U.S. 202, 209 (1994).

4. Section 550

The Bankruptcy Code contains separate requirements for the avoidance and recovery of transfers that are avoided under Sections 544-549, 553 and 724 of the Bankruptcy Code. Even if a transfer from a debtor is avoided, whether it is *recoverable* or not is a separate question that is answered by § 550. *See, e.g.*, *In re Fisher*, 296 Fed. App'x 494, at *8 (6th Cir. 2008) ("[a]voidance and recovery are distinct, with the former a necessary precondition for the latter"); *SIPIC v. Bernard L. Madoff Inv. Sec.*, 501 B.R. 26, 30 (S.D.N.Y. 2013) ("it is well established that the concepts of avoidance and recovery are separate and distinct."). Section 550 states in relevant part:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553 (b), or 724 (a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a) (emphasis added). Section 550(d) limits a trustee to a single satisfaction. A number of issues arise under Section 550.

(a) An Avoidance Judgment Is Not Required Before A Section 550 Action May Be Filed.

A majority of courts have held that a trustee need not obtain a fully litigated, final judgment of avoidance against an initial transferee before pursuing recovery under Section 550 against an immediate or subsequent transferee. *See, e.g., In re Int'l Admin. Servs., Inc.*, 408 F.3d 689, 706 (11th Cir. 2005); *SIPIC,* 501 B.R. at 31-32.

(b) Good Faith Defense

Section 550(b) limits liability for immediate or mediate transferees providing that a trustee may not recover from such a transferee if the transferee (a) takes for value, including the satisfaction or securing of a present or antecedent debt, (b) in good faith, and (c) without knowledge of the voidability of the transfer avoided. An immediate transferee does not receive a transfer directly from the debtor. Instead, the immediate transferee receives the transferred property "from someone other than the debtor." *Covey v. Peoria Speakeasy, Inc. (In re Duckworth)*, Case No. 11-8092, 2013 WL 1397456, at *5 (Bankr. C.D. Ill. April 5, 2013). The Section 550(b) good faith defense does not apply to initial transferee in the chain; only to those who received the transferred property from someone other than the debtor.

Nonetheless, the transfer at issue in immediate transferee cases is the transfer that took place between the debtor and the initial transferee. The immediate transferee's good faith and knowledge are based on what the immediate transferee knew about that earlier transfer. *Brandt v. Horseshoe Hammond, LLC (In re Equipment Acquisition Resources, Inc.)*, 2014 U.S. Dist. LEXIS 67100 at *14 (N.D. Ill. May 15, 2014); *cf. Wasserman v. Bressman (In re Bressman)*, 327 F.3d 229 (3rd Cir. 2003) (focusing on transfer from debtor to initial transferee); *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890, 898 (7th Cir. 1988) (explaining that the inquiry should focus on what the immediate transferee knew about the debtor's financial condition or plans to use the debtor in a fraud scheme).

If value is provided for the transfer, an immediate transferee has a complete defense if he or she can show that they took the transfer in good faith and without knowledge of the voidability of the transfer made by the debtor to the initial transferee. Although "good faith" and lack of "knowledge of the voidability of transfers received" are separate elements of a Section 550(b)(1) defense, they are best considered together, as "both appear to hinge on knowledge—what the transferee knew about the transfer." *CLC Creditors' Grantor Trust v. Howard Savings Bank (In re Commercial Loan Corp.)*, 396 B.R. 730, 745 (Bankr. N.D. Ill. 2008).

As the Seventh Circuit explained in *Bonded*, "[t]ransferees . . . generally deal only with the previous person in line . . . ." 838 F.2d at 897. *Bonded* instructs that the inquiry is whether the immediate transferee had knowledge or reason to know of the "financial peril" at the debtor, or had knowledge of plans to use the debtor for fraud. *Id.* at 898. In other words, did the immediate transferee possess "enough knowledge of the events [occurring at the debtor] to induce a reasonable person to investigate." *Id.* at 897-98. If there is no knowledge of this type, the failure to conduct an investigation does not demonstrate a lack of good faith. *Id*. Further, there must be some basis to conclude that a reasonable investigation would have discovered that the debtor's transfer to the initial transferee was subject to avoidance. *See Brandt*, 2014 U.S. Dist. LEXIS 67100, at * 21.

(c) An Immediate Transferee's Right To Raise Defenses Of The Initial Transferee

If the trustee sues an immediate transferee, the immediate transferee is entitled to raise all of the defenses the initial transferee could have raised to defeat the avoidability of the transfer. *SIPIC,* 501 B.R. at 30. That is true even if the initial transferee is sued and fails to raise a valid defense. *Id*.

(d) Benefit To The Estate

A trustee is limited to a judgment ordering recovery when that recovery will "benefit" the estate. In *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003), the Seventh Circuit upheld a lender's right to recover preferences. The lender had received the lien on avoidance actions as part of an agreement to provide it with adequate protection and the Seventh Circuit reasoned that the potential to bring these claims was put to the estate's benefit and facilitate a sale of the debtor's assets. *Id*. at 292-93. Therefore, the fact that the estate has since been liquidated and the debtor was no longer operating in its chapter 11 case did not mean that the secured creditor's Section 550 action was not for the benefit of the estate. *See In re Burlington Motor Holdings, Inc.*, 2002 U.S. Dist. LEXIS 805, at * (D. Del. 2002) (benefit may occur prior to an actual avoidance recovery); *but see Dunes Hotel Associates v. Hyatt Corp.*, 245 B.R. 492, 510-11 (D. S.C. 2000) (finding no benefit when only creditors were insiders of debtor).

