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GENERAL BANKRUPTCY CASE LAW UPDATE

Honorable Dennis R. Dow, United States Bankruptcy Judge
Western District of Missouri

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Issue: Does a bankruptcy court have the authority to approve a Chapter 11 plan that releases nondebtors from liability without the consent of all parties in interest (nonconsensual third-party release)?

Third-party releases are provisions included in proposed plans of reorganization and proposed confirmation orders that would bar creditors from suing non-debtor third parties. The Bankruptcy Code contains no provisions that expressly provide for third-party releases except for cases dealing with asbestos liability where the law expressly authorizes settlement trusts and channeling all claims against the debtor and other related parties to the trust. *See* §524(g)).

Section 524(e) provides generally that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." Nonconsensual third-party releases have been used in large Chapter 11 and mass tort cases and their use has been controversial.

Proponents of third-party releases have relied upon general provisions such as Bankruptcy Code section 105, which says that "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." They argue that the releases incentivize non-debtors to contribute to reorganization plans, allow for greater distributions to creditors, and often serve to facilitate a viable reorganization plan that otherwise would not exist.

Opponents of third-party releases contend that they are not expressly authorized by the Bankruptcy Code and exceed constitutional limits on bankruptcy power and that the express grant of authority in asbestos cases impliedly excludes other cases. They argue that third-party releases provide non-debtors with the benefits of a Chapter 11 bankruptcy, without the commitments, obligations and responsibilities required by that process. There is a circuit split regarding third-party releases.

Outside of asbestos-related cases, rulings have varied in permitting liability releases. Different federal circuits have developed different tests and standards to determine whether releases can be approved over a party's opposition, with some saying the code prohibits them.

Majority view:

Majority view courts in the Second and Seventh Circuits have allowed nondebtor third-party releases when unusual circumstances exist, and the two factors outlined in *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005), are met. Majority view courts in the Third Circuit have allowed such releases when the release is fair to the nondebtor third-party, necessary to the plan reorganization, and backed by specific factual findings utilizing the factors listed in *In re Zenith Electronics Corp.*, 241 B.R. 92 (Bankr. D. Del. 1999). Finally, majority view courts in the Fourth, Sixth, and Eleventh Circuits have allowed nondebtor third-party releases when the factors listed in *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002), are applied. Most courts have held such prebankruptcy conduct releases for third parties are permissible under certain circumstances relying on the general authority provided by 105(a). They find that bankruptcy courts have statutory authority as well as constitutional authority. These circuits apply a flexible approach and look to the context of the releases and apply factors of fairness, necessity to the reorganization and extraordinary nature of the cases. The rationale for allowance of such releases is that they incentivize non-debtors to contribute to reorganization plans, allow for greater distributions to creditors, and often serve to facilitate a viable reorganization plan that otherwise would not exist.

In *Continental*, the Third Circuit stated that the Bankruptcy Code "does not explicitly authorize the release and permanent injunction of claims against non-debtors, except in one instance not applicable here." Notwithstanding, the Court did not adopt the logic of those courts precluding third-party releases in all instances. Rather, for the next twenty years, the Third Circuit (and courts within this circuit) has permitted nonconsensual third-party releases in narrow circumstances where the releases are fair and necessary to the reorganization. The Third Circuit reiterated that conclusion in *Millennium*, and while it did not reach the merits of the third-party releases granted in that instance, it did conclude that a bankruptcy court is constitutionally authorized to confirm a plan containing nonconsensual third-party releases if it concludes that the releases are integral to the debtor-creditor relationship. The ruling suggests an implicit recognition that the granting of third-party releases is still permissible as part of the confirmation process. *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 212-13 (3rd Cir. 2000).

In *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126 (3rd Cir. 2019), the bankruptcy court approved a plan that included releases for equity holders in exchange for significant monetary contributions. On appeal, the 3rd Circuit found the bankruptcy court "indisputably had core statutory authority to confirm the plan" under §157(b)(2)(L). However, for the authority to be constitutional, the matter must be "integral to the restructuring of the debtor-creditor relationship." The court was "not broadly sanctioning the permissibility of non-consensual third-party releases" as they must meet "exacting standards" for approval.

In re Mallinckrodt PLC, 639 B.R. 837, 866 (Bankr. D. Del. 2022) (approved nonconsensual third party prebankruptcy conduct releases as to opioid claimants based on the extraordinary nature of the case of 3000 lawsuits; the settlement of massive liabilities against debtor necessary for Plan confirmation; and the releases are a fair result for claimants).

In a recent case in a bankruptcy court in the 2nd Circuit, Purdue Pharma sought chapter 11 protection based primarily on more than 3,000 personal injury/product-liability lawsuits filed against it and its various subsidiaries and affiliates. As part of its proposed chapter 11 reorganization plan, Purdue sought to trade a release of civil liability against the Sackler family owners for a payment by the Sacklers (and their various entities) of about $4.3 billion into a trust fund to pay victims of the opioid scourge. The bankruptcy court confirmed the plan with its proposed release over the objection of nine attorneys general and about 2,700 individual plaintiffs in personal-injury lawsuits against Purdue Pharma.

That confirmation order was reversed by Hon. Colleen McMahon of the Southern District of New York on Dec. 16, 2021. *In re Purdue Pharma,* LP, 635 B.R. 76, 78 (S.D.N.Y. 2021). The district court reversed the bankruptcy court and determined that the bankruptcy court had subject matter jurisdiction to approve nonconsensual releases of non-debtor family members from personal legal liability. *Citing SPV OSUS Ltd. v. UBS*, 882 F.3d 333, 339-340 (2nd Cir. 2018) (holding the Bankruptcy Court has broad "related to" jurisdiction over any civil proceedings that "might have any conceivable effect" on the estate).

However, the district court found that the Bankruptcy Code does not authorize a bankruptcy court to order the nonconsensual release of third-party claims against non-debtors in connection with the confirmation of a chapter 11 bankruptcy plan. Sections 105(a) and 1123(a)(5) & (b)(6), whether read individually or together, do not provide a bankruptcy court with such authority; and there is no such thing as "equitable authority" or "residual authority" in a bankruptcy court untethered to some specific, substantive grant of authority in the Bankruptcy Code.

