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34th Annual Advanced Bankruptcy Seminar: "Bankruptcy Unredacted"

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34th Annual Advanced Bankruptcy Seminar:
"Bankruptcy Unredacted"

Cosponsored by the OBA Bankruptcy and Reorganization Section

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Speaker Biographies

BRIAN HUCKABEE

Brian Huckabee is a Tulsa, Oklahoma, attorney with a practice concentrated in bankruptcy and business law. He has handled thousands of business, tax and consumer bankruptcy cases in the past three decades, consisting primarily of chapter 7 and 13 cases, but also including numerous chapter 11 business reorganizations and chapter 12 farm bankruptcies. He represents debtors but has credit union and creditor clients. He serves as an Adjunct Settlement Judge in the United States Bankruptcy Court for the Northern District of Oklahoma. He is a member of the Board of Governors of the Bankruptcy and Reorganization Section of the Oklahoma Bar Association. He is a frequent speaker at continuing legal education events. He is licensed in all of Oklahoma's federal judicial districts, but he concentrates in the Northern and Eastern Districts. He is a member of the Bankruptcy Section of the Tulsa County Bar Association. He received a Bachelor of Arts degree with Honors from Oklahoma State University in 1978 and a Juris Doctorate degree from University of Oklahoma in 1981. He has been married for 37 years. He has two grown children. He attends Harvard Avenue Christian Church in Tulsa.

JACK F. WILLIAMS

Center for Middle East Studies in Atlanta, Georgia. Williams is also a Principal in the Restructuring, Disputes & Valuation Advisory Services Group with Baker Tilly Virchow and Krause, LLP. His areas of interest include bankruptcy and business reorganizations, mergers and acquisitions, business valuations in dispute, forensic accounting, commercial law and damages models, corporate finance, capital markets, fraud and anti-corruption, Islamic banking and finance, taxation, public finance, and law and statistics.

Williams is a member of the Board of Advisors of the St. John's University School of Law LLM Program in Bankruptcy. He is also a member of the Board of Advisors of the American Bankruptcy Institute (ABI) Law Review.

Williams is the Association of Insolvency and Restructuring Advisors Scholar in Residence. He also served as the inaugural Robert M. Zinman ABI Scholar in Residence in 2001 and returned to that post in 2008. In 2009, Williams was recognized by the ABI with its Annual Service Award (2009), honoring the ABI member whose contributions over the past year have been extraordinary. He is a Fellow in the American College of Bankruptcy and a Fellow in the Bankruptcy Policy Institute at St. John's University School of Law.

Williams has a BA in Economics from the University of Oklahoma, a JD (High Honors) from the George Washington University National Law Center, and a PhD in Archaeology from the University of Leicester. Williams presently serves on the Board of the Department of Human Services for the State of Georgia.

MARK A. CRAIGE

Mark A. Craige is Shareholder of the law firm of Crowe & Dunlevy and has been an OBA member since 1982. Mr. Craige's practice is devoted to insolvency, reorganization and related areas with primary emphasis on Chapter 11 Bankruptcy reorganizations and business Chapter 7 cases, bankruptcy litigation and Receiverships. He has been counsel of record in over forty reported cases on bankruptcy law issues and has been an attorney of record in over 1600 bankruptcy cases. Mr. Craige has been Board Certified in Business Bankruptcy Law by the American Board of Certification since 1992 and has been a member of their board of directors for over 20 years where he held several different offices including President and Chairman. He was inducted as a Fellow of the American College of Bankruptcy in 2000, and has been an active member of the American Bankruptcy Institute for over 29 years where he has worked on several national committees. He was named in Best Lawyers in America since 2009, Super Lawyers in Oklahoma since 2008, one of the Top 50 Lawyers in Oklahoma in 2012, Best Lawyers Lawyer of the Year for Litigation - Bankruptcy in 2017 and was recently named as 2020 Lawyer of the Year for Bankruptcy and Creditor Debtor Rights / Insolvency and Reorganization Law in Tulsa. Mr. Craige is a frequent lecturer at continuing education seminars on bankruptcy and insolvency topics, and has published numerous articles on a variety of topics. Mr. Craige has received the Oklahoma Bar Association's Earl Sneed award as the outstanding contributor to continuing legal education in the State of Oklahoma. Mr. Craige received his B.S., cum laude, from Southeastern Oklahoma State University and his J.D. from the University of Tulsa College of Law. For more information visit:

http://attorneysuscrowedunlevy.com/AttorneysDetail.aspx?id=171

C. DAVID RHOADES

Mr. Rhoades is the Managing Director of Turnaround Processionals, LLC, which offers businesses the services of court-appointed oversight (receiver, special master, special administrator, or examiner), assistance in the interim crisis corporate governance and general management counseling. Mr. Rhoades is a Certified Fraud Examiner, a Certified Turnaround Professional, and a Certified Forensic Consultant. Additionally, Mr. Rhoades is the managing Director of Fraud & Forensic Investigations, LLC, a firm dedicated to providing clients with the services of discovery, evidentiary analysis, general accounting forensics, expert testimony, and litigation support. Mr. Rhoades was formerly an adjunct professor of Forensic Accounting and Fraud Examination at Oklahoma City University. Mr. Rhoades is the inaugural recipient of the 2014 Beacon Award from the Northeast Oklahoma Chapter of Certified Fraud Examiners for his contribution to the fields of fraud deterrence, detection, investigation and education.

PATRICK MALLOY

Notre Dame University B.A. 1968
Oklahoma University College of Law 1972
Malloy and Malloy now Malloy Law Firm 1972 to present
Bankruptcy Panel Trustee 1972 to present

SCOTT KIRTLEY

Scott Kirtley has had the pleasure to serve as a Panel Chapter 7 Trustee for the Bankruptcy Courts in the Northern and Eastern Districts of Oklahoma since 1988. After his graduation from Oral Roberts University Law School in 1985, he was the Estate Administrator for the Bankruptcy Court for the Northern District of Oklahoma and a law clerk for the Honorable Mickey D. Wilson. In 1988, he joined the Tulsa office of Riggs Abney Neal Turpen Orbison & Lewis.

Ilene Lashinsky is currently serving as the United States Trustee for Region 14 (District of Arizona) since November 18, 2002. Between January 2, 2004 and February 2008, she also served as the Interim United States Trustee for Region 18 (Washington, Oregon, Montana, Idaho and Alaska). Ilene became the United States Trustee for Region 20 (Kansas, Oklahoma and New Mexico) for an interim period, effective April 30, 2018.

Immediately before her appointment as Region 14 U.S. Trustee, Ilene was of counsel to the Scottsdale, Arizona firm of Hymson & Goldstein, P.C. where her practice focused on representing creditors and debtors in complex commercial bankruptcy matters and commercial litigation. For the previous 17 years, she was a partner at the bankruptcy law firm of Davis & Lowe, P.C. in Phoenix. During a leave from Davis & Lowe, between June 1998 and June 1999, Ilene served as resident bankruptcy advisor to the CFED- USAID Macedonia Commercial Law Project, assisting in workouts of major financially distressed Macedonian businesses and advising ministry representatives regarding the government's role in the transition to a free market economy.

Before joining Davis & Lowe, P.C., she practiced commercial and bankruptcy law with Leslie L. Miller, P.C. and with Streich Lang. As the first Director of Continuing Legal Education of the State Bar of Arizona, Ilene helped design and develop legal education curricula and material. She is also an adjunct faculty member for Arizona State University's Melikian Center for Russian and East European Studies. Ilene received her law degree cum laude in 1972 from Arizona State University College of Law, Tempe, Arizona and her undergraduate degree in 1969, also from Arizona State University.

Biographical Information

Seminar Advanced Bankruptcy Seminar 2016

Name Katherine Vance

Firm Name Office of the United States Trustee, Region 20, U.S. Department of Justice

Position Assistant United States Trustee for the Northern and Eastern Districts of Oklahoma

EDUCATION:

UNDERGRADUATE	St. Lawrence University, Canton, NY University and Location	BA, Government Degree Earned
GRADUATE	University and Location	Degree Earned
LEGAL	Tulsa University College of Law University and Location	JD Degree Earned

OBA/CLE does not currently have your biographical information on file. Please submit your information (about 10-20 lines of text) to Stephanie Burke at *stephanieb@okbar.org.*

Ms. Vance entered private practice after graduating from law school, where she specialized in bankruptcy and commercial law, along with a general practice. Prior to her current position, she served as the Estate Administrator for the U.S. Bankruptcy Court for the Eastern District of Oklahoma. With the enactment of the legislation creating the U.S. Trustee, she was appointed by the Attorney General and was responsible for setting up the office in Tulsa in 1987. Ms. Vance is a member of the Oklahoma Bar Association and Tulsa County Bar Association, and in 2001 received the OA Neil Bogan Award for Professionalism. She currently serves on the Bankruptcy and Reorganization Section Board of Directors.

Charles S. Glidewell

In 1988, Charles S. Glidewell joined the United States Trustee Program where he served as the Assistant U. S. Trustee for the Northern District of Florida. In 1998 he relocated to Oklahoma City where he served as a trial attorney and since 2010 he has served as the Assistant U.S. Trustee for the Western District of Oklahoma. He was previously in private practice in Dallas and was a chapter 7 trustee. Prior to his legal career he was a CPA and financial auditor with a national accounting firm. He is a member of the State Bar of Texas.

CHARLES E. SNYDER

Since 1991 Charlie Snyder has served as a trial attorney with the Office of the United States Trustee in Oklahoma City. He was previously in private practice in Oklahoma City and Fort Worth. He is a member of the Oklahoma Bar Association and the State Bar of Texas.

Marjorie Creasey

MJ Creasey graduated from OU law school in 1999. She began her career in private practice where she handled business litigation and bankruptcy matters, representing debtors, creditors and a chapter 7 trustee. In 2006 she joined the U.S. Department of Treasury as an IRS auditor. From there she transitioned to the U.S. Department of Justice where she remains as a trial attorney for the U.S. Trustee.

KEVIN F. BRADY
OF COUNSEL
REDGRAVE LLP

Kevin Brady is Of Counsel at Redgrave LLP, a law firm that focuses on Information Law, which includes information governance, records and information management, data protection and privacy issues, as well as the discovery of electronically stored information. Kevin focuses his practice on providing advice and counsel on electronic discovery, electronic information management, data privacy, and data security issues. Kevin serves as Chair of the Steering Committee of The Sedona Conference Working Group WG1 on Best Practices for Electronic Document Retention and Production. Kevin served as Co-Chair of the Georgetown University Law Center's Advisory Board for the Advanced E-Discovery Institute and is now Co-Chair Emeritus. Kevin was a member of the Planning Committee for the Georgetown University's Law Center's six-day E-Discovery Training Academy. Kevin served as Co-Chair of the Delaware Supreme Court's Commission on Law and Technology. He also serves on BNA Board of Advisors of Digital Discovery and Electronic Evidence, and is a member of the Seventh Circuit Council on eDiscovery and Digital Information.

Kevin has been involved with the American Inns of Court for over thirty years. He is a founding member of three American Inns of Court in Delaware including the Richard K. Herrmann Technology Inn of Court. In addition to being an expert witness, a court-appointed expert and Special Discovery Master, Kevin lectures and publishes extensively in the areas of eDiscovery, records management, data privacy, data security, attorney competence and legal ethics. Kevin publishes a regular column on technology in the American Inns of Court's *Bencher* magazine and the Delaware State Bar Association's *Journal* publication.

Kevin has been ranked in Chambers USA, Leading Individuals (Litigation: E-Discovery) (Band 2) since 2009. Kevin received a J.D. from Widener University School of Law (magna cum laude), an M.B.A. from Widener University, and a B.A. from the University of Delaware.

DOUGLAS ROSNER

Doug Rosner represents clients throughout the country and internationally in bankruptcy and restructuring matters. He counsels corporate debtors, unsecured creditors and creditors' committees, lenders, landlords, asset purchasers and trustees. Doug handles a wide range of bankruptcy matters including complex Chapter 11 reorganizations, Chapter 7 liquidations, workouts and related litigation and transactions. Chambers USA recognized Doug as "one of the superstars in the bankruptcy arena . . . " Additionally, he counsels lenders and borrowers in corporate and real estate financing transactions, including asset-backed securitizations, inter-creditor agreements, factoring arrangements and asset-based loans. Doug is a Fellow in the American College of Bankruptcy.

Foundations of Discharge of Debt

Materials Coming Soon

Receiverships, Another Chapter

By

C. David Rhoades, CFE, CTP, CFC
and
Mark A. Craige

Receiverships, another Chapter.

The concept of Receiverships dates back well over 150 years. The case law, much of which was promulgated by the United States Supreme Court in the late 1800s laid a foundation that has remained solid to this day. In this paper, we will give the applications that have been used to operate Receiverships and that can be used today as an alternative to utilizing the Federal Bankruptcy Courts.

Receiverships can be either under Federal or State jurisdiction. In Mr. Rhoades practice of doing nearly 200, Federal cases only comprise about 5% of those filed. Regardless of the jurisdiction, the basics are governed by the state law with a few twists when in Federal Court. We will explore the operations of a Receivership and the case law that sets forth the rules for the operations. The reference to "rules" is a bit tongue in cheek, since it turns out there are very few statutory provisions that actually provide guidance when dealing with Receiverships.

Because much of the case law and statutes are state related, and since our experience is primarily in Oklahoma, we will tie most of the concepts in this paper to Oklahoma law. The operative Oklahoma Statutes are 12 O.S. §§1551 – 1554 and 1560, see Exhibit A. As you can see, there is very little statutory law that governs Receiverships in Oklahoma. There is a high probability that the other states will have comparable case law and statutes that can be applied, as we have in Oklahoma.

It is paramount to get an Order Appointing Receiver that defines as many variables as possible. At least under Oklahoma law, the scope for the Receivership Estate and the power of the Receiver is functionally unlimited as long as the Order Appointing Receiver dictates the guidelines. The scope and powers are outlined herein:

1. A Receiver is Independent. Although usually nominated by a creditor, a receiver can be appointed *sua sponte*. The parties must understand the relationship between all of the stakeholders. The Receiver works for the Judge and the Judge alone. This creates an independent party for a situation in which the parties usually are adverse. These cases support this relationship:

A receiver is not an agent of a receivership's creditor, and, thus, statements by the receiver cannot be imputed to the creditor. *See Atlantic Trust Co. v. Chapman*, 208 U.S. 360, syllabus (1908) ("The receiver is not the agent of the plaintiff in the litigation nor does the plaintiff have any control or authority over him : . . ."); 12 C. Wright, A. Miller, & M. Kane, Fed. Practice and Proc., § 2981, at 9-10 (2d ed. 1997) (A receiver "is . . . not an agent of the parties."); Actions of a receiver cannot be imputed to a party in the receivership action. *In re Phillips*, 24 B.R. 712, 714 (Bankr. E.D. Cal. 1982) ("The receiver is not the agent of the plaintiff nor . . . acting on the plaintiff's behalf or under his control.").

2. Judicial Immunity. A Receiver must be able to do their job without the threat of intervention. It is inevitable that the parties will attempt to influence the decisions that the Receiver makes and when they are unsuccessful, the threats begin. With judicial immunity, the Receiver is protected by this shield and can do their job. The Courts have reinforced this concept.

The case of *Hathcock v. Barnes*, 25 P.3d 295, 296 (Okla.Civ.App. 2001) cited with approval the Oklahoma Supreme Court case of *Farrimond v. State ex rel. Fisher*, 8 P.3d 872, 876 (Okla. 2000) which noted "a court-appointed receiver acts as a functionary of the court and as such is performing a judicial act. Thus, immunity is justified and defined by the functions it

protects and serves, not by the person to whom it attaches". *See also, Teton Millwork Sales v. Schlossberg,* 311 F. App'x 145, 150 (10th Cir. 2009) ("a court-appointed receiver has absolute quasi-judicial immunity if he is faithfully carrying out the appointing judge's orders.") (citation omitted).

3. Business Judgment Rule. As a Receiver, one cannot always 'get it right' even with Court approval of the major decisions. It has been recognized that in a fiduciary capacity, a Receiver has to do the best they can with what they have to work with. It is important when considering a candidate for appointment, that you attempt to find someone that has some relevant experience, where their decisions have a better chance of success. This does not mean industry specific, although that helps, but does mean that a broad range of experience is necessary. An example of this is:

Although there appears to be a dearth of federal common law on this topic, Oklahoma courts have also long recognized that a receiver's decisions regarding the management and operations of property within his control are subject to the business judgment rule. *See Harris v. Dildine,* 251 P. 76, 77 (Okla. 1926), ("A receiver is vested with discretion to manage and control the property entrusted to him in such manner as an ordinarily prudent business man would manage and control his own property.") (Internal quotation marks and citations omitted). "[R]eceivers, just like corporate directors, are entitled to the deference of the business judgment rule in their decision-making concerning the management of a corporation." *Golden Pac. Bancorp v. F.D.I.C.*, No. 95 CIV. 9281 (NRB), 2002 WL 31875395, at *9 (S.D.N.Y. Dec. 26, 2002), *aff'd sub nom. Golden Pac. Bancorp. v. F.D.I.C.,* 375 F.3d 196 (2d Cir. 2004).