(e) Recovery Of The Transferred Items Value

When the transferred item is not cash, Section 550 allows for the recovery of the item or the value of that item, if the Court so orders. "The essential purpose of either preservation or recovery of an avoided transfer is to place the estate in the position it would have been if the avoided transfer had not been made." *Rodriguez v. Drive Fin. Serv. (In re Trout)*, 392 B.R. 869, 871 (Bankr. D. Colo. 2008). For that reason, courts favor "return [of] the property transferred unless to do so would be inequitable. . . ." *In re Morris Communications NC, Inc.*, 914 F.2d 458, 467 (4th Cir. 1990). While a court has significant discretion on this issue, courts typically consider the following factors in determining whether to order the "value of the property" as the appropriate remedy under Section 550: (1) whether there is conflicting evidence regarding the value of the avoided property (favoring the return of the property); (2) no evidence as to the value of the property (favoring the return of the property); (3) the property is unrecoverable (favoring a monetary award); and (4) whether the property has diminished in value (favoring a monetary award). *In re Classic Drywall, Inc.*, 127 B.R. 874, 877 (D. Kan. 1991); *see also In re Aero-Fastener, Inc.*, 177 B.R. 120, 139 (Bankr. D. Mass. 1994) (listing same factors).

(f) The Conduit Defense

"The term 'initial transferee' is a term of art whose meaning in any given transaction is not always straightforward." *Andreini & Co. v. Pony Express Delivery Servs., Inc. (In re Pony Express Delivery Servs.)*, 440 F.3d 1296, 1300 (11th Cir. 2006). A "literal or rigid interpretation" of the term leads to the conclusion that 'the first recipient of the debtor's fraudulently-transferred funds is an initial transferee." *Martinez v. Hutton (In re Harwell)*, 628 F.3d 1312, 1322 (11th Cir. 2010). Recognizing the inequities that can result under a rigid interpretation of the term "initial transferee," the courts have crafted an exception known as the "mere conduit or control test." *See, e.g.*, *Menotte v. United States (In re Custom Contractors, LLC)*, 745 F.3d 1342, 1349 (11th Cir. 2014); *In re Incomnet, Inc.*, 463 F.3d 1064, 1069-71 (9th Cir. 2006); *Bailey v. Big Sky Motors, Ltd., (In re Ogden)*, 314 F.3d 1190, 1202-03 (10th Cir. 2002); *Bonded Fin. Servs.,* 838 F.2d at 893-96.

Under the "mere conduit" exception, an initial recipient of the funds must show that they did not have control over the assets received, or as the Seventh Circuit put it, "the right to put the money to one's own purposes." *Id*. at 894. The control test examines the entire transaction as a whole to determine who controlled the funds. *Incomnet*, 463 F.3d at 1071. If the initial recipient of the funds is found to be a conduit, the party to whom it transfers the funds may be the initial transferee. *CNB Int'l, Inc. Litigation Trust v. Lloyds TSB Bank (In re CNB Int'l, Inc.)*, 440 B.R. 31, 40-41 (W.D.N.Y. 2010).

III. <u>Counterclaims and Third Party Claims.</u>

Rule 13 of the Federal Rules of Civil Procedure, which governs which counterclaims are compulsory and which are permissive applies in bankruptcy adversary proceedings by incorporation through Rule 7013. Under Rule 13, a defendant generally must plead all counterclaims against the plaintiff if the claim arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and the counterclaim does not require adding another party over whom the court cannot acquire jurisdiction. Generally, the following four inquiries are relevant in considering whether a counterclaim is compulsory: (1) whether the issues of fact and law in the claim and counterclaim are essentially the same; (2) whether *res judicata* would bar a subsequent suit on the counterclaim absent the compulsory counterclaim rule; (3) whether the same evidence would support or refute the claim and the counterclaim; and (4) whether there is a logical relationship between the claim and the counterclaim. *Painter v. Harvey*, 863 F.2d 329, 331 (4th Cir. 1988). Under Rule 7013 of the Federal Rules of Bankruptcy Procedure, the compulsory counterclaim rules are relaxed to provide that a party sued by a debtor in possession or trustee need not state as a counterclaim any claim that the party has against the debtor, the debtor's property or the estate unless the claim arose after the entry of the order for relief.

Rule 7013 also allows for the filing of crossclaims against a co-party, however, a bankruptcy court will not have subject matter jurisdiction over the crossclaim under 28 U.S.C. § 1334 unless the resolution of the claim has an effect on the bankruptcy estate. *Samuel's Temple Church of God in Christ v. Parade Place, LLC (In re Parade Place, LLC)*, 508 B.R. 863, 871-72 (Bankr. S.D.N.Y. 2014).

IV. Motions for Partial Summary Judgment And/ Or To Strike Affirmative Defenses.

Rule 56(a) of the Federal Rules of Civil Procedure as incorporated into Rule 7056 of the Federal Rules of Bankruptcy Procedure authorizes the filing of a motion for summary judgment on "part of each claim or defense". A motion for summary judgment may be presented in response to a complaint in lieu of a motion to dismiss. Fed. R. Civ. P. 12(d). A partial summary judgment motion may be used strategically to address an issue that cannot be resolved in a motion to dismiss, or to resolve an element of a claim or defense, where extensive discovery is not required.