The case is currently on appeal to the 2nd Circuit.

In re Boyscouts of America and Delaware BSA, LLC, 2022 WL 3030138 (Bankr. D. Del. July 29, 2022) (holding bankruptcy code does not explicitly authorize, nor prohibit, releases. Identifies factors to review: whether (i) there is an identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate; (ii) the non-debtor has contributed substantial assets to the reorganization; (iii) the injunction is essential to reorganization such that without it, there is little likelihood of success; (iv) a substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment and (v) the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction).

Patterson v. Mahwah Bergen Retail Group, Inc., No. 3:21cv167 (E.D. Va. Jan. 13, 2022) (holding that due to failure of bankruptcy court to review the claims, as well as the lack of relation of the claims to the plan itself, it exceeded the constitutional limits of its authority by releasing, and thereby adjudicating, the claims); *In re Seaside Eng'g & Surveying Inc.*, 780 F.3d 1070, 1078-81 (11th Cir. 2015)(holding bankruptcy courts have authority to approve non-consensual non-debtor releases or bar orders in bankruptcy restructuring plans, though such releases or orders ought not to be issued lightly, and should be reserved for those unusual cases in which they are necessary for the success of the reorganization, and only in situations in which they are fair and equitable under all the facts and circumstances); *Behrmann v. Nat'l Heritage Found., Inc.*, 663 F.3d 704, 712 (4th Cir. 2011)(holding bankruptcy courts have power to approve nondebtor, third-party releases under §105(a) and lays out factors for courts to apply); *Deutsche Bank AG v. Metromedia Fiber Network Inc. (In re Metromedia Fiber Network Inc.)*, 416 F.3d 136, 141 (2nd Cir. 2005) (holding nonconsensual third-party releases against nondebtors could be approved in narrow circumstances).

Minority view:

(Fifth, Ninth and Tenth Circuits) The Fifth, Ninth, and Tenth Circuits have definitively held that courts are not authorized to grant third-party releases. The sole exception to this rule comes in the context of asbestos cases, in which these circuits find that courts are explicitly authorized by § 524(g) of the Code to enjoin third-party claims against non-debtors. These holdings are based on that "section 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors." The Ninth Circuit also rejected the argument that a bankruptcy court could rely upon the broad equitable powers created by § 105(a) to release non-debtors from liability.

In a recent 5th Circuit case, the Court affirmed a workaround to accomplish a limited third-party release. Prior to confirmation, the bankruptcy court entered an order barring any claims against the appointed independent directors and current CEO unless the court authorized such claim as a "colorable claim of willful misconduct or gross negligence," due to the litigiousness of the debtor's founder and former CEO. The Plan was drafted to exculpate certain non-debtor third parties from post-petition lawsuits not arising from gross negligence, bad faith, or willful or criminal misconduct and required the bankruptcy court's approval of a claim before any lawsuit is filed. The beneficiaries of the gatekeeper provision and the third-party nondebtor exculpations were nearly all bankruptcy participants. The exculpation covered any claims "in connection with or arising out of" the Chapter 11 case, excluding fraud and the like. The gatekeeper function barred "bankruptcy participants" from taking action to interfere with the Plan or filing any claim related to the Plan or proceeding unless specifically authorized by the bankruptcy court.

The 5th Circuit determined that the exculpation provisions were appropriate only as to the debtor, creditors' committee and its members for conduct within the scope of their duties, and the independent directors but struck provisions exculpating debtor's employees, the new CEO, the general partner, the trust created by the plan, the professionals for the debtor and the committee, the plan's oversight board and "related persons." It also determined that the bankruptcy court can perform a gatekeeping function. The Court made much of an order entered prior to confirmation being final and not appealed in that it had the effect of exculpating the directors and CEO. *NexPoint Advisors LP v. Highland Capital Management LP (In re Highland Capital Management*

LP), Case No. 21-10449 (5th Cir. Aug. 19, 2022) (precluding broad nondebtor third-party releases but holding a chapter 11 plan may give the court a gatekeeping function to approve or disapprove commencement of lawsuits against those non-debtor parties protected in other circuits).

Blixseth v. Credit Suisse, 961 F.3d 1074 (9th Cir. 2020), *cert. denied*, 141 S.Ct. 1394 (2021)(holding § 524(e) does not bar a narrow exculpation clause of the kind that is only focused on actions of various participants in the Plan approval process and relating only to the plan/bankruptcy process; a bankruptcy discharge thus protects the debtor from efforts to collect the debtor's discharged debt indirectly and outside of the bankruptcy proceedings, it does not, however, absolve a non-debtor's liabilities for that *same* "such" debt.); *Bank of New York Tr. Co. NA v. Off. Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 252 (5th Cir. 2009) (holding §524(e) only releases the debtor, not co-liable third parties); *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995) (same); *In re W. Real Estate Fund*, 922 F.2d 592, 600 (10th Cir. 1990)(same).

It should be noted that bills have been introduced in Congress in an attempt to limit such releases. The bills propose to add a new §113 to the Code which would prevent a bankruptcy court from approving any plan provisions that would discharge, release or modify the liability of a nondebtor or the bankruptcy estate. They also propose to prohibit the bankruptcy court from enjoining the commencement or continuation of any other proceeding to enforce the claim or cause of action, except for a short-term stay. The proposed prohibition does not apply if consent to the release is given by each creditor.

Issue: What did the Supreme Court hold in *City of Chicago v. Fulton*, 141 S.Ct. 585 (2021) and how have subsequent cases applied that holding?