4. Authority. In addition to the state statutes and case law, there is some Federal support

for the receivership process. Examples are:

a) Federal Rules of Civil Procedure 66 and federal common law support the appointment of a receiver. The 11th Circuit Court of Appeals held in the case of *National Partnership Inv. Corp. v. National Housing Development Corp.,* 153 F.3d 1289 (11th Cir. 1998) at pages 1291-1292:

As the First Circuit noted in Chase *Manhattan Bank, N.A. v. Turabo Shopping Center, Inc.,* 683 F.2d 25, 26 (1st Cir. 1982), "[m]ost federal court decisions dealing with the appointment of a receiver pendente lite appear to apply federal law without discussion." Of those circuits that have directly addressed the issue, each has held that the appointment of a receiver in a diversity action is governed by federal law. *See Aviation Supply Corp. v. R.S.B.I. Aerospace, Inc.*, 999 F.2d 314, 316 (8th Cir. 1993); *Turabo*, 683 F.2d at 26; see also *Resolution Trust Corp. v. Fountain Circle Assocs. Ltd. Partnership,* 799 F.Supp. 48, 50 (N.D.Ohio 1992); *New York Life Ins. Co. v. Watt West Inv. Corp.,* 755 F.Supp. 287, 289-90 (E.D.Cal.1991). Commentators generally approve of the conclusion reached by these courts. *See* 12 Charles Alan Wright et al., Federal Practice and Procedure § 2983, at 33-35 (2d ed.1997); 13 James Wm. Moore et al., Moore's Federal Practice ¶ 66.09 (3d ed.1998).
The conclusion that federal law governs the appointment of receivers is based on several considerations. First and foremost, the appointment of a receiver in equity is not a substantive right; rather, it is an ancillary remedy which does not affect the ultimate outcome of the action. *Pusey & Jones Co. v. Hanssen,* 261 U.S. 491, 497, 43 S.Ct. 454, 456, 67 L.Ed. 763 (1923). The conclusion that federal law governs the appointment of a receiver thus does not conflict with the *Erie* doctrine's requirement that state law apply to matters of substance. *New York Life,* 755 F.Supp. at 291, 12 Wright § 2983, at 34; 13 Moore ¶ 66.09; *see also Skelly Oil Co. v. Phillips Petroleum Co.*, 339 U.S. 667, 674, 70 S.Ct. 876, 880, 94 L.Ed. 1194 (1950) (noting that, in a diversity case, a declaratory remedy may be given by a federal court even if that remedy is unavailable in state court); *Guaranty Trust Co. of New York v. York*, 326 U.S. 99, 65 S.Ct. 1464, 89 L.Ed. 2079 (1945) (stating that the equity power of a federal court exercising diversity jurisdiction cannot be equated with state law under the *Erie* doctrine).

Second, Federal Rule of Civil Procedure 66 and the accompanying Advisory Committee's Note assert the primacy of federal law in the practice of federal receiverships. *New York Life,* 755 F.Supp. at 289-90, 12 Wright § 2983, at 35. Thus, to the extent Rule 66 dictates what principles should be applied to federal receiverships, courts must comply with the Rule even in the face of differing state law. *See Hanna v. Plumer,* 380 U.S. 460, 471, 85 S.Ct. 1136, 1144, 14 L.Ed.2d 8 (1965) (stating that in a diversity case, "[w]hen a situation is covered by one of the Federal Rules, ... the court has been instructed to apply the Federal Rule, and can refuse to do so only if the

> Advisory Committee, this Court, and Congress erred in their prima facie judgment that the Rule in question transgresses neither the terms of the Enabling Act nor constitutional restrictions."); *see also* 12 Wright § 2983, at 34 (stating that the conclusion that federal law governs the appointment of a receiver is consistent with *Hanna*). [footnotes omitted]
>
> *See also, Am. Bank & Trust Co. v. Bond Int'l Ltd.*, No. 06-CV-0317-CVE-FMH, 2006 WL 2385309, at *7 (N.D. Okla. Aug. 17, 2006) (accord).

5. What assets to take must be considered in the Pleadings. The universe is limited to one of two decisions. The decision consists of what needs to be considered is the breath and scope of what needs to be done. Fundamentally, do you take:

(a) **The assets.**

(i) These must be defined.

(ii) Eliminates confusion.

(ii) Is usually faster to convert from a tangible asset(s) to cash, or

(b) **The entity.**

(i) Allows for inclusion of things that you do not know at the time of the filing. Sometimes this is good and sometimes it is bad. Knowing the debtor/defendant, their history, their credibility, and their business operations will guide this decision.

(ii) More responsibility for dealing with the taxes and other enforcement actions, becomes the responsibility of the Receiver, unless exculpated in the Order Appointing.

At the conclusion of the case, the Receivership is dismissed and all of the historical liabilities go back to the debtor/defendant. This is important when there are things like

environmental impacts that are not remediated, assets that have a negative value and taxes that cannot be dealt with within the Receivership.

6. Impediments:

A. Receivership is an extraordinary remedy exercised at the discretion of the Court. Once a Judge becomes comfortable with the process, they usually will give a great deal of deference to the Receivership process. It allows them to have someone step in and shield the Court from unnecessary work with the best interests of the Court and the parties in mind. The Receiver can make nearly all of the operating decisions, bring solutions instead of problems to the Court and move a case along, sometimes dragging the parties with them. Below is some support for the appointment:

a) the 5th Circuit Court of Appeals in the case of *Santibanez v. Wier McMahon & Co.,* 105 F.3d 234 (5th Cir. 1997) at page 241 opines:

> Moreover, the District Court had the power to appoint a receiver to take possession of the judgment debtor's property for preservation under Federal Rule of Civil Procedure 66. Under that rule, the appointment of a receiver can be sought "by anyone showing an interest in certain property or a relation to the party in control or ownership thereof such as to justify conservation of the property by a court officer." 7 Moore et al., ¶ 66.05[1]. The appointment is in the sound discretion of the court. *Id.* Similarly, "the form and quantum of evidence required on a motion requesting the appointment of a receiver is a matter of judicial discretion." 12 Charles A. Wright & Arthur R. Miller, Federal Practice and Procedure § 2983 (1973) (citing authorities). Courts have held that receivers may be appointed "to preserve property pending final determination of its distribution in supplementary proceedings in aid of execution." 7 Moore et al., ¶ 66.05 [1] (citing *Haase v. Chapman*, 308 F.Supp. 399 (W.D.Mo.1969)).

b) the 1st Circuit Court Appeals in the case of *Consolidated Rail Corp. v. Fore River Ry. Co.*, 861 F.2d 322 (1st Cir. 1988) beginning at page 326 noted (this is reformatted below to allow for better analysis):

Courts have recognized many factors that are relevant for a court to consider when determining the appropriateness of the appointment of a receiver. These include:

i. fraudulent conduct on the part of the defendant, *see Burnrite Coal Briquette Co. v. Riggs,* 274 U.S. 208, 212, 47 S.Ct. 578, 579, 71 L.Ed. 1002 (1927);

ii. imminent danger that property will be lost or squandered, *see Gordon v. Washington*, 295 U.S. 30, 37-39, 55 S.Ct. 584, 588-89, 79 L.Ed. 1282 (1935); *Garden Homes, Inc. v. United States*, 200 F.2d 299, 301 (1st Cir.1952);

iii. the inadequacy of available legal remedies, *see Leighton v. One William Street Fund, Inc.,* 343 F.2d 565, 568 (2d Cir.1965);

iv. the probability that harm to the plaintiff by denial of the appointment would be greater than the injury to the parties opposing appointment, *see Mintzer*, 263 F.2d at 825;

v. the plaintiff's probable success in the action and the possibility of irreparable injury to his interests in the property, *see Bookout v. First Nat'l Mortgage & Discount Co.*, 514 F.2d 757, 758 (5th Cir.1975); and

vi. whether the interests of the plaintiff and others sought to be protected will in fact be well served by the receivership, *see Commodity Futures,* 481 F.Supp. at 441.

All of the foregoing do not have to be met, in fact, one is sufficient. Additionally, this is not the universe of the reasons that a Receiver should be appointed.

c) the 2nd Circuit Court of Appeals opined in *Citibank, N.A. v. Nyland (CF8) Ltd.,* 839 F.2d 93 (2d Cir. 1988) at page 97:

We agree with appellants' contention that the appointment of a receiver is not automatic under the mortgage agreement, that "the appointment of a receiver is considered to be an extraordinary remedy", and that the remedy should be employed cautiously and granted only when clearly necessary to protect plaintiff's interests in the property. *Chambers v. Blickle Ford Sales, Inc.,* 313 F.2d 252, 260 (2d Cir.1963). We believe that Citibank made an adequate showing that allowing New York Land to have a continuing role in managing the building would be harmful to the premises' marketability. This harm to its marketability would also reduce the value of the security represented by Citibank's mortgage.

> Furthermore, the mortgage agreement between Citibank and Nyland provides that upon the occurrence of any event of default (as explained in the mortgage), Citibank may apply for the appointment of a receiver. Given that it is undisputed that several events of default had occurred, we believe that this provision strongly supports the appointment of a receiver. *See* New York Real Property Law § 254(10); *Meyer v. Indian Hill Farm, Inc.*, 258 F.2d 287, 293-94 (2d Cir.1958); *Febbraro v. Febbraro*, 70 A.D.2d 584, 585, 416 N.Y.S.2d 59 (2d Dep't 1979). It is entirely appropriate for a mortgage holder to seek the appointment of a receiver where the mortgage authorizes such appointment, and the mortgagee has repeatedly defaulted on conditions of the mortgage which constitute one or more events of default. *See, e.g., Mancuso v. Kambourelis*, 72 A.D.2d 636, 637, 421 N.Y.S.2d 130, 131 (3d Dep't 1979); *Febbraro v. Febbraro, supra; Home Title Insurance Co. v. Isaac Scherman Holding Corp.*, 240 A.D. 851, 267 N.Y.S. 84, 85 (2d Dep't 1933). *See also, Am. Bank & Trust Co.*, 2006 WL 2385309, at *7.

B. By the terms of the agreement. It is common in commercial loans secured by real property for the mortgage agreement to include language whereby the mortgagor/debtor consents to the immediate appointment of a receiver. For example:

> Upon the occurrence of any Event of Default, the [Lender] shall be entitled as a matter of right, to enforce any right of the [Lender], to the appointment of a receiver or receivers of any or all of the Property of the [Defendant] with such powers as the court making such appointment shall confer. [Defendant] hereby consents and agrees, and shall, if requested by the [Trustee], consent and agree at the time of application by the [Trustee] for appointment of a receiver of its Property to the appointment of such receiver of its Property and that such receiver may be given the right, power and authority, to the extent the same may lawfully be given, to take possession of and operate and deal with such Property and the revenues, profits and proceeds therefrom, with like effect as the [Defendant] could do so, and to borrow money and issue evidences of indebtedness as such receiver.

Where the underlying loan agreements contain the borrower's express consent to the appointment of a receiver upon an event of default, such appointment is appropriate and justified. *See Am. Bank & Trust Co. v. Bond Int'l Ltd.*, Case No. 06-CV-0317-CVE-FMH, 2006 U.S. Dist. LEXIS 58361, *21-22 (N.D. Ok. Aug. 17, 2006) (citing cases) (finding that the bank was

"entitled to the appointment of a receiver under the bargained-for provisions of the parties' agreements, because "[a]ppointment of a receiver is appropriate where the parties have contractually agreed to receivership."). Indeed, the Oklahoma Receivership Statute, 12 O.S. § 1551(2)(c), specifically provides for the appointment of a receiver in a mortgage foreclosure action whenever "condition of the mortgage has not been performed and the mortgage instrument provides for the appointment of a receiver." The Oklahoma Supreme Court has found that contracts whereby a borrower consents to the appointment of a receiver are valid and enforceable under the above cited language of the Oklahoma Receivership Statute and that such agreements are not contrary to public policy in the case of *MIF Realty L.P. v. Duncan Dev. Co.*, 1995 OK CIV APP 25, 892 P.2d 664, 667 where the Court held "Accordingly, we hold that the parties' agreement for the appointment of a receiver is enforceable if otherwise qualified under § 1551." Indeed, as discussed in MIF Realty L.P. v. Duncan Dev. Co., at 25, 666, the 1989 amendment to 12 O.S. §1551 which added section 1551(2)(c) was specifically enacted to overrule Jacobs v. Real Estate Mortgage Trust Co., 122 Okla. 1, 249 P. 930 (1926), wherein the Oklahoma Supreme Court held a provisions in a mortgage containing an agreement for the appointment of a receiver was executed prior to 1989 contrary to public policy and thus void.

Here, the strongest argument seems to be that consent to the receiver's appointment is an express and enforceable provision of a binding contract under 15 O.S. §§ 1551(2)(c). Further, a party may contractually "waive notice altogether." *State ex rel. Fisher v. S. Atl. Dredging Co.*, 2000 OK CIV APP 123, ¶ 7, 15 P.3d 523 (quoting *National Equipment Rental, Limited v. Szukhent*, 375 U.S. 311, 316 (1964)). *Fisher* goes on the state that when "The Defendant expressly agreed to the appointment of a receiver without notice in the event of default. It is bound by this contractual agreement. Oklahoma law provides the borrower may waive notice of

a potential contemplated action, including the appointment of a receiver, by contract." *Fisher at 123/525* ("[P]arties to a contract may agree in advance to submit to the jurisdiction of a given court, to permit notice to be served by the opposing party, or even to waive notice altogether."); *see also United States Bank Nat'l Ass'n v. Minnillo,* No. 98593, 2012 Ohio App. LEXIS 4544, *8-9 (Ohio Ct. App. Nov. 8, 2012) (recognizing that provisions in mortgages for the appointment of a receiver without notice waive the evidentiary requirements of the applicable receivership statute).

It is worthwhile to note the trial court's order appointing a Receiver was reversed and remanded on appeal because the trial court took no evidence and made no findings that a condition of the mortgage had not been performed. It is critical to offer actual admissible evidence of the mortgage and proof that a condition of the mortgage has not been performed. MIF Realty L.P. v. Duncan Dev. Co., at 25, 667.

C. By other statute.

The members of a Limited Liability Company may seek the appointment of a receiver as part of a judicial proceeding to oversee the dissolution and wind-up of the LLC. Pursuant to 18 O.S. § 2039(A)(3), a District Court is empowered to wind up the affairs of an LLC upon application of the Member. Under Oklahoma law, pursuant to 12, O.S. §§ 1551(5) and (6), as incorporated into the Oklahoma Limited Liability Act via 18 O.S. § 2060, the appointment of a receiver is authorized when a limited liability company is to be dissolved. The Member of the LLC seeking dissolution may seek the appointment of a receiver to conduct the wind-up on the LLC is authorized pursuant to above statutes.

The same process is available for a corporation under 18 O.S. §1100, paraphrased as: When any corporation organized in accordance with the provisions of the Oklahoma General Corporation Act[1] shall be dissolved in any manner whatever, the district court, on application of any creditor, shareholder or director of the corporation, or any other person who shows good cause therefor, at any time, may appoint one or more persons to be receivers to (1) take charge of the corporation's property, (2) collect the debts and property due and belonging to the corporation, (3) prosecute and defend, in the name of the corporation, necessary or proper lawsuits and (4) appoint an agent or agents under them, and to do all other acts which might be done by the corporation; all as necessary for the final settlement of the unfinished business of the corporation. Although this same statute authorizes the appointment of an officer or director as a "trustee" to wind-up the dissolved corporation; however, such persons are exposed to the potential for some personal liability. "There can be no question about the liability of such trustees for transactions arising before the dissolution of the corporation, being limited to the assets of the corporation in their hands. However, it has been judicially determined that such trustees are personally liable for transactions engaged in by them after its dissolution, even for the benefit of the corporation. Riedell v. Stuart, 151 Okl. 266, 2 P.(2d) 929, 76 A.L.R. 1469." Trower v. Stonebraker-Zea Live Stock Co., 17 F. Supp. 687, 689 (N.D. Okla. 1937). Receivers have no such personal liability.

7. Power of the Receiver. The Receiver has many of the same powers that a Trustee under 11 USC bankruptcy provisions can invoke. This allows for a case to be handled with efficiency and mitigates the involvement of the Courts. Again, these are other ways where the Receivership speeds the process along. Some of those powers are:

a) The ability to reject contracts. The Receiver has a right to reject any contracts or leases related to the Assets as found in *Sunflower Oil Co. v. Wilson,* 142 U.S. 313, 322 (1892) and *U.S. Trust Co. v. Wabash W. Ry. Co.,* 150 U.S. 287 (1893).

b) The ability to sell assets free and clear of liens, claims and encumbrances. The limitations are similar to a trustee's, in that they cannot remove deed covenants, avoid certain taxes, and other provisions. It is clear that a Receiver may conduct a sale of assets prior to the entry of a final judgment. One hundred thirty-two (132) years ago, the United States Supreme Court addressed the notion of a Receiver's sale free and clear prior to entry of a final judgment in *First National Bank of Cleveland v. Shedd*, 121 U. S. 74, 7 Sup. Ct. 807, 30 L. Ed. 877 (1887); wherein it was held that there is "no doubt" that a Court has the power to authorize a Receiver to sell property prior to an adjudication of the merits of a foreclosure case.

Oklahoma case law incorporates and approves the process of a Receiver selling property prior to a judgment pursuant to an order of this Court as discussed in Threadgill v. Colcord, 85 P. 703 (Okla.Terr. 1906) beginning at page 705:

> The statutes are entirely silent as to the manner of the conduct of such sales, and we think that if the sale is conducted in the manner prescribed by the court in its decree, that the proceedings would be sufficient to give the purchaser a good title to the property.
>
> And continuing at page 710:
>
> A purchaser, under a deed from a receiver, is not bound to examine all the proceedings in the case in which the receiver is appointed. It is sufficient for him to see that there is a suit in equity, or was one, in which the court appointed a receiver of property, that such receiver was authorized by the court to sell the property, that a sale was made under such authority, that the sale was confirmed by the court, and that the deed given by the receiver accurately recites the property or interests thus sold. A purchaser at a judicial sale is not bound to inquire whether any errors intervened in the action of the court, or irregularities were committed by the receiver in the sale. Koontz v. Northern Bank, 16 Wall. 196, 21 L. Ed. 465; Grignon's Lessee v. Astor, 2 How. 319, 11 L. Ed. 283; Voorhees v. Bank of U. S., 10 Pet. 449, 9 L. Ed. 490. Even though the case in which the receiver was appointed might be subsequently reversed on appeal, such reversal would not affect the sale if the court had jurisdiction

> to render the decree, and the fact that the plaintiff in the suit in which the receiver was appointed was himself the purchaser at the receiver's sale, would not alter the case.

