STATE BAR OF TEXAS

BANKRUPTCY LAW SECTION

NEWSLETTER

Summer 2007 **Volume 5 — No. 3**

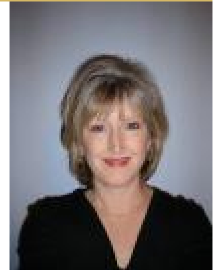
INSIDE THIS ISSUE:

A Message from Your Chair	1
Case Law Update: 11th Circuit Weighs in on Dischargeability of Tax Evasion	1
Consumer Corner: In re Shults: A Look at FRBP 4003 Post-Conversion	2
Announcing… The Young Lawyers Committee	2
Upcoming Events	3
Speaking Out: Does the Fifth Circuit Need a BAP?	3
Weighing the Evidence: Bankruptcy Secrets and Proposed FRE 502	4
23rd Annual Farm, Ranch and Agri-Business Bankruptcy Seminar	4
Officers/Council Members/About the Section	5
Chapter 11 Practice: NonConsensual Third Party Releases: To Confirm or Not Confirm, in a Chapter 11 Plan?	6
Chapter 11 Practice: Claims Trading in Distress: Clearing an Imperfect Market	6

A MESSAGE FROM YOUR CHAIR

I would like to thank the members of the Section for the opportunity to serve as Chair for the next year. We have many exciting projects planned for this year:

- We continue to expand our MoneyWise high school financial education program. Presentations were offered this past year in Houston, Dallas and Austin. We will expand the high school program to San Antonio this year, and appreciate any volunteers who would like to present or sign up high schools for presentations. Please contact Beth Smith at beth@egsmithlaw.com if you would like to volunteer in San Antonio.
- Barrett Burke Wilson Castle Daffin & Frappier has committed $20,000 toward developing an adult MoneyWise program for Texas. We appreciate the generous contribution in support of this important program.
- The Litigation Seminar, jointly sponsored by the Section and UT Law, will be held next spring. If you have any suggestions for location or format, please email or call me or Berry Spears.



- Janna Countryman is chairing next year's "distance" seminar which will be in Barcelona, Spain with an extension to Madrid. Please mark these dates on your calendar and plan to register for this popular seminar: March 4 - March 10, 2008. Watch for updates in subsequent newsletters.
- Two new Section committees have been created: the Young Lawyers Committee (advisor - Judge Hale) and the History Committee (chaired by Mark Andrews). If you are interested in joining the Young Lawyers Committee, please email Jonathan Bolton at jbolton@fulbright.com. If you are interested in recording the history of the Texas bankruptcy bar and bench, please contact Mark Andrews at mandrews@coxsmith.com.

(Continued on page 7)

CASE LAW UPDATE: 11th Circuit Weighs in on Dischargeability of Tax Evasion

By Sanjeev Ayyar and Matthew S. Parkin, Cox Smith Matthews Incorporated[1]

Generally, taxes are dischargeable in a bankruptcy proceeding. However, certain items, as listed in Section 523 of the Bankruptcy Code, are not dischargeable. One such item is taxes "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax."[2] In *United States v. Jacobs* (*In re Jacobs*), No. 06-15333, 2007 U.S. App. LEXIS 15542 (11th Cir. June 29, 2007), the 11th Circuit reviewed and interpreted the scope of this exception to discharge. Initially, the Bankruptcy Court had determined that Mr. Arthur Jacobs' debts were properly dischargeable. The Federal District Court overturned the Bankruptcy Court. Mr. Jacobs appealed to the 11th Circuit.

Summary of Facts

Mr. Jacobs is a real estate and transactional lawyer who has practiced in Florida since the early 1970s. He had initially established his own law firm in the early 1990s under the name Arthur I. Jacobs, P.A. This firm incurred federal tax debt that drove it into bankruptcy. Mr. Jacobs subsequently reorganized and renamed his firm Jacobs &

(Continued on page 11)

Consumer Corner: *In re Shults*: A Look at FRBP 4003 Post-Conversion

By Leigh Jorgeson, University of Texas School of Law (2009) (Intern to the Honorable Judge Harlin D. Hale)

Shults addresses the question whether the objection deadline in Federal Rule of Bankruptcy Procedure 4003(b) restarts after conversion from Chapter 13 to Chapter 7. While there is no controlling authority in the Fifth Circuit, Judge Houser mirrors the outcome and reasoning of the only other bankruptcy court opinion in the Fifth Circuit to address this issue, *In re Fonke*, 321 B.R. 199 (Bankr. S.D. Tex. 2005) (Isgur, J.), which held that the objection deadline does not recommence post-conversion. Now, with clear case law in two districts in Texas, Chapter 13 creditors and Chapter 13 Trustees will be required to consider carefully a debtor's claim of exemptions and, if appropriate, file a timely objection.

Factual Background

On August 17, 2005, the Debtor filed a Chapter 13 bankruptcy petition and listed his real property as exempt. On November 16, 2005, the section 341 meeting of creditors was held and concluded. No challenge was made to the Debtor's exemptions. Then, on January 20, 2006, the Debtor voluntarily converted his case to Chapter 7 and filed an amended set of exemptions. On February 27, 2006, a second, post-conversion 341 meeting was held and concluded. On March 24, 2006, the Chapter 7 Trustee objected to the Debtor's claimed exemptions under sections 522(o) and (p) of the Bankruptcy Code.

Legal Analysis

The central issue before the court was whether the Trustee's objection should be denied as untimely, an analysis that turns on the interpretation of Bankruptcy Rule 4003(b), which provides:

> A party in interest may file an objection to the list of property claimed as exempt only within 30 days after the meeting of creditors held under § 341(a) is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later.

Fed. R. Bankr. P. 4003(b). The Debtor claimed that the objection was untimely because it was not filed within 30 days of the ***original*** 341 meeting. The Trustee claimed that the 30-day period should have restarted from the date of the post-conversion 341 meeting.

Courts throughout the country are divided as to whether the Rule 4003(b) objection deadline restarts after conversion. Judge Houser, however, denied the objection, following the precedent set by Judge Isgur in *In re Fonke*, 321 B.R. 199 (Bankr. S.D. Tex. 2005). *Fonke* held that the deadline to object to exemptions did not recommence when a Chapter 13 case was converted to Chapter 7. Judge Isgur based his decision on the majority of courts' interpretation of Rule 1019(2), which states:

> When a chapter 11, chapter 12, or chapter 13 case has been converted … to a chapter 7 case: … [a] new time period for filing claims, a complaint objecting to discharge, or a complaint to obtain a determination of dischargeability of any debt shall commence…

Fed. R. Bankr. P. 1019(2). Following the "***expressio unius est exclusio alteriu***" principle of statutory construction, the enumeration of exceptions to a rule means that all other exceptions are to be

(Continued on page 8)

Announcing.... The Young Lawyers Committee

The Council has formed a Young Lawyers Committee for the Bankruptcy Section and has a group of motivated young attorneys from across the State who have volunteered their time and talent. The purpose of the Committee is to increase the involvement of and integrate young lawyers on a state-wide basis into the Section at all levels, promote participation of young lawyers in seminars and events at all stages, and raise the visibility of our young lawyers by assisting them in professional networking and promoting professional development on a statewide basis. The Committee will be led by:

Jonathan Bolton of Houston as Chair (jbolton@fulbright.com)
Brian Rogers of Victoria as Vice Chair (brogers@andersonsmith.com)
Jay Ong of Austin as Secretary (jong@munsch.com)

Other members of the Young Lawyers Committee include:

Omar J. Alaniz	Allison Davison Byman	Elliott S. Cappuccio	Vickie L. Driver	Layla D. Elzner-Sislen
Demetra L. Liggins	Timothy A. Million	Rakhee V. Patel	Joshua Searcy	Eric M. Van Horn

Contact Jonathan Bolton at jbolton@fulbright.com for more information.

