

■ An Overview of Landlord Rights Against Tenants in Bankruptcy

BY ANDREW HARDENBROOK AND BENJAMIN W. REEVES

The number of individuals and businesses filing for bankruptcy continues to grow at a staggering rate. The Administrative Office of the U.S. Courts reports that a total of 1,306,315 bankruptcy cases were filed between June 30, 2008, and June 30, 2009,¹ which represents a 35 percent increase from the previous year. As these numbers show, if a landlord does not already have a tenant in bankruptcy, it may have one in the near future. This article discusses the treatment of leases by the Bankruptcy

Code and the impact it may have on a landlord, as well as what, if anything, a landlord can do to influence whether a lease is ultimately rejected, assumed, or assigned by the tenant.

The treatment of most leases of real property in bankruptcy is governed by section 365 of the Bankruptcy Code,² under which a bankrupt tenant³ generally has three ways that it can treat a lease: (1) assumption, (2) assumption and assignment, or (3) rejection.⁴ Each choice can significantly alter a landlord's rights and remedies.

What Rights Do Landlords Have Against a Tenant in Bankruptcy?

The Bankruptcy Code severely restricts the state law rights and remedies that a landlord usually enjoys. In fact, the filing of the bankruptcy case by a tenant enjoins the landlord from proceeding

(Continued on page 10)

■ Compelling Arbitration in an Adversary Proceeding

BY LAURANCE J. WARCO

Although debtors and bankruptcy trustees typically favor litigating claims against third parties in the friendly confines of a bankruptcy court, those initiating adversary proceedings against counterparties to a contract that contains an arbitration provision may find themselves litigating in a somewhat less friendly venue: in a conference room in the local offices of an arbitration association. Debtors and bankruptcy trustees, who stand in the shoes of the debtor, are often subject to arbitration provisions contained in the debtor's pre-petition contracts when they assert claims arising out of those agreements. In such a case, the Federal Arbitration Act generally requires bankruptcy judges to compel a debtor or trustee to comply with the debtor's agreement to arbitrate certain disputes between the parties, unless arbitration would conflict with a fundamental purpose of the Bankruptcy Code. Conflicts between the Bankruptcy Code and arbitration are not easily identified, and more and more bankruptcy and district courts have compelled arbitration against debtors or their trustees.¹

The Federal Arbitration Act

The Federal Arbitration Act provides that an agreement to settle by arbitration any claim arising out of such agreement "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."² The act has

(Continued on page 13)

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Letter from the Chairs

One point three million bankruptcies. It doesn't look any less daunting when spelled out. It is a staggering number. That is how many people filed for bankruptcy in the 12 months from July 2008 to June 2009. Combine that with 10.5 percent unemployment, 17 percent under/unemployment, unbelievable residential foreclosures, and the worst commercial foreclosure prospects to come down the pike in decades; this country is in a world of trouble. But help has arrived.

You alone can help save this country. You alone can be part of the solution, not the problem. Your first step to economic recovery is admitting you have a problem. If you have never read *Commercial and Business Litigation*, you are part of the problem and not part of the solution. Now is the time to reverse that trend. With five in-depth articles to help you through many aspects of bankruptcy law, you are well on your way to learning how to deal with this little understood area of the law (at least by most commercial litigator's standards). After you have read these articles, think of how you can further help to save this wonderful country of ours:

- Think about what you can do to share your knowledge of the law. Write an article for *Commercial & Business Litigation*. Please see the Letter from the Editor for more information on future issues and manuscript submissions;

- Attend the ABA Section of Litigation Annual Conference in April in New York City. Our group will hold a three-hour business meeting on Wednesday, April 21, 2010, to plan the next year and, of course, talk about how we can save the country through the practice of law. We also will have a dutch-treat dinner on either Wednesday or Thursday night;
- Think about a program you could present at a future meeting (and then tell us about it so we can propose it to the powers that be);
- Attend the ABA Annual meeting in San Francisco in August (more fun and learning to be had by all);
- Tell us you want to be involved and we will help you find an area in which to participate (or, better yet, tell us what you want to do and do it);
- Offer to write a chapter in our newly assigned book regarding securities law; or
- Write a case note to be published on our website.

Remember, ask not what your ABA can do for you but what you can do for your ABA.

Barb Dawson
Bart Greenwald
Byron K. Mason



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Letter from the Editor

This issue of *Commercial & Business Litigation* focuses on bankruptcy, and it includes five articles addressing issues that bankruptcy practitioners may encounter.

Upcoming issues of this newsletter will focus on class actions, securities litigation, and intellectual property litigation. The schedule for these issues is as follows:

WINTER 2010: Class Actions

Submission Deadline: February 1

SPRING 2010: Securities Litigation

Submission Deadline: April 1

SUMMER 2010: Intellectual Property Litigation

Submission Deadline: June 1

If you wish to submit an article, please contact me at stioa@pepperlaw.com. Submissions should be approximately 1,500 words in length, with all citations in the form of endnotes. The article should be written in MS Word format and may be submitted to my attention by email. You will be notified shortly after your submission if your article was selected for publication.

As always, thank you for your interest in the Committee on Commercial & Business Litigation.

Angelo A. Stio III

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Section of Litigation

The Attorney-Client Privilege in Bankruptcy—Don't Let Your Client Walk into a Trap

BY ANN D. ZEIGLER

Stop me if you've heard this one before: The Commodity Futures Trading Commission (CFTC) conducted a formal investigation of a brokerage house for brokers' misappropriation of customer funds and for violations of federal law related to the brokerage's actions as a futures commission merchant. Wait—this version has a slightly different punch line than the ones you've been hearing recently.

On the day in October 1980 that the CFTC filed its complaint in federal district court in the Northern District of Illinois, Frank McGhee, the sole remaining officer and

director of the corporation, entered into a consent decree, which provided for a receiver to be appointed and for the receiver to file a chapter 7 bankruptcy petition to liquidate the corporation. The district court obliged by appointing John Notz as the receiver, and Notz obliged by filing a bankruptcy petition under Bankruptcy Code sections 761–766, the special provisions of the Code for commodity brokers. The

bankruptcy court appointed Notz as the interim, then permanent, chapter 7 bankruptcy trustee for the corporate case.

The CFTC continued its investigation of the defunct brokerage's activities, in the course of which it issued a subpoena duces tecum to Gary Weintraub, to compel his testimony about the activities of the brokerage, its management, and its employees. Weintraub appeared at the deposition and testified at length. However, he refused to answer 23 of the questions put to him, even in the face of a subsequent motion and order to compel.

Fifth Amendment? No, attorney-client privilege. Weintraub was the former corporate attorney for the brokerage and refused to respond to those specific questions at Frank McGhee's direction as the remaining officer and director of the debtor corporation.

Trustee Notz waived the attorney-client privilege at the CFTC's request, a magistrate ordered Weintraub to testify, and McGhee appealed in the name of the corporation. After various procedural adventures, the question of who held the keys to Weintraub's testimony landed before the United States Supreme Court on a conflict among the circuits.¹

The simple question, as articulated by Justice Marshall for a unanimous eight-member court (Justice Powell did not participate), was this: “[W]hether the trustee of a corporation

in bankruptcy has the power to waive the debtor corporation's attorney-client privilege with respect to communications that took place before the filing of the petition in bankruptcy.”² In other words, does the bankruptcy trustee completely oust the individuals who constitute a corporation's management from their absolute control of the attorney-client privilege, even though technically those individuals continue to hold their positions in management?