An Oklahoma District Court has the jurisdiction and authority to authorized and empower the Receiver to sell assets free and clear of liens, claims and encumbrances. The United States Supreme Court approved this concept in First National Bank of Cleveland v. Shedd, supra, when it affirmed a lower Court's Order empowering a Receiver to "sell the mortgage property free of all liens, and to bring the proceeds into Court, to be distributed in accordance with the respective liens and priorities of the parties". Further, there is no question this Court has the authority to order the sale of real property free and clear of liens in various situations, see 12 Okl.St.§§ 686, 1147.1 and 1513; 11 Okl.St.Ann. § 36-308.

Courts in other states have so held, citing authority from the Federal Courts. "A court of equity has the power to order the sale of property free and clear of liens and encumbrances. (*Spreckels v. Spreckels Sugar Corp.* (2d Cir.1935) 79 F.2d 332, 334; *Miners' Bank of Wilkes–Barre v. Acker* (3d Cir.1933) 66 F.2d 850, 853.)" City of Riverside v. Horspool, 223 Cal. App. 4th 670, 684, 167 Cal. Rptr. 3d 440, 453 (2014)

Note that receivership sales are not foreclosure sales. There is one Oklahoma case so holding: "The sale in the case at bar was a receivers' sale wherein the property was in the custody of the court through its receivers, while the cases cited by plaintiff involved a sale of property under a mortgage foreclosure." Bailey & Collins v. Ryan Cotton Oil Mill Co., 1926 OK 138, 119 Okla. 57, 248 P. 321, 323. There is an oft cited case from Utah holding "The statutory provisions governing mortgage foreclosures or sales on execution do not apply to a sale by a receiver. American Mine Equipment Co. v. Ill. Coal Corporation, 7 Cir., 31 F.2d 507; Yakima Finance Corp. v. Thompson, 171 Wash. 309, 17 P.2d 908; Bailey & Collins v. Ryan Cotton Oil

Mill Co., 119 Okl. 57, 248 P. 321; Home Mortgage Co. v. Sitka Co., 148 Or. 502, 36 P.2d 1038; Clark on Receivers, Sec. 592; High on Receivers, Sec. 199c; 53 C.J. 210, Sec. 330." Chapman v. Schiller, 95 Utah 514, 83 P.2d 249, 251 (1938). We are not aware of any published opinions in Oklahoma to the contrary.

NOTE: A receivership court is prohibited from extinguishing property tax liens by judicial sale. Edwards v. Pratt, 1935 OK 304, 171 Okla. 257, 42 P.2d 506, 507.

"A court of equity under proper circumstances has power to order a receiver to sell property free and clear of all incumbrances, and to deny the mortgagee the right to foreclose his mortgage. Stokes v. Williams (C.C.A.) 226 F. 148; In re Dyer (D.C.) 8 F.(2d) 376; Broadway Trust Company v. Dill 0C.C.A.) 17 F.(2d) 486; Seaboard National Bank v. Rogers Milk Products Company (C.C.A.) 21 F.(2d) 414; Mellen v. Moline Malleable Iron Works, 131 U.S. 352, 9 S.Ct. 781, 33 L.Ed. 178; Van huffel v. Harkelrode, etc., 284 U.S.225, 52 S.Ct. 115, 76 L.Ed. 256." Miners' Bank of Wilkes-Barre v. Acker, 66 F.2d 850, 853 (3d Cir. 1933)

In Federal Court, the court's authority to order the sale of the receivership Property free and clear of an easement, mortgage or other lien interest is located in the court's general equitable power to order sales of property within its jurisdiction on terms ordered by the court. *See Mellen v. Moline Malleable Iron Works*, 131 U.S. 352, 367 (1889) (observing that "the removal of alleged liens or incumbrances upon property, the closing up of the affairs of insolvent corporations, and the administration and distribution of trust funds are subjects over which courts of equity have general jurisdiction"). A Federal District Court clearly possesses the authority to order the sale of the receivership property "free of all encumbrances" and to order that interest be transferred to the proceeds of the sale. *See Van Huffel v. Harkelrode*, 284 U.S. 225, 227 (1931)

(declaring that the power to sell property "free from incumbrances" has "long been exercised by federal courts sitting in equity when ordering sales by receivers or on foreclosure"); *Seaboard Nat. Bank v. Rogers Milk Prod. Co.*, 21 F.2d 414, 416 (2d Cir. 1927) (observing that "[t]here is no doubt of the power of a court of equity under proper circumstances to sell property free of liens, transferring the lien to the proceeds"). *See also* Annotation, *Power of court to authorize or direct receiver (or trustee in bankruptcy) to sell property free from liens*, 120 A.L.R. 921 (1939, with supplement through 2016). See generally United States v. Par. Chem. Co., No. 2:09-CV-804-CW, 2017 WL 4857547, at *10 (D. Utah Oct. 24, 2017), aff'd in part, appeal dismissed in part, 759 F. App'x 722 (10th Cir. 2019).

8. **When defined in the Motion to sell the assets, the sale can force the Right of Redemption or its abandonment.** We include in our sale orders the verbiage that addresses this right by forcing the issue: To protect the Debtor's equity of redemption pursuant to 42 Okl. St. §18, the Sale Order should provide that the Debtor has the right to redeem the property by paying the total amount due on the Creditors' claims in cash at any time prior to the entry of the Confirmation Order. Such procedure protects the Debtor's right to redeem the property by tendering money. The origin of the equity of redemption and the means by which such right is terminated in Oklahoma is the case of *Balduff v. Griswold*, 60 P. 223 (Okla.Terr. 1900), which cites as the origin of such concept the case of *Carr v. Carr*, 52 N.Y. 251 (1873), which in turn cites at page 258 the case of *Murray v. Walker*, 31 N.Y. 399 (1865) wherein at page 404 it was held that a debtor's equity of redemption in mortgaged real property is terminated when they have the "right to answer; and either contest the honesty of the loan, or tender the money and redeem". The Receiver requests the Court enter the Sale Order, providing that the equity of redemption afforded to Debtor shall be fully enforceable until entry of the

Confirmation Order; and that upon entry of the Confirmation Order, all rights of the Debtor in and to the property including any equity of redemption shall be finally and forever extinguished and that the Receiver's fee is earned in either case.

9. **Injunctions to prohibit creditors from gaining a superior position without justification.** In nearly every case, creditors attempt to improve their payment position by trying to get a judgement or other priming position to other unsecured creditors. This race to the courthouse can be eliminated by including in the Order Appointing something similar to the following: To facilitate this Court's jurisdiction and to protect the assets in its possession, it has long been held that other parties should not be permitted to interfere with a receiver's administration of the assets held *in custodia legis*. This concept dates back at least 164 years to English common law and the case of *Ames v Birkenhead Dock Trustees* (1855) 20 Beav 332 wherein Lord Romilly, Master of Rolls said "There is no question but that this court will not permit a receiver appointed by its authority, and who is therefore its officer, to be interfered with or dispossessed of the property he is directed to receive, by anyone, although the order appointing him may be perfectly erroneous; this court requires and insists that application should be made to the court, for permission to take possession of any property of which the receiver either has taken or is directed to take possession." Cited with approval by the U. S. Supreme Court in *Barton v. Barbour*, 104 U.S. 126, 129 (U.S. 1881). This Court has authority to issue blanket injunctive relief that is binding on both parties and non-parties as part of this Court's equitable jurisdiction over the assets in this receivership. The recent case of *Liberte Capital Group, LLC v. Capwill*, 462 F.3d 543 (6th Cir. 2006) addressed and specifically approved a blanket injunction binding on both parties and non-parties beginning at page 551:

> Once assets are placed in receivership, a district court's equitable purpose demands that the court be able to exercise control over claims brought against those assets. The receivership court has a valid interest in both the value of the claims themselves and the costs of defending any suit as a drain on receivership assets. *See SEC v. Universal Fin.*, 760 F.2d 1034, 1038 (9th Cir.1985). To this extent, the receivership court may issue a blanket injunction, staying litigation against the named receiver and the entities under his control unless leave of that court is first obtained. *See Barton v. Barbour,* 104 U.S. 126, 128, 26 L.Ed. 672 (1881) ("It is a general rule that before suit is brought against a receiver leave of the court by which he was appointed must be obtained.") This power extends to the institution of any suit, and not just a proceeding for execution of a judgment against the receivership in the receivership court. *Id.* at 129, 104 U.S. 126. ("We think, therefore, that it is immaterial whether the suit is brought against [the receiver] to recover specific property or to *552 obtain judgment for a money demand. In either case leave should first be obtained.") Because the court's power of injunction in a receivership proceeding arises from its power over the assets in question, non-parties to the underlying litigation may be bound by a blanket stay, so long as the non-parties have notice of the injunction. *See Bien v. Robinson,* 208 U.S. 423, 427, 28 S.Ct. 379, 52 L.Ed. 556 (1908) (finding "frivolous" the contention that a non-party would not be bound by the court's injunction against claims against a receivership under the court's control); *see also SEC v. Wencke,* 622 F.2d 1363, 1371 (9th Cir.1980) (finding the district court's equitable powers over the property in receivership sufficient to justify a blanket stay against litigation without leave of the court, even against non-parties).
>
> The appointment of a Receiver constitutes an implied injunction against any interference with property in the custody of the Receiver. *See Moller v. Herring*, 255 F. 670, 670 (5th Cir. 1919). *see also State ex rel Ketchum v. District Court of Tulsa County*, 198 P. 480, 482-483 (Okla. 1921);

It is important to note the injunctive relief in the Order Appointing Receiver is not granted under the statutory requirements related to temporary restraining orders under 12 O.S. § 1384.1. The injunctive relief granted by this Court does not implicate that statute because the injunctive relief was granted in aid of the Receiver's appointment to protect the estate's property that this Court now holds in *custodia legis*, not in connection with a suit between two private litigants. The Oklahoma Supreme Court specifically recognized this difference in Witt v. Jones, 1925 OK 149, 106 Okla. 227, 233 P. 722, 724:

> The remedy of the [tax collector] in such case should be sought by intervention in the suit in which the receiver was appointed, and that court may properly enjoin him from levying upon the property, and has undoubted jurisdiction to punish him for contempt in violating such injunction. And in such case a receiver may have an injunction to restrain the collection of a tax, although there are present none of the grounds of equitable jurisdiction, as where the property seized is personalty and could accordingly be recovered in an action at law. And the rule under discussion is not confined in its application to the federal courts, but has been recognized and followed by the state courts.

10. Subpoena power can be granted in the Order Appointing Receiver and should be, to facilitate the discovery process. This concept allows the Receiver to find assets and marshal them. It also inspires parties that are reluctant to either divulge or turn over data to do so to avoid being held in contempt of Court or have the Court's protection in the event other parties do not want them to divulge information.

11. The ability to bridge operating licenses can be granted in the Order Appointing Receiver. There are times that it is critical for the ongoing operation of the Receivership Estate business to be able to operate with licenses that are held by the company. This dictates that the Receivership be granted over the entity, not just the assets. Examples:

In the healthcare field, without the preservation of the license, the facility has to close and sometimes lose a competitive funding advantage from CMS who pays Medicare and Medicaid. Also, the certificate of need was awarded by the State Department of Health and without it, no new patients or residents can be on-boarded.

In most states where individuals or companies are in the business of selling alcoholic beverages, whether in a package store or in a bar/restaurant, there is a license required to operate.

Without the instant preservation of the license, the business closes and the going concern value lost.

12. The assets can be marshalled immediately. The Order Appointing Receiver should include provisions where anyone who is currently holding any assets of any kind (or the proceeds of the sale of the assets) should turn them over to the Receiver and those assets will become a part of the Receivership Estate. The Receiver can analyze the assets and then choose to keep them or reject them, based upon the business judgment rule.

a) **Assets of the Receivership Estate are held in Custodia Legis.** Once a Receiver is appointed, all property in the possession of the debtor passes into the custody of the Receivership court, and becomes subject to its authority and control. In the exercise of its jurisdiction over the debtor's property, the court has power to issue injunctions and all other writs necessary to protect the estate from interference and to ensure its orderly administration. *Eller Indus., Inc. v. Indian Motorcycle Mfg., Inc.,* 929 F. Supp. 369, 372 (D. Colo. 1995).

The concepts of Receiver's holding property in custodia legis and the issuance of injunctions to protect such property to facilitate its administration by a duly appointed Receiver have long been recognized by Oklahoma Courts. See U.S. Nat. Bank v. National Bank of Guthrie, 51 P. 119, 136 -137 (Okla.Terr. 1897) and Stanolind Crude Oil Purchasing Co. v. Busey, 90 P.2d 876, 880 (Okla. 1939). These concepts are essential to protect the Receiver and the related exclusive jurisdiction of the Court appointing the Receiver. See State, ex rel, Ketchum v. District Court of Tulsa County, 198 P. 480, 482 -483 (Okla. 1921), wherein the Oklahoma Supreme Court adopted the reasoning and rule of law laid down by the Circuit Court of Appeals of the Eighth Circuit in the case of Merritt et al. v. American Steel Barge Co., 79 F. 228(8th Cir. 1897) that "when suits are brought to enforce liens against specific property, to

marshal assets, administer trusts, or liquidate insolvent estates, and in all other suits of a similar nature, where, in the progress of the litigation, the court may be compelled to assume the possession and control of specific personal or real property. In cases of the latter kind, the rule is that the tribunal which first acquires jurisdiction of the cause by the issuance and service of process is entitled to retain it to the end, without interference or hindrance on the part of any other court. And this rule, in its application to federal and state courts, being the outgrowth of necessity, is 'a principle of right and of law' which leaves nothing to the discretion of a court, and may not be varied to suit the convenience of the litigants. Gates v. Bucki, 12 U. S. 69, 4 C. C. A. 116, and 53 Fed. 961; Chittenden v. Brewster, 2 Wall. 191; Orton v. Smith, 18 How. 263, 265; Union Trust Co. v. Rockford, R. I. & L. R. Co., 6 Biss. 197, 24 Fed. Cas. 704; Owens v. Railroad Co., 20 Fed. 10; Union Mut. Life Ins. Co. v. University of Chicago, 6 Fed. 443".

13. Forced cooperation by Defendant/Debtors.

i. We include in the Order Appointing Receiver the following paragraph: In the event that any parties to this action or any entities owned by the Defendants, either individually or collectively, have assets in their possession or have transferred assets that may be or was property of the Estate, the parties shall identify those assets and at the Receiver's discretion, turn the assets over to the Receiver for further disposition. All such property shall be included in the Estate.

14. Forced cooperation by creditors (including injunctive relief).

i. We put in our Orders Appointing Receiver the following paragraph: In order to promote judicial efficiency, all persons who receive actual or constructive notice of this Order are enjoined in any way from disturbing or in any way interfering with the Receiver's administration of the Estate or from prosecuting any new proceedings (including collection or enforcement proceedings) that involve the

Receiver or the Estate unless such person or persons first obtain the permission of this Court or the Receiver. All parties to this case and any other entity given notice of this order are hereby enjoined from any and all of the following:

a) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the Assets, the Estate or the Receiver that was or could have been commenced before the entry of this Order or to recover a claim against the Assets, the Estate or the Receiver that arose before the entry of this Order;

b) any act to obtain possession of or to exercise control over the Estate or any property thereof;

c) any act to create, perfect, or enforce any lien against the Estate or any property thereof;

d) any act to create, perfect, or enforce against the Estate or any property thereof any lien to the extent that such lien secures a claim that arose before the entry of this Order;

e) any act to collect, assess, or recover a claim against the Assets, the Estate or any property thereof, or the Receiver, that arose before the entry of this Order; or

f) the setoff of any debt related to the Assets that arose before the entry of this Order against any claim against the Assets, the Estate or any property thereof or the Receiver.

15. Forced cooperation by outsiders. We put the following paragraph in the Order Appointing Receiver: The parties and all other persons or entities served with a copy of this order shall cooperate fully with and assist the Receiver in the performance of his duties subject to a party's appropriate assertion of the Fifth Amendment privilege against self-incrimination, and

other appropriate assertion of any other privilege or right. This cooperation and assistance shall include, but not be limited to, the turnover of any and all Assets, providing any information to the Receiver that the Receiver deems necessary to exercising the authority and discharging the responsibilities of the Receiver under this order; providing any password required to access any computer or electronic files in any medium; turning over any assets (cash or other tangible assets); and advising all persons who owe money to Defendants resulting from Defendants' ownership of the Assets that all such debts should be paid directly to the Receiver.

16. The ability to put the entity into either a Chapter 7 or 11 if circumstances warrant. There are instances that the ability to invoke the powers of the Receivership in other jurisdictions are cumbersome and it is more efficient to use the bankruptcy court to facilitate the process.

Likewise, the Receiver should typically be the only one who can file a bankruptcy case after they have been appointed. If the debtor wants to avoid a receivership, then they should file the bankruptcy case before the entry of the Order Appointing Receiver. It is recommended the Order Appointing Receiver have language similar to the following:

> The Receiver is empowered to file a voluntary petition for relief pursuant to 11 U.S.C. § 301 et seq., if such is deemed appropriate in the sole discretion of Receiver in the exercise of his business judgment. The officers, directors, managers, members, and/or shareholders are specifically enjoined from taking any action inconsistent with the terms of this Order and from authorizing any action by the Company inconsistent with the by-laws or operating agreement as of the entry of this Order. The Receiver, and no one else, shall be vested with the sole and exclusive power and authority to file and maintain a voluntary bankruptcy petition under the United States Bankruptcy Code, Title 11 U.S.C. § 101, et seq.