Upcoming Events

September 13-14:	Farm, Ranch, and Agri-Business Bankruptcy Institute, Texas Tech Merket Alumni Center, Lubbock. Register at www.law.ttu.edu/careerservices
September 20:	Fourth Annual Federal Bankruptcy Practice Seminar , Belo Mansion, Dallas. Registration form available at www.fedbar.org/dallas_bankr07.pdf
October 4-5:	Eastern District Bankruptcy Bench/Bar Conference, Embassy Suites Hotel, Frisco. Register at www.txeb.uscourts.gov/bench-bar/
October 15:	Consumer Bankruptcy Boot Camp, Hyatt Hill Country Resort, San Antonio. Register at www.TexasBarCLE.com
October 16-17:	23rd Annual Advanced Consumer Bankruptcy Course, Hyatt Hill Country Resort, San Antonio. Register at www.TexasBarCLE.com
November 15-16:	UT/Jay L. Westbrook Bankruptcy Conference, Four Seasons Hotel, Austin
March 4-10, 2008:	"Distance" Seminar in Barcelona, Spain, with an extension in Madrid. More information to follow. Stay tuned!
February 23, 2008:	Elliot Cup Competition (Bankruptcy Moot Court), Dallas

Fort Worth - Tarrant County

Bankruptcy Section - monthly CLE luncheon meetings on the third Monday of each month to its members. Contact - Marilyn Garner at (817) 462-4075 or marilyndgarner@flashwave.com. Meetings are normally held at the Ft. Worth Petroleum Club.

San Antonio

The San Antonio Bankruptcy Bar Association meets on the 4th Tuesday of every month at the San Antonio Country Club. Social begins at 5 p.m. with program beginning at 5:30 p.m. Participants receive 1 hour CLE credit.

A Brown Bag lunch with Judge Clark, Judge King, the Bankruptcy Clerk, and members of the Bankruptcy Bar is held quarterly at the Adrian Spears Judicial Training Center.

Dallas

The Dallas Bar Association Bankruptcy and Commercial Law Section meets the first Wednesday of each month at the Belo Mansion. Social begins at 5 p.m. with program beginning at 5:30 p.m.

Please Note the Rescheduled Date: The Dallas Chapter and Bankruptcy Section of the Federal Bar Association has rescheduled the 4th Annual Federal Bankruptcy Practice Seminar for **September 20, 2007** at the Belo Mansion. This half-day seminar will feature very informative and practical presentations by federal bankruptcy judges, representatives of the bankruptcy trustee's office, and local lawyers. The FBA has applied for 3.75 hours of CLE credit for the seminar, of which 1.00 hour will be ethics.

Speaking Out: Does the Fifth Circuit Need a BAP?

Josiah M. Daniel, III, Vinson & Elkins LLP

Recently I represented the winning bidder in an appeal from the Bankruptcy Court in Los Angeles to the Bankruptcy Appellate Panel of the 9th Circuit. It was a pleasant experience, not solely because our client prevailed, and it has me thinking that the 5th Circuit should reconsider establishing a BAP.

First, the 9th Circuit BAP has its own Clerk, Harold Marenus, who takes care of processing appeals filed by appellants anywhere in the Circuit, including the assigning of panels of bankruptcy judges and the scheduling of hearings. In my case, our client won a Section 363 auction, and a disappointed bidder appealed, seeking a stay from the BAP after the Bankruptcy Court had denied the stay motion. Within a few business hours, a panel of judges had been designated and it granted the stay temporarily—for a week as it turned out—to enable the parties to file responses and supporting declarations. Thus timely judicial action on the stay motion was assured and not subject to competition from criminal and civil cases already inundating the District Clerk's and District Court's staff.

Second, no one had to travel anywhere; everything was done electronically. The BAP of the 9th Circuit is not yet on PACER, and all filings are emailed to the Clerk. The hearing on the stay motion was then conducted by teleconference, with one judge in San Diego and another in Oregon, and the lawyers located in several other places. Each side was accorded thirty minutes, with questioning done appellate-style. In oral arguments on the appeal itself, the BAP panel travels to a district whenever there are three or more cases to be heard; otherwise the oral argument can be by teleconference or videoconference. In my experience, the District

(Continued on page 7)

WEIGHING THE EVIDENCE:
BANKRUPTCY SECRETS AND PROPOSED FRE 502

Lee Barrett, Forshey & Prostok, L.L.P.

The business of protecting clients' secrets, even when those secrets are no longer secrets, might become much easier in the near future. Proposed evidentiary Rule 502, if enacted in its present form, would institute sweeping protections of attorney-client communications and work product privileged documents aimed at preventing waiver of the privilege through inadvertent disclosure. For bankruptcy practitioners, while the proposed rule substantially reduces the likelihood of waiving privilege, not unlike some other areas of bankruptcy practice the rule has numerous traps for the unwary. More importantly, the proposed rule will continue to ratchet up the pressure on bankruptcy lawyers to understand and address inevitable duties concerning electronically stored information ("ESI").

For bankruptcy practitioners, the proposed Rule 502 has numerous inherently attractive features. At the outset, Rule 502 may be drafted so broadly as to protect against waiver of privilege by inadvertent disclosure at almost every step in a bankruptcy proceeding. Assuming that the rule is enacted in its current form, bankruptcy counsel may also benefit from provisions designed to protect against waiver of privilege through inadvertent disclosure in state court as well.

The Advisory Committee on Evidence Rules has drafted and submitted proposed Rule 502 of the Federal Rules of Evidence, and suggested that the Standing Committee and the Judicial Conference recommend to Congress that the proposed rule be directly enacted.

Boiled down to its key components, there are four key provisions to the proposed rule:

1. Prevention of waiver of the attorney-client privilege or work product protection in a federal or state proceeding;
2. Waiver resulting from inadvertent disclosure;
3. Rule extends to disclosures made in "state proceedings"; and,
4. Parties to an agreement regarding disclosure are bound by the agreement.

According to the Committee Notes accompanying the proposed rule, the proposed rule has two major purposes. At the outset, the proposed rule is intended to resolve differences in the emerging jurisprudence regarding disputes involving inadvertent disclosure and subject matter waiver as it relates to attorney-client privilege.

The second, and perhaps more telling, purpose of the proposed rule is a response to increasing concerns over the rising costs of litigation, and particularly those costs accruing from the necessity of

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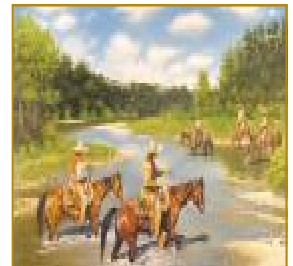
DON'T MISS THE . . . .



Twenty-Third Annual
FARM, RANCH AND AGRI-BUSINESS BANKRUPTCY INSTITUTE
Surveying the Field; Current Issues Relating to Consumer and Agricultural Bankruptcies
Lubbock, Texas
September 13-14, 2007

Registration fee:

$405.00 per registrant for early bird registration (prior to August 4)

$420.00 per registrant for regular registration (August 14 - September 13), and $450.00 per registrant at the door.

Contact

Wendy Durbin,
Durbin & Associates
(806) 771-7500
(806) 744-4740 fax

For On-line Registration
www.law.ttu.edu/careerservices

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Call for Articles and Announcements

The **State Bar of Texas Bankruptcy Law Section** is dedicated to providing Texas practitioners, judges, and academics with comprehensive, reliable, and practical coverage of the evolving field of bankruptcy law. We are constantly reviewing articles for upcoming publications. We welcome your submissions for potential publication. In addition, please send us any information regarding upcoming bankruptcy-related meetings and/or CLE events for inclusion in the newsletter calendar, as well as any items for our "Troop Movements" section (changes in practices).