In an 8-0 opinion authored by Justice Alito, the United States Supreme Court in ***City of Chicago v. Fulton*, 141 S. Ct. 585 (2021)** held that an entity's mere retention of estate property after the filing of a bankruptcy petition does not constitute an act to exercise control over property of the estate in violation of the Bankruptcy Code's automatic stay, resolving a circuit split and vacating a Seventh Circuit decision. The Supreme Court relied on the language of § 362(a)(3), which prohibits "any act … to exercise control over property of the estate." Taken together, the most natural reading of the terms "stay," "act," and "exercise control" is that the provision "prohibits affirmative acts that would disturb the status quo of estate property as of the time when the bankruptcy petition was filed." This language "implies that something more than merely retaining power is required to violate the disputed provision." In addition, reading § 362(a)(3) to cover mere retention of property would make that section a blanket turnover provision, thus rendering the Code's express turnover provision, § 542, "largely superfluous," and the provisions' commands contradictory.

Justice Sotomayor filed a concurring opinion, emphasizing that "the Court has not decided whether and when" other parts of the Bankruptcy Code " may require a creditor to return a debtor's property." She noted that this was a case involving the city's refusal to return impounded cars and said that even if it "satisfies the letter of the Code, it hardly comports with its spirit." In particular, Justice Sotomayor noted that having a car is important for many people to be able to stay employed and make payments on their bankruptcy plans, and that nothing in the current ruling stands in the way of bankruptcy judges or the legislature to find alternative solutions to facilitate the return of debtors' vehicles to their owners.

Fulton did not settle the other subsections of §362(a).

Following *Fulton*, the Bankruptcy Appellate Panel for the Ninth Circuit addressed similar circumstances: a creditor's obligation under § 362(a) with regard to pre-petition garnishments of a debtor's bank account. *Stuart v. City of Scottsdale (In re Stuart)*, 632 B.R. 531, 534 (B.A.P. 9th Cir. 2021). In that case, the City of Scottsdale garnished several of debtor's bank accounts prior to his bankruptcy filing, and the debtor argued that the automatic stay mandated that the City lift the garnishments immediately.

The *Stuart* court found that the City of Scottsdale did not violate § 362(a)(1), (2), (3), or (6) when it declined to move to quash the pre-petition garnishments since it had taken the proper steps to stay the non-bankruptcy case and stated on multiple occasions that it had no objection to the release of the frozen funds to the debtor. *Id.* Emphasizing that the City took no action post-petition to "obtain possession" of the funds, but simply did not "affirmatively release the frozen bank account funds," the Court found that the City was "merely preserv[ing] the status quo." *Stuart*, 632 B.R. at 542-43; *But see In re Educ. Tech. College, Inc.*, 2022 WL

3149464 (Bankr. D.P.R. Aug. 5, 2022) (distinguishing from *Fulton* and *Stuart* the court found that the tactics allegedly employed by the defendants in both the bankruptcy proceeding and the local court case go beyond "merely preserv[ing] the status quo" and are sufficiently distinct from the actions taken by the City of Scottsdale in a similar situation." The allegation that the defendants purposely misled Edutec about the whereabouts of the garnished funds concerned the court).

In *Cordova v. City of Chicago*, 2021 WL 5774400 (Bankr. N.D. Ill. 2021), the class plaintiffs had their vehicles impounded by the City, filed Chapter 13 and demanded return of their vehicle. The City attempted to condition the return of the vehicle upon payment of the fines and argued this was not a violation of §362(a)(4) or (6) but merely a demand for adequate protection under §363(e). The bankruptcy court held this sufficiently raised claims under §§362(a)(4) and (6) and 542(a) to avoid dismissal and that *Fulton's* §362(a)(3) rationale does not control and noted the phrase "exercise control" does not appear in §362(a)(4) and (6) but does in (a)(3). The court suggested *Fulton's* concurring opinion implying a creditor's motive should be considered to determine whether it has taken an "act" to enforce a lien or an "act" to collect.

The question of whether §542(a) requiring turnover of estate property unless inconsequential to the estate is "self-executing" arose in both *Fulton* and *Cordova*. The *Fulton* court found that it need not decide the issue but the concurring opinion suggested it was up to the Bankruptcy Rules Advisory Committee to consider amendments that will ensure prompt resolution of turnover requests. Ultimately, the *Cordova* court held that the plaintiffs' claims for violations of §542(a) survive motions to dismiss, leaving for another day the question of whether a Chapter 13 debtor is authorized to enforce §542(a) in the first instance. The court noted that actions under §542(a) would result in delay to a debtor getting his property back versus an action under §362. The court declined to "adopt in the context of a motion to dismiss a reading of *Fulton* that is so expansive that it eliminates clear and obvious remedies against recalcitrant creditors."

In *In re Guido*, 2021 WL 2226613 (Bankr. S.D. Cal. June 1, 2021), the court found that action is not required when litigation existed pre-bankruptcy and continues in an inactive state and that the creditor satisfied its responsibility by withdrawing its motion to compel within three days of receiving notice of the petition, the only active motion in the matter. The court found that *Fulton* is not directly on point; it was decided under § 362(a)(3) which prohibits "any act" while § 362(a)(1) prohibits the continuation of an action and in no way supports that a creditor is not required to cure a stay violation arising from a post-petition action. But while the *Fulton* decision is not squarely applicable, it does support the Court's view that a stay violation did not occur on the facts as pled by the debtor. "In short, *Fulton* indicates a shift away from the conclusion that a stay violation exists where a creditor merely maintains an otherwise non-stay violative *status quo.*" *Id.*

In *In re Connor*, 2022 WL 2062214 (Bankr. M.D. Tenn. June 7, 2022), the court discussed that *Fulton* left undisturbed a line of cases holding that other subsections of § 362(a) include an affirmative duty to act such that a failure to act would be considered a violation of the automatic stay. *(citing In re Banks*, 253 B.R. 25, 31 (Bankr. E.D. Mich. 2000) ("[A] willful violation of the stay can be found from an act of omission and does not require an act of commission."); *In re Webb*, 472 B.R. 665 (B.A.P. 6th Cir. 2012) ("In instances in which a foreclosure sale has been put in motion pre-petition, creditors have an affirmative duty to stop the sale from continuing once they receive actual notice of a debtor's bankruptcy filing."); *In re Hardesty*, 442 B.R. 110, 114 (Bankr. N.D. Ohio 2010) ("For purposes of § 362(a), a creditor, once it receives notice of a debtor's bankruptcy, has an affirmative duty to take reasonable measures to ensure that the collection activities, which it set in motion, are discontinued).