17. The ability to issue Receiver's Certificates (Court approved loans). There is the ability, with the Court's approval, where a Receiver can borrow money for the operation of the

assets that becomes a super priority obligation and a priming lien similar to § 364 of the Federal Bankruptcy Code.

18. Cost. It is my experience that the cost is substantially less in state court receiverships. The elimination of many of the procedural processes, the types of pleadings, the flexibility of the Receiver versus the trustee or the Debtor in Possession saves money. The lack of mandatory reporting such as the voluminous Monthly Operating Reports saves manpower, which equates to money. The reporting is done on a request basis, typically. The elimination of the first day motions and orders and other basic pleadings also saves time and money. When it comes to a plan, in Receiverships it is done with the sale to a third party or back to the original equity holders and there are no disclosure statements or formal plans, just the sale motions and orders, which are substantially shorter, but still inclusive.

19. Speed.

a) Sales can be done and closed in 75 days.
b) Discovery can be accelerated.
c) Usually the dockets are processed faster.

20. Similar result as a foreclosure, just faster.

a) Free and Clear.
b) With notice and opportunity, the buyer can be in title inside of 75 days.
c) Insurable title.

21. Avoidance of environmental liability for the Plaintiff.

a) One of the biggest fears from a Plaintiff's standpoint is that they could become a 'responsible party' for liabilities that are discovered in the future and that is eliminated because they do not take the asset in title.

b) The Receiver can do the clean-up without incurring any liability. Another utilization of the Judicial Immunity protection awarded to the Receiver.

22. Multi-state jurisdiction is possible by domesticating the case. This can be done by:

a) Filing a separate action in the affected state.

i. This is a short pleading and only deals with the specific assets that need attention in that jurisdiction.

ii. Requesting that the new court take judicial notice of the base case with an emphasis on what is being requested in the new jurisdiction.

b) Or, filing the case in Federal District Court if there is the appropriate jurisdictional predicate, typically diversity under 28 U.S.C. § 1332(a).

23. Appointment of a receiver in Federal Court is not accomplished under any Oklahoma Law, but rather under Federal Common Law. Federal Rule of Civil Procedure 66 and federal common law support the appointment of a receiver in Federal Court cases. For example, the 11th Circuit Court of Appeals opined in the case of National Partnership Inv. Corp. v. National Housing Development Corp., 153 F.3d 1289 (11th Cir. 1998) at pages 1291-1292:

As the First Circuit noted in *Chase Manhattan Bank, N.A. v. Turabo Shopping Center, Inc.*, 683 F.2d 25, 26 (1st Cir. 1982), "[m]ost federal court decisions dealing with the appointment of a receiver pendente lite appear to apply federal law without discussion." Of those circuits that have directly addressed the issue, each has held that the appointment of a receiver in a diversity action is governed by federal law. See *Aviation Supply Corp. v. R.S.B.I. Aerospace,*

Inc., 999 F.2d 314, 316 (8th Cir. 1993); Turabo, 683 F.2d at 26; see also *Resolution Trust Corp. v. Fountain Circle Assocs. Ltd. Partnership*, 799 F.Supp. 48, 50 (N.D.Ohio 1992); *New York Life Ins. Co. v. Watt West Inv. Corp.*, 755 F.Supp. 287, 289-90 (E.D.Cal.1991). Commentators generally approve of the conclusion reached by these courts. See 12 Charles Alan Wright et al., Federal Practice and Procedure § 2983, at 33-35 (2d ed.1997); 13 James Wm. Moore et al., Moore's Federal Practice ¶ 66.09 (3d ed.1998).

The conclusion that federal law governs the appointment of receivers is based on several considerations. First and foremost, the appointment of a receiver in equity is not a substantive right; rather, it is an ancillary remedy which does not affect the ultimate outcome of the action. *Pusey & Jones Co. v. Hanssen*, 261 U.S. 491, 497, 43 S.Ct. 454, 456, 67 L.Ed. 763 (1923). The conclusion that federal law governs the appointment of a receiver thus does not conflict with the Erie doctrine's requirement that state law apply to matters of substance. *New York Life*, 755 F.Supp. at 291, 12 Wright § 2983, at 34; 13 Moore ¶ 66.09; see also *Skelly Oil Co. v. Phillips Petroleum Co.*, 339 U.S. 667, 674, 70 S.Ct. 876, 880, 94 L.Ed. 1194 (1950) (noting that, in a diversity case, a declaratory remedy may be given by a federal court even if that remedy is unavailable in state court); *Guaranty Trust Co. of New York v. York*, 326 U.S. 99, 65 S.Ct. 1464, 89 L.Ed. 2079 (1945) (stating that the equity power of a federal court exercising diversity jurisdiction cannot be equated with state law under the Erie doctrine).

Second, Federal Rule of Civil Procedure 66 and the accompanying Advisory Committee's Note assert the primacy of federal law in the practice of federal receiverships. *New York Life*, 755 F.Supp. at 289-90, 12 Wright § 2983, at 35. Thus, to the extent Rule 66 dictates what principles should be applied to federal receiverships, courts must comply with the Rule even in the face of differing state law. See *Hanna v. Plumer*, 380 U.S. 460, 471, 85 S.Ct. 1136,

1144, 14 L.Ed.2d 8 (1965) (stating that in a diversity case, "[w]hen a situation is covered by one of the Federal Rules, ... the court has been instructed to apply the Federal Rule, and can refuse to do so only if the Advisory Committee, this Court, and Congress erred in their prima facie judgment that the Rule in question transgresses neither the terms of the Enabling Act nor constitutional restrictions."); see also 12 Wright § 2983, at 34 (stating that the conclusion that federal law governs the appointment of a receiver is consistent with Hanna). [footnotes omitted]

See also, *Am. Bank & Trust Co. v. Bond Int'l Ltd.*, No. 06-CV-0317-CVE-FMH, 2006 WL 2385309, at *7 (N.D. Okla. Aug. 17, 2006) (accord).

The decision to appoint a receiver is within the sound discretion of the Federal District Court as discussed by the 5th Circuit Court of Appeals in the case of *Santibanez v. Wier McMahon & Co.*, 105 F.3d 234 (5th Cir. 1997) at page 241:

Moreover, the District Court had the power to appoint a receiver to take possession of the judgment debtor's property for preservation under Federal Rule of Civil Procedure 66. Under that rule, the appointment of a receiver can be sought "by anyone showing an interest in certain property or a relation to the party in control or ownership thereof such as to justify conservation of the property by a court officer." 7 Moore et al., ¶ 66.05[1]. The appointment is in the sound discretion of the court. Id. Similarly, "the form and quantum of evidence required on a motion requesting the appointment of a receiver is a matter of judicial discretion." 12 Charles A. Wright & Arthur R. Miller, Federal Practice and Procedure § 2983 (1973)(citing authorities). Courts have held that receivers may be appointed "to preserve property pending final determination of its distribution in supplementary proceedings in aid of execution." 7 Moore et al., ¶ 66.05 [1] (citing *Haase v. Chapman*, 308 F.Supp. 399 (W.D.Mo.1969)).

There is no statutory rule setting forth the basis or grounds for appointment of a Receiver, rather reported decisions refer to various factors that this Court should consider. For example, the 1st Circuit Court Appeals in the case of Consolidated Rail Corp. v. Fore River Ry. Co., 861 F.2d 322 (1st Cir. 1988) beginning at page 326 noted:

> Courts have recognized many factors that are relevant for a court to consider when determining the appropriateness of the appointment of a receiver. These include fraudulent conduct on the part of the defendant, see *Burnrite Coal Briquette Co. v. Riggs*, 274 U.S. 208, 212, 47 S.Ct. 578, 579, 71 L.Ed. 1002 (1927); imminent danger that property will be lost *327 or squandered, see *Gordon v. Washington*, 295 U.S. 30, 37-39, 55 S.Ct. 584, 588-89, 79 L.Ed. 1282 (1935); *Garden Homes, Inc. v. United States*, 200 F.2d 299, 301 (1st Cir.1952); the inadequacy of available legal remedies, see *Leighton v. One William Street Fund, Inc.*, 343 F.2d 565, 568 (2d Cir.1965); the probability that harm to the plaintiff by denial of the appointment would be greater than the injury to the parties opposing appointment, see *Mintzer*, 263 F.2d at 825; the plaintiff's probable success in the action and the possibility of irreparable injury to his interests in the property, see *Bookout v. First Nat'l Mortgage & Discount Co.*, 514 F.2d 757, 758 (5th Cir.1975); and whether the interests of the plaintiff and others sought to be protected will in fact be well served by the receivership, see *Commodity Futures*, 481 F.Supp. at 441.

In the case of a mortgage foreclosure, the 2nd Circuit Court of Appeals opined in *Citibank, N.A. v. Nyland (CF8) Ltd.*, 839 F.2d 93 (2d Cir. 1988) at page 97:

We agree with appellants' contention that the appointment of a receiver is not automatic under the mortgage agreement, that "the appointment of a receiver is considered to be an extraordinary remedy", and that the remedy should be employed cautiously and granted only when clearly necessary to protect plaintiff's interests in the property. *Chambers v. Blickle Ford Sales, Inc.*, 313 F.2d 252, 260 (2d Cir.1963). We believe that Citibank made an adequate showing that allowing New York Land to have a continuing role in managing the building would be harmful to the premises' marketability. This harm to its marketability would also reduce the value of the security represented by Citibank's mortgage.

Furthermore, the mortgage agreement between Citibank and Nyland provides that upon the occurrence of any event of default (as explained in the mortgage), Citibank may apply for the appointment of a receiver. Given that it is undisputed that several events of default had occurred, we believe that this provision strongly supports the appointment of a receiver. See New York Real Property Law § 254(10); *Meyer v. Indian Hill Farm, Inc.*, 258 F.2d 287, 293-94 (2d Cir.1958); Febbraro v. Febbraro, 70 A.D.2d 584, 585, 416 N.Y.S.2d 59 (2d Dep't 1979). It is entirely appropriate for a mortgage holder to seek the appointment of a receiver where the mortgage authorizes such appointment, and the mortgagee has repeatedly defaulted on conditions of the mortgage which constitute one or more events of default. See, e.g., *Mancuso v. Kambourelis*, 72 A.D.2d 636, 637, 421 N.Y.S.2d 130, 131 (3d Dep't 1979); *Febbraro v. Febbraro*, supra; *Home Title Insurance Co. v. Isaac Scherman Holding Corp.*, 240 A.D. 851, 267 N.Y.S. 84, 85 (2d Dep't 1933).

24. Operation of a business is flexible.

a) Initially it is better to leave the existing folks in place to maintain continuity. Most of the staff people need and want their jobs and the upper management is not important to the day-to-day operations.

b) However, replace whomever (including the owners) if they cannot be trusted.

25. Tasks that should be granted in the Order Appointing Receiver:

a) Forensic Accounting to determine where the money went.

b) GAAP conversion of the existing accounting to allow all stakeholders to be able to compare the business to some level of standards that would be more

easily defined. Caution is warranted if the historical accounting was done consistently on a tax basis.

c) Valuation of the business or the assets. This is not typically as detailed as an appraisal and is much less costly.

d) Going Concern Analysis should be done superficially in the early stages and then in more depth once the case has progressed and the Receiver has a better handle on the business.

26. Fees and expenses are a super priority and there is a specific lien issued at appointment that extends beyond the life of the case. Without this provision, it is suspect that anyone would want to be appointed. It is important for a Receiver to do a superficial analysis of the assets to determine if they are going to get paid. There are circumstances where one takes a Receivership to assist the Court or the citizens of the community. Those should be considered carefully.

The imposition and validity of the Receiver's Lien in the Order Appointing Receiver is merely a recognition of long standing receivership jurisprudence that payments to a receiver for the administration of a receivership are "mere incidents to the judicial administration of a fund" created by the receiver's administration of the property held *in custodia legis*. *The Poznan*, 274 U.S. 117, 121, 47 S. Ct. 482, 484, 71 L. Ed. 955 (1927). The Receiver's "expenses which have contributed either to the preservation or creation of the fund in its custody shall be paid before a general distribution among those entitled to receive it." *The Poznan*, supra. "The weight of authority appears to support the view that it is within the power of a state court, under a case such as sub judice, to determine and fix the compensation of its receivers and their counsel,

expenses, and disbursements incident to the administration of the insolvent estate, and also obligations incident to the conduct of a going business of the insolvent defendant assumed or contracted under appropriate order of the court therefor. It has been so held in *Singer v. National Bedstead Mfg. Co.*, 65 N. J. Eq. 290, 55 A. 868; *Kennedy v. American Tanning Co.*, 81 N. J. Eq. 109, 85 A. 812, 813; *Cudahy Packing Co. v. N. J. Dairy Products Co.*, supra; *Cavagnaro v. Indian Tire & Rubber Co.*, 90 N. J. Eq. 532, 538, 107 A. 643; *Mauran v. Carpet Lining Co.*, 23 R. I. 344, 50 A. 387; *Shachat v. Standard Auto Supply Co.*, 106 N. J. Eq. 105, 150 A. 183, and cases cited; *In re Watts & Sachs*, 190 U. S. 1, 23 S. Ct. 718, 47 L. Ed. 933, and *Colton v. Bankshares Corporation of the United States*, 108 N. J. Eq. 417, 155 A. 471; High on Receivers (4th Ed.) p. 938, Sec. 796b." *Perfection Garment Co. v. Crosby Stores*, 109 N.J. Eq. 450, 457–59, 158 A. 380, 383–84 (Ch. 1932). All of the authorities cited above are in accord with the seminal case from the United States Supreme Court establishing that general principle that an estate, such as the receivership estate in this case, must bear the expenses of its administration. *Internal Imp. Fund Trustees v. Greenough*, 105 U.S. 527, 532, 26 L. Ed. 1157 (1881). Indeed, the Oklahoma Supreme Court recognized this principal in *Oklahoma Tax Comm'n v. Ricks*, 1994 OK 115, 885 P.2d 1336, 1340, "The conceptual underpinnings for the chancery common-fund doctrine teach us that an equitable charge may be impressed in favor of its creator *when the fund is within the direct control of the court."* (Citing *Trustees v. Greenough*, with approval.) [Footnotes omitted.]. There is no question the Receiver's Lien and its priority over the alleged liens of the Objectors as set forth in the Receiver Order are valid as a matter of law. The fact that the alleged liens of the Objectors are prior in time to the Receiver Order is of no consequence. Indeed, the Objectors cite no authority to the contrary.

"Expenditures incurred by a receiver with the express or implied consent of lienholders may be paid ahead of the liens." *Colorado Wool Mktg. Ass'n v. Monaghan*, 66 F.2d 313, 315 (10th Cir. 1933) citing two cases by the United States Supreme Court *Kneeland v. Am. Loan & Trust Co.*, 136 U.S. 89, 10 S. Ct. 950, 34 L. Ed. 379 (1890) and *Union Trust Co. of N.Y. v. Souther*, 107 U.S. 591, 593, 2 S. Ct. 295, 296–97, 27 L. Ed. 488 (1883). In the case of *Union Trust Co. of N.Y. v. Souther*, the United States Supreme Court opined that it had "no doubt" that when a court of chancery is asked to appoint a receiver that "the court, in the exercise of a sound judicial discretion, may, as a condition of issuing the necessary order, impose such terms in reference to the payment from the income during the receivership." There is no question that the Receiver's Lien is a valid, first priority lien upon the Assets. Consequently, the Receiver's Lien has priority over all of the liens asserted by the Objectors as a matter of law.

If there were any doubt as to the efficacy of the Receiver Order in priming the liens of the Objectors, the Oklahoma Supreme Court has adopted these principals of receivership jurisprudence set forth above in the case of *Sinopoulo v. Portman*, 1943 OK 90, 192 Okla. 558, 137 P.2d 943, 947–48[1]:

When a court exercising jurisdiction in equity appoints a receiver of all the property of a corporation, the court assumes the administration of the estate; the possession of the receiver is the possession of the court; and the court itself holds and administers the estate through the receiver as its officer for the benefit of those whom the court shall ultimately adjudge to be entitled to it. *Atlantic Trust Co. v. Chapman*, 208 U.S. 360, 28 S.Ct. 406, 52 L.Ed. 528, 13

[1] Cited with approval: INA Life Ins. Co. v. Brandywine Assocs., Ltd., 1990 OK CIV APP 86, 800 P.2d 1073, 1078; State ex rel. Weatherford v. Senior Sec. Life Ins. Co., 1996 OK CIV APP 32, 916 P.2d 288, 290; and Miller v. Leadership Hous. Sys., Inc., 57 Haw. 321, 328, 555 P.2d 864, 869 (1976).

Ann.Cas. 1155. The receiver is an arm of the court. Expenditures incurred by the court during a receivership are in reality costs of administration. They constitute expenditures which are necessary to enable the court to exercise its jurisdiction. *Malm v. Home Riverside Coal Mines Co.*, 152 Kan. 419, 103 P.2d 798.