Short answer: yes, he does. Short reasoning: because the legislative history shows that Bankruptcy Code section 542(e) must be read to give all corporate power in a liquidation to the trustee, not to the ousted management of the corporation. Justice Marshall goes on for 13 more pages, discussing why the individuals who retain corporate titles lose control of this critical corporate power. But the point he makes is a simple one: The attorney who formerly acted at the instruction of the individuals in corporate management must follow the corporate power, not the individuals, when a corporation files a bankruptcy petition.

Weintraub is a chapter 7 liquidation case, with a trustee replacing the individuals previously in management. What about a chapter 11 reorganization, where there is no trustee, and management remains in control? The *Weintraub* opinion makes plain that in chapter 11, the primary fiduciary duty of management of the insolvent company is no longer to the shareholders but to the creditors.

At this point, the attorney is in the difficult position of analyzing the motives of the individuals who are giving the attorney's marching orders. Are the individuals instructing the attorney to cover for their prior misdeeds, or are they now on the side of the angels? Not a pretty picture for the attorney, certainly.

Indeed, during pre-bankruptcy planning, and regardless of the chapter under which the company will file, the bankruptcy attorney must very plainly inform each individual in management and the corporate attorney of these two plain facts: (1) They will all have a new set of fiduciary duties and a new master, and (2) the corporate attorney's testimony and files may well be under someone else's control. The corporate and bankruptcy attorneys who fail to deliver this message in clear terms dig not only a hole for management but also a malpractice hole for themselves—and a *Weintraub* hole as well, when the trustee and his or her attorneys call, instructing them to turn over their own attorney files to the trustee.

Whenever the corporate fiduciary duties shift (including, arguably, when the corporation enters the infamous “zone of insolvency”), the attorney is exposed to the possibility that “the other side” is going to ask very pointed questions, and the attorney is going to be compelled to answer them.

As for the corporate attorney's own ethical obligations,

The attorney cannot count on being a bystander when the corporate client gets in trouble.

consider the *Weintraub* implications for the following litigation-related situations in which inside as well as outside corporate attorneys regularly find themselves: simultaneous representation of two related individuals or entities; internal investigations of possible fraud or malfeasance by an executive; Sarbanes-Oxley documentation requirements; litigation demands for electronically stored information, which may include attorney drafts, pre-litigation planning memos, and analysis documents; fee disputes and third-party claims defense; bankruptcy claim objections and claim valuation disputes; and, of course, Securities and Exchange Commission and other governmental investigations in which the attorney is a preliminary target along with corporate executives.

Post-Enron, and in the current economic climate, the attorney cannot count on being an interested bystander when the corporate client gets in trouble. Keep your eye on the privilege, and keep your client's eye on it as well.

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Endnotes

1. *Commodity Futures Trading Comm'n v. Weintraub et al.*, 471 U.S. 343, 105 S. Ct. 1986, 85 L. Ed. 2d 372 (1985).
2. *Id.* at 345, 105 S. Ct. at 376, 85 L. Ed. 2d at 1989.



Attorneys Who Mishandle Their Clients' Proofs of Claim Leave Themselves Open to Significant Blame

BY HON. JEFF BOHM, BRENETTA ANTHONY SCOTT, AND SUHANI DESAI

Creditors' attorneys, faced with a multitude of proof of claim (POC) filings, sometimes dispense with the requirements of properly filing a POC. As a matter of routine, attorneys often sign their clients' POCs and submit them to the bankruptcy court without attaching supporting documentation. In light of the recent credit crisis and increase in bankruptcy filings nationwide, this article aims to equip attorneys with information that will assist them in filing POCs and help them avoid the pitfalls associated with deficient POCs. This article focuses on recent rulings that are leading the charge against lax practices by attorneys who sign a POC without adequately investigating its validity or attaching documents in support of the claim.

Adopting an assembly-line approach to signing and filing POCs without due regard to the provisions of the Federal Rules of Bankruptcy Procedure may subject attorneys to dire quality control measures taken by courts. The inefficient process may strip the claim of *prima facie* validity¹ at best or subject the claim to disallowance at worst.² A lack of attention to detail may also result in sanctions against the offending attorney.

Proceed with Caution with Signatures

An attorney *may* sign a POC on behalf of a client without attaching evidence of authority to act for the client.³ Pursuant to Rule 3001(b) of the Federal Rules of Bankruptcy Procedure, an attorney is entitled to sign a POC on behalf of a client, but by doing so, the attorney may put himself or herself in harm's way. The attorney must be prepared to prove the claim by a

preponderance of evidence.⁴ Advocacy of a document that is not sufficiently investigated may violate Rule 9011. Therefore, attorneys must fully understand the consequences of signing a POC on behalf of a client.

By signing a POC, attorneys hold themselves accountable for the following:⁵

- *Investigation of the claim:* The attorney's signature on the POC indicates that the attorney has conducted a thorough investigation of the facts underlying the claim.
- *Compliance with the law:* The signature attests that the claim is warranted by existing law, has evidentiary support, and is not being presented for improper purposes.
- *Validity of the claim:* The signature indicates that the signing attorney attests to the validity and accuracy of the claim.
- *Burden of proof:* The burden is on the filing party, namely the signing attorney, to submit evidentiary support for all the allegations and factual contentions in a POC.⁶

Given the consequences of signing a POC on a client's behalf, the best practice is to advise the client, who has firsthand knowledge of the claim, to sign the POC. The attorney should also advise the client to conduct a thorough review of the claim. In addition, the attorney should apprise the client of the consequences of filing an invalid or an inaccurate POC.

FORM LETTER

This form letter is suggested as a template that attorneys could adopt as standard practice.

Name of Creditor/Client:
Address of Creditor/Client:
Re: In re [Name of Debtor]; Case Number [Insert];
Account Number [Insert].

Dear [Ms./Mr. Client]:

Pursuant to your request, I have completed the proof of claim that is to be filed on your behalf in the above-referenced bankruptcy case, based upon my knowledge of the file. I enclose this proof of claim for your review and signature. If it is incorrect on any point, you should tell me so that we can address the issue *before* filing the claim.

As you can see by reviewing the very bottom of the document, the penalty for submitting a fraudulent claim is a fine of up to \$500,000.00 or imprisonment for up to five years.

Because you are signing this proof of claim, please review it carefully to ensure that it is accurate in every respect. It is my recommendation that you, not I, should sign this proof of claim because if the debtor, or any other creditor or party in interest, ever files an objection to your claim, you will want me to represent you at the hearing on this objection. If I sign the proof of claim, the court could require me to testify as a fact witness at this hearing, and when that happens, court rules prevent attorneys from continuing to represent their client in the case. You would then have to engage a different attorney, which would impose additional expenses on you. Because I have no doubt that you want to avoid incurring such an additional expense, it is my strong recommendation that you sign the proof of claim, but only after you have reviewed it and have assured yourself that it is accurate.

Please also be aware that *all* documents on which the claim is based must be attached to the proof of claim when it is filed with the bankruptcy court (as required by Paragraph 7 of the Official Proof of Claim Form). If you cannot find such documents, you must attach a written statement explaining why the documents are not attached. When you send the signed and dated proof of claim back to me to file with the court, please make sure that you have attached all the documents supporting this claim. It is important that the original proof of claim be accurate and complete. In this manner, we will minimize the risk that the debtor will file an objection to the claim and force us to prepare for and attend a hearing, or hearings, on the objection.

The deadline for filing the proof of claim with the court is [Insert Date]. If the signed form and supporting documents are not filed by this date, the court may deny you any distributions in the bankruptcy.

Please do not hesitate to call or email me if you have any questions.