Future Implications

The Advisory Committee on Bankruptcy Rules considered suggestions by 45 law professors to allow turnover of estate property to be brought by motion rather than as an adversary proceeding. The original suggestion and its addendum were prompted by Justice Sotomayor's concurring opinion in *City of Chicago v. Fulton*, 141 S. Ct. 585, 595 (2021), in which she wrote that "[i]t is up to the Advisory Committee on Rules of Bankruptcy Procedure to consider amendments to the Rules that ensure prompt resolution of debtors' requests for turnover under § 542(a), especially where debtors' vehicles are concerned."

Based on its deliberations, the Advisory Committee recommended that the following amendment to Rule 7001(1) be proposed for publication for public comment:

Rule 7001. Types of Adversary Proceedings

An adversary proceeding is governed by the rules in this Part VII. The following are adversary proceedings: (a) a proceeding to recover money or property—except a proceeding to compel the debtor to deliver property to the trustee, <u>a proceeding by an individual debtor to recover tangible personal property under § 542(a),</u> or a proceeding under § 554(b), § 725, Rule 2017, or Rule 6002;

Committee Note: Paragraph (a) is amended to create an exception for certain turnover proceedings under § 542(a) of the Code. An individual debtor may need to obtain the prompt return from a third party of tangible personal property—such as an automobile or tools of the trade—in order to produce income to fund a plan or to regain the use of property that may be exempted. As noted by Justice Sotomayor in her concurrence in *City of Chicago v. Fulton*, 141 S. Ct. 585, 592-95 (2021), the more formal procedures applicable to adversary proceedings can be too time consuming in such a situation. Instead, the debtor can now proceed by motion to require turnover of such property under § 542(a), and the procedures of Rule 9014 will apply. In an appropriate case, however, Rule 9014(c) allows the court to order that additional provisions of Part VII of the rules will apply to the matter.

Taggart v. Lorenzen, 139 S. Ct. 1795 (2019)

Background:

The debtor owned an interest in an Oregon company. The company and two other owners filed suit against Taggart in state court, claiming that he had breached the company's operating agreement. The debtor filed bankruptcy under Chapter 7 before the trial took place in state court, and received a discharge. After the discharge order was issued, the state court entered judgment against the debtor and awarded attorney's fees to the company and its owners.

The Debtor reopened his bankruptcy case, seeking civil contempt sanctions against the owners for collecting fees in violation of the discharge order. The bankruptcy court held the owners in contempt and imposed sanctions (effectively applying a strict liability standard). The Ninth Circuit BAP reversed, ruling that the creditors' good faith belief that their actions did not violate the discharge injunction absolved them of contempt. The Ninth Circuit affirmed, holding that a creditor's good faith belief precludes a finding of contempt even if that belief is unreasonable.

In a unanimous decision, the Supreme Court vacated the Ninth Circuit's judgment and remanded the case. It concluded that a court may hold a creditor in contempt for violating a debtor's discharge if there is "no fair ground of doubt" as to whether the order barred the creditor's conduct. *Taggart*, 139 S.Ct. at 1799. Put another way, "civil contempt may be appropriate if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful." *Id.* The "fair ground of doubt" standard, generally an objective one, was derived from nonbankruptcy cases on which the Court relied. The Court concluded that §524(a)(2) and §105(a) incorporate the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction. *Id.* at 1801. In the Court's view, the "fair ground of doubt" standard struck the careful balance between the interests of creditors and debtors. *Id.* at 1804.

Discussion:

Does Taggart also apply to stay violations?

The Supreme Court specifically declined to address whether the word "willful" in the context of the automatic stay provision should be based on the same standard as determining civil contempt for violations of a discharge order, noting differences between discharge and the automatic stay in terms of language and purpose: a stay aims to prevent damaging disruptions to the administration of a case in the short run, while a discharge is entered at the end of a case and seeks to bind creditors over a much longer period. *Id.*

Some courts have held that *Taggart* does apply to stay violation contempt proceedings. *See, e.g., In re GYPC, Inc.*, 634 B.R. 983, 991 (Bankr. S.D. Ohio 2021) (corporate debtors cannot pursue stay violations under the willful "akin to strict liability" stay violation standard because it is inconsistent with the conclusion in *Taggart* that damages for contempt under § 105, and the private right of action supporting damages under § 362(k) have different standards); *In re Jeong*, 2020 WL 1277575, n.3 (9th Cir. BAP 2020) (assuming that the *Taggart* standard applied to automatic stay violations since that application was consistent with Ninth Circuit's precedent holding that the same contempt standards apply to both discharge and stay violations).

Others have held that the *Taggart* standard does not apply to stay violation civil contempt proceedings. *See, e.g., In re Rice*, 613 B.R. 690 (Bankr. N.D. Ill. 2020) (concluding that until the Supreme Court holds otherwise, the Seventh Circuit's strict liability standard remains the law of this circuit) (citing *Thompson v. Gen. Motors Acceptance Corp., LLC*, 566 F.3d 699, 708 (7th Cir. 2009), which required a finding that a creditor willfully violated the automatic stay).

One court explained:

> There are at least two reasons to make such a distinction. First, to the extent that section 362(k) of the Bankruptcy Code applies to a stay violation, it reflects a congressional policy separate from the courts' general contempt power and is the subject of extensive case law interpretation. Second, because (a) bankruptcy courts are actively supervising cases covering all of the debtor's property while the automatic stay is in effect and (b) the automatic stay is of fundamental importance in the collective, multi-party context of bankruptcy cases, it is logical to require those in doubt whether the stay applies to seek clarification from the court or be sanctioned for shooting first and aiming later.
>
> In any event, it should be clear from the nature of *Taggert's* reservation regarding breaches of the automatic stay that applying a standard that is more *lenient* to potential violators of the automatic stay than the objective "fair ground of doubt" approach is highly unlikely.

In re Windstream Holdings, Inc., 627 B.R. 32, 40 (Bankr. S.D.N.Y. 2021) (citations omitted).