If you are interested in submitting an article to be considered for publication or to calendar an event, please either e-mail your submission to chufft@velaw.com or mail it to the following address:

John E. Mitchell
Clayton T. Hufft
Vinson & Elkins LLP
2001 Ross Avenue, Suite 3700
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Telephone: (214) 220-7700
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Please format your submission in Microsoft Word. Citations should conform to the most recent version of the Bluebook, the Texas Rules of Form, and the Manual on Usage, Style & Editing.

Should you have any questions, please visit our website at http://txbankruptcylawsection.com.

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The Editor-in-Chief is seeking an additional Assistant Editor, preferably with a consumer oriented practice in either the Western or Eastern District of Texas.

If interested, please contact John Mitchell.

Chapter 11 Practice: Nonconsensual Third Party Releases: to Confirm or Not Confirm, in a Chapter 11 Plan? That is the Question!

Nicholas Sterling Herron, Rutgers University School of Law (Intern to the Honorable Judge Harlin D. Hale)

Nonconsensual third party releases in Chapter 11 plans have enjoyed a mixed reception. Some courts hold that approval of third party nonconsensual releases is beyond the power and scope of a bankruptcy court. However, almost an equal number of courts have held exactly the opposite.

In re Wool Growers Central Storage Company, Case No. 06-60055-RJL-11, 2007 WL 2088303 (N.D. Tex. July 19, 2007) (Jones, J.), is the latest case to weigh in on whether bankruptcy courts have the authority to grant nonconsensual non-debtor releases in confirming a Chapter 11 plan. In ***Growers***, Judge Jones considered a Chapter 11 plan that provided for payments to be made by three of Wool Growers Central Storage Company's directors to creditors in the sum of $2,625,000. In return for the payments, the three directors would receive a general release personally, and as board members, from any potential claims or causes of action that may arise from any of Wool Growers creditors. The confirmation order would also bar all creditors from pursuing any claims or causes of actions against them. Certain creditors objected to the proposed plan and release of the three directors. The court denied the release and confirmation of the plan, falling in line with other decisions in the Fifth Circuit.

Chapter 11 Plans Generally

A Chapter 11 plan must comply with the applicable provisions of the Bankruptcy Code and a court cannot approve a plan that is inconsistent with these provisions. ***See*** 11 U.S.C. §§ 1129, 1123(b)(6); ***see also, In re Bernhard Steiner Pianos USA, Inc***., 292 B.R. 109 (Bankr. N.D. Tex. 2002). Yet, a bankruptcy court has wide authority to alter the relationship between a debtor and its creditors in order to achieve a successful reorganization. ***See U.S. v. Energy Res. Co. Inc***., 495 U.S. 545 (1990); ***In re Dow Corning Corp***., 280 F.3d 648 (6th Cir. 2002). This axiom of bankruptcy law is well settled; however, the dispute among courts is whether a bankruptcy court can grant a third party non-debtor nonconsensual release in confirming a Chapter 11 plan.

In ***Growers***, ***supra***, Judge Jones observed that in determining whether to grant or deny a non-debtor release, Bankruptcy Code sections 105(a) and § 524(e) are the relevant provisions to apply. How broadly or narrowly a court construes these statutes will determine whether the court will grant or deny the release. ***See***, Joshua M. Silverstein, ***Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate over Non-Debtor Releases in Chapter 11 Reorganizations***, 23 Emory Bankr. Dev. J. 13, 44-90 (2006). Courts approving releases generally interpret these provisions very broadly; courts denying such releases will give a narrow interpretation. ***See*** Silverstein, ***supra*** at 42-44.

There are two major types of non-debtor releases: (1) consensual non-debtor releases and (2) nonconsensual non-debtor releases.

Consensual Non-Debtor Releases

A majority of courts have approved consensual releases of non-debtors in the confirmation of Chapter 11 plans. ***See***, ***In re Arrowmill Dev. Corp***., 211 B.R. at 505; ***See also***, ***Matter of Specialty Equip. Co. Inc***., 3 F.3d 1043 (7th Cir. 1993); ***In re AOV Indus. Inc***., 792 F.2d 1140 (D.C. Cir. 1986). A consensual non-debtor release is seen as a settlement agreement between the parties and therefore does not run afoul of section 524(e), because the bankruptcy court does not alter the parties' relationship as they relate to each other. ***In re Arrowmill Dev. Corp***., 211 B.R. at 507.

Although there exists no test widely accepted among courts, which

(Continued on page 12)

Chapter 11 Practice: Claims Trading in Distress: Clearing an Imperfect Market

William L. Wallander & Clayton T. Hufft, Vinson & Elkins LLP

Creditors and non-creditors of a distressed entity may seek to trade in claims against an entity for a variety of reasons. The economics of claims trading can be a lure to risk capital depending on the specific case situation. Trading in claims has become a significant investment business unto itself. The trading of claims has its proponents and opponents. Proponents generally cite the need for efficiently functioning markets and the need for liquidity. Opponents generally hold an aversion to the notion of profit making in claims and influencing a bankruptcy reorganization via the positions acquired in the claims trading process. This article takes no sides on any particular claims trading practice or strategy. Experience and market activity do suggest however that even the most imperfect markets have the need for orderly market making in order to facilitate liquidity based on particular supply and demand requirements. That being said, there are potential pitfalls and complexities when trading in distressed claims which should be evaluated by market participants.

Claims Trading Issues

From the standpoint of those engaging in claims trading, primary risks associated with claims purchasing include equitable subordination, recharacterization of loans to equity interests, and vote designation.

Bankruptcy Court Regulation of Claims Assignments and Purchases. There are currently no provisions in the Bankruptcy Code that generally govern the purchase or sale and assignment of claims against a

(Continued on page 8)

A Message From Your Chair

(Continued from page 1)

- The Elliott Cup, a Texas bankruptcy moot court competition in memory of Judge Joe Elliott, will be held next spring in Dallas. In its third year, this competition serves as a warm-up for Texas law schools that compete in the Duberstein bankruptcy moot court competition, sponsored jointly by St. John's Law School and the ABI, which is held each year in New York. This year, invitations to the Texas Elliott Cup will be extended to other law schools within the 5th Circuit.
- Our next state-wide Bench/Bar conference will be held in spring 2009.
- Our Second Texas Bankruptcy Bench/Bar Conference at the Hyatt Lost Pines was a great success. Our sponsors were wonderfully generous and allowed us to offer a first rate, incredibly fun event. Thanks to the American Bankruptcy Institute for underwriting the fabulous reception and wine-tasting. We also appreciate the active participation of the Texas bankruptcy judges, the planning committee, speakers and attendees.

This newsletter contains an organizational list of the Council members. Council members meet monthly to discuss the business of the Section. Please feel free to contact me or any council member with questions, comments or suggestions. We appreciate your participation in Section projects. Remember also that the Section has a website. The address is www.txbankruptcylawsection.com

Thanks again for your support of the Bankruptcy Section of the State Bar of Texas.

— *Debbie*

Deborah Williamson addresses the Bankruptcy Section at Bench/Bar

The Banco Rotto award is given to Joel P. Kay, Robert C. Maley, Jr. and Myron M. Sheinfeld

Speaking Out. . .

(Continued from page 3)

Courts within the Fifth Circuit often do not provide an opportunity for oral argument on bankruptcy appeals or stay motions.

Third, and the best thing about the BAP process, everyone was on the same page. The judges did not, of course, require any explanations of the fundamental principles or basic concepts of bankruptcy law. Within 24 hours of the hearing, via the Clerk, the BAP issued its simple but fully explanatory ruling on the stay motion.