Thank you.

Don't File Without Supporting Documentation

Rule 3001 specifies that supporting materials substantiating a claim should be filed with a POC, and a POC filed in accordance with this rule's provisions "shall constitute *prima facie* evidence of the validity and amount of the claim."⁷ Creditors who fail to attach supporting documents to their POCs risk having their claim disallowed for evidentiary reasons.⁸

Although it is true that a POC may not be disallowed for a failure to provide supporting documentation, the lack of evidence to substantiate the claim may deprive it of *prima facie* validity.⁹ The *prima facie* validity afforded to the POC is based on the presumption that the POC complies with the promulgated rules and forms. If compliance with the rules is questionable, the courts strip the POC of *prima facie* validity and shift the burden of proof to the filing party to prove the claim by a preponderance of evidence.¹⁰

In a legal system based on evidence, the initial burden of proving and providing documents supporting a claim is on the party filing a POC. The rules promulgated by the Supreme Court under congressional authority require that documents be attached to a POC, or that an explanation be provided for the absence of documents. Among the supporting documents that may be attached are the contract, assignments, pay history, and invoices for incurred expenses or fees. However, recent rulings highlight the lax treatment POCs receive from attorneys who wait until objections have been lodged by the debtor before they consider amending the POC to attach supporting documents.

One co-author of this article, a bankruptcy judge for the Southern District of Texas, has issued a notice and order that for every chapter 7 and chapter 13 case assigned to his court, Federal Rule of Bankruptcy Procedure 15 automatically applies once an objection to a POC is filed.¹¹ The claimant will not be permitted to amend the claim after the objection is filed unless the claimant first obtains leave of court or, alternatively, obtains the objecting party's written consent. Sanctions may be imposed against any claimant who amends the POC after an objection is filed without first obtaining leave of court or the objecting party's written consent. Imposing automatic application of Rule 15 gives greater incentive to creditors and their counsel to file the initial POC with all the appropriate documentation attached thereto. Such circumstances reduce the number of objections lodged by debtors, who most certainly do not need to incur any more fees than they already have.

A POC unsupported by documentation not only is subject to disallowance but also may result in sanctions against the attorney who ignored due diligence

procedures to verify the claim. “Advocacy of a document that counsel has not sufficiently investigated can be a Rule 9011 violation.”¹²

The Consequences for Attorneys

Attorneys who attest to the validity of a POC by signing and filing it without supporting documents subject themselves to the following risks and impediments:

- *Doubts about credibility*: Signing a POC without client approval or without attaching supporting documents calls into question the credibility of the attorney who is unable to satisfy his or her burden of proof with evidentiary support.
- *Hearsay objections*: Any testimony proffered by the attorney based upon out-of-court statements of the client may draw hearsay objections.
- *Objections regarding lack of foundation*: Any testimony regarding the validity of the POC may draw objections for lack of foundation.
- *Motions to disqualify*: By signing a POC and thereby attesting to its validity, an attorney may risk a motion to disqualify for becoming a fact witness.
- *Loss of presumption of prima facie validity*: If a party in interest contests the claim, the POC loses its prima facie validity. The signing attorney then bears the burden of proof by a preponderance of the evidence to bring forth documentation in support of the contested POC.

Assignments Gone Awry

A frequent scenario encountered by the courts adjudicating disputes over POCs is the assignment of secured or unsecured debt from the original creditor to assignee creditors. Too often, the supporting documentation submitted to the courts fails to substantiate the assignment of the debt to the assignee creditors. Recent rulings indicate that creditors holding a transferred claim will not be relieved of their evidentiary burden to produce a proof of assignment.¹³ Attorneys representing assignee creditors should secure proof of assignment and attach such documentation to the POC before filing it.

Sanctions and Penalties

Section 157 of title 18 of the United States Code makes a false or fraudulent representation or claim in relation to a bankruptcy case a federal crime.¹⁴ Section 152 of title 18 provides for the imposition of a fine, a prison sentence not to exceed five years, or both, on any person who commits such conduct—such as filing a false or fraudulent POC. In addition, Rule 9011(c) permits a court to sanction attorneys who make false representations on a POC. Section 105 of the Bankruptcy Code also gives the courts the power to issue orders to prevent abuse of the bankruptcy process.¹⁵ Additional sanctions and penalties may exist under individual state laws.

A BEST-PRACTICES APPROACH TO FILING POCs

When signing or filing a POC, attorneys can avoid running afoul of the Bankruptcy Code and the Bankruptcy Rules by taking the following steps:

- Always conduct due diligence of the documents presented in support of a POC.
- Always attach an itemized breakdown of the claim and supporting documents.
- Always inform the client in writing of the requirement of verification and authenticity of the documents supporting the POC.
- Always have the client sign the POC.
- Always adhere to POC deadlines stringently.

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Endnotes

1. Rule 3001(f) provides evidentiary benefit to a POC that complies substantially with the rule. It provides that a POC “executed and filed in accordance with these rules shall constitute *prima facie* evidence of the validity and amount of the claim.”
2. A POC is disallowed only when the claimant is unable to establish his or her burden of proof by a preponderance of the evidence.
3. *Wilson v. Valley Elec. Membership Corp.*, 141 B.R. 309, 312–13 (Bankr. E.D. La. 1992). See also FED. R. BANKR. P. 9010(c).
4. *In re Armstrong*, 320 B.R. 97, 103–4 (Bankr. N.D. Tex. 2005).
5. See FED. R. BANKR. P. 9011(b).
6. *Heath v. Am. Express Travel Related Servs. Co. (In re Heath)*, 331 B.R. 424, 435 (B.A.P. 9th Cir. 2005); *Dove-Nation v. eCast Settlement Corp. (In re Dove-Nation)*, 318 B.R. 147, 151 (B.A.P. 8th Cir. 2004). See also *Raleigh v. Ill. Dep’t of Revenue*, 530 U.S. 15, 21 (2000).
7. FED. R. BANKR. P. 3001(f).
8. *Samson v. B-Real, LLC (In re Samson)*, 392 B.R. 724, 728 (Bankr. N.D. Ohio 2008).
9. *Heath*, 331 B.R. at 433; *Dove-Nation*, 318 B.R. at 152.
10. *In re Kendall*, 380 B.R. 37, 47 (Bankr. N.D. Okla. 2007).
11. *In re DePugh*, 2009 Bankr. LEXIS 1796, at *35, (Bankr. S.D. Tex. June 26, 2009). See also *In re Gilbreath*, 395 B.R. 356, 366 (Bankr. S.D. Tex. 2008).
12. *In re Padilla*, 2006 WL 2090210, at *1 (Bankr. S.D. Tex. June 26, 2006).
13. *In re Parrish*, 326 B.R. 708, 719 (Bankr. N.D. Ohio 2005). See also *In re Hughes*, 313 B.R. 205, 210 (Bankr. E.D. Mich. 2004).
14. A person making a false oath on a POC is subject to a penalty of up to five years in prison. 18 U.S.C. § 157.
15. 1 U.S.C. § 105. See also *In re Thomas*, 337 B.R. 879, 888 (Bankr. S.D. Tex. 2006), *aff’d*, 223 F. App’x 310, 315–16 (5th Cir. 2007).

Discovering Fraud Post-Confirmation: Is There Recourse after 180 Days?