Many courts, however, recognize *Taggart's* possible application to stay violations, but do not decide the issue. *See, e.g., In re Ellingsworth Residential Community Association, Inc.*, 2022 WL 2388636 (Bankr. M.D. Fla. March 28, 2022) (recognizing that the "fair ground of doubt" standard arguably applies to all contempt orders issued under §105, but concluding that the court did not have to decide because finding of contempt was appropriate under any standard).

Has Taggart been expanded to apply in other contexts?

The application of the *Taggart* standard for holding a creditor in civil contempt for attempting to collect a debt that a discharge order entered under Chapter 7 had immunized from collection has not been limited to those facts. For instance, it has been applied when a court is considering whether to hold a creditor in civil contempt for violating a plan of reorganization entered under Chapter 11. *Beckhart v. NewRez LLC*, 31 F.4th 274 (4th Cir. 2022). As the Fourth Circuit stated: "Nothing about the Supreme Court's analysis in *Taggart* suggests it is limited to violations of Chapter 7 discharge orders ... or that the Court's decision turned on considerations unique to the Chapter 7 context." *Id.* at 277. *See also Conway v. Palczuk*, 2022 WL 2802339 (D.E.D. N.C. July 15, 2022) (case remanded because bankruptcy court did not expressly find that there was "no fair ground of doubt" as to whether the Chapter 11 discharge order barred the pursuit of the securities litigation, citing *Beckhart* and *Taggart*); *In re Kimball Hill, Inc.*, 620 B.R. 894 (Bankr. N.D. Ill. 2020) (finding that *Taggart* language was broad enough to cover Chapter 11 plan injunctions in a confirmation order even though it was decided under §524). The standard has also been applied in a Chapter 13 case for non-compliance with a confirmed plan. *See, e.g., In re Seaver*, 640 B.R. 555 (Bankr. D.S.C. 2022).

In *In re Gravel*, 6 F. 4th 503 (2nd Cir. 2021), the Second Circuit applied the *Taggart* standard to determine whether a mortgage servicer's actions in violation of a court order confirming that the debtors were current on their mortgage payments constituted contempt. The Second Circuit noted that the "fair ground of doubt" standard had long been used in that circuit to determine when a party may be held in contempt in the district court. *Id.* at 512 (citations omitted). This suggests that the standard applies to all potential contempt proceedings in bankruptcy court.

What are the pleading and evidentiary standards under Taggart?

There is widespread agreement among the courts that the *Taggart* standard is a rigorous one. *See, e.g., In re Roth,* 935 F.3d 1270, 1278 (11th Cir. 2019). At least in the Sixth Circuit, it is beyond debate that the willful standard for proving a debtor is entitled to damages for a stay violation is easier to prove than the *Taggart* discharge violation standard. *GYPC, Inc.*, 634 B.R. at 989. *See also In re Pursell Holdings*, LLC, 605 B.R. 914, n. 11 (Bankr. W.D. Mo. 2019) (questioning whether debtor met the "heightened pleading standards" for a discharge violation as set out in *Taggart*).

Courts have focused on several factors to determine whether a fair ground of doubt exists: 1) whether the creditor had been sanctioned before for a similar, prior action, 2) whether the creditor had notice of the injunction, and 3) whether the creditor presented relevant law to support its actions. *See Kimball Hill,* 620 B.R. at 907-909. In *In re Gravel*, *supra*, the Second Circuit stated that "a contempt order is warranted only where the party has notice of the order, the order is clear and unambiguous, and the proof of noncompliance is clear and convincing." *Gravel*, 6 F. 4^{th} at 512. A party's subjective belief that it was complying with the order ordinarily will not insulate it from contempt if that belief was objectively unreasonable. *In re Freeman*, 608 B.R. 228, 234 (9^{th} Cir. BAP 2019) (quoting *Taggart*).

For two recent examples of the submission of sufficient evidence to meet the standard, *see In re Go*, 642 B.R. 50 (Bankr. Nev. 2022) (applying *Taggart* standard to hold that there was no objectively reasonable basis for the lender to conclude that its attempts at collection after debtor's discharge were lawful); *In re Skaggs*, 2022 WL 3221903 (Bankr. W.D.Va. Aug. 9, 2022) (same). For an example of the submission of insufficient evidence, *see In re Lett*, 635 B.R. 713 (Bankr. N.D. Ga. 2022) (summary judgment denied because there was insufficient evidence to determine whether creditor knew about debtor's discharge).

Bifurcation of Fees

Issue: Are bifurcated fee agreements permissible?

Discussion:

Background

The phrase "bifurcation of fees" in bankruptcy refers to the practice of separating services provided to a client into those provided prepetition and postpetition – a "dual contract" system. It is different than a limited services agreement or unbundling. With unbundling, the attorney is contractually limiting services to a discrete task, whereas with bifurcation, the attorney is contracting to represent the debtor during the entire case so long as the debtor signs the post-petition agreement.

A chapter 7 debtor's prepetition agreement to pay attorneys' fees post-petition is an unenforceable dischargeable debt. See *Lamie v. U.S. Trustee*, 540 U.S. 526, 538 (2004). Thus, an attorney who takes a post-petition action to collect unpaid prepetition fees violates either the automatic stay or the discharge injunction. Bifurcated fee agreements attempt to solve this problem, particularly when individuals in need of bankruptcy relief are unable to pay a pre-petition flat fee to hire an attorney. *In re Prophet*, 639 B.R. 664, 669 (D.D.S.C. 2022). More specifically, they are designed to change the attorney's fees into a postpetition, nondischargeable debt that can be collected from the client without violating either the automatic stay or discharge injunction. *In re Allen*, 628 B.R. 641, 644 (8th Cir. BAP 2021).

Under the current framework of the Bankruptcy Code, Bankruptcy Rules, and jurisprudence, bifurcated fee arrangements are not *per se* prohibited. However, courts have analyzed various versions of these arrangements and have come to different conclusions as to their permissibility.