My experience in the 9th Circuit BAP contrasted favorably to the usual experience of bankruptcy appellate practice in the District Courts within the Fifth Circuit. Regardless of which side one represents, it surely promotes justice for the decisions in bankruptcy appeals to be made expeditiously by jurists who are already knowledgeable in this area of law and whose learning curves are limited primarily to factual, not legal, issues. The membership of the BAP rotates among the bankruptcy judges of the 9th Circuit. No bankruptcy judge of the district from which the appeal emanates may sit on the panel in that case. Either party may elect to route the appeal to a District Court, if desired. BAP decisions are published more often than District Court decisions in bankruptcy appeals, and while the *res judicata* effect of BAP decisions is as yet unclear[1], the BAPs unquestionably contribute to consistency in bankruptcy jurisprudence. The 9th Circuit BAP's website contains an exceedingly helpful manual tailored to bankruptcy appeals. In short, I find a lot to recommend the institution of a BAP.

The 1st, 6th, 8th, 9th, and 10th Circuits have BAPs[2]. Section 158(b) of the Judicial Code mandates the establishment of a BAP in each circuit unless the Judicial Council of the circuit finds that available judicial resources are insufficient or that a BAP would cause undue delay or increased cost to parties. In 1995, the 5th Circuit Judicial Council determined that both of such factors militated against a BAP "at this time."[3] Should the 5th Circuit revisit the question whether to establish one?[4]

[1] *See* cases collected at 1 Collier on Bankruptcy Para. 5.02[3] at 5-8 n.11. See also Thalia L. Downing Carroll, *Why Practicality Should Trump Technicality: A Brief Argument For The Precedential Value Of Bankruptcy Appellate Panel Decisions*, 33 Creighton L. Rev. 565 (2000); Henry J. Boroff, *The Precedential Effect Of Bankruptcy Appellate Panel Decisions*, 103 Com. L.J. 212 (1998).

[2] The 11th Circuit recently decided not to create a BAP, but the 10th Circuit recently expanded its BAP to cover all districts within that circuit.

[3] *See* Resolution of the Judicial Council of the Fifth Circuit (July 28, 1995).

[4] *See* Judith A. McKenna and Elizabeth C. Wiggins, *Alternative Structures for Bankruptcy Appeals*, 76 Am. Bankr. L.J. 625 (2002).

Editor's Note: The 1995 Report of the Fifth Circuit Judicial Council Regarding the Creation of a Bankruptcy Appellate Panel can be found at www.txbankruptcylawsection.com under the "Newsletter" section.

INTERESTED IN PRO BONO WORK?

The Council for the Bankruptcy Section is considering reactivating the Section's pro bono subcommittee. In the event you have an interest in assisting with this important subcommittee, please contact Berry D. Spears at bspears@fulbright.com.

In re Shults

(Continued from page 2)

excluded. Therefore, Judge Isgur held that because the Rule 4003(b) deadline was not included in Rule 1019(2)'s list of what is to recommence, Rule 4003(b) must be assumed not to recommence. *Fanke*, 321 B.R. at 202.

Ultimately Judge Houser denied the Trustee's Objection, following the logic of *Fanke*. (A footnote indicated that all the judges in the Northern District agreed with her conclusion.)

Impact

After *Shults*, parties in interest in bankruptcy cases will need to take greater care to examine a debtor's exemptions very early in the proceedings, and not hope for a second bite at the apple if the case converts.

Claims Trading in Distress

(Continued from page 6)

debtor. Under the Federal Rules of Bankruptcy Procedure (the "Rules"), Rule 3001(e) specifies certain procedural rules regarding the postpetition assignment of claims, but does not substantively govern the process. In fact, Rule 3001 was amended in 1991 in response to what Congress perceived to be excessive judicial intervention into the terms of claims assignment.[1] Since Rule 3001 only deals with "claims," it does not apply to trading in equity securities, which are called "interests" under the Code and are addressed in Rule 3002. Transfers of claims based on publicly traded bonds or debentures are also specifically exempt from Rule 3001(e)(2)-(4) and no other bankruptcy Rule regulates any such postpetition trading, at least if the transaction is an outright purchase. The intent behind such exclusions is to avoid interference with existing markets for publicly traded bonds and debentures.[2] As discussed below, in certain situations full disclosure of the claim purchase may nonetheless be advisable.

Claims Trading Risks for Insiders/Fiduciaries. Any risk analysis of claims trading in bankruptcy must begin with the determination of the status of the purchasing entity, specifically, whether such entity is deemed an insider. The outcome of this determination plays a key role in the scrutiny applied to the transaction and the burden of proof to be shouldered by the purchaser. Insiders owe fiduciary duties to the debtor and are required to deal in good faith with its creditors and equity holders, while noninsiders have no fiduciary obligation to the debtor or its creditors. Additionally, absent some exercise of control, non-management creditors do not owe the debtor and its creditors a duty of fair dealing. Because of these differences, courts closely scrutinize conduct by insiders and hold them to a higher standard of conduct. Insiders are held to a "rigorous scrutiny" standard requiring that, once the movant has shown evidence of a breach of fiduciary duty or that the creditor engaged in conduct that was somehow unfair, the burden shifts to the claimant to show the fairness of the transaction. For noninsider claimants, the burden of proof does not shift and proponents of subordination must show with particularity "egregious conduct", such as fraud, spoliation or overreaching.[3] The determination of insider status is a question of fact that must be determined on a case-by-case basis through examination of the totality of the circumstances.[4] Although not determinative, the purchaser's control over the debtor is a persuasive factor.

Control Over the Enterprise and Closer Scrutiny. Additional factors considered by courts in analyzing claims trading are issues of control and usurpation of corporate opportunity. When discerning control, courts generally consider whether the creditor and debtor have a sufficiently close relationship with each other that their "conduct is made subject to closer scrutiny than those dealing at arms length."[5] The two factors often considered are (i) the closeness of the parties and (ii) the relative degree of control each has over the other.[6] Although the above standard appears ambiguous, courts generally require "evidence of extensive control" before finding insider status under Bankruptcy Code Section 101 (31)(B)(iii).[7] Even if a purchaser is not in "control" of the debtor, however, receipt of nonpublic information, such as through the performance of due diligence or with debtor cooperation, may be sufficient to fall under the ambit of section 101(31), although none of the listed requirements are technically met.[8]

Purchase by Fiduciaries - Corporate Opportunity. It is well settled that officers, directors and dominant or controlling stockholders of corporations are fiduciaries of those corporations.[9] Upon insolvency, a fiduciary relationship is also created between such individuals and the corporation's creditors.[10] As such, any dealings that the officer, director, or dominant stockholder has with the corporations for which they are fiduciaries are subjected to "rigorous scrutiny",[11] and the test for determining the fairness of such transactions is whether "the transaction carries the earmarks of an arm's-length bargain."[12] In order to avoid inequitable conduct through the usurpation of corporate opportunity, a claims purchasing fiduciary has the duty to share "everything it [knows]", including its identity,[13] with the company's board and creditors' committee before commencing its purchase. Such notification should be an affirmative act on the part of the purchaser, as informal knowledge on the part of the board or committee may not be a defense.[14]

(Continued on page 13)

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protecting against waiver of the attorney-client privilege or work product protection. More specifically, this proposed rule is intended to address the concerns of waiver through inadvertent disclosure in the increasing number of cases involving electronic discovery.

Moreover, the Committee Notes stress that system-wide protection against waiver by inadvertent disclosure is fundamental to making the proposed rule work. For this reason, the committee has recommended that the normal rule-making process, necessarily, be forborne so that the rule may also apply to disclosures made in state court. In order for the proposed federal rule to apply in such a manner, it must be directly enacted by Congress.

Rule 502(a) – The proposed rule would provide for the waiver of privilege as to undisclosed, privileged information when a disclosure is made in "a federal proceeding or to a federal office or agency…", but only if the disclosure itself was intentional, the disclosed and undisclosed information concern the same subject matter, and, they "ought in fairness be considered together."