BY ERICA HARRIS

Section 1144 of the United States Bankruptcy Code allows a party in interest to seek revocation of a confirmation order within 180 days if the confirmation order was procured by fraud. Section 1144 is strictly construed; to promote the finality of bankruptcy confirmations, any challenge to the confirmation order brought after 180 days is untimely and barred.¹

What happens, then, when a client does not discover fraud until after a plan has been confirmed and the 180-day grace period has passed? Will the general release and injunctive provisions found in most confirmed plans bar a subsequent civil action for relief? Will those provisions stand, even if a nondebtor defendant actively worked to conceal the fraud until long after confirmation?

The courts that have addressed the issue have found that section 1144 is the only available means to revoke a confirmation order but is not the exclusive remedy for fraud.² Instead, where the action is truly independent, such that the claims would not “upset the confirmed plan,” a civil action outside section 1144 may proceed.³

documents produced in the bankruptcy had been carefully analyzed. As a prior opinion in that case made clear:

The plaintiffs do not contend that the defendants wrongfully concealed material facts from them prior to confirmation. Rather, the plaintiffs contend that the documents produced by the defendants prior to confirmation were too voluminous to review adequately, that there was insufficient time to review the materials thoroughly, and that the materials were not reviewed to ferret out fraud, because the prospect that fraud had been committed in connection with management assumptions and adjustments to EBITDA was not yet apparent.⁷

In light of these facts, the court considered whether the action was “truly independent” or whether the action amounted to an attempt to revoke the confirmed plan and “redivide the pie.” In holding that the action would not “redivide the pie,” the court reasoned as follows:

What if a creditor filed a false or inflated claim and this fact was not discovered prior to plan distributions and was discovered more than 180 days after plan confirmation? The effect would be to unfairly inflate that creditor’s distribution while deflating the distributions to other similarly situated creditors. Why deny the adversely affected creditors from pursuing a fraud claim against the wrongdoing creditor, with no impact on the reorganized debtor or the plan? In this Court’s view, under the facts alleged here (assuming they are proven at trial), there ought to be a remedy to redress the harms suffered and a mechanism to divest the alleged tortfeasors of their ill-gotten gains, at least where doing so would not affect innocent parties.⁸

Because the guilty creditors would have to satisfy a judgment out of their own pockets, the court found that the plaintiffs’ action was not a collateral attack on the confirmation order such that section 1144 would apply. In addition, the court found that because the plaintiffs alleged that defendants had concealed their fraud until after confirmation, the claims were not barred by res judicata.

The court in *California Litfunding* approached the same general analysis very differently. Just as in *Genesis Health Ventures*, the court in *Litfunding* considered whether the civil action was “truly an independent cause of action” that would not upset the confirmation order.⁹ On very similar facts, however,

However, in determining whether actions are “truly independent,” courts diverge substantially in their analyses and outcomes. A comparison of *In re Genesis Health Ventures, Inc.*⁴ and *In re California Litfunding*⁵ illustrates the problem.

In *Genesis Health Ventures*, the plaintiffs filed a civil action two years after plan confirma-

tion, alleging that parties to the bankruptcy had “cooked” the debtor company’s actual and projected earnings before interest, taxes, depreciation, and amortization (EBITDA). The plaintiffs alleged that the nondebtor defendants’ fraud resulted in a low valuation of the debtor company that resulted in “senior creditors [receiving] almost all of the equity in the reorganized company, while Plaintiffs received almost nothing.”⁶

The plaintiffs claimed they could not have reasonably known of the fraud until long after the plan had been confirmed. The plaintiffs alleged that information revealing the fraud was not published until months after the confirmation of the plan: A subsequently published 10-K revealed that reserves had doubled in a year; a 10-Q revealed a business that had been represented as being lost was not lost; cost of goods sold was later published to be much lower than presented in the bankruptcy; and certain substantial revenues were revealed to have been excluded from income (and EBITDA) during the relevant period.

Despite this, the fraud could have been discovered if the

Section 1144 is not the exclusive remedy for fraud.

the *Litfunding* court reached an opposite conclusion.

As in *Genesis Health Ventures*, the plaintiffs in *Litfunding* argued that the fraud could “not have been raised preconfirmation as it was not discovered until after confirmation.” The court rejected this argument:

The facts that purport to give rise to the fraud were the same statements that were either provided in or omitted from the Debtors’ Disclosure Statement. . . . In the exhibits that were attached to the Disclosure Statement and the settlement letter between the parties, the list of all pending cases constituting the “Contract Pool” from which cash flow distributions are to be made, the history/analysis of collections from the Contract Pool, and the projections of gross collection from the Contract Pool include the cases from Ravis who, according to Plaintiffs, entered into a “secret loan” with the Weiner Trust.¹⁰

The court reasoned that because “[t]he alleged fraudulent representations were available for investigation months before the hearing on confirmation and indeed, months after plan confirmation,” the plaintiffs “could have (and should have) conducted their due diligence and investigated the accuracy (or inaccuracy) of the statements made in or omitted from the Disclosure Statement.”¹¹

As in *Genesis Health Ventures*, the *Litfunding* plaintiffs argued that they could not have known to investigate the accuracy of the statements because the defendants concealed their fraud until after confirmation and that, even if they had undertaken an investigation, they would not have been able to discover the secret transaction between two of the defendants that served to conceal the fraud. The court rejected this argument as well, reasoning that even without that information:

Plaintiffs were convinced, based on their own expert’s opinion, that the Defendants were “lining their pockets with corporate funds derived from their investments and engaging in ‘bad acts and financial mismanagement’” and never believed the Debtors’ projections and representations in the Disclosure Statement. . . . While it may be true that Plaintiffs’ [sic] may not have voted to accept the Plan or executed the Settlement Agreement if they were aware of the acts of fraud discovered postconfirmation, the events leading up to Plan confirmation suggest that the parties disputed the amount of the proceeds to be collected from the litigation investments comprising the Contract Pool under the Plan. These are the same operative facts that gave rise to the allegations of fraud that they could have investigated and discovered preconfirmation.¹²

Finally, the court concluded that even though the plaintiffs sought only damages from the non-debtor defendants, that

claim would nonetheless upset the confirmed plan because others in plaintiffs’ position would also have a right to sue, and defendants would never have agreed to the settlement in the bankruptcy without the release from plaintiffs. The court reasoned that if the fraud vitiated part of the release, then it should vitiate all of the release so that any moneys paid to plaintiffs pursuant to the settlement agreement and those who stood in a similar position would have to be undone.

The *Litfunding* analysis is remarkable for several reasons. First, it gives defendants an incentive to go to great lengths to conceal their fraud until after confirmation. If a defendant successfully conceals his or her fraud until 181 days post-bankruptcy, the defendant will be insulated from suit because the representations that were fraudulent were made during the bankruptcy. Second, it compels a plaintiff to conduct exhaustive discovery during the bankruptcy proceeding even if he or she has no reason to suspect fraud. Because a failure to discover fraud will serve as an absolute bar, a plaintiff will have to go to great expense to protect against the risk of fraud. Finally, because standard releases are mutual and there are generally multiple parties in interest that would be affected by a fraud during bankruptcy, any civil action for damages, even if against only one nondebtor defendant, will be construed as a collateral attack on the confirmation order. This last holding of the *Litfunding* court begs the question of what civil action could ever be deemed a “truly independent action” that would be allowed to proceed in that court’s judgment.

The majority of courts appear to follow *Genesis Health Ventures*. Civil actions brought against nondebtor defendants that seek only monetary relief from the nondebtor defendants are allowed to proceed so long as the alleged fraud claims were not previously tried in the bankruptcy court. Until the U.S. Supreme Court rules on the issue, however, parties in interest beware.