Even in cases of private corporations where lienholders either expressly or impliedly consent to a receivership of the property over which they hold a lien, and the receivership benefits their property, either by preserving it or realizing it or otherwise, then such lienholders may have to bear their portion of the costs and expenses of the receivership. Clark on Receivers, § 641, p. 879. To the same effect, see the following cases: *Title Ins. & Trust Co. v. California Development Co. et al.*, 171 Cal. 227, 152 P. 564; *Bailey v. Bailey et al.*, 262 Mich. 215, 247 N.W. 160; *Stacey et al. v. McNicholas et al.*, 76 Or. 167, 144 P. 96, 148 P. 67; *Westinghouse Elec. Mfg. Co. v. Barre & Montpelier Traction & Power Co., et al.*, 98 Vt. 130, 126 A. 594; *Bliss et al. v. Linden Cemetery Ass'n, et al.*, 90 N.J.Eq. 404, 107 A. 594; *Standard Oil Co. of New York v. Nashua St. Ry.*, 88 N.H. 342, 189 A. 166; *Turner et al. v. State Wharf & Storage Co.*, 263 Mass. 92, 160 N.E. 542; *C. H. Sprague & Son, Inc. v. Price Hill Colliery Co. et al.*, W.Va., 10 S.E.2d 574; *Harrison Improvement Co. v. Guardian Trust Co. of New Jersey*, 106 N.J.Eq. 445, 151 A. 103; Annotation at 40 A.L.R. 244.

27. Privileged communications. The Receiver should have a provision in the Order Appointing Receiver that allows them privileged communications with all lawyers in the case and their staff. This inclusion usually improves the potential for settlement, since all parties can tell the Receiver the truth and not just the specific side's wants and desires. We have had at least one case where it was argued that the Fiduciary Exception to Attorney-Client Privilege recognized in most Courts as applying to an ERISA fiduciary, also applied to the Attorney for

the Receiver. In order avoid this fight, put it in the Order.

28. Corporate Governance. The ability to remove the board of directors and appoint someone else or himself can be done if the Receiver is appointed over the entity. This eliminates the capacity for the Defendant to attempt to put the entity into a Chapter proceeding or do other things that will throw a wrench in the gears of the operation of the business.

29. Acceptance usually requires an education.

a) Many Judges do not understand the process and the scope, so it is important to give the Court enough ammunition to be able to grant the request for the appointment. Once they have appointed a Receiver and it goes smoothly, the subsequent requests are much easier.

b) Many lawyers don't understand how a Receivership benefits their client and their case. On the other hand, the defendant/debtor that does understand will resist, because their client does not want to be exposed to the light of day that the Receivership invokes.

A question that has come up and I have not done appropriate research to deal with is: Can a Receiver create a procedure that would allow for the cram down of secured creditors similar to USC §1129 of the bankruptcy code? The answer appears to be NO.

The powers and opportunities of a Receivership can be used by insolvency professionals to benefit their clients and the Courts. This saves time and money for both the Courts and the creditors. Hopefully, the foregoing provides some support for you to use when appropriate.

12 Oklahoma Statutes

A receiver may be appointed by a Judge of the Supreme Court or a district court judge:

1551. A receiver may be appointed by a Judge of the Supreme Court or a district court judge:

1. In an action by a vendor to vacate a fraudulent purchase of property, or by a creditor to subject any property or fund to his claim, or between partners or others jointly owning or interested in any property or fund, on the application of the plaintiff, or of any party whose right to or interest in the property or fund, or the proceeds thereof, is probable, and where it is shown that the property or fund is in danger of being lost, removed or materially injured.

2. In an action by a mortgagee for the foreclosure of his mortgage and sale of the mortgaged property or in connection with a mortgagee foreclosing his mortgage by power of sale under the Oklahoma Power of Sale Mortgage Foreclosure Act:

a. where it appears that the mortgaged property is in danger of being lost, removed or materially injured, or

b. that a condition of the mortgage has not been performed, and that the property is probably insufficient to discharge the mortgage debt, or

c. that a condition of the mortgage has not been performed and the mortgage instrument provides for the appointment of a receiver.

3. After judgment, to carry the judgment into effect.

4. After judgment, to dispose of the property according to the judgment, or to preserve it during the pendency of an appeal, or in proceeding in aid of execution, when an execution has been returned unsatisfied, or when the judgment debtor refuses to apply his property in satisfaction of the judgment.

5. In the cases provided in this Code, and by special statutes, when a corporation has been dissolved, or is insolvent, or in imminent danger of insolvency, or has forfeited its corporate rights.

6. In all other cases where receivers have heretofore been appointed by the usages of the courts of equity.

1552. No party, or attorney, or person interested in an action, shall be appointed receiver therein except by consent of all parties thereto.

1553. Before entering upon his duties, the receiver must be sworn to perform them faithfully, and with one or more sureties, approved by the court or judge; execute an undertaking to such person and in such sum as the court or judge shall direct, to the effect that he will faithfully discharge the duties of receiver in the action, and obey the orders of the court therein.

1554. The receiver has, under the control of the court, power to bring and defend actions in his own name, as receiver; to take and keep possession of the property, to receive rents, to collect debts, to compound for and compromise the same, to make transfers, and generally to do such acts respecting the property as the courts may authorize.

1555. Funds in the hands of a receiver may be invested upon interest, by order of the court; but no such order shall be made, except upon the consent of all the parties to the action.

1556. When it is admitted, by the pleading or oral examination of a party, that he has in his possession or under his control any money or other thing capable of delivery, which, being the subject of litigation, is held by him as trustee for another party, or which belongs or is due to another party, the court may order the same to be deposited in court or delivered to such party, with or without security, subject to the further direction of the court.

1557. Whenever, in the exercise of its authority, a court shall have ordered the deposit or delivery of money or other thing, and the order is disobeyed, the court, besides punishing the disobedience as for

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contempt, may make an order requiring the sheriff to take the money, or thing, and deposit or deliver it, in conformity with the direction of the court.

1558. Repealed by Laws 1970, HB 1743, c. 289, § 3, emerg. eff. July 1, 1970

1559. In all cases in the Supreme Court in which a receiver has been appointed, or refused, by any Justice of the Supreme Court, the party aggrieved may, within ten (10) days thereafter have the right to file a motion to vacate the order refusing or appointing such receiver, and hearing on such motion may be had before the Supreme Court, if the same be in session, or before a quorum of the Justices of said Court in vacation, at such time and place as the said Court or the Justices thereof may determine, and pending the final determination of the cause, if the order was one of the appointment of a receiver, the moving party shall have the right to give bond with good and sufficient sureties, and in such amount as may be fixed by order of the Court or a Justice thereof, conditioned for the due prosecution of such cause, and the payment of all costs and damages that may accrue to the state, or any officer, or person by reason thereof, and the authority of any such receiver shall be suspended pending a final determination of such cause, and if such receiver shall have taken possession of any property in controversy in said action, the same shall be surrendered to the rightful owner thereof, upon the filing and approval of said bond.

1560. A. In the event that a licensed medical marijuana dispensary, commercial grower or processor is foreclosed, is the subject of an order appointing a receiver, becomes insolvent, bankrupt or otherwise ceases operations, a secured party or receiver may continue operations at the dispensary, grower or processor upon submitting to the Oklahoma Medical Marijuana Authority, State Department of Health, proof that the secured party or receiver, or if the secured party or receiver is a business entity, any individual who has a financial interest in the secured party or receiver, meets the requirements and restrictions set forth in:

1. For licensed medical marijuana dispensaries, Section 421 of Title 63 of the Oklahoma Statutes;

2. For licensed commercial medical marijuana growers, Section 422 of Title 63 of the Oklahoma Statutes; or

3. For licensed medical marijuana processors, Section 423 of Title 63 of the Oklahoma Statutes.

The Authority may prescribe the form and manner of submitting proof under this subsection. Neither the state nor agency of this state shall require an additional fee from the secured party or receiver, other than payment of annual fees which may become due during the operation by the secured party or receiver.

B. Subject to the requirements of subsection A of this section, the Oklahoma Medical Marijuana Authority, State Department of Health, shall promulgate rules for the manner and conditions under which:

1. Marijuana items left by a deceased, insolvent or bankrupt person or licensee, or subject to a security interest or a court order appointing a receiver, may be foreclosed, sold under execution or otherwise disposed whether by foreclosure or by sale as a going concern;

2. The business of a licensee who is deceased, insolvent, bankrupt, or the subject of an order appointing receiver or a foreclosure by a secured party, may be operated for a reasonable period following the death, insolvency, appointment of a receiver or bankruptcy; and

3. A secured party or court-appointed receiver may continue to operate a business for which a license has been issued under Section 421, 422 or 423 of Title 63 of the Oklahoma Statutes for a reasonable period after default on the indebtedness by the debtor or after the appointment of the receiver.

Mayhem – When an Individual Member
of a Limited Liability Company Files Bankruptcy

As the name implies, a limited liability company is generally created for asset protection, and to limit the liability of its members from the debts and obligations of the limited liability company. Likewise, members of a limited liability company want to prevent interference from a member's creditors as to the company's governance and operations, and especially liquidation of its assets to satisfy individual debts of a member. Public policy principles weave their way through the unique relations among members of a limited liability company, such as:

- Recognition of the unique relationship that exists among members of a limited liability company,

- Protection of solvent members from forced relationships they did not choose resulting from the bankruptcy of one of their members,

- Prevention of the sale of assets for the obligations of a member,

- Elimination of fear that members of a limited liability company may have of a bankruptcy trustee or an assignee of a bankruptcy trustee as a fellow member,

- Development of a charging order to prevent disruption of a limited liability company's business by a judgment creditor forcing an execution sale of the member's interest to satisfy a non-company debt,

- Specific provisions in operating agreements denying assignees of a membership interest any right to participate as a member in the limited liability company's governance, and

- Recognition of the economic harm that could result with having a bankruptcy trustee whose economic incentives are based upon liquidation which may be detrimental to the business venture as a whole and its other members.

The commencement of a bankruptcy case by a member of a limited liability company can create mayhem among the bankruptcy trustee, creditors, the debtor, the other members of a limited liability company, and the assets of a limited liability company. Bankruptcy courts have exercised powers over single member limited liability companies without using legal theories usually seen in state court litigation, such as alter ego, constructive trust and piercing the corporate veil. A limited liability company, and its other members and creditors may find it entangled with a bankruptcy trustee asserting economic and managerial rights, the bankruptcy trustee and creditors seeking sale of a limited liability company's assets, or imposition of the automatic stay as to a limited liability company's property. Many observers see these bankruptcy court decisions as statutory interpretation of the limited liability state statutes and operating agreements, while others have defined these decisions as judicial legislation. Nevertheless, when a single member of a limited liability company files bankruptcy, bankruptcy courts are rendering opinions that affect creditors, bankruptcy trustees, debtors, members of limited liability companies, and the assets of limited liability companies.

In Oklahoma, the membership interest is separated into two parts. One part of a membership interest is the economic interest or "capital interest" which entitles the owner to share only in the right to receive profits or a distribution from a limited liability company. A second part of the membership interest includes the governance or management interest which entitles the owner to vote and participate in the affairs

of a limited liability company. The Oklahoma Limited Liability Company Act (18 O.S. Section 2000 et seq.), defines a membership interest or interest as:

> A member's rights in the limited liability company, collectively, including the member's share of the profits and losses of the limited liability company, the right to receive distributions of the limited liability company's assets and capital interest, any right to vote or participate in management, and such other rights accorded to members under the articles of organization, operating agreement, or the Oklahoma Limited Liability Company Act.

18 O.S. Section 2001(15).

It is this membership interest that becomes property of the bankruptcy estate. Property of the estate is defined as "all legal and equitable interest of the debtor in property as of the commencement of the case." 11 U.S.C. Section 541(a)(1). Although federal law might determine what becomes property of the bankruptcy estate, it is clear that state law is used to determine the nature and extent of a debtor's interest in property. *Butner v. United States*, 440 U.S. 48, 55 (1979), the Tenth Circuit, in *Bailey v. Big Sky Motors, Ltd.*, 314 F.3d 1190, 1197 (10th Cir. 2002), and the Tenth Circuit Bankruptcy Appellate Panel in *In re Ogden*, 314 F.3d 1190, 1197 (10th Cir. BAP 2002). Therefore, it may depend on a state's statutes, the terms of an operating agreement, or a decision by the bankruptcy court, as to whether only the "capital interest", or both, the "capital" and governance interest, become property of the bankruptcy estate.

Oklahoma limited liability company statutes allow only the transfer of a member's "capital interest"; therefore, the bedlam a bankruptcy trustee could cause a limited liability company, or its members and assets should be limited. If only the "capital

interest" is transferrable when a member of a limited liability company files bankruptcy, a bankruptcy trustee would only be entitled to receive a distribution when made. The bankruptcy trustee would not have an interest in the assets of a limited liability company. The bankruptcy trustee would not have an interest in the management of a limited liability company.

A member's interest in an Oklahoma limited liability company is personal property and is defined as a "capital interest" under 18 O.S. Section 2032. This section also provides "A member has no interest in specific limited liability company property." But when a member is entitled to a distribution, "the member has the status of and is entitled to all remedies available to a creditor of the limited liability company with respect to the distribution." 18 O.S. Section 2029. Unless otherwise provided in an operating agreement, only a "capital interest" is transferrable which entitles the assignee to receive distributions without the right to participate in the management of a limited liability company. 18 O.S. Section 2033. The assignee of a "capital interest" in a limited liability company may become a member if the operating agreement provides or upon majority vote of the other members. Only when the assignee of a "capital interest" becomes a member of a limited liability company does the assigning member lose his management rights as a member. 18 O.S. Section 2035.

Ashley Albright was the sole member and manager of a Colorado limited liability company, Western Blue Sky, LLC when Albright filed for relief under Chapter 7. *In re Albright*, 291 BR. 538 (Bankr. D. Colo. 2003). Albright's bankruptcy trustee sought bankruptcy court authority to sell the real estate owned by Western Blue Sky

even though Western Blue Sky had not filed bankruptcy. The caption of the pleading filed by the bankruptcy trustee was "Motion to Allow Trustee to Take Any and All Necessary Actions to Liquidate Property owned by Western Blue Sky, LLC." The bankruptcy trustee claimed since Albright was the sole member and manager of Western Blue Sky, the bankruptcy trustee was now in control of the limited liability company. As bankruptcy trustee, he could cause Western Blue Sky to sell the real property, pay its creditors, and distribute the net proceeds to the creditors of Albright. Albright argued the bankruptcy trustee's rights in Western Blue Sky were limited to a charging order which would entitle the bankruptcy trustee to the profits and distributions of the limited liability company. Owning only an economic interest, the bankruptcy trustee could not manage Western Blue Sky nor cause the liquidation of its assets.

The bankruptcy court turned to the Colorado limited liability statutes and found:

- A membership interest constitutes the personal property of the member.
- Upon a member's bankruptcy, the membership interest became property of the estate and was transferred to the Trustee.
- Since there are no other members, the Trustee owns the entire membership.
- The Trustee has become a Substituted Member.
- The Colorado limited liability act requires the unanimous consent of other members to allow a "transferee" to participate in the management of a limited liability company.
- Because there are no other members, unanimous consent of the transfer of Albright's membership interest was not necessary; therefore, the Trustee obtained all rights of management.

- The intent of the charging order in Colorado's limited liability statutes was designed to protect other members of a limited liability company from having to involuntarily share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager.

- Because the Trustee became the sole member of a single member limited liability company, he has the power to elect and change managers; and sell the limited liability company's assets.

"A charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a single member liability company, because there are no other parties' interest affected," *Albright*, at 541. In footnote 7 of the opinion, the bankruptcy court in *Albright* commented it would render a different result if there were other non-debtor members of Western Blue Sky. In a multi-member limited liability company, the bankruptcy trustee would only be entitled to his share of the profits or other compensation by way of income and return of contributions.

A charging order is the lone remedy for collection in Oklahoma as to a member's interest in a limited liability company. Under Oklahoma law, "whether the limited liability company has one member or more than one member" the "sole and exclusive" remedy of a creditor who has a judgment against a member is a charging order against the member's "capital interest". 18 O.S. Section 2034. This statute even prohibits the conversion of a membership interest by court order through foreclosure or other action.

In a non bankruptcy setting, the Florida Supreme Court, in *Olmstead v. FTC*, 44 So.3d 76 (Fla. 2010), expanded the statutory "charging order" remedy in answering a certified question from the Eleventh Circuit Court of Appeals. The Florida Supreme Court held a court may order a judgment debtor to surrender all "right, title and interest" of his membership interest in his single member limited liability company to satisfy an outstanding judgment. At the time, Florida's "charging order" statute provided:

> On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the limited liability company membership interest of the member with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of such interest. This chapter does not deprive any member of the benefit of any exemption laws applicable to the member's interest.

Section 608.433(4), Fla. Stat. (2008).

In response to the *Olmstead* decision, the Florida legislature quickly amended Section 608.433 and later repealed it and replaced it with Section 604.0503 Fla. Stat. (2015). The current Florida statute provides that a "charging order" is the sole and exclusive remedy except in the case of a limited liability company having only one member. If a judgment creditor establishes certain factors, the court may order foreclosure and sale of the entire membership interest.

Albright has been cited to dismiss bankruptcy cases filed without proper authority, ignore charging order state statutes, determine that both the economic and management rights of a membership interest are property of the estate, resuscitate a

dissolved limited liability company, and allow a bankruptcy trustee to sell assets of the limited liability company.

In *In re A-Z Elecs, LLC*, 350 BR 886 (Bankr. D. Idaho 2006) the bankruptcy court dismissed a Chapter 11 petition because the single member and manager of the limited liability company did not have the authority to file the limited liability company's bankruptcy because he was a debtor in a pending Chapter 7 case. The membership interest was property of the Chapter 7 case; therefore, it was the bankruptcy trustee who owned the interest and had the rights as manager.