One matter not clarified by the proposed rule, or by the Committee Notes, is whether some of the traditional players in a bankruptcy proceeding are considered a "federal office or agency" for purposes of Rule 502. How much protection will be afforded an inadvertent disclosure to the U.S. Trustee, a panel trustee, an examiner, an auditor, an official creditor's committee, or improperly secured filings on PACER? The Committee Notes related to Rule 502(b) do indicate that the rule applies to a federal office or agency that is acting "in the course of its regulatory, investigative, or enforcement authority." One area to watch, as suggested above, will be the interplay between the protections provided in Rule 502 and §107(c)(3) of the Bankruptcy Code regarding the access and prohibitions on disclosure of the "United States trustee, bankruptcy administrator, trustee, and any auditor", when the interests of the debtor-in-possession diverge from the interests of the estate.

While not necessarily a concern in the run of the mill bankruptcy, the adoption of Rule 502 arguably does not clarify the results of policies such as that of the Department of Justice reflected in first the Thompson Memorandum, which was later succeeded and replaced by the McNulty Memorandum. Although the rule appears to apply to all federal government actors, a selective waiver position has not been adopted by the Evidence Rules Committee.

The proposed rule provides that, if each of these conditions are present, then the waiver also extends to a communication or proceeding in a "state proceeding". Again, while the Committee Notes do not fully articulate this position, a "state proceeding" presumably encompasses state court litigation, arbitration, mediation, administrative proceedings, and investigations by state regulatory agencies.

Aside from the applicability to "state proceedings," one of the more curious Committee Notes addresses the thorny issue of "subject matter waiver" by stating that inadvertent disclosure never results in subject-matter waiver. In support of this proposition, the Committee Notes cite to the proposed Rule 502(b). As we shall see, Rule 502(b) appears to require a bit more, and a bit less.

Rule 502(b) - The key to determining waiver under Rule 502(a) is whether or not the waiver was intentional. The answer to that question is found by looking to 502(b). 502(b) indicates that disclosure does not result in waiver in either a federal or state proceeding when the disclosure is "inadvertent", when the "holder of the privilege or protection took reasonable steps to prevent disclosure", and the "holder promptly took reasonable steps to rectify the error, including (if applicable) following FED. R. CIV. P. 26(b)(5)(B)". According to the Committee Notes, this formulation represents the middle ground in the spectrum created by existing case law, and also reflects the majority view.

Assuming that establishing the "inadvertence" of a disclosure will be a factual issue with a relatively low threshold, the real answer lies in how lenient courts will be in determining whether or not counsel took reasonable steps to prevent disclosure. The Committee Notes seem to suggest that counsel may not break much of a sweat in demonstrating the reasonable steps aimed at preventing such disclosure. Current case law sets out a multi-factor test including the reasonableness of precautions taken, the time taken to rectify the error, the scope of the discovery, the extent of the disclosure and the "overriding issue of fairness." None of the factors are dispositive, yet the rule is flexible enough to "accommodate any of those listed factors."

Specific to ESI/EDD type considerations, the Committee Notes suggest some approaches that might constitute such ephemeral "reasonable steps". This includes the use of "advanced analytical software" and "linguistic tools" used to screen for privilege. Similarly, the use of an "efficient system of records management" might also be considered.

"State proceedings" and Proposed FRE 502 – The relationship between federal law relating to privilege and the laws of the many states, and the variations therein, has long been the subject of debate and heartache for practitioners. While it seems that this issue most frequently arises in diversity cases, for Chapter 11 practitioners, the potential for divergent outcomes in state and federal practice is very real, given the likelihood for "real-time" proceedings taking place in state court during the administration of a bankruptcy. Proposed Rule 502 takes tremendous strides in shoring up the differing privilege-killing varieties.

A disclosure made in a "state proceeding", that is not the subject of a state-court order, will not operate as a waiver of privilege in a federal proceeding if: the disclosure would not constitute a waiver under 502 if the disclosure had been made in a federal proceeding; or if the disclosure does not constitute a waiver under the law of the state where the disclosure occurred.

In reconciling the competing public policy concerns, the committee opted to choose the path deemed "most protective of privilege and work product." While there can be little serious debate that the fundamental value of attorney-client privilege has been deflated over the last 20 to 30 years, the committee offers no reassurance that the proposed rule has not gone too far in protection of certain information. Although exceptions abound, the bankruptcy system depends on transparency and voluntary disclosure. Moreover, some states have broadly stated discovery policies geared towards the liberal construction of evidentiary rules as both a means to

(Continued on page 10)

Weighing the Evidence

(Continued from page 9)

facilitate efficient discovery and to have the fact-finder fully informed for a fair and just outcome. Assuming that Rule 502 is adopted by Congress, there is a strong argument that once receiving counsel has seen, or still possesses, privileged or confidential information, intense litigation is likely to result regarding the "reasonable steps" both pre and post-disclosure to determine whether or not receiving counsel gets to keep, and use, that which was disclosed.

The proposed rule also adopts, by omission, the assumption that a state court confidentiality order will be enforced in a federal proceeding, so long as that order is protective of the privilege. Of concern however, are those "state proceedings" which may not be considered a state court, such as administrative hearings or other such regulatory proceedings.

In answer to some of these questions, Rule 502(d) allows for the entry of an order by a federal court preventing waiver by disclosure "connected with the litigation pending before the court." Moreover, the order will be binding on anyone in federal or state proceedings, even if not parties to the litigation. The Committee Notes indicate that this provision is intended to facilitate the use and effectiveness of confidentiality orders.

For the bankruptcy practitioner though, Rule 502(d) appears to have some significant traps. What effect of a disclosure during the administration of a bankruptcy, prior to the time that any related adversary or contested matter has been filed? For purposes of Rule 502, does the existence of the pending bankruptcy constitute litigation?

Despite the committee's belief that a state court order will be provided due courtesy and respect, on the face of 502(c) and (d), taken together, there appears to be no prohibition against a party to a "state proceeding" filing either an adversary complaint or initiating a related contested matter in bankruptcy court to trump a related state court order. Given the potential for some distinction between "litigation" and the administration of a bankruptcy estate, it seems likely that a bankruptcy court will eventually be asked to enter a countervailing order effecting a "state proceeding", even in the absence of an adversary proceeding. The rule also provides no guidance to practitioners regarding the enforceability of such an order in the event that the bankruptcy is dismissed, or the debtor fails to obtain confirmation of a plan.

Rule 502(e) – Confidentiality agreements, as opposed to confidentiality orders, are binding only on the parties who enter into such agreements. Rule 502(e) appears to be a tacit invitation to have the terms of such an agreement incorporated into an order of the court, thereby binding all interested parties in both state and federal proceedings. Judges and practitioners alike should closely scrutinize any such request, especially if the agreement is between affiliates or insiders of a debtor. An agreement that is particularly one-sided, overly broad, or overly restricting will need to be considered in view of its potential effect on all of the interested non-parties at both the state and federal level.

Proposed FRE Rule 502 and Bankruptcy – Despite the apparent, and numerous, attractive qualities of the ***proposed*** rule, in its implementation, bankruptcy counsel may find themselves singed like moths in an open flame.

Bankruptcy counsel will need to use caution when relying on the provisions related to the effect of inadvertent disclosure in "state proceedings". It is not at all clear that the proposed rule will have the reach and applicability that the drafters seem to have assumed.

Whether or not the traditional players in bankruptcy, such as the creditors committee, is considered to be a federal agency or office for purposes of FRE 502 remains to be seen. Newly emerging players, such as an "auditor", will also have to be considered.