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Endnotes

1. See *In re Midstate Mortgage Investors, Inc.*, 105 F. App’x 420, 423 (3d Cir. 2004) (“Expiration of the limitations period bars a motion to set aside the confirmation of a reorganization plan even if the fraud is not discovered until the period has passed”).

2. *Browning v. Prostok*, 165 S.W.3d 336, 344–45 (Tex. 2005) (citing *In re Newport Harbor Assocs.*, 589 F.2d 20, 23–24 (1st Cir. 1978)). See also *In re Coffee Cupboard, Inc.*, 119 B.R. 14, 19 (E.D.N.Y. 1990) (“Section 1144 does not act as a bar to a truly independent course of action based on a debtor’s wrongful conduct”).

3. *Donaldson v. Bernstein*, 104 F.3d 547, 777 (3d Cir. 1997) (quoting *Newport Harbor Assocs.*, 589 F.2d at 24); *In re Genesis Health Ventures, Inc.*, 355 B.R. 438, 445 (D. Del. 2006) (finding

(Continued on page 15)



Landlord Rights Against Tenants in Bankruptcy

(Continued from page 1)

outside of the bankruptcy court to enforce its rights under the lease. Thus, the Bankruptcy Code prohibits a landlord from, among other things, initiating or continuing any state court action against the tenant, attempting to obtain possession of the leased property, or undertaking any collection efforts against the tenant.⁵

Until a tenant elects how to treat the lease under section 365, the Bankruptcy Code requires both the landlord and tenant to comply with all of the terms and conditions of the lease. As a result, the tenant has the obligation to pay rent when due, and its failure to do so entitles the landlord to an administrative claim for any and all rent incurred, but not paid, after the bankruptcy filing.⁶ Although administrative claims are given priority in bankruptcy cases,⁷ the landlord still runs the risk of not receiving any money on its claim if the bankruptcy estate is administratively insolvent. In these cases, the interests of the landlord are best served if a tenant quickly decides whether to assume or reject the lease.

When Does the Tenant Have to Decide to Assume or Reject a Lease?

The time a tenant has to either accept or reject a lease generally depends on the type of property being leased and the chapter under which the bankruptcy case was filed. For landlords, it is important to note that a lease of nonresidential real property under which the debtor is a lessee must either be assumed within 120 days of the bankruptcy filing or before an order is entered confirming a plan, whichever is earlier, or it is automatically deemed rejected.⁸ In a chapter 7 case, tenants of residential property must assume or reject the lease within 60 days of the bankruptcy filing.⁹ In almost all other instances, leases of real property can be assumed or rejected at any time before plan confirmation.¹⁰

How Can the Landlord Affect Whether a Tenant Accepts or Rejects a Lease?

Although the tenant's decision to assume or reject a lease is discretionary, the tenant's decision is subject to court review. Bankruptcy courts review the tenant's decision under the liberal business judgment rule.¹¹ Nevertheless, the landlord has some ability to influence the outcome of whether the court allows the tenant to assume or reject the lease.

For example, even though a landlord cannot force a tenant to assume or reject a lease, it can attempt to hasten the process by filing a motion to compel the tenant to make a decision by a certain date.¹² To determine whether to set a deadline, bankruptcy courts generally consider a multitude

of factors, including whether delay will harm the landlord; whether the tenant has had sufficient time to evaluate its financial condition;¹³ and whether the tenant has continued to perform its obligations under the lease.¹⁴ Bankruptcy courts usually do not rush the debtor into making a decision absent a showing that an earlier decision would benefit the estate.¹⁵

What Happens to the Landlord If the Tenant Rejects the Lease?

As previously mentioned, the decision to assume or reject a lease is reviewed under the business judgment rule. Thus, the tenant must merely have a sound business reason to support its decision. Not surprisingly, the decision to reject a lease is typically approved absent a showing of bad faith or manifest unreasonableness.¹⁶

With the exception of some chapter 7 cases¹⁷ and time-share interests,¹⁸ rejection entitles the landlord to a breach of contract claim that is deemed to have arisen immediately prior to the filing of the bankruptcy case.¹⁹ The landlord may assert a general, unsecured claim against the bankruptcy estate for the damages that it suffered as a result of the breach.²⁰ The amount of damages allowed, however, is capped by section 502(b)(6) of the Bankruptcy Code.²¹ As a result, the landlord usually cannot recover the full amount of the actual damages suffered if a tenant rejects a lease.

How Does the Assumption Differ from Rejection?

What Leases Can Be Assumed?

Although any lease may be rejected by the tenant, only certain types of leases can be assumed or assigned. The Bankruptcy Code excludes three categories of leases from assumption: (1) nonresidential real property leases that have been terminated under state law prior to the tenant's filing for bankruptcy; (2) leases that involve a contract to make a loan or extend other debt financing; and (3) agreements that involve specialized performance to, or from, the bankrupt tenant.²²

All three categories affect leases in the landlord-tenant context. First, automatic termination of an unexpired lease prior to bankruptcy can relieve a landlord from all of the uncertainty of the bankruptcy process. Landlords should be aware, however, that contractual provisions that purport to terminate a lease agreement automatically due to bankruptcy will not be enforced by a bankruptcy court.²³ Such provisions are referred to as *ipso facto* provisions and are generally unenforceable in the bankruptcy context.²⁴ Second, section 365(c)(2) of the Bankruptcy Code prevents a tenant from assuming or assigning a lease that requires the landlord to provide funds for tenant improvements in the future because such agreements require the landlord to extend financial accommodations to the tenant.²⁵ Third, if applicable state law would relieve the landlord from accepting or providing services to anyone other than the tenant, then the lease cannot be assumed or assigned absent the landlord's consent.²⁶

How Can the Tenant Assume the Lease?

Provided that the lease does not fall into one of the three aforementioned categories, the tenant may elect to assume or assign the lease. If the tenant is not in default of the lease, then a tenant generally may assume the lease after approval from the Bankruptcy Court.²⁷ If a default exists, however, a tenant must first cure certain defaults, compensate the landlord for its losses, and provide adequate assurance of future performance prior to assumption or assignment.²⁸

Although a tenant must show that it has cured, or promptly will cure, certain existing defaults,²⁹ the Bankruptcy Code does not require a tenant to cure all defaults. Specifically, a tenant does not have to cure defaults that (1) relate to the tenant's insolvency, (2) were caused by the tenant's filing for bankruptcy, (3) were caused by the appointment of a trustee or custodian in the bankruptcy case, (4) relate to penalties arising from the tenant's failure to perform non-monetary obligations, or (5) arise from any non-monetary requirements that could not be cured by the tenant's post-bankruptcy conduct.³⁰ Thus, if the tenant is in default on the lease based on one of the foregoing reasons, then the tenant typically will be able to assume the lease without curing.

In addition to curing its defaults, the tenant also must compensate, or provide adequate assurance that it will compensate, the landlord for its losses.³¹ This includes any actual pecuniary loss resulting from the default, which may encompass attorney fees.

Finally, the tenant must also provide adequate assurance of future performance.³² The term "adequate assurance" is not defined in the Bankruptcy Code. Generally, this standard requires the tenant to provide some evidence that it will be able to make its payments going forward.³³ In the case of shopping centers, the tenant bears the added burden of providing adequate assurance of the source of rent, percentage rentals, that the assumption will not disrupt any other tenant leases, and that the tenant mix in the shopping center will remain unchanged.³⁴ Adequate assurance does not require absolute certainty but depends upon realistic expectations and projections in the context of the tenant's business.³⁵

How Does a Tenant's Assumption of the Lease Affect the Landlord?