The court in *In re Modanlo*, 412 BR 715 (Bankr. D. Md. 2006) further expanded the bankruptcy trustee's powers. Nadar Modanlo's single member limited liability company dissolved upon his filing a Chapter 7 bankruptcy. However, the bankruptcy trustee "effectively resuscitated" the limited liability company because the bankruptcy court found that he possessed the management rights, not just an economic interest. In *Modanlo*, the individual debtor was the single member and manager of NYSI which owed a 65% equity and an 85% voting interest in FACS. The bankruptcy trustee wanted to hold a shareholder meeting for FACS and oust Modanlo so that the bankruptcy trustee could control a valuable asset of FACS. Modanlo argued since he filed for bankruptcy, NYSI was effectively dissolved and the only rights the bankruptcy trustee had in NYSI were economic rights and no rights of governance. When the bankruptcy trustee was appointed in the *Modanlo* Chapter 7 case, he amended NYSI's formation papers, undid its dissolution and filed a Chapter 11 for it. The bankruptcy court found that the bankruptcy trustee was the

personal/legal representative of the debtor and he effectively revived NYSI. The *Modanlo* Court found the decisional law interpreting limited liability company statutes that divest bankruptcy trustees of a limited liability company member's management rights are founded on notions that remaining members should not be forced to accept substituted performance by a member's bankruptcy trustee. Since Modanlo was the sole member of NYSI those policy issues did not exist. The court described the bankruptcy trustee stepping into the shoes of the debtor with both managerial and economic rights. *Modanlo* was affirmed by the 4th Circuit in 2008.

In *Fursman v. Ulrich*, 440 BR. 821 (9th Cir. BAP 2010), the Ninth Circuit Bankruptcy Appellate Panel affirmed the bankruptcy court's determination that a Chapter 11 debtor's post petition transfer of 50% of his membership interest in a limited liability company was a fraudulent transfer. The debtor claimed (i) no transfer was made, the limited liability company simply expanded the membership, and (ii) the Trustee had no right to participate in the management of the limited liability company because only the debtor's membership interest and resulting rights to profits and distribution became property of the estate. The BAP agreed with the outcome in *Albright*, but reached the same conclusion focusing on 11 U.S.C. Section 541 in holding that the membership interest was property of the estate, therefore, if the debtor had both economic and management rights, then the bankruptcy trustee possessed those same rights. Note: *Fursman* also is authority that the nature of an operating agreement is not an executory contract for the bankruptcy trustee to assume or reject

because the debtor's membership interests and contractual rights under the operating agreement became property of the estate.

In *Hagemeyer v. Peachy Adventures, LLC,* 2013 Lexis 5788 (Bankr. W.D. Tenn. 2013) the bankruptcy trustee was able to sell the debtor's motorhome and motorcycle owned by his limited liability company because the debtor's bankruptcy resulted in the single member limited liability company's dissolution. The court concluded the bankruptcy trustee was the only person who can now act on behalf of the limited liability company. In *In re Hopkins*, 2012 Bankr. Lexis 801 (Bankr. W.D. Mich. 2012), the bankruptcy court found the bankruptcy trustee did not have the authority to sell the real estate owned by the debtor's limited liability company because the property was not property of the estate. Nevertheless, the court authorized the trustee to cause the limited liability company to sell the property.

The bankruptcy court held in *In re Cleveland*, 519 B.R. 304 (D. Nev. 2014) the debtor's interests in limited liability companies were property of the bankruptcy estate, but the trustee had no right to sell or take ownership of any the companies' assets. The district court in *Cleveland* reversed the bankruptcy court's decision and found the bankruptcy trustee "has the right to sell or otherwise take ownership of any assets of Appellees' LLC," at 308.

In contrast, *Connolly v. Office of the United States Trustee (In re Morreale)*, 595 B.R. 409 (10th Cir. BAP 2019) found a bankruptcy trustee has the right to manage and control the assets of a debtor's limited liability company; however the limited liability company's assets were not property of the estate. In *Morreale*, the individual Chapter

7 debtor was the single member of a limited liability company that had filed a Chapter 11 case. Prior to filing Chapter 11, the debtor's limited liability company had acquired, renovated and operated two real estate properties. The bankruptcy trustee in the debtor's Chapter 7 case substituted himself as the manager of the limited liability company in Chapter 11. The bankruptcy trustee filed a plan of liquidation, sold the properties, paid the creditors in the Chapter 11 case, and transferred the surplus funds to his Chapter 7 case. When closing the Chapter 7 case, the bankruptcy trustee sought a commission under 11 U.S.C. Section 326(a) including amounts disbursed in the Chapter 11 case. The Tenth Circuit Bankruptcy Appellate Panel found:

> It is true that Morreale's Chapter 7 estate included his single-member interest in MHLLC. It is also true that, as Morreale's Chapter 7 trustee, Connolly succeeded to that interest. That positioned him to control and manage the LLC and its assets, but that did not bring MHLLC's property into Morreale's Chapter 7 estate. As a matter of general limited liability company law, Morreale's interest in the LLC did not entitle him to possession of its assets.

Morreale, at 417. Thus, a bankruptcy trustee who liquidates the assets of the debtor's single member limited liability company is not entitled to a trustee's fee based upon the assets liquidated and paid to the limited liability company's creditors.

In *In re B&M Land & Livestock, LLC*, 498 BR 262 (Bankr. D. Nev. 2013), the bankruptcy court dismissed a limited liability company Chapter 11 bankruptcy because the bankruptcy trustee of the individual debtor automatically gave him the equitable and management interests of the membership interest. The court also found

the bankruptcy trustee did not have to take any measures to comply with state statutes to take control over the limited liability company. The debtor's argument that a judgment creditor's collection rights against a member's interest in a limited liability company are limited to the debtor's share of profits and distributions; and not management rights was not applicable because "state law does not control the administration of property interests that are part of the bankruptcy estate," at 268. Please note *the B&M Land & Livestock* court held in dicta, "[t]his principle may be limited where the LLC is run by or deals with matters such as professional practices or personal services. For instance, a trustee likely may not manage a law firm, medical practice, or account firm that is organized as an LLC," at 267.

In *In re Dzierzawsk*i, 528 B.R. 357 (Bankr. E.D. Mich. 2015), the bankruptcy court denied the debtor's motion to dismiss his case because it was not in the best interests of a judgment creditor. The debtor was the single member of a limited liability company. The judgment creditor contended if the case was dismissed, it would only be entitled to a charging order; however, as a Chapter 7 case, the bankruptcy trustee could step into the debtor's shoes as the sole member of the limited liability company and exercise management control including liquidation of assets.

There are bankruptcy courts that do not limit the bankruptcy trustee's interest to an economic interest when the debtor is a member of a multi-member limited liability company.

In *Waldron v. Huber*, 2013 Bankr. Lexis 4981 (Bankr. W.D. Wash. 2013) the bankruptcy trustee recovered a membership interest in a limited liability company by

avoiding a fraudulent transfer. The membership interest in the limited liability company recovered by the bankruptcy trustee owned an 85% membership interest in another limited liability company. Over the objection of the member who owned the remaining 15% interest, the bankruptcy court found the bankruptcy trustee succeeded to the economic and non-economic membership rights of the multi-member limited liability company. *Waldron* raised these questions:

- Does the operating agreement limit the bankruptcy trustee's interest to an economic interest when property of the estate is an 85% membership interest in a multi-member limited liability company?

- Does 11 U.S.C. Section 541 trump the anti-transfer provision in an operating agreement allowing the bankruptcy trustee both economic and management rights?

- Does 11 U.S.C. Section 541(c)(a)(A) include property the bankruptcy trustee recovers by avoiding a fraudulent transfer?

The *Waldron* court answered these questions in the affirmative finding the avoided transfer of the debtor's 85% interest was not restricted by the operating agreement, and that the bankruptcy trustee succeeded to all of the debtor's interest, including management and voting rights, even though this was a multi-member limited liability company.

Further, *Movitz v. Fiesta Invs., LLC (In re Ehmann),* 319 B.R. 200 (Bankr. D. Az. 2005) found even in a multi-member limited liability company, the debtor's membership interest became property of the estate notwithstanding restrictions or prohibitions in the operating agreement or Arizona law. 11 U.S.C. Section 541(c)(1) renders those restrictions inapplicable.

In *In re Desmond*, 316 BR 593 (Bankr. D. N.H. 2004), the court distinguished *Albright* from the facts before it by finding that the bankruptcy trustee in *Albright* sought authority in future actions, while the individual Chapter 11 debtor in *Desmond* sought to undo actions from which there was apparent authority. The *Desmond* Court found that since the debtor's single member limited liability company was not a debtor; and during his Chapter 11, the debtor operated his limited liability company without court approval, the court would not restrain a third party from litigation against the limited liability company.

In *Pajooh v. Royal W. Invs. LLC*, 518 S.W.3rd 557 (Tex. App. 2017), the court declined to follow *Albright's* rejection of the public policy reasons supporting charging orders when there are no non-members to protect. The *Pajooh* Court found a single member limited liability company does not have to involuntarily share governance responsibilities with someone they did not choose, or from having to accept a creditor on another member as a co-manager. The court vacated the appointment of a receiver over Pajooh's membership interest in his limited liability company and the limited partnership that Pajooh and his limited liability company owned.

In *Bombay Dev. LLC v. Jivana, LLC*, 2015 Vt. Super. LEXIS 19 (Vt. 2015), the court distinguished the judgment creditor's argument that the bankruptcy court in *Albright* found that the debtor's bankruptcy caused a transfer of the debtor's interest to the Trustee; therefore, the court could simply transfer the membership interest to the judgment creditor. The Vermont court denied the judgment creditor's request for

a transfer of the membership interest, and allowed only a charging order. Interestingly, after certain conditions are met, the Vermont limited liability statute allows for an appointment of a receiver of a limited liability company and foreclosure of the lien against the membership interest.

Keen drafting of an operating agreement is essential because "off-the-shelf" operating agreements drafted with little involvement by a limited liability company's member can result in a disconnect in what members want and the plain meaning of the language of the agreement. The district court in *In re Catalyst Life Styles Resort, LLC*, 2019 WL 2208840 (D. Ind. 2019) recognized the difficult task of bankruptcy courts have in interpreting operating agreements. The *Catalyst* Court found the bankruptcy court did not abuse its discretion in its interpretation of "disposition of all" assets even though the district court commented that it may have reached a different result. In *Catalyst*, the court found the filing of a Chapter 11 case "disposes" or transfers all of the property under 11 U.S.C. Section 541 to the estate, and dismissed the bankruptcy case because the manager who filed the cases did not have 75% of membership approval. See also *Mid-South Business Associates, LLC*, 555 B.R. 565 (Bankr. N.D. Miss. 2016).

Even though bankruptcy courts are finding that the assets of a limited liability company of a single member who files bankruptcy can be liquidated, these courts are not extending the automatic stay to the limited liability company or its assets. The limited liability company is still a separate entity from its member. A single member debtor's membership interest does not provide the debtor with an interest in the

limited liability company's assets. *In re Burgess*, 2010 Bankr. Lexis 1352 (Bankr. M.D. Tenn. 2010). Likewise, the single member's transfer of all of the assets of his limited liability company was not grounds for denial of his discharge. The court found that it was the debtor's membership interest that was property of the estate, and the liquidation of his limited liability company's assets involved property of the limited liability company. *Marcantonio v. Abott*, 2010 Bankr. Lexis 974 (Bankr. D.Conn. 2010).

However, in *In re Pickel*, 487 BR. 289, (Bankr. D. N.M. 2013) a New Mexico bankruptcy court extended the automatic stay to a creditor's lawsuit against a Virgin Islands limited liability company owned by the a Chapter 11 individual debtor because the Chapter 11 debtor, post petition, dissolved the limited liability company. In *Pickel*, the creditor argues the Virgin Islands statutes require a limited liability company to wind up its affairs, discharge its obligations to creditors, and any net proceeds be distributed to it members. The court did not condone the debtor's actions taken without bankruptcy court authority, but found a bona fide dispute existed and denied the creditor's stay motion.

A member's decision to file bankruptcy dramatically impacts what happens to a limited liability company, its assets and its members. Although limited liability companies are separate legal entities from their owners, their members do not own the companies' assets, statutes and operating agreements recognize that a membership interest is comprised of an economic and management interest, and charging orders may be the exclusive remedy for a judgment creditor of a member, a bankruptcy

trustee's rights can cause mayhem. The commencement of a Chapter 7 bankruptcy case by an owner of a single-member limited liability company can endow the bankruptcy trustee to more than an economic interest in a limited liability company. Court are finding a bankruptcy trustee has management rights as well. Once in bankruptcy, the trustee is not limited to a charging order or an economic right which entitles him only to profits and distributions made to the members, but also rights to manage the limited liability company by filing bankruptcy, dissolving, liquidating assets, and providing payment to creditors. The bankruptcy of a single member of a limited liability company can end the asset protection and control of management sought in creation of a limited liability company.

TRUSTEE CLAIMS FOR AIDING AND ABETTING—THE WORLD BEYOND AVOIDANCE CLAIMS

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Introduction

Most of us are aware of the fraudulent transfer claims that arise out of Ponzi schemes, fraudulent dividend claims, corporate looting schemes, pump and dump, and other stock schemes. As I have said throughout my career, "I have never met a fraudulent transfer I did not like." However, there is an entire world---if not universe---of other claims to consider in the context of these avoidance claims. Most, if not all, of the fraudulent schemes I have seen simply could not have occurred without the assistance of various third parties—banks, attorneys, accountants, etc. These parties tend to fly under the radar and are rarely considered targets by Trustees. After all, they were neither transferees of any assets or an "entity for whose benefit such transfer was made." However, in many instances, they both knew of the fraudulent intent and provided substantial assistance to the fraudsters. This paper will explore the nature and extent of potential claims against third parties for aiding and abetting common law fraud, breach of fiduciary duty, and civil conspiracy---all of which raise the possibility of substantial punitive

damage awards which can be twice the amount of the fraudulently transferred assets.

1. AIDING AND ABETTING BREACH OF FIDUCIARY DUTY AND/OR FRAUD

a. Existence of an Underlying Breach of Fiduciary Duty or Act of Fraud

With respect to an underlying fiduciary duty, there are essentially two types of fiduciary relationships:

i) those created under law, e.g. corporate officers and directors owe a fiduciary duty to the corporation. *See Adams v. Mid-West Chevrolet Corp.*, 179 P.2d 147 (Okla. 1947); *SFF-TIR, LLC v. Stephenson*, 264 F.Supp.3d 1148 (N.D. Okla. 2017); *City of Cambridge Ret. Sys. v. Ersek*, 921 F.2d 912 (10th Cir. 2019);

ii) those that are created by case law as a result of the factual circumstances underlying the relationship of the parties and the transactions at issue. In Oklahoma, a fiduciary duty exists when "one person acquires influence over another such that the influenced allows the influencer to substitute his or her will for the influenced's own." *See Horton v. Hamilton*, 345 P.3d 357 (Okla. 2015).

With respect to fraud, the Trustee must allege the acts of fraud with specificity pursuant to FED. R. CIV. P. 9(b). In most of the cases, Trustees see the underlying conduct as both a breach of fiduciary duty and an act of fraud. For example, when officers and directors "loot" the corporation of assets on the eve of bankruptcy, they have both breached a fiduciary duty and committed an act of fraud.

b. Aiding and Abetting—As we speak, it appears that the Oklahoma Supreme Court has not yet expressly recognized the tort of aiding and abetting a breach of fiduciary duty. **However**, breach of fiduciary duty is a recognized tort in Oklahoma. *See May v. Oklahoma Ban and Trust Co.*, 261 P.3d 1138, 1142 (Okla. 2011). In addition, Oklahoma courts have recognized claims for aiding and abetting in other circumstances. *See Cooper v. Bondoni*, 841 P.2d 608, 611 (Okla. Ct. App. 1999) (negligence); *Keel v. Hainline*, 331 P.2d 397 (Okla. 1958) (assault and battery); *Continental Gin Co. v. De Bord*, 123 P.159 (Okla. 1912) (conversion). In the *Cooper* case, the court approvingly quoted from the RESTATEMENT(SECOND) OF TORTS § 876 which recognizes that a person may be subject to liability for the resulting harm to a third person caused by the tortious conduct of another when the non-acting person knows that the tortfeasor's conduct constitutes a breach of duty and he aids its commission by giving substantial assistance or encouragement to the tortfeasor. If you pursue your claim in federal district court (not recommended for various reasons), the federal court "must determine what decision the Oklahoma court would make with the same facts and circumstances." *Oliveros v. Mitchell*, 449 F.3d 1091, 1093 (10th Cir. 2006). There is little doubt in my mind that the Oklahoma Supreme Court would recognize such a claim if the facts and circumstances warranted it.

c. Elements of Aiding and Abetting Breach of Fiduciary Duty and/or Fraud.

Courts recognize the following as elements of aiding and abetting breach of fiduciary duty and/or fraud:

i. existence of an underlying breach or fraud;

ii. knowledge of the breach or fraud on the part of the aider and abettor; and

iii. substantial assistance by the aider and abettor in perpetration of the fraud. *See Unicredito Italiano SpA v. J.P. Morgan Chase Bank*, 288 F.Supp.2d 485, 502 (S.D.N.Y. 2003) (quoting *Gabriel Capital L.P. v. Nat. West Fin. Inc.*, 94 F.Supp.2d 491, 511 (S.D.N.Y. 2000) (financial institutions subject to liability for assisting Enron Ponzi scheme)). *See* also REST. 2D TORTS § 876.

---**Existence of an Underlying Breach or Fraud**: With respect to the **existence of an underlying breach or fraud**, this element is seldom an issue in the kinds of cases Trustees are confronted with, e.g. corporate officers looting the corporation to which they owe a duty.