At the heart of the proposed rule is the reduction of expense related to preventing waiver of privilege by inadvertent disclosure. As debtors and debtors-in-possession will increasingly be called upon to account for their electronic books and records, cost-containment will continue to be an overriding goal for the betterment of the estate. However, it seems unlikely that the mere implementation of FRE 502 will lessen counsel's legal and ethical obligations to protect the sanctity of client secrets regardless of the impact on privilege. Despite the intended consequences and stated policy of the proposed rule, counsel will continue to implement internal privilege reviews, a cost of which will continue to be passed along to the client. Indeed, obtaining protection of the proposed rule requires just such "reasonable efforts."

Editor's Note: Due to publishing space considerations, citations to authority were withheld. The full article, with applicable authoritative references, can be found at http://txbankruptcylawsection.com under the "Newsletter" section.

Case Law Update

(Continued from page 1)

Associates, P.A. ("J&A"). Mr. Jacobs was at all relevant times the sole shareholder and sole officer.

Characterization of Income. Mr. Jacobs owed personal federal income taxes for the years 1990-1995, 1997, and 1998. For most of that time, Mr. Jacobs had his law firm, in its various forms, treat his income as officer compensation as opposed to wages paid to a salaried employee. The difference in characterization was that, as officer compensation, there was no tax withholding by the law firm. Mr. Jacobs did file his tax returns each year (with extensions), but he did not make any estimated tax payments with his extension requests. From 1990-1998, Mr. Jacobs did pay some $200,000 in federal income taxes. The 11th Circuit was not clear on the exact amount of the unpaid balance but, nonetheless, said that the amount was not at issue. Rather, it was specifically whether Mr. Jacobs willfully attempted to evade or defeat his taxes so as to fit within the exception to dischargeability.

Intra-Family Transfers. Mrs. Jacobs operated a jewelry store, Morton-Jacobs Jewelers, Inc., from 1997 to 2001 that was organized as a corporation ("MJ"). It never turned a profit. Mrs. Jacobs was the sole shareholder, officer and director. From 1998 to 2001, Mr. Jacobs and his law firms made payments to MJ totaling approximately $45,000 and loans of approximately $120,000. There was little to no documentation of the loans or payments. Further, Mrs. Jacobs received a "dividend" of approximately $22,000 when she sold the business in 2001.

Form of Title. Though Mr. Jacobs did not pay his taxes, he lived in a nice house that he bought in 1995 for approximately $500,000. He made sure to title the property in only his wife's name because he "had all the tax liens." Mrs. Jacobs did not earn any significant amount of income during their marriage. Mr. Jacobs, therefore, had to sign the note and both mortgages. He made all the payments himself. Many business vehicles were also financed in his wife's name, but his law firms made the payments.

Lavish Lifestyle. The 11th Circuit noted that Mr. Jacobs had a lavish lifestyle. He belonged to a country club, where the dues were approximately $1,600 a month, in addition to monthly golf fees of at least $250. Mr. Jacobs paid approximately $20,000 for his wife to have cosmetic surgery. He leased expensive Mercedes-Benz cars for his wife. He often used business vehicles for personal purposes, made large charitable donations, and often made monetary gifts to his children.

Bankruptcy Court's Analysis

The Bankruptcy Court viewed Mr. Jacobs in a sympathetic light. It determined that the government had not carried its burden of proof, which is a preponderance of the evidence standard in the 11th Circuit. The Bankruptcy Court looked to three 11th Circuit cases to interpret Section 523(a)(1)(C): ***In re Fretz***, 244 F.3d 1323 (11th Cir. 2001); ***In re Griffith***, 206 F.3d 1389 (11th Cir. 2000); and ***In re Haas***, 48 F.3d 1153 (11th Cir. 1995). The Bankruptcy Court noted that the statute has both a mental state requirement as well as a conduct requirement. In analyzing the "willfulness" prong, the Bankruptcy Court engaged in a three-step test (from ***In re Fretz***): "the government must establish that the debtor (1) had a duty to file income tax returns and pay taxes, (2) knew he had such duty, and (3) voluntarily and intentionally violated such duty." ***In re Jacobs***, 324 B.R. at 381 (citing ***In re Fretz*** at 1327-30).

The Bankruptcy Court found Mr. Jacobs was a "remorseful debtor with a white heart." Id. at 382. Further, the Bankruptcy Court found that Mr. Jacobs did not willfully attempt to evade his taxes because he filed "accurate returns each year, voluntarily assessed himself with such tax debt, and paid during the years 1990 through 1998, approximately $200,000 in income taxes to the government." Id. Further, the Bankruptcy Court interpreted Griffith to require "evidence of actual evasion" to satisfy the conduct prong.

11th Circuit Analysis

The 11th Circuit (the "Court") disagreed on all counts. First, the Court reaffirmed its holding in Haas that "a debtor's failure to pay his taxes, alone, does not fall within the scope of Section 523(a)(1)(C)'s exception to discharge in bankruptcy." ***Haas***, 48 F.3d at 1158. Second, the Court made clear that willfulness could be predicated on a taxpayer's payments or transfers to third parties. Third, the Court also clarified that even if tax returns are timely filed, the taxpayer does not gain the benefit of a higher mental state standard under this exception to discharge.

The Court also clarified that the three-stage mental state inquiry stands. In ***Fretz***, the Court interpreted the mental state test to include only those debtors "whose efforts to evade tax liability is knowing and deliberate." ***Fretz***, 244 F.3d at 1330. However, the Court clarified that the "knowing and deliberate" standard is functionally equivalent to the "voluntary and intentional" of Griffith.

Regarding the conduct inquiry, the Court clarified that the conduct prong does not itself have to be "willful"; rather, the two prongs are analyzed separately. The Court noted that in ***Fretz***, it held that the conduct requirement is satisfied…where a debtor engages in affirmative acts to avoid payment or collection of taxes…." ***Fretz***, 244 F.3d at 1329. Further, the Court stated that the Bankruptcy Court applied the wrong legal standard to have required a showing of fraud or a "fraudulent scheme" to satisfy the conduct requirement.

The Court's analysis of the conduct requirement showed that Mr. Jacobs met it in several respects. It noted that placing his home's title solely in the name of Mrs. Jacobs, while remaining on the mortgage, was an affirmative act that satisfied the conduct requirement. Also, the Court pointed out that the conduct requirement was also met by Mr. Jacob's characterization of his earnings as officer compensation to avoid withholding and not paying his estimate taxes, as well his use of his corporation to pay personal expenses are all "affirmative attempts" to conceal assets under Section 523(a)(1)(C). Further, the Court noted that Mr. Jacobs' large discretionary expenditures (***i.e.***, his charitable donations and monetary gifts to family members, including his wife's plastic surgery) satisfied the conduct requirement.

While analyzing the prongs separately, the Court also took note of the same facts in determining that Mr. Jacobs met the mental state requirement. The characterization of his earnings as non-wage income to avoid withholding, his failure to pay estimated taxes and his undocumented loans to his wife's jewelry store all "strongly indicate willfulness" according to the Court. Further, the Court stated that at a minimum such actions show that they were done voluntarily, consciously, or knowingly and intentionally."

(Continued on page 14)

Nonconsensual Third Party Releases

(Continued from page 6)

must be met before a court will grant a nonconsensual non-debtor release in a Chapter 11 plan, *Growers* looked to a five-factor test created by the court in *Master Mortgage*: (1) identity of interest between the debtor and the third party; (2) substantial contribution of assets to reorganization; (3) release is necessary to the reorganization; (4) majority affected creditors have overwhelmingly accepted plan treatment; and (5) plan provides payment of all, or substantially all, of affected classes' claims. *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. at 934. *Growers* notes that for each of the factors that: (1) the court looks to whether or not indemnity or contribution exist between the debtor and third party; (2) substantial contribution includes cash, insurance proceeds, subordination of claims, and forfeiture of claims; (3) whether if no release reorganization would not occur; (4) there is ninety percent approval from impacted creditors; and (5) full payment is necessary. *Growers*, 2007 WL 2088303 at *7.