Key Factors in Determining Permissibility

Two common threads run through the cases addressing the permissibility of bifurcated fee arrangements: reasonableness and disclosure. The reasonableness of the prepetition fees and the postpetition fees must be analyzed on the basis of the services provided with respect to each flat fee, not compared to each other." *In re Carr*, 613 B.R. 427, 439 (Bankr. E.D. Ky. 2020). Fees for postpetition services must be rationally related to the services actually rendered postpetition. *In re Brown*, 631 B.R. 77, 93 (Bankr. S.D. Fla. 2021) (citations omitted). *See also In re Allen, supra* (affirming the bankruptcy court's reduction of attorney's fees by the amount contemplated under the post-filing fee arrangement because it exceeded the value of the services provided by the attorney). Additionally, the fact that a cash discount is offered does not render the bifurcated fee unreasonable. *In re Moxley*, 2022 WL 1420890, *6 (Bankr. D. Idaho May 4, 2022). *But see Prophet*, 628 B.R. at 804 (noting that if debtors choosing bifurcated arrangements were charged more than debtors choosing to prepay, that factor could weigh against reasonableness of fees).

Disclosure is also key. As one court noted, "[T]he propriety of using bifurcated fee agreements in consumer chapter 7 cases is directly proportional to the level of disclosure and information the attorney provides to the client and the existence of documentary evidence that the client made an informed and voluntary election to enter into a postpetition fee agreement." *In re Hazlett,* 2019 WL 1567751, *8 (Bankr. D. Utah Apr. 10, 2019). Bankruptcy Code §329 and Bankruptcy Rule 2016(b) set forth an attorney's disclosure requirements. The attorney's Rule 2016(b) disclosure must be clear and consistent. *See In re Allen*, 2022 WL 3093713 (Bankr. D. Idaho Aug. 3, 2022) (court ordered disgorgement of fees because attorney's disclosure regarding bifurcated payment arrangement was misleading, created a conflict of interest that violated professional code of conduct, and was financially harmful to debtors). In instances where an attorney has entered into a third-party financing arrangement, full disclosure is critical. *See, e.g., In re Kolle*, 641 B.R. 621 (Bankr. W.D. Mo. 2021) (court made disciplinary referral for attorney who failed to disclose factoring arrangement in connection with many cases involving bifurcation agreements).

Cases Allowing Bifurcated Fee Agreements

The case cited most often to support the use of bifurcation agreements is *Hazlett, supra*. The debtor in *Hazlett* accepted an offer by his attorney that involved no fee for filing the petition, and then a post-petition fee agreement to pay the full legal fee of $2,000 in ten monthly installments. The U.S. Trustee moved for sanctions, and the attorney filed a motion for summary judgment. The court evaluated the fee arrangement by considering the purpose of the agreement, Utah's Rules of Professional Conduct, and the Bankruptcy Code and Rules. It concluded that the purpose of the agreement was not to abandon the debtor but to increase the debtor's access to legal representation and enable the debtor's attorney to be paid for post-petition services. *Id.* at *8. It also found that the attorney's disclosures were adequate and his fees were reasonable. The court held that there was no basis to impose sanctions, and granted summary judgment in favor of the attorney. *Id.* at *14. *See also Carr*, *supra* (finding compensation arrangement permissible under state's rules of professional conduct, and because attorneys made full disclosures to the debtors so they could make an informed decision); *In re Slabbinck*, 482 B.R. 576 (Bankr. E.D. Mich. 2012) (finding that the two agreements did not constitute a single one which was dischargeable as a prepetition debt, and that debtors were not coerced into signing the post-petition agreement); *Walton v. Clark & Washington, P.C.*, 469 B.R. 383 (Bankr. M.D. Fla. 2012) (court not concerned about harm to the debtor since law firm had agreed to represent the debtor during the gap period during which debtor could determine which post-petition fee option to choose).

Cases Not Allowing Bifurcated Fee Agreements

A common criticism of bifurcated fee arrangements is that they are a vehicle to sidestep the attorney's obligations to the debtor. As one court stated:

> Upon filing a petition, counsel agrees to represent the debtor and provide all reasonably necessary bankruptcy services throughout the case, until and unless permitted to withdraw through substitution or court approval, and authorization to withdraw is neither automatic nor presumed. An agreement that purports to withhold such services, or to condition such services upon execution of an additional fee agreement, is fundamentally untrue and misleading, in violation of §526(a)(2) and (3).

In re Siegle, 639 B.R. 755, 760 (Bankr. D. Minn. 2022). *See also Prophet,* 628 B.R. at 804 (fee arrangements were impermissible under local bankruptcy rules imposing a continuing duty of debtor's attorneys to represent their clients throughout a bankruptcy case); *In re Suazo*, 2022 WL 1468083 (Bankr. D. Colo. May 10, 2022) (bifurcation agreements rendered void because they contained misrepresentations about debtor's counsel's obligations under the Bankruptcy Code and local rules).

Third-Party Financing/Factoring

An emerging practice related to bifurcation is the contracting by debtors' attorneys with factoring or finance companies to ensure some amount of upfront compensation. In such a situation, the attorney sells to a factor the post-petition accounts receivable for the services contracted under the post-petition fee agreement. The factor then collects these fees directly from the debtor without fear of violating the automatic stay or discharge injunction. A common criticism is that fee-financing arrangements primarily benefit attorneys rather than clients, encourage inflated fees and involve coercing the debtor to agree to the arrangement. *See* Adam D. Herring, "Problematic Consumer Debtor Attorneys' Fee Arrangements and the Illusion of

'Access to Justice,' " XXXVII ABI Journal 10, 32, 58-59, October 2018. For another discussion of the problems with this business model, *see* David Cox, "Why Chapter 7 Bifurcated Fee Agreements are Problematic," ABI Journal, 30, 31, 53, June 2021. *See also Prophet,* 628 B.R. at n. 1 (noting the inherent dangers in factoring, especially when the debtor may not understand the nature of the agreement); *Moxley*, 2022 WL 1420890 at *5 (installment payment plan through third party collection violated state's rules of professional conduct and put debtors at financial risk).