If the tenant decides to assume the lease, it must assume the lease in its entirety. This means that the tenant must accept all of the benefits and obligations of the lease.³⁶ If the tenant should later reject or breach the lease after assuming it, the landlord's damages resulting from the breach are entitled to administrative priority.³⁷ With respect to leases of nonresidential real property, the amount of the total damages entitled to administrative priority is capped.³⁸

Once a Lease Has Been Assumed, Can the Landlord Stop It from Being Assigned?

Section 365(f) of the Bankruptcy Code allows the tenant to assign its unexpired leases to third parties. Before assignment

can occur, the tenant must both assume the lease and provide adequate assurance of future performance, regardless of whether a default exists. The tenant's right to assign the lease exists even if the unexpired lease itself or applicable law expressly provides that assignments are not allowed.³⁹

In the commercial landlord-tenant context, assignments most often occur when a tenant has an advantageous lease that it can assign for a profit.⁴⁰ When an assignment occurs, the tenant transfers all of its rights under the lease and is relieved of all future liability.⁴¹ The Bankruptcy Code allows tenants to take advantage of these situations, despite contractual provisions that would otherwise restrict the tenant's ability to do so. For

example, some commercial landlord-tenant agreements require the landlord's consent before the lease may be assigned. Although such restrictions are enforceable in the non-bankruptcy context, a bankruptcy court will uphold such a provision only if the landlord can show that it will suffer

some economic harm if assignment occurs.⁴² If, on the other hand, the tenant merely desires to sublease the commercial space, the tenant arguably will be subject to any clauses restricting the right to sublease.⁴³ Despite the tenant's ability to assign the lease, the Bankruptcy Code requires the assignee to provide the landlord a deposit or other security substantially the same as the landlord would require from a similar tenant.⁴⁴

Conclusion

As the number of bankruptcy cases increases, so too does the probability that a landlord will encounter a tenant who has filed for bankruptcy protection. Section 365 of the Bankruptcy Code is a complex statute that affords a tenant the ability to reject, assume, and assign a lease. Because these choices can drastically alter the landlord's rights, duties, and expectations, landlords should learn the effect of each decision and what, if anything, they can do to influence the outcome of the tenant's decision.

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In the commercial context, assignments most often occur when a tenant has a lease it can assign for profit.

Endnotes

1. Press Release, Administrative Office of the U.S. Courts, Bankruptcy Filings Continue to Rise in June (Aug. 2009), available at http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsJun2009.cfm.

2. Section 365 of the Bankruptcy Code governs “unexpired leases” or “executory contracts” of the debtor. 11 U.S.C. § 365(a). Although the Bankruptcy Code does not define either of these terms, whether a contract is executory traditionally hinges on whether the contract requires further performance from each party at the time the bankruptcy petition is filed. *In re Qintex Entm’t, Inc.*, 950 F.2d 1492 (9th Cir. 1991); *Matter of C & S Grain Co., Inc.*, 47 F.3d 233 (7th Cir. 1995).

3. In certain cases, a trustee may be appointed over the bankruptcy estate. 11 U.S.C §§ 702, 1104. For ease of reference, this article refers to the debtor-in-possession or the trustee equally as the tenant.

4. 11 U.S.C. § 365(a), (f).

5. 11 U.S.C. § 362(a)(1), (3), (6); *see also In re 48th Street Steakhouse*, 835 F.2d 427, 431 (2d Cir. 1984) (holding that landlord’s termination notice to tenant violated automatic stay); *but see In re Sumpter*, 171 B.R. 835, 842 (N.D. Ill. 1994) (holding that creditors who evicted debtor a few hours before bankruptcy case was filed did not violate the automatic stay).

6. *HA-LO Indus. v. Center Points Props. Trust*, 342 F.3d 794 (7th Cir. 2003).

7. 11 U.S.C. § 507(a)(2).

8. *See* 11 U.S.C. § 365(d)(4)(A).

9. 11 U.S.C. § 365(d)(1).

10. In chapter 11 and 13 cases, the tenant may assume or reject the leases of residential property at any time before the confirmation of a plan. 11 U.S.C. § 365(d)(2).

11. *In re Pomona Valley Med. Group, Inc.*, 476 F.3d 665 (9th Cir. 2007).

12. Motions to compel acceptance or rejection of a lease should be filed pursuant to Federal Rule of Bankruptcy Procedure 9014, which governs contested matters.

13. *In re Enron Corp.*, 279 B.R. 695, 702 (Bankr. D. Del. 2001).

14. *In re Republic Techs. Int’l, LLC*, 267 B.R. 548, 554 (Bankr. N.D. Ohio); *see also In re Enron Corp.*, 279 B.R. at 702–3; *In re Kmart Corp.*, 290 B.R. 614, 619 (Bankr. N.D. Ill. 2003) (“In making this determination, the court does not abuse its discretion by considering the interests of the nondebtor party pending the debtor’s decision to assume or reject.”).

15. *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 12 (7th Cir. 1984) (stating that “to minimize flexibility and rush the debtor into what may be an improvident decision does not further the purposes of the reorganization process”); *see also In re Pub. Serv. Co.*, 884 F.2d 11, 15 (1st Cir. 1989) (“The interest of the creditors collectively and the bankruptcy estate as a whole will not yield easily to the convenience or advantage of one creditor out of many”).

16. *In re Pomona Valley Med. Group*, 476 F.3d 665.

17. Rejection of residential leases under section 365(d)(1) may constitute abandonment of the lease. *In re Onecast Media, Inc.*, 439 F.3d 558, 563 (9th Cir. 2006); *In re Stoltz*, 315 F.3d 80, 86 (2d Cir. 2002). In these cases, rejection of the lease removes the lease from the bankruptcy estate, whereupon the landlord “may generally

pursue state-law remedies for breach of contract, including eviction for breach of lease.” *In re Stoltz*, 315 F.3d at 86.

18. 11 U.S.C. § 365(h)(2), (i)(2).

19. 11 U.S.C. § 365(g)(1).

20. *Id.*

21. Section 502(b)(6) provides that the amount of the claim resulting from a breach of a lease on real property cannot exceed the rent reserved by the lease, without acceleration, for greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease, following the earlier of the petition date, the date on which the landlord repossessed, or the tenant surrendered the property, plus any unpaid rent due under the lease, without acceleration, on the earlier of such dates.

22. 11 U.S.C. § 365(c).

23. 11 U.S.C. § 365(b)(2)(A).

24. 11 U.S.C. § 365(e)(1); *see also In re Mirant Corp.*, 440 F.3d 238, 245–46 (5th Cir. 2006) (“Generally, § 365(e) of the Code bars the enforcement of *ipso facto* clauses in executory contracts”).

25. *See In re Postle Enter., Inc.*, 48 B.R. 721 (Bankr. D. Ariz. 1985).

26. 11 U.S.C. § 365(c)(1)(A).

27. 11 U.S.C. § 365(b).

28. *Id.*

29. *See* 11 U.S.C. § 365(b)(1)(A).

30. 11 U.S.C. §§ 365(b)(1)(A) and (b)(2).

31. *See* 11 U.S.C. § 365(b)(1)(B).

32. *See* 11 U.S.C. § 365(b)(1)(C).

33. *In re Liljeberg Enter.*, 304 F.3d 410 (5th Cir. 2002).

34. *See* 11 U.S.C. § 365(b)(3).

35. 2 WM. L. NORTON JR., *NORTON BANKRUPTCY LAW AND PRACTICE* § 46:31 (3d ed. 2009).

36. *In re Nat’l Gypsum Co.*, 208 F.3d 498 (5th Cir. 2000).