---**Knowledge of the Underlying Breach or Fraud**: With respect to **knowledge,** it has been held the plaintiff must allege sufficient facts to support a "**strong inference of fraudulent intent.**" *See In re AHIT Corp.*, 292 B.R. 734, 746 (S.D.N.Y. 2003); aff'd 123 Fed. Appx. 17 (2d Cir. 2005). The idea that knowledge of the underlying fraud or breach of duty may be inferred is critical. For example, cases hold that a bank's knowledge of underlying fraud or breach of duty may be "inferr[ed]" from "atypical banking procedures." *See Neilson v. Union Bank of*

California, 290 F.Supp.2d 1101, 1120 (C.D. Cal. 2003). This case involved the operation of a Ponzi scheme. In discussing the adequacy of the plaintiff's allegations against the defendant bank for aiding and abetting breach of fiduciary duty and fraud, the court stated:

> It alleges, in particular, that the Bank utilized atypical banking procedures to service Slatkin's accounts, raising an inference that they knew of the Ponzi scheme and sought to accommodate it by altering their normal ways of doing business. This supports the general allegations of knowledge.

Id.

The court also approvingly quoted *Camp v. Dema*, 948 F.2d 455, 459 (8th Cir. 1991) stating:

> A party who engages in atypical business transactions which lack business justification may be found liable as an aider and abettor with a minimal showing of knowledge. (Citing *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Woofard v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975)).

Courts have held that "deliberate indifference" to the perpetration of the scheme can be sufficient to establish knowledge. *See Commodity Futures Trading Corp. v. Sidoti*, 178 F.3d 1132, 1136 (11th Cir. 1999). Ignoring "danger signals" can be sufficient to establish liability. In *German v. Securities Exchange Commission*, 334 F.3d 1183 (10th Cir. 2003), the court found that "inaction" in the face of danger signs was "reckless" and sufficient to support a finding of aiding and abetting. It should be noted that although this case involved securities fraud, it

must be viewed as at least persuasive in the context of civil aiding and abetting claims. I would also point out that "inaction" is not only evidence of knowledge, it is evidence of assistance.

---**Substantial Assistance:** The RESTATEMENT(SECOND) OF THE LAW OF TORTS § 876 identifies five relevant factors for evaluating whether encouragement or assistance was "substantial." Those factors include (1) the nature of the act encouraged; (2) the amount and kind of assistance given; (3) the defendant's relation to the tortious actor; and (4) the defendant's state of mind. Some courts have found that the mere act of lending money or otherwise transacting business with the fraud actor may give rise to aider-abettor status if the institution knows the loan or other transaction will assist the fraudulent scheme. *See Aetna Cas. & Sur. Co. v. Leahey Constr. Co.,* 219 F.3d 519, 535 (6th Cir. 2000); *Rolf v. Blyth,* 570 F.2d 38, 48 (2d Cir. 1978); see also *Linde v. Arab Bank, PLC*, 384 F. Supp.2d 571, 582 (E.D.N.Y. 2005). In *Leahey*, the court observed that there is "no conflict between the position that an aider and abettor must have actual knowledge of the primary party's wrongdoing and the statement that it is enough for the aider and abettor to have a general awareness of its role in the other's tortious conduct for liability to attach." *Id.* at 532-34.

2. HYPOTHETICAL

Attached as **Ex A** hereto, and as a slide on the Power Point, is a diagram of an actual case that I was involved in more than thirty years ago. I have used this case for years to discuss fraudulent transfers. However, these same facts are even more applicable to aiding and abetting. The narrative explanation of the graph is as follows:

a. An offshore corporation located in Bermuda owns 100% of a local crude trading corporation referred to in the graph as "Crude." The offshore corporation is referred to simply as "Offshore" in the graph, and it is in turn owned by several prominent local business and professional people.

b. The price of crude is dropping like a rock, and the economy in general is headed for a recession.

c. Offshore, and more importantly, its shareholders, want to "loot" $2 million from Crude before it is forced to file bankruptcy.

d. Counsel for the shareholders and Offshore understands claims to avoid fraudulent transfers by an insolvent debtor within 2 years of bankruptcy under 11 U.S.C. § 548 or four years under 11 U.S.C. § 544 and the Oklahoma Uniform Fraudulent Transfer Act. As a result, he designs the scheme that is reflected in the diagram.

e. The powers that be approach the salaried CEO of Crude and advise him they want to sell Crude to him for $2 million. He responds that he does not have $200.00. He is then advised of the critical elements of the scheme which are implemented by all parties:

   ---the CEO forms shell corporation referred to on the graph as "Pawn;"

   ---Pawn will then borrow $2 million from Bank;

   ---Pawn will, of course, have no assets, no business, no income, no tax returns, no financial statements, no balance sheets, etc. and would, under any normal circumstance, not qualify for a loan of $500 much less $2 million;

---in order to secure the loan, Crude pledges a $6 million CD already on deposit in the bank;

---Bank agrees to the transaction despite the fact it is loaning $2 million to an entity that cannot repay the loan. Bank also agrees to accept the pledge of a $6 million CD from Crude to secure the loan, despite the fact that there is no consideration for the pledge of the CD, and Crude was insolvent at the time of the pledge;

---upon receiving the loan proceeds, Pawn pays the loan proceeds to Offshore, and the shareholders enjoy an evening in Bermuda to celebrate the receipt of ill-gotten gains;

---the insolvent Crude now issues a $2 million dividend to Pawn who uses the dividend funds to repay the Bank loan; and

---a few months later Crude files bankruptcy.

f. When the loan officer is asked in his Rule 2004 exam why he made the loan, he testified "it was a no brainer."

g. The principal shareholder of Offshore was one of Bank's largest customers.

This paper does not deal with fraudulent transfer claims. However, and without going into detail, such transfers clearly abound. The most intriguing claim for me is the claim against the Offshore shareholders. The intent of the scheme was, of course, to remove these parties as potential targets of claim by the Trustee by removing them from the chain of **transfers of assets of the debtor.** These parties never received a transfer of property of the estate. However, the drafters of the Code fully anticipated schemes of this nature, and thus, added the brilliant phrase found in § 550(a)(1): "Except as otherwise provided in this section...the trustee may recover, for the benefit of the estate, the property transferred, or, if the

court so orders, the value of such property, from---(1) the initial transferee of such transfer or the **entity for whose benefit such transfer was made**..."(emphasis added). This entire scheme was for the benefit of the Offshore shareholders—not Pawn. But, again, we are today discussing aiding and abetting—not fraudulent transfers.

There are two principal targets of an aiding and abetting scheme---the attorney who designed the claim and the Bank. In applying the elements of aiding and abetting, discussed above, a claim against the attorney would be, in the words of the Bank officer, a "no brainer." By designing the scheme, the attorney had both knowledge of and provided substantial assistance to the underlying fraud and breach of duty. With respect to Bank, its loan, in consideration for the fraudulent pledge of the debtor's CD, was a critical element in the attempt to conceal what was, in actuality, going on. This entire transaction goes beyond atypical. As noted in the cases above, a critical aspect related to motive in the hypothetical was the fact that a Shareholder was one of the Bank's largest customers.

3. PUNITIVE DAMAGES

The obvious question is why are we discussing aiding and abetting when the Trustee has great fraudulent transfer claims against very solvent entities? The answer is two words: **"punitive damages."** OKLA. STAT. TIT. 23 § 9.1 provides in material part:

> A. In an action for the breach of an obligation not arising from contract, the jury, in addition to actual damages, may, subject to the provisions and limitations in subsection B, C and D of this section, award punitive damages for the sake of example and by way of punishing the defendant based upon the following factors:
>
> 1. The seriousness of the hazard to the public arising from the defendant's misconduct;
> 2. The profitability of the misconduct to the defendant;
> 3. The duration of the misconduct and any concealment of it;
> 4. The attitude and conduct of the defendant upon discovery of the misconduct or hazard;
> 5. In the case of a defendant which is a corporation or other entity, the number and level of employees involved in causing or concealing the misconduct; and
> 6. The financial condition of the defendant.

Under the facts of our hypothetical most of these bullet points are present:

--Profitability: $2 million in fraudulently acquired monies is no small sum.

--Concealment: The entire point of the scheme, of course, was to conceal what was, in essence, a fraudulent transfer, or looting, of corporate assets. It is worth noting another aspect of the continuing concealment of the scheme post-bankruptcy. The graph, discussed above, was not prepared and delivered to the Trustee as a kind of road map of the transactions which preceded bankruptcy. There was no full disclosure of these facts in either the schedules or the statement of financial affairs. The Trustee was required to unravel the scheme via Rule 2004.

--Defendants' awareness: The scheme was clearly a well-planned and thought-out act of willful fraud.

---The financial condition of the defendants: As mentioned above, the scheme involved one of the largest banks in the state, and the shareholders were all highly successful and wealthy businesspeople.

With respect to calculation of the damages, OKLA. STAT. TIT. 23 § 9.1 (C)(1) provides in material part:

> Where the jury finds by clear and convincing evidence that:
>
> 1. The defendant acted intentionally and with malice towards others...the jury, in a separate proceeding conducted after the jury has made such finding and awarded damages, may award punitive damages in an amount not to exceed the greatest of:
>
> a. Five Hundred Thousand Dollars ($500,000.00),
>
> b. Twice the amount of actual damages awarded.

The Trustee's fraudulent transfer claim is now worth $6million—not $2 million.

4. VENUE

As I discussed last year in a Trustee panel, Trustees tend to stay in their home court—bankruptcy court. However, at least in my mind, these claims should be pursued in state court with a jury. To begin with, fraudulent transfer claims under § 544, 548, and 550 do not include claims for punitive damages. Secondly, the aiding and abetting claims are state law claims. Finally, state courts, as most plaintiff attorneys know, are not likely to grant motions to dismiss, motions for

summary judgment, or motions for judgment notwithstanding the verdict. By virtue of adding the law firm and including claims that carry punitive damage awards, the Trustee will clearly have his work cut out for him. However, this case would not be that difficult to try, and there are incredibly compelling arguments to make.

5. STANDING ISSUES

Let's assume you are the Trustee for the individual fraudster. There are two problems for the Trustee. First, he stands in the shoes of the fraudster, and, as a result, he cannot by virtue of the doctrine of *in pari delicto* assert claims against third parties for aiding and abetting the debtor's fraud. Secondly, the injuries to investors are injury specific to them, and the Trustee has no standing to assert those claims under § 544. However, the Trustee can convert the case to one under Ch. 11 and propose a plan that involves a litigation trust and the assignment of investor claims to that trust. *See Semi-Tech Litig. L.L.C. v. Bankers Trust Co.*, 272 F. Supp.2d 319, 2003 U.S. Dist. LEXIS 12220. The assignments can be part of the balloting process. A few years ago, I wrote about this topic for this seminar. To the extent anyone wants a more complete analysis of the law applicable to this topic, please let me know. The entire concept makes sense. I have been involved in a large Ponzi and a pump and dump stock scheme. The total amount of investor claims in each of those cases exceeded $50 million. However, the individual

claims were in the neighborhood of $10,000 to $20,000—maybe as high as $50,000. The individual investors simply do not have the resources, or do not want to spend the resources, to prosecute claims for $10k to $50k. They are, however, willing to assign claims to a trust that will prosecute all the claims for the benefit of all parties. The assignments must be unconditional, i.e. the investor cannot retain any interest in the assigned claim other than as a general unsecured creditor in the case entitled to his pro rata distribution of any proceeds.

If the Trustee is appointed in a corporate case, standing can be somewhat complicated. I could spend the next 10 pages addressing this topic. In lieu of that, consider the following summary:

a. Generally, courts have held that the trustee may pursue claims against the former officers and directors of a debtor corporation pursuant to § 541 if the acts complained of represent the pursuit of individual self-interests to the detriment and harm of the corporate debtor. *See Arwood v. Dunn (In re Caribbean K Line Ltd.)*, 288 B.R. 908 (S.D. Fla. 2002). This general proposition represents an exception to the general rule, that the acts of corporate officers and directors are imputed to the corporation---and thus, the doctrine of *in pari delicto* bars the Trustee's claims. This exception is referred to as the "adverse interest" exception to the application of *in pari delicto*. *See O'Connell v. Arthur Andersen LLP (In re AlphaStar Ins. Group Ltd.)*, 383 B.R. 231, 272 (Bankr. S.D. N.Y. 2008).

b. There is an exception to the adverse interest exception—you knew there would be one—the "sole actor" exception. If the debtor corporation was, in essence, controlled by a single person, the sole actor is viewed as the alter ego of the corporation, and his bad acts are imputed to the corporation—thus the dreaded *in pari delicto* doctrine bars the Trustee's claims. *See O'Connell* at 272.

c. Even if the "wrongdoer" is not the sole actor, the adverse interest exception will not apply, unless there is at least one "innocent" decision-maker among management or the shareholders who could stop the fraud. *See O'Connell* at 272 (quoting *Breeden v. Kirkpatrick & Lockhart LLP (In re The Bennett Funding Group, Inc.)*, 336 F.3d 94, 101 (2d Cir. 2003)). In the hypothetical discussed above we have the equivalent of the "Orient Express" of wrongdoing. **Everybody did it!**

To the extent you are having problems following this litany of exceptions, let's summarize:

---the adverse interest exception to the *in pari delicto* doctrine;

---the sole actor exception to the adverse interest exception;

---the one innocent party exception to the sole actor exception;

---the Orient Express exception to the one innocent party exception i.e. they are all guilty.

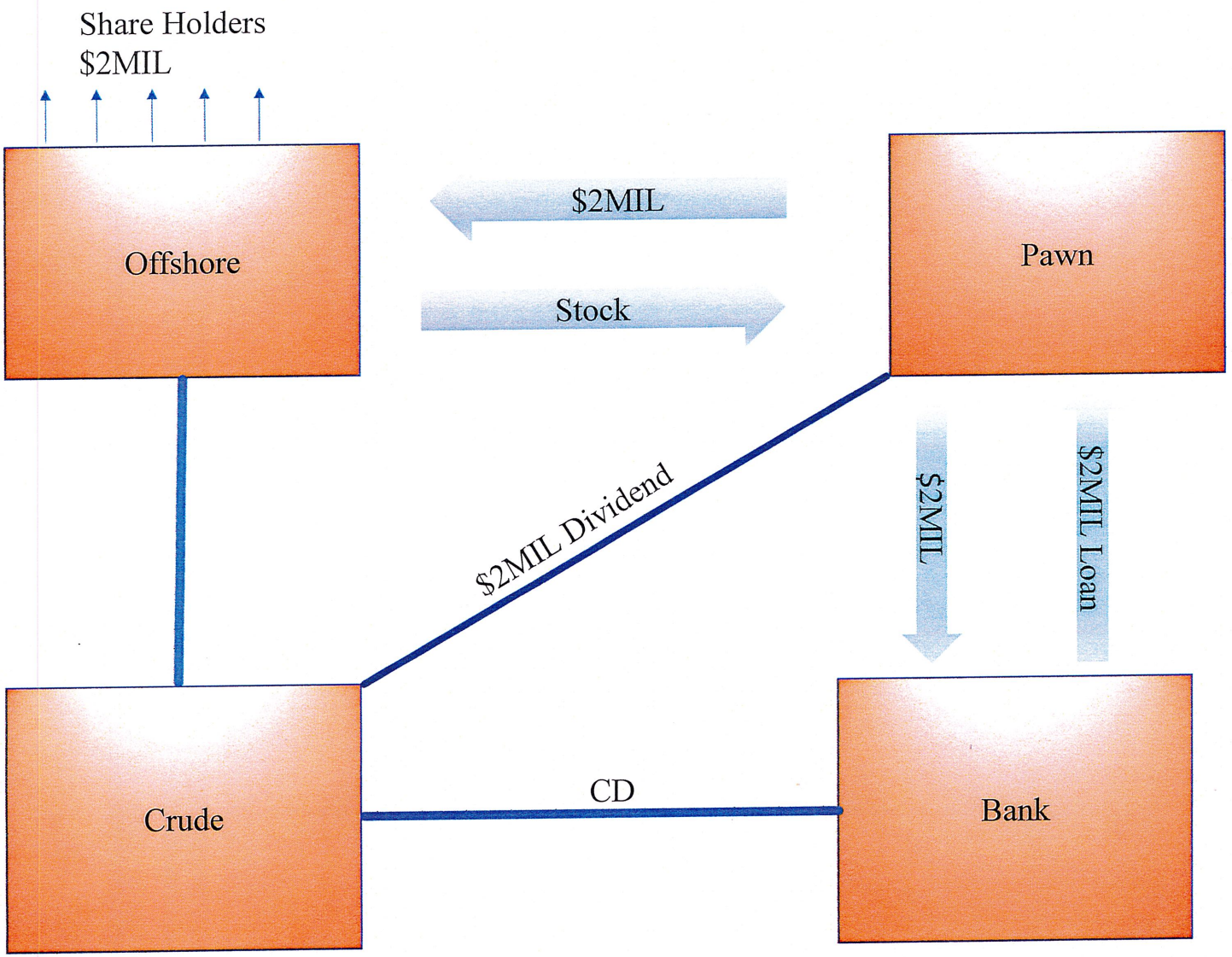
The insanity of it all! Clearly someone(s) does not want Trustees pursuing these claims---knowing full well that the odds of creditors doing it are slim to none. I would contend that the claims at issue are clearly derivative, i.e. they are based on harm to the corporate body as a whole and to the creditors generally. There are no injury specific creditor claims here. There is only one party who should be asserting these types of general injury claims for the benefit of all creditors---the Trustee. In *Newsome v. Gallacher*, 722 F.3d 1257, 1267 (10th Cir. 2013), the court provided the following:

> Third, a bankruptcy trustee has standing to pursue the creditors' claim for breach of fiduciary duty, but not because the trustee is somehow stepping into the shoes of the creditors. Rather, 'a bankruptcy trustee may assert only the claims that belong to the bankruptcy estate' but 'those claims may include the interests of creditors in the sense that the trustee has the duty to marshal the assets of the estate so they can be distributed to creditors on a pro rata basis.' (Citations Omitted).