Conclusion:

Numerous courts recognize that the payment of chapter 7 debtor's counsel can be very challenging under the framework established by the Bankruptcy Code. At the same time, they recognize that changes must be passed by Congress, so policy arguments have no real role in the courts' analyses. *Suazo,* 2022 WL 1468083, at *20 ("The Court cannot legislate and cannot just make up a new policy framework for Chapter 7 debtor's counsel fees."). As the court stated in *In re Baldwin*, 2022 WL 107376, *5 (Bankr. W.D. Ky. Jan. 11, 2022): "It is not this Court's position to find clever 'work arounds' of the fee structure determined by Congress. It is this Court's job to enforce the Bankruptcy Code as written. Any changes in that procedure are to be left to the legislature."

In its 2019 Final Report, the ABI Consumer Commission outlined several options for consideration to resolve the chapter 7 attorney compensation issues. The options ultimately recommended would require amending the Bankruptcy Code and Rules to better balance attorney compensation with the provision of competent services to chapter 7 debtors. For a detailed discussion, *see* David Cox, "Chapter 7 Debtors And Their Counsel Deserve Better: Instead Of Contorting the Attorney Client Relationship Through Bifurcated Fee Agreements, It Is Time To Find A Legislative Fix," Norton Journal of Bankruptcy Law and Practice, No. 3, 331 – 353, 2022.

Nevertheless, several courts have provided guidance regarding bifurcated fee arrangements. As stated previously, disclosure and informed consent are paramount. For example, one court set these requirements:

a.) The two-contract procedure must be set forth on a separate cover page of each agreement.
b.) Clients must acknowledge that they have received and read the procedure disclosure.
c.) Clients must execute the prepetition agreement before the case is filed and the postpetition agreement afterwards.
d.) The postpetition agreement must spell out the client's right to cancel the postpetition agreement.

e.) Lawyers must state in its Rule 2016 disclosure that the firm will continue its representation of the client until the Court enters an order allowing the firm to withdraw (even fi the debtor chooses not to retain the firm for postpetition services).

Walton v. Clark & Washington, P.C., 469 B.R. 383, 387-88 (Bankr. M.D. Fla. 2012). *See also Brown*, 631 B.R. at 100 (to be permissible, the bifurcation agreement must be adequately disclosed to a potential client and to the Court, must provide the debtor with a rescission period, and must include services that are required by applicable professional bar rules, local rules and the Bankruptcy Code and Rules).

In addition, "Guidelines for United States Trustee Program Enforcement Related to Bifurcated Chapter 7 Fee Agreements" were released in June, 2022. In general, the U.S. Trustee Program's position is that bifurcated fee agreements are permissible so long as three criteria have been met: 1) the fees charged must be fair and reasonable, 2) the agreements are entered into with the debtor's fully informed consent, and 3) the agreements are adequately disclosed. *See* Adam Herring and Scott Bomkamp, "Ensuring 'Access' and 'Justice' – USTP's Enforcement Guidelines for Bifurcated Fee Agreements," XLI ABI Journal, September 2022, 22-23, 48-49.

Finally, the Judicial Conference of the United States met in September of 2022 to consider the recommendation of the Committee on the Administration of the Bankruptcy System to address the issues regarding chapter 7 debtors' attorney fees. It adopted that recommendation which seeks legislation to amend the Bankruptcy Code to 1) except from discharge chapter 7 debtors' attorney fees due under any agreement for payment of such fees; 2) add an exception to the automatic stay to allow for postpetition payment of such fees, and 3) provide for judicial review of fee agreements at the beginning of a chapter 7 case to ensure the reasonableness of such fees.

Bartenwerfer v. Buckley

860 Fed. Appx. 544 (9th Cir. 2021), *cert. granted.*, 2022 WL 1295707 (U.S. May 2, 2022)(No. 21-908)

Issue: Can an individual be subject to liability for the fraud of another that is barred from discharge under §523(a)(2)(A), by imputation, without any act, omission, intent or knowledge of her own?

Background: Husband and wife renovated a house and then sold it. The buyer alleged that there were defects in the house, and sued the couple in state court for nondisclosure of material facts. The court found in favor of the buyer and awarded him damages. The husband and wife filed for bankruptcy.

The judgment creditor initiated an adversary proceeding against the debtors, arguing that the state court judgment was nondischargeable under §523(a)(2)(A) as a debt obtained through fraud. The bankruptcy court agreed. It found that Mr. Bartenwerfer had actual knowledge of the false representations made to the creditor and that his fraudulent conduct could be imputed to Mrs. Bartenwerfer (the "Petitioner") based on their partnership relationship. On appeal, the Ninth Circuit BAP remanded the imputed liability finding for a determination as to whether Mrs. Bartenwerfer "knew or should have known" of her husband's fraud. On remand, the bankruptcy court held that Mr. Bartenwerfer's fraud could not be imputed to his wife because she didn't know about it. The BAP affirmed, and the creditor appealed.

Citing *Strang v. Bradner*, 114 U.S. 555 (1885), the Ninth Circuit applied partnership principles to hold that the bankruptcy court applied the incorrect legal standard for imputed liability in a partnership. It concluded that Mrs. Bartenwerfer's debt was non-dischargeable regardless of her knowledge of the fraud, and remanded the case.

Mrs. Bertenwerfer's Petition for Writ of Certiorari has been granted.

Discussion: The circuit courts are split on this issue. Some require at least a minimal level of scienter on the part of the debtor in question and others impose vicarious liability on "innocent debtors."

The leading case applying the approach requiring scienter is *In re Walker*, 726 F. 2d 452 (8th Cir. 1984). In *Walker*, the Eighth Circuit concluded that more than the mere existence of an agent-principal relationship is required to charge the agent's fraud to the principal. *Id.* at 454. It held that §523(a)(2)(A) requires that a debtor-principal "knew or should have known" of his agent's fraud before the liability can be rendered nondischargeable, citing *In re Lovich*, 117 F.2d 612 (2d Cir. 1941). *Id.* The *Lovich* court justified the scienter requirement this way:

> On principle we think that more should be shown to justify withholding a discharge that an agent made a fraudulent statement within the scope of a general authority to transact the bankrupt's business. A discharge is a privilege accorded to bankrupts by the statute unless they are chargeable with conduct showing some lack of personal business morality. *Lovich*, 117 F.2d at 615.