37. 11 U.S.C. § 365(g)(2); *In re Frontier Props., Inc.*, 979 F.2d 1358 (9th Cir. 1992).

38. With respect to leases of nonresidential real property, section 503(b)(7) of the Bankruptcy Code does not allow administrative claims to arise from or relate to a failure to operate or a penalty provision. 11 U.S.C. § 503. The monetary claim is also capped at the sum equal to all monetary obligations due for the period of two years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums received (or to be received) from a nondebtor entity. *Id.* The remaining sums are recoverable as a general, unsecured claim. *Id.*; 11 U.S.C. § 502(b)(6).

39. 11 U.S.C. § 365(f)(1).

40. NORTON, *supra* note 35, § 46:32.

41. *See In re Lafayette Radio Elecs. Corp.*, 9 B.R. 993 (Bankr. N.Y. 1981).

42. *In re Barclay Indus., Inc.*, 736 F.2d 75 (3d Cir. 1984).

43. NORTON, *supra* note 35, § 46:32.

44. 11 U.S.C. § 365(l).



Adversary Proceeding

(Continued from page 1)

established a liberal federal policy favoring arbitration agreements,³ and courts are required to enforce rigorously agreements to arbitrate.⁴ A party to an arbitration agreement may move for an order compelling arbitration,⁵ and the burden is placed on any party opposing arbitration—including a debtor or bankruptcy trustee—to show that Congress intended to preclude an arbitration under the circumstances.⁶

Hays v. Merrill Lynch

In 1989, the Third Circuit considered whether a bankruptcy trustee was bound by a pre-petition contract between the debtor and a securities brokerage firm that contained an arbitration provision. In holding that the trustee was obligated to arbitrate claims arising out of the contract, the court cited the long-recognized principle that a trustee is generally bound by the debtor's nonexecutory contracts.⁷ The Third Circuit noted that there was no reason to make an exception for arbitration agreements, especially in the face of the strong federal policy favoring arbitration. The court therefore held that "the trustee-plaintiff stands in the shoes of the debtor for the purposes of the arbitration clause and that the trustee-plaintiff is bound by the clause to the same extent as would the debtor."⁸

The Third Circuit, however, distinguished between debtor-derived claims and Bankruptcy Code-derived creditor claims under section 544. The latter, according to the Third Circuit, are creditor claims that the Bankruptcy Code authorizes a bankruptcy trustee to assert on their behalf, and because creditors were not parties to an agreement to arbitrate, the Third Circuit reasoned that the trustee was not bound to arbitrate their claims. Notably, though, no circuit court decision concerning the compelling of an arbitration against a bankruptcy trustee outside the Third Circuit has since made a distinction between "debtor-derived" and "creditor-based" claims. Thus, given the decisions discussed below, it is not clear that the Third Circuit's distinction regarding creditor claims has continued vitality, especially outside the Third Circuit.

In re Mintze

The Third Circuit had an opportunity to address the issue of the ability to compel arbitration against a debtor again in 2006.⁹ Reiterating its earlier holding in *Hays*, the Third Circuit held that a bankruptcy court lacked authority and discretion to deny enforcement of an arbitration provision where the debtor failed to establish that Congress intended to preclude judicial remedies for its claims. Importantly, the Third Circuit reached this conclusion even though the debtor's claim was a "core" proceeding under section 157 of

the Bankruptcy Code, specifically noting that its decision in *Hays* applied equally to core and noncore proceedings.¹⁰ To prevent an arbitration, the debtor must establish that Congress intended to preclude a waiver of judicial remedies.¹¹ The Third Circuit held that a rescission claim that would affect the order of priority and amount of distribution to other creditors did not create a conflict between the Bankruptcy Code and an arbitration.¹²

MBNA v. Hill

The Second Circuit also took up this issue in 2006, similarly concluding that a bankruptcy court did not have discretion to refuse to stay an adversary proceeding under the facts at issue pending an arbitration.¹³

The debtor asserted that a creditor violated the automatic stay by automatically withdrawing a monthly payment from her bank account even though the creditor had notice of her bankruptcy filing. The Second Circuit noted that even as to core proceedings (such as an alleged violation of the automatic stay), a bankruptcy court does not have

discretion to override an arbitration agreement unless it finds that the proceedings are based on provisions of the Bankruptcy Code that "inherently conflict" with the Arbitration Act or that arbitration of the claim would "necessarily jeopardize" the objectives of the Bankruptcy Code.¹⁴ Because the debtor's debts had already been discharged, the Second Circuit concluded, among other reasons, that an arbitration would not "seriously" jeopardize the objectives of the Bankruptcy Code, and it therefore ordered the debtor to arbitration.¹⁵

In re Electric Machinery Enterprises, Inc.

The Eleventh Circuit followed suit in 2007 in *Whiting-Turner Contracting Co. v. Electric Machinery Enterprises, Inc.* (*In re Electric Machinery Enterprises, Inc.*), which involved an adversary proceeding filed by a debtor subcontractor against a general contractor, alleging that the general contractor owed it funds collected by the general contractor in a settlement with its customer. Prior to the adversary proceeding, the general contractor and the subcontractor entered into a tolling agreement containing an arbitration provision regarding their dispute. The bankruptcy court, in holding that the funds were being held by the general contractor in a "constructive trust" on behalf of the subcontractor, denied a motion to compel on the grounds that the dispute involved a core proceeding.¹⁶

The Eleventh Circuit noted that other courts distinguished between core and noncore proceedings.

In evaluating whether an inherent conflict existed between an arbitration and the underlying purposes of the Bankruptcy Code, the Eleventh Circuit noted that other courts distinguished between core and noncore proceedings (including *Hays*, which, as noted above, had also distinguished between “debtor-derived” and “creditor-based” claims).¹⁷ The Eleventh Circuit stated that, in general, bankruptcy courts do not have discretion to decline to enforce an arbitration agreement relating to a noncore proceeding. Furthermore, even if a core proceeding was involved, the bankruptcy court was obligated to determine whether enforcing a valid arbitration agreement would inherently conflict with the underlying purposes of the Bankruptcy Code. Although the Eleventh Circuit determined that the proceeding at issue was noncore, it stated that even if the proceeding were core, the debtor had not sustained its burden

to demonstrate that Congress intended to preclude an arbitration. Therefore, it held the bankruptcy court erred in denying the motion to compel arbitration.

Conflicts Between an Arbitration and the Bankruptcy Code

As these cases suggest, courts have not readily found that an arbitration conflicts with general bankruptcy policy,

especially with respect to non-core proceedings. There are, however, exceptions where an arbitration has been found to conflict with the Bankruptcy Code.

In *In re U.S. Lines, Inc.*, the Second Circuit held that a bankruptcy court did not abuse its discretion in refusing to refer an adversary proceeding to arbitration.¹⁸ In that case, a reorganization trust (as successor in interest to the debtor) filed an adversary proceeding against four insurance companies seeking a declaratory judgment that the companies were liable to the trust under pre-petition insurance policies issued to the debtor. The Second Circuit found that the action involved a core proceeding because the insurance agreements included a pay-first provision that required the debtor to pay the claims of its injured workers before the insurance companies became liable to indemnify the debtor. Thus, if the reorganization trust were to pay claims from assets available for other creditors first and then fail to recover under the policies (the subject of the adversary proceeding), then an inequitable distribution among creditors would result. Therefore, the Second Circuit concluded that the proceeding was core because it directly affected the bankruptcy court’s core administrative function of asset allocation among creditors and that the bankruptcy court had discretion to reject an arbitration.