Finally, courts that have approved nonconsensual non-debtor releases over the objections of creditors have done so in rare cases, when the facts are unique and the injunction plays an important part in the debtor's reorganization plan. *See Id.; see also, In re Dow, Corning Corp.*, 280 F.3d 648, 657-58 (6th Cir. 2002); *In re Cont'l Airlines*, 203 F.3d 203, 212-13 (3rd Cir. 2000). These courts do so on the court's inherent equitable powers, as found in section 105(a). In response to the argument that the language of section 524(e) limits the courts equitable power to enjoining the creditors debtors and not third parties, these courts contend that such language explains the effects of a debtor's discharge and does not specifically prohibit the grant of releases to non-debtors. *See, In re Dow Corning Corp.*, 280 F.3d at 657.

On the other end of the spectrum other courts have held bankruptcy courts have no power to grant nonconsensual non-debtor releases in confirming a Chapter 11 plan. *See, In re Lowernshuss*, 67 F.3d 1394, 1401 (9th Cir. 1995); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 600 (10th Cir. 1990); *In re Davis Broadcasting Inc.*, 176 B.R. 290 (M.D. Ga. 1994); *In re Future Energy Corp.*, 83 B.R. 470 (Bankr. S.D. Ohio 1988); *In re Eller Bros. Inc.*, 53 B.R. 10 (Bankr. M.D. Tenn. 1985). Both the Ninth and Tenth Circuits agree that the only exceptions to this rule are asbestos cases. *In re Lowernshuss*, 67 F.3d at 1402 N. 6; *In re Western Real Estate Fund, Inc.*, 922 F.2d at 600-02.

These courts follow the general rule that section 105(a) standing by itself does not allow a bankruptcy court to "create substantive right[s] that are otherwise unavailable under applicable law." *See, New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc.*, 351 F.3d 86, 92 (2nd Cir. 2003); *U.S. v. Sutton*, 786 F.2d 1305, (5th Cir. 1986); *Southern Ry. Co. v. Johnson Brozen Co.*, 758 F.2d 137, 141 (3rd Cir. 1985). Hence, since there is no provision under the Bankruptcy Code or other statutes that grant bankruptcy courts the power to approve nonconsensual non-debtor releases, such power does not exist and cannot be created via section 105(a). *See, Abel v. West, 932 F.2d 898* (10th Cir. 1991); *In re American Hardwood, Inc.*, 885 F.2d 621, 626 (9th Cir. 1989). Other courts hold that section 524(e) prohibits releases to non-debtors. *See, e.g., Marine Midland Business Loans, Inc. v. Miami Trucolor Offset Service Co.*, 217 B.R. 341 (S.D. Fla. 1998); *In re Davis Broadcasting Inc.*, 176 B.R. at 292*; In re Market Square Inn, Inc.*, 163 B.R. 64, 66 (Bankr. W.D. Pa. 1994).

Fifth Circuit Cases

As *Growers* notes, the Fifth Circuit has taken the position that nonconsensual non-debtor releases violate section 524(e). *See, Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 751 (5th Cir. 1995); *see also, In re Bernhard Steiner Pianos USA, Inc.*, 292 B.R. at 116; *In re B.W. Alpha, Inc.*, 89 B.R. 592, 595 (Bankr. N.D. Tex. 1988). While the injunction in *Zale* was entered in the context of a settlement and not a plan of reorganization, the panel found that section 524(e) prohibited the bankruptcy court from granting a release because "the permanent injunction as entered improperly discharged a potential debt [to a non-debtor]," and that the bankruptcy court had overstepped its powers under section 105. *Id.* at 761. The opinion in *Zale* acknowledged that other courts have granted nonconsensual non-debtor releases, however it noted that those releases were done so as to channel potential claims and allow recovery from separate assets; thereby avoiding a discharge from debts to the non-debtor. *Id.* (citing *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d at 293). Thus, *Zale* left open the door for the court to revisit the issue if the right set of facts presents itself. The decision in *Zale* finds temporary injunction to be permissible under unusual circumstances. These circumstances include (1) when the non-debtor and debtor enjoy such an identity of interest that the suit against the non-debtor is essentially a suit against the debtor, and (2) when the third-party action will have an adverse impact on the debtor's ability to accomplish reorganization. *Id.* at 761. Bankruptcy courts in the Fifth Circuit have acknowledged this as well. *See, In re Bernhard Steiner Pianos*, 292 B.R. at 116 (Bankr. N.D. Tex. 2002); *In re Seatco*, 257 B.R. 469, 475 (Bankr. N.D. Tex 2001) (plan found to be confirmable when provisions did not affect the principal/guarantor's liability to the creditor, but prohibited enforcement of the guarantee agreement for the term of the plan). Once plans have been confirmed, third party releases have also been upheld on *res judicata* grounds. *See Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1050 (5th Cir. 1987). However, these provisions must be specific. *See, In re Applewood Chair Co.*, 203 F.3d 914, 919 (5th Cir. 2000).

Holding in Growers

Utilizing the five-factor test from *Master Mortgage*, Judge Jones found the release in question did not meet the requirements given by cases outside the Fifth Circuit for approving such a provision, finding that "no authority in the Bankruptcy Code or in case law…allows the Court to construe the release provisions as complying with any applicable provisions of the Bankruptcy Code." *Growers* 2007 WL 2088303 at *11. Judge Jones found that while the directors satisfied the first four factors they failed to meet the fifth and final factor providing full or almost full payment of the affected claims. Judge Jones opinioned that the fifth factor is very critical for the approval of the release at least under the scenario before the court. In failing to satisfy the fifth and final factor the court denied the confirmation of the Chapter 11 plan. *Id.*

Conclusion

The *Growers* decision does not depart from the Fifth Circuit's somewhat disfavor for nonconsensual non-debtor releases. However, *Growers*' analysis of the *Master Mortgage*'s test offers some guidelines for courts to consider when determining whether to grant nonconsensual non-debtor release agreements.

(Continued from page 8)

Remedies Against Improper Claims Trading

Potential remedies that a court may impose on a claims trading transaction deemed inappropriate include disgorgement of profits, equitable subordination and vote designation.

Disgorgement of Profits, Damages. The minimum remedy for improper purchase of claims at a discount by a fiduciary is to subordinate or disallow the fiduciary's claim to the extent its face amount exceeds the amount paid.[15] If this remedy is inapplicable, *e.g.*, the insider has no pending claim against the estate, a measure of damages for breach of fiduciary duty is the profits lost by the corporation as a consequence of the breach.[16] If circumstances warrant, it is conceivable that other damages could be assessed against the breaching party.

Equitable Subordination of Claims. Equitable subordination is a doctrine that allows a bankruptcy court, as a court of equity, to subordinate the claim of one creditor to those of other creditors in circumstances where the creditor has engaged in some type of inequitable conduct that has resulted in injury to other creditors.[17] The fundamental aim of equitable subordination is to undo or offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of bankruptcy results.[18] The doctrine is remedial, not penal, and should only be applied to the extent necessary to offset the specific harm creditors suffered on account of the inequitable conduct.[19] Pursuant to Bankruptcy Code Section 510, courts have held that to establish that equitable subordination is appropriate with regard to a creditor's claim against the debtor's estate, the debtor or trustee must show that the creditor engaged in inequitable conduct (fraud, illegality, breach of fiduciary duty, undercapitalization of the debtor, or use of the debtor as an alter ego or mere instrumentality); the inequitable conduct must have resulted in injury to creditors; and subordination of the creditor's claim must not be inconsistent with other bankruptcy laws.[20] The inequitable conduct directed against the bankrupt or its creditors may be sufficient to warrant subordination of a claim irrespective of whether it was related to the actual acquisition or assertion of that claim.[21] Further, inequitable conduct by a claim transferor has also been held sufficient to justify subordination of the transferred claim in the hands of an innocent purchaser.[22] A claim arising from dealings between a debtor and an insider will be more "rigorously scrutinized" by the courts.[23] Moreover, in circumstances where the plaintiff seeks equitable subordination with regard to a claim of a fiduciary or insider of the debtor who is also a creditor, the line between the insider-creditor and the debtor is often blurred, as the insider-creditor is typically in a position to exert control over the debtor. Consequently, it can become more difficult to establish with particularly that the insider-creditor has engaged in inequitable conduct.[24] In response, courts have shifted the burden from the plaintiff to the insider defendant to show the fairness of transactions.[25]