See also In re Huh, 506 B.R. 257 (9th Cir. BAP 2014) (en banc) (adopting *Walker's* "knew or should have known" standard); *In re Treadwell*, 637 F.3d 855 (8th Cir. 2011) (same); *In re Reuter*, 427 B.R. 727 (Bankr. W.D. Mo. 2010) (finding that debtor should be held vicariously liable for his partner's fraud because debtor should have known that his partner was engaged in fraudulent conduct). The Eighth Circuit stated that the requisite knowledge could be imputed when the principal is recklessly indifferent to his agent's acts. *Walker*, 726 F. 2d at 454, citing *David v. Annapolis Banking & Tr. Co.*, 209 F.2d 343, 344 (4th Cir. 1953) (finding that a wife who allows her husband to do business in her name and signs without question or examination any paper that he presents to her is not entitled to a discharge). Interestingly, neither *Walker* nor the cases on which the Eighth Circuit relies mentions *Strang*.

Several courts have criticized the *Walker* decision as contrary to the legislative history and proper statutory interpretation of § 523. *See, e.g., In re Calhoun,* 131 B.R. 757, 760-62 (Bankr. D.C. 1991); *BancBoston Mortgage Corp. v. Ledford,* 127 B.R. 175, 180–85 (M.D.Tenn.1991), *aff'd,* 970 F.2d 1556 (6th Cir.1992), *cert. denied,* 507

U.S. 916 (1993); *In re Paolino,* 75 B.R. 641, 645–50 (Bankr.E.D.Pa.1987). One court put it this way: "Granted, the *Walker* standard is a bit mushy; if it's enough to deny the discharge that the principal 'should have known of the agent's fraud,' there will never be an occasion for requiring proof of reckless indifference." *Sullivan v. Glenn*, 782 F.3d 378, 382 (7th Cir. 2015).

The leading case imposing liability without knowledge is *Strang v. Bradner*, 114 U.S. 555 (1885). The question in *Strang* was whether the debtors could be held liable for the fraudulent representations of their business partner when the representations were not made under their direction nor with their knowledge. The Supreme Court held that the "innocent" partners were barred from discharging their debt in bankruptcy, reasoning that since each partner was an agent and representative of the firm, one partner's fraud was to be imputed to all the members of his firm. *Id.* at 561. It stated further that the wrongdoer's partners "cannot escape pecuniary responsibility" on the ground that the misrepresentations were made without their knowledge. *Id. See also In re Palilla*, 493 B.R. 248 (Bankr. D. Colo. 2013) (applying *Strang* to hold debtor liable for partner's felonious conduct despite the fact that he was unaware of it); *In the matter of M.M. Winkler & Associates*, 239 F. 3d 746, 751 (5th Cir. 2001) ("[I]f a debt arises from fraud and the debtor is liable for that debt under state partnership law, the debt is nondischargeable under §523(a)(2)(A)."). The court noted that this is especially true when the innocent partners "received and appropriated the fruits of the fraudulent conduct." *Strang*, 114 U.S. at 561. *But see Winkler*, 239 F.3d at 751-2 (concluding that the receipt of benefits is irrelevant to this inquiry).

The Petitioner in *Bartenwerfer* contends that *Strang* is inapposite or an aberration, and that requiring scienter is consistent with the legislative history of §523(a)(2)(A). Courts grappling with the conflicting *Walker* and *Strang* standards have likewise pointed to the historical background of the statute – noting that while *Strang* has not been overruled, it constitutes part of the background to the adoption of the statute and its amendments by Congress. *See, e.g.*, *In re Huh*, 506 B.R. 257, 264 (9th Cir. BAP 2014). In *Huh*, the BAP explains that, unlike the current Bankruptcy Code, the provisions of the Bankruptcy Act of 1867 (in effect when

Strang was decided) were not liberally construed in favor of debtors and included exceptions to discharge that were broader than the subsequent Bankruptcy Act. *Id.* The BAP also distinguished *Strang* on the grounds that it relied on partners and partnership law, and was decided before agency law was well-developed. *Id.*

The Petitioner also points out that there is no analysis or discussion of dischargeability in *Strang*; it simply focuses on the liability of the firm's partners for another partner's fraud. While that is true, other courts applying the *Strang* standard have recognized the distinction between liability and dischargeability. *See, e.g., Palilla*, 493 B.R. at 256 (commenting that §523 has compensatory objectives which aim to protect certain types of creditors regardless of the debtor's culpability); *Winkler*, 239 F. 3d at 749 (noting that §523 focuses on the character of the debt, not the culpability of the debtor).

In addition, the Petitioner asserts that *Strang* is inconsistent with other Supreme Court precedent on the mental state required in dischargeability litigation. For example, in *Bullock v. BankChampaign, N.A.,* 569 U.S. 267 (2013), the Supreme Court considered the question of whether excepting a debt for fiduciary defalcation from discharge under § 523(a)(4) required a showing of the debtor's subjective bad or extremely reckless state of mind. Relying, in part, on statutory context and policy considerations, the Supreme Court interpreted the term "defalcation" to require a showing of the debtor's intentional state of mind. *Id.* at 273-74. *See also Neal v. Clark*, 95 U.S. 704 (1877) (interpreting "fraud" under §523(a)(4) to mean intentional wrong, and not implied fraud); *Field v. Mans*, 516 U.S. 59 (1995) (finding that statutory history of §523(a)(2)(A) and (B) did not support stripping fraud exception of scienter requirement). These decisions weigh against imputing fraud under §523(a)(2) in the absence of some showing of culpability on the debtor's part.

Note that the issue of vicarious liability has been addressed in the context of the dischargeability of debt resulting from securities law violations: Does §523(a)(19)(A)(i) encompass debts arising from violations committed by third parties, or is it limited to those committed by the debtor? For a discussion of the split of authority, *see In re Reefe*, 2022 WL 1295935 (Bankr. S.D. Fla. April 29, 2022).