Similarly, the Fifth Circuit affirmed a bankruptcy court’s refusal to compel arbitration in *In re Gandy*.¹⁹ Among other claims, the debtor primarily sought to recover alleged fraudulent transfers from the debtor’s partners in a limited partnership. The Fifth Circuit noted that the bankruptcy court retained significant discretion to refuse to refer a proceeding to arbitration where the proceeding involves claims derived entirely from federal rights conferred by the Bankruptcy Code.²⁰ The Fifth Circuit further pointed out that resolution of the debtor’s claims appeared to represent nearly the entirety of the debtor’s bankruptcy estate and was therefore central to the purposes and policies of the Bankruptcy Code.

Finally, in *In re White Mountain Mining Co.*, the Fourth Circuit affirmed a bankruptcy court’s rejection of an international arbitration in London where investors in the debtor were disputing whether millions of dollars in advances made by one of the investors to the debtor were debt or equity.²¹ The bankruptcy court concluded that a conflict existed with allowing an arbitration to proceed because it would interfere with the debtor’s efforts to reorganize by making it difficult for the debtor to obtain additional financing, undermine creditor confidence in the debtor’s ability to reorganize, impose additional costs on the estate, and divert attention and time of the debtor’s management.²²

Conclusion

If a party is sued by a debtor or bankruptcy trustee on claims arising out of or related to a pre-petition contract that contains an arbitration clause, it should give serious consideration to moving to compel arbitration of the dispute and seeking a stay of the adversary proceeding pending in bankruptcy court. In many recent cases, the debtor has not been able to identify a conflict sufficient to preclude application of the Federal Arbitration Act, although debtors may have a greater chance of avoiding arbitration in core bankruptcy matters.

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Endnotes

1. See, e.g., *In re Great Spa Mfg. Co.*, 2009 WL 1457740 (Bankr. E.D. Tenn. 2009); *In re Tirex, Inc.*, 395 B.R. 182 (Bankr. S.D. Fla. 2008); *In re Shores of Panama, Inc.*, 387 B.R. 864 (N.D. Fla. 2008); *In re Wire Comm Wireless, Inc.*, 2008 WL 4279407 (E.D. Cal. 2008); *In re Piedmont Eng’rs of Carolinas, P.C.*, 2008 WL 2902182 (Bankr. M.D.N.C. 2008); *Brownstone Inv. Group, LLC v. Levey*, 514 F. Supp. 2d 536 (S.D.N.Y. 2007); *In re Martin*, 387 B.R. 307 (Bankr. S.D. Ga. 2007); *In re Friedman’s, Inc.*, 372 B.R. 530 (Bankr. S.D. Ga. 2007); *Pac. Employers Ins. Co. v. Moglia*, 365 B.R. 863 (N.D. Ill. 2007); *In re Cooley*, 362 B.R. 514 (Bankr. N.D. Ala. 2007); *In re Fries*, 2007 WL 1073868 (Bankr. D. Md. 2007); *In re Dixon*, 2007 WL 703612 (Bankr. M.D. Ala. 2007); *In re Arellano*, 2007 WL 1746246 (Bankr. D. N.M. 2007); *In re Dawsey*, 2007 WL 1140358 (Bankr. M.D. Ala. 2007); *In re Rozell*, 357 B.R. 638

Courts have not readily found that arbitration conflicts with bankruptcy policy.

(Bankr. N.D. Ala. 2006); *In re White*, 2006 WL 3694858 (Bankr. N.D. Ala. 2006); *In re Merrill*, 343 B.R. 1 (Bankr. D. Me. 2006).

2. 9 U.S.C. § 2.

3. See *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

4. See *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985).

5. 9 U.S.C. § 4.

6. See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 227 (1987).

7. *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1153–54 (3d Cir. 1989).

8. *Id.* at 1153.

9. *Mintze v. Am. Gen. Fin. Servs., Inc. (In re Mintze)*, 434 F.3d 222 (3d Cir. 2006).

10. *Id.* at 229, 231.

11. *Id.* See also *Rozell v. Citifinancial Auto Corp. (In re Rozell)*, No. 06-80123-JAC-13, 2006 WL 3531284, at *4 (Bankr. N.D. Ala. Dec. 7, 2006) (“Under *McMahon*, the inherent conflict standard must still be satisfied before a bankruptcy court has discretion to deny arbitration”).

12. *Id.* at 232.

13. *MBNA Am. Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006).

14. *Id.* at 108.

15. *Id.* at 109.

16. *Whiting-Turner Contracting Co. v. Elec. Mach. Enters., Inc. (In re Elec. Mach. Enters., Inc.)* 479 F.3d 791, 795 (11th Cir. 2007).

17. *Id.* at 796.

18. *In re U.S. Lines, Inc.*, 197 F.3d 631 (2d Cir. 1999).

19. *In re Gandy*, 299 F.3d 489 (5th Cir. 2002).

20. *Id.* at 495, 497 (citing *In re Nat'l Gypsum*, 118 F.3d 1056, 1067 (5th Cir. 1997) (“The heart of Debtor’s complaint concerns the avoidance of fraudulent transfers and implicates non-bankruptcy contractual and tort issues ‘in only the most peripheral manner’”).

21. *In re White Mountain Mining Co.*, 403 F.3d 164 (4th Cir. 2005).

22. *Id.* at 170.



Discovering Fraud Post-Confirmation

(Continued from page 9)

that § 1144 did not apply to claims brought two years after confirmation for fraud and conspiracy to defraud against non-debtor defendants because the claims would not “redivide the pie”); *S.N. Phelps & Co. v. Circle K Corp.*, 181 B.R. 457, 462 (Bankr. D. Ariz. 1995) (holding § 1144 inapplicable to plaintiff’s claim that valuation in bankruptcy had been misrepresented; “[i]f plaintiffs prevail, the Court can fashion a remedy that does not upset the confirmed plan, i.e., monetary damages”); *In re Crown-Globe, Inc.*, 107 B.R. 60, 61 (Bankr. E.D. Pa. 1989) (allowing claims of breach of third-party beneficiary contract, intentional misrepresentation, and negligent misrepresentation to proceed, while barring a claim for equitable subordination); *In re Emmer Bros. Co.*, 522 B.R. 385, 392 (D. Minn. 1985) (holding the time limitation in § 1144 inapplicable to post-confirmation discovery of fraudulent conduct).

4. *In re Genesis Health Ventures, Inc.*, 355 B.R. 438, 445 (D. Del. 2006).

5. *In re Cal. Litfunding*, 360 B.R. 310 (C.D. Ca. 2007).

6. *Genesis Health Ventures*, 355 B.R. at 443.

7. *Haskell v. Goldman, Sachs & Co.*, 340 B.R. 729, 734 (D. Del. 2006).

8. *Genesis Health Ventures*, 355 B.R. at 445

9. *Litfunding*, 360 B.R. at 318.

10. *Id.* at 319.

11. *Id.* at 318–19.

12. *Id.* at 319–20.



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In This Issue

- | | | | |
|---|--|---|---|
| 1 | An Overview of Landlord Rights Against Tenants in Bankruptcy | 4 | The Attorney-Client Privilege in Bankruptcy—Don't Let Your Client Walk into a Trap |
| 1 | Compelling Arbitration in an Adversary Proceeding | 5 | Attorneys Who Mishandle Their Clients' Proofs of Claim Leave Themselves Open to Significant Blame |
| 2 | Letter from the Chairs | 8 | Discovering Fraud Post-Confirmation: Is There Recourse after 180 Days? |
| 3 | Letter from the Editor | | |