Plan Vote Designation – Section 1126(e). The bankruptcy court has the power to designate any vote as "not cast in good faith" and to disqualify it for purposes of determining plan acceptance. This standard applies to any claim regardless of insider classification.[26] "Good faith" is not defined in the Code, so the determination of what constitutes good faith has been left to be developed by the courts. The general rule is that bad faith will not be found where a creditor's purpose is to further its interests as a creditor. Where a creditor believes a plan does not provide for the best interests of its class, as a whole, rejection of the plan is not bad faith. Where a creditor votes against a plan in order to extort terms favorable only to itself[27] or to propose a plan designed solely to facilitate a competitor's acquisition of the debtor,[28] the court may disqualify the vote as being cast in bad faith. Section 1126(e) has also been invoked to designate votes resulting from claims purchases made to advance non-creditor interests, such as attempts to gain control of the company.[29] Further, Section 1126(e) has been interpreted to preclude votes motivated by "pure malice, strikes and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business."[30]

Other Claims Trading Issues

Recovery vs. Control – Improper Purpose. The purpose of reorganization is to offer an opportunity to maximize value for all creditors and interests holders. Against this backdrop, some courts have differentiated between recovery and control (or control profit).[31] Control profit is not shared through a reorganization plan with all creditors and all interest holders. A control profit will be shared only by the acquirer and its affiliates, when the acquirer intends to use its newly acquired control to extract economic profits for itself, not to maximize the results for all creditors.[32] One court has held that acquiring claims with the clear purpose of achieving control of the debtor and earning a control profit deprives other creditors of this value by "manipulation of the bankruptcy process through the strategic purchase of claims."[33] Accordingly, the *Allegheny* Court stated, under a "competitor takeover" fact pattern, that trading in claims to achieve profits on a specific claim may be destructive of the reorganization process unless: (i) both buyer and seller are informed; (ii) the purchaser is willing to hold the claim until distribution; and (ii) the original claimant does not wish to hold the claim or needs immediate cash.[34]

Trading Orders and Trading Restrictions. In larger Chapter 11 cases, the entry of trading orders designed to protect net operating losses and other tax attributes of debtors is increasingly becoming commonplace.[35] Such trading orders typically restrict trading of claims against, or securities of, the debtor, absent compliance with certain notification and objection procedures.[36] Such trading orders are necessary in many cases because NOLs are often very valuable assets of the estate and unregulated trading in a debtor's claims and equity interests may result in limitations on the use of NOLs.[37] Because the sale of claims against or securities of a debtor in violation of trading orders can result in a bankruptcy declaring such transactions null and void, purchasers and sellers of claims or securities should familiarize themselves with the provisions of any trading orders prior to entering into any such transactions.

Plan Confirmation - Section 1145 Securities Issues. Claims trading can trigger application of the securities laws upon confirmation of a plan of reorganization. Generally, Bankruptcy Code Section 1145 (a) exempts creditors from the registration requirements of the Securities Act of 1933 when they resell securities that they received pursuant to a Chapter 11 plan because the plan issuance is deemed to be a public offering.[38] However, purchasers of claims must be

(Continued on page 14)

Claims Trading in Distress

(Continued from page 13)

aware of potential limitations on this safe harbor with respect to securities received on account of purchased claims.[39] This is because the Section 1145 exemption is unavailable to underwriters."[40] Section 1145(b)(1)(A) defines an underwriter to include any entity which purchases claims "with a view to distribution of any security received or to be received in exchange for such a claim." Thus, a purchaser who purchases claims after the filing of a chapter 11 case, who believes that it will receive securities on account of such claim and anticipates selling such securities in the after market, "may well have purchased the claim with a view to distribution of the security to be received in exchange for the claim."[41] In such event, the Securities and Exchange Commission has indicated that such a purchaser may still dispose of its securities in "ordinary trading transactions" – those not involving concerted action, special informational documents or special compensation to brokers or dealers.[42] Given these issues, a purchaser of claims who has received securities pursuant to a Chapter 11 plan should consult with counsel prior to reselling such securities.

Bankruptcy Rule 2019 Disclosure Issues. Rule 2019 provides that, in a case under Chapter 9 or 11 of the Bankruptcy Code, any entity or committee representing more than one creditor or security holder of the debtor must file a verified statement with the court making certain enumerated disclosures.[43] In the case of committees, these disclosures include information of each committee member which is commonly regarded by claims traders as highly confidential and proprietary – the time at which each committee member's claims were acquired, the amount paid therefor, and any subsequent sales or dispositions thereof.[44] In a recent decision, ***In re Northwest Airlines Corp.***, 363 B.R. 701 (Bankr. S.D.N.Y. 2007), the United States Bankruptcy Court for the Southern District of New York held that a group of hedge funds acting as an unofficial committee was required to make the above-described disclosures.[45] However, on the heals of the ***Northwest*** ruling, the Bankruptcy Court for the Southern District of Texas refused to compel an unofficial committee of noteholders to make such disclosures under similar facts.[46] To date, the ***Northwest*** and ***Scotia Development*** courts appear to be the only two that have ruled on this issue. Given these inconsistent interpretations of the disclosure requirements of Rule 2019, claim holders should be mindful of Rule 2019.

Conclusion

Trading in claims has evolved into a sophisticated means by which buyers seek to obtain special situations returns and sellers seek to obtain recovery and liquidity without having to take on the risk of a restructuring or the process of a Chapter 11 bankruptcy case. The dynamics of claims trading will vary from case to case. Given the potential complexities and downside risks in the claims trading arena, having a clear understanding of the facts and potential issues surrounding a trade is key to managing risk when trading claims. Whether a proponent or an opponent of claims trading, it is something that has in the larger matters become a material dynamic and must be factored into any restructuring and reorganization practice and strategy.

Editor's Note: Due to publishing space considerations, citations to authority were withheld. The full article, with applicable authoritative references, can be found at http://txbankruptcylawsection.com under the "Newsletter" section.

Case Law Update

(Continued from page 11)

The Court addressed Mr. Jacobs' arguments that his conduct was nothing more than failing to pay his taxes. The Court stated that Mr. Jacobs did more than pay personal and business debts rather than his tax liability. Specifically, it was the action of titling his home in the sole name of his wife, the undocumented loans to his wife's company, and his very substantial expenditures "despite knowing he owed federal income taxes." Clearly, Mr. Jacobs was not sympathetic in the eyes of the 11th Circuit.

The Court also noted that regret does not "defeat a finding of willfulness" ; nor does the fact that Mr. Jacobs paid part of his tax liability. By the Court's reasoning, paying part of your tax liability does not affect the remaining balance; you must segregate and analyze separately.

Conclusion

The policy reason behind having taxes dischargeable was to be able to have debtors get a fresh start after going through bankruptcy. The soft spot in the Court's reasoning is its emphasis on Mr. Jacobs' discretionary expenditures (i.e., to his charities and to his family). By construing Section 523(a)(1)(C) so broadly, and by noting repeatedly the discretionary expenditures that Mr. Jacobs had made, the 11th Circuit has gutted the general rule of dischargeability of tax liabilities.

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[2] 11 U.S.C. 523(a)(1)(C)