I could not agree more. However, these comments raise some additional questions. Assuming the injury to the corporation is general and derivative in nature, under what section of the code does the Trustee assert the claims--§ 541 or § 544? Answer—I have no idea. Perhaps someone could discuss next year. Conclusion—pray that your case includes at least one innocent decision maker so you can avoid these complexities.

Conclusion:

When Trustees are confronted with substantial and complex fraudulent schemes involving millions of dollars they should consider adding claims for aiding and abetting against third parties who both knew about the scheme and provided substantial assistance in perpetrating the fraud. In pursuing such a strategy the Trustee wil dramatically increase the possible recovery for the benefit of the estate and at the same time address significant public policy concerns as well.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AMERICAN BANKRUPTCY INSTITUTE
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On Our Watch

By Adam D. Herring and Walter W. Theus

New Laws, New Duties

USTP's Implementation of the HAVEN Act and the SBRA

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Editor's Note: *ABI recently held a webinar that provided an overview of three new bankruptcy laws. ABI Executive Director* ***Samuel J. Gerdano*** *moderated the webinar, which featured* ***Robert J. Keach*** *(Bernstein Shur; Portland, Maine),* ***Kristina M. Stanger*** *(Nyemaster Goode, PC; Des Moines, Iowa),* ***Joseph A. Peiffer*** *(Ag & Business Legal Strategies; Cedar Rapids, Iowa) and* ***Donald L. Swanson*** *(Koley Jessen; Omaha, Neb.). Catch a replay at abi.org/newsroom/press-releases/educational-press-briefings.*

On Aug. 23, 2019, President Donald Trump signed into law four significant pieces of legislation affecting the bankruptcy system: the Small Business Reorganization Act (SBRA),[1] the Honoring American Veterans in Extreme Need (HAVEN) Act,[2] the Family Farmer Relief Act[3] and the National Guard and Reservists Debt Relief Extension Act.[4] The SBRA and HAVEN Act each represent substantial changes to bankruptcy law and practice. For example, revised bankruptcy forms will likely be promulgated related to both new laws.

The U.S. Trustee Program (USTP) will likewise adjust its exercise of its statutory oversight and enforcement responsibilities to faithfully implement both new statutes. Teams of experienced field and Executive Office personnel have also been assembled to review and recommend changes to the USTP's practices and to identify legal issues involved in implementing the new laws.[5] This article provides an overview of the changes practitioners should look out for, particularly the important changes relative to the appointment of a "case-by-case" trustee in new subchapter V cases.

HAVEN Act

The HAVEN Act excludes certain disability and death-related benefits payable to servicemembers, veterans and their survivors from the Bankruptcy Code's[6] definition of "current monthly income" (CMI).[7] This treatment mirrors the Code's exclusion from CMI of benefits under the Social Security Act. The excluded benefits are administered by the Department of Defense or Department of Veterans Affairs.[8] Retired pay is excluded from CMI, but only if it is pay the debtor receives because of disability. The HAVEN Act's amendments apply to means-testing or disposable-income calculations in individual cases under chapters 7, 11 and 13.[9]

The USTP reviews all individual chapter 7 cases for abuse,[10] including the presumption of abuse that might arise under the means test and abuse that might arise based on the debtor's bad faith or under the totality of the circumstances.[11] By modifying CMI's definition, the HAVEN Act directly changes the means-testing analysis under § 707(b)(2) of the

1 Pub. L. No. 116-54 (2019).
2 Pub. L. No. 116-52 (2019).
3 Pub. L. No. 116-51 (2019) (amending 11 U.S.C. § 101(18) to increase the debt limit for chapter 12 relief to $10 million, subject to adjustment under 11 U.S.C. § 104).
4 Pub. L. No. 116-54 (2019) (extending, for an additional four years, existing exemption from means test for qualifying reservist and National Guard debtors who are called to active duty or to perform a homeland defense activity for not less than 90 days). *See* 11 U.S.C. § 707(b)(2)(D)(ii).
5 The USTP recognizes James L. Snyder, Acting U.S. Trustee for Region 12, and **Daniel J. Casamatta**, Acting U.S. Trustee for Region 13, for their diligent work in coordinating these efforts.
6 11 U.S.C. §§ 101, *et seq.*
7 11 U.S.C. § 101(10A)(B)(IV) (CMI "excludes ... any monthly compensation, pension, pay, annuity, or allowance paid under title 10, 37, or 38 in connection with a disability, combat-related injury or disability, or death of a member of the uniformed services, except that any retired pay excluded under this subclause shall include retired pay paid under chapter 61 of title 10 only to the extent that such retired pay exceeds the amount of retired pay to which the debtor would otherwise be entitled if retired under any provision of title 10 other than chapter 61 of that title").
8 A Department of Veterans Affairs annual benefits report indicated that more than 5 million veterans and survivors/dependents receive these benefits. *See* "VBA Annual Benefits Report Fiscal Year 2018," *available at* benefits.va.gov/REPORTS/abr (last visited Sept. 3, 2019).
9 *See* 11 U.S.C. §§ 707(b), 1129(a)(15), 1325(b)(2). The chapter 12 disposable-income test, 11 U.S.C. § 1225(b)(1)(B), and the disposable-income test applicable to individual cases under new subchapter V created by the SBRA do not incorporate CMI and are thus unaffected.
10 11 U.S.C. § 704(b).
11 11 U.S.C. § 707(b).

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Bankruptcy Code, but it does not explicitly affect dismissal under the bad-faith or totality-of-the-circumstances provisions of § 707(b)(3).

The USTP will limit its requests for documents related to income excluded from CMI under the HAVEN Act to avoid unduly burdening debtors. The USTP does not routinely request from debtors documents not otherwise required by the Bankruptcy Code or Rules without a specific need for additional information. The USTP will advise chapter 7 and 13 trustees, as a best practice, to similarly limit their HAVEN Act-related document requests to what is necessary for proper administration of the case.

As issues related to the HAVEN Act amendments arise, the USTP will work to ensure that its approach is faithful to the language of the statute and, if ambiguities arise, will generally resolve them in favor of the recipients of benefits covered by the Act.

SBRA

The SBRA creates a new subchapter V of chapter 11[12] for "small business debtors" as currently defined in the Bankruptcy Code.[13] If the debtor's primary business activity is owning single-asset real estate, the debtor is not considered a small business debtor.[14]

Under the SBRA, a small business debtor may elect to have its case administered under subchapter V. Absent such an election, the small business case will be administered under the small business provisions of chapter 11 that have been in effect since 2005.

A full analysis of the provisions of subchapter V is beyond the scope of this article. However, the principal changes for subchapter V cases include the following:

- A trustee will be appointed in every case to perform a variety of duties ranging from facilitating the development of a consensual reorganization plan to appearing in court at status conferences and hearings on major issues (*e.g.*, property valuation, plan confirmation and plan modification).[15]
- No creditors' committee will be appointed unless the court orders one appointed for cause.[16]
- The plan must be filed within 90 days after the order for relief. Only the debtor may file a plan.[17]
- No disclosure statement is required absent a court order, but the plan must contain certain basic disclosures.
- The plan may provide for the modification of rights of holders of a claim secured by a security interest in the debtor's principal residence if the new value secured by the security interest was not used primarily to acquire the property and was used primarily for the debtor's business.
- If all impaired classes vote to accept the plan, confirmation will be considered consensual, with three consequences: (1) the claims will be discharged upon confirmation; (2) the trustee's services will be terminated upon substantial plan consummation; and (3) the reorganized debtor will be responsible for making plan payments to creditors.
- The rules in subchapter V for nonconsensual confirmation differ quite radically from the rules for cramdown in ordinary chapter 11 cases. A creditor's ability to block confirmation by rejecting the plan is significantly weakened. The absolute priority rule is abrogated. If one or more impaired classes does not accept the plan, the court may confirm it nonconsensually if the court finds that the plan does not discriminate unfairly, and is fair and equitable with respect to each impaired class of claims or interests that has not accepted the plan. Although the definition of "fair and equitable" in ordinary chapter 11 cases incorporates the traditional absolute-priority rule,[18] the definition of "fair and equitable" in subchapter V applies a test similar to the chapter 12 disposable-income test.[19] If the subchapter V plan is confirmed nonconsensually, the trustee will continue to serve (and be compensated) for the three- to five-year term of the plan. The debtor will make payments to the trustee, who will make distributions to claimants under the plan.
- Subchapter V debtors are excused from the statutory obligation to pay quarterly fees to the U.S. Trustee System Fund.[20]

The SBRA will become effective on Feb. 19, 2020, for cases filed on or after that date.[21] The U.S. Trustee is required to appoint a trustee for each subchapter V case.[22] Although the SBRA authorizes the U.S. Trustee to appoint standing trustees to serve in all subchapter V cases in their judicial districts, the SBRA does not require it. If the U.S. Trustee does not appoint a standing trustee, the U.S. Trustee will appoint a disinterested individual in each particular subchapter V case to serve as trustee (a "case-by-case trustee").[23]

Between now and the SBRA's effective date, the USTP must identify a pool of individuals, likely at least 200, who have the interest and the qualifications to serve as subchapter V trustees. These individuals must have skills beyond those of an asset liquidator or disbursing agent.

Real acumen in smaller businesses will be highly desirable, given the trustee's obligation to aid the debtor in its rehabilitation and in the development of a workable and acceptable chapter 11 plan. The trustee must also have the capability to receive and distribute funds in nonconsensual cases, and must be able to perform the trustee's duties while understanding the appointment's economics. A partner in a law firm accustomed to billing clients for $1,000 per hour might find it difficult to recover the partner's normal fees in a subchapter V case.

The USTP will soon solicit applications from the bankruptcy community and others who might be qualified to serve as subchapter V trustees. While currently serving private trustees — many of whom are likely well qualified — are eligible to apply, the USTP urges all qualified and interested individuals to apply for consideration as a subchapter V trust-

12 11 U.S.C. §§ 1181-1195.

13 11 U.S.C. § 101(51D). A small business debtor is defined as a chapter 11 debtor that is engaged in commercial or business activities and has no more than $2,725,625 (excluding debts owed to affiliates or insiders) in noncontingent liquidated secured and unsecured debt, not less than 50 percent of which arose from the commercial or business activities of the debtor.

14 *Id.*

15 11 U.S.C. § 1183(a), (b).

16 11 U.S.C. § 1102(a)(3). This amendment applies to all small business cases, whether or not the debtor elects to proceed under subchapter V.

17 11 U.S.C. § 1189.

18 11 U.S.C. § 1129(b)(2).

19 11 U.S.C. § 1191(b); 11 U.S.C. § 1225(b).

20 Pub. L. No. 116-54, § 4(b)(3) (amending 28 U.S.C. § 1930(a)(6) to exclude cases under subchapter V from cases responsible for payment of quarterly fees).

21 Pub. L. No. 116-54, § 5.

22 11 U.S.C. § 1183(a).

23 *Id.*

ee candidate as soon as possible in response to the advertisements the USTP will soon issue.

At least initially, the U.S. Trustees will likely appoint case-by-case trustees from pools established in each district through an application process, which could include interviews. The USTP does not anticipate assembling panels as it does in each district for chapter 7 cases, and appointments will not be made through a strictly blind rotation. Rather, the U.S. Trustee will appoint a trustee based on the nature of the debtor and whether a trustee candidate possesses special skills that make the candidate especially suitable for the appointment.[24]

The U.S. Trustee is specifically required to monitor and supervise subchapter V trustees and cases.[25] As part of this supervision, the USTP will develop uniform protocols for reporting by subchapter V trustees to enable the U.S. Trustees to evaluate the performance of subchapter V trustees just as they monitor trustees under other chapters.

Moreover, the USTP does not anticipate that its monitoring of these chapter 11 cases will be substantially lessened compared to non-subchapter V cases simply because of the trustee appointments. For example, the U.S. Trustee will still conduct initial debtor interviews, most likely in consultation with the trustee, and will review monthly operating reports as part of its general oversight of the cases, as well as seek to convert or dismiss subchapter V cases or remove a debtor from possession and put the trustee in possession (when appropriate).[26] In keeping with the USTP's traditional oversight duties, the U.S. Trustee will review applications by the debtor to retain professionals, applications by those professionals for compensation and the compensation requests of subchapter V trustees.

Conclusion

Both the HAVEN Act and the SBRA represent efforts to expand the availability of bankruptcy relief to different populations of debtors. Along with that expansion, the USTP will continue to uphold its statutory duties to prevent abuse and provide effective oversight across the bankruptcy system. The USTP will continue to analyze the new statutory provisions and will participate in cases as necessary to ensure a consistent application of the law. abi

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24 The USTP will track and analyze subchapter V filings to determine whether the appointment of one or more standing trustees in a district would result in increased efficiency and decreased costs to the estate.

25 28 U.S.C. § 586(a)(3).

26 11 U.S.C. § 1185.

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THE BUSINESS REORGANIZATION ACT OF 2019

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THE BUSINESS REORGANIZATION ACT OF 2019

Since the Bankruptcy Code became law in 1978, there have been amendments purporting to allow small businesses to reorganize in a less complicated and less expensive manner than the relief available under Chapter 11. In addition, the obligation to comply with the absolute priority rule found in 11 U.S.C. § 1129(b)(2)(B)(ii), which bars "cramdown" confirmation of a Chapter 11 Plan if junior interest holder, usually the equity owner of the business, retains their ownership interest. See Bank of Am. Nat. Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607 (1999)

First, Chapter 12 was enacted in 1988 to help family farmers in response to the U.S. Supreme Court case of Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 209, 108 S. Ct. 963, 970, 99 L. Ed. 2d 169 (1988) which held that the individual Debtor's retention of the over-encumbered ownership of their farm land violated the absolute priority rule. Chapter 12 effectively eliminated the absolute priority rule. However, Chapter 12 is only available to a very limited class of debtors and generally is no help to a typical small business.

Second was the Bankruptcy Reform Act of 1994 which added Section 1125(f) to make the reorganization process less expensive and more expeditious for the small business debtor. This provision provides a small business debtor a shorter path to confirmation whereby the court may conditionally approve a disclosure statement as the basis for solicitation of votes on a plan, and then hold a combined hearing for final approval of the disclosure statement and confirmation of the plan. *See*, Collier on Bankruptcy, ¶ 105.08, at 105-83 to 105-84 (15th ed. rev. 1997). This change does make cases less expensive, but provides no relief from the absolute priority rule.

Third, in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) Congress revised chapter 11 to accelerate the plan-confirmation process for small business debtors. While this could be viewed as a mechanism to reduce the cost of small business Chapter 11 cases, because of the perceived futility of so many small business debtors' attempts to reorganize it has mostly the opposite effect. BAPCPA imposed strict time limits on the filing and confirmation of a plan and provided that missing these deadlines the constitutes "cause for dismissal" under §1112(6)(4)(J). BAPCPA made it more difficult for small business debtors to reorganize.[1]

In addition, for individual debtors BAPCPA imposes strict limitations on the ability of individuals with significant income and debt to file Chapter 7 or Chapter 13, leaving them with only Chapter 11 as an option. Although it facially appears Congress intended to replace the absolute priority rule with the requirement that an individual debtor contribute their disposable income for up to 5 years similar to Chapter 13, the Tenth Circuit along with every other Circuit Court has held that BAPCPA did not abolish the absolute priority rule for individual debtors. Specifically, the Tenth Circuit opined in the case of In re Stephens, 704 F.3d 1279, 1286–87 (10th Cir. 2013):

> Because both the statutory language and Congress's intent are ambiguous, we heed the presumption against implied repeal. "[R]epeals by implication are not favored and will not be presumed unless the intention of the legislature to repeal is clear and manifest." *Nat'l Ass'n of Home Builders v. Defenders of Wildlife,* 551 U.S. 644, 662, 127 S.Ct. 2518, 168 L.Ed.2d 467 (2007) (quotations omitted). Where a party contends "that legislative action changed settled law," that party "has the burden of showing that the legislature intended such a change." *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 521, 109 S.Ct. 1981, 104 L.Ed.2d 557

[1] See Tyler Ferguson (FN1), Between Devil and Deep Blue Sea the Chapter 11 Plan and the Small Business Debtor, Am. Bankr. Inst. J., October 2012 for a good discussion of the issues for small business debtors in a post-BAPCPA world.

> (1989). These interpretive principles are particularly critical in bankruptcy cases, where parties rely on settled rules in conducting and structuring business. Thus, "[p]re-BAPCPA bankruptcy practice is telling because we will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." *Hamilton v. Lanning,* 560U.S. 505, 130 S.Ct. 2464, 2473, 177 L.Ed.2d 23 (2010) (quotation omitted). Here, the statutory language and legislative history lack any clear indication that Congress intended to erode a pillar of creditor bankruptcy protection. *See Hui v. Castaneda,* 559 U.S. 799, 130 S.Ct. 1845, 1853, 176 L.Ed.2d 703 (2010); *Dewsnup v. Timm,* 502 U.S. 410, 419–20, 112 S.Ct. 773, 116 L.Ed.2d 903 (1992). ***Especially in light of the fact that Congress has expressly repealed the APR in the past, see H.R. Rep. 82–2320, at 1981–82, we decline to find an implied repeal here.*** [emphasis added].

When read in conjunction with the Ahlers decision, the result makes it virtually impossible for an individual debtor to obtain confirmation of a Chapter 11 Plan if their creditors vigorously oppose them. One must conclude until very recently, that the Absolute Priority Rule is alive and well in all Chapter 11 cases no matter the size or composition of the Debtor.

On August 23, 2019, the Business Reorganization Act of 2019. Pub. L. No. 116-54, §§ 4(a)(9)(A)–(C), 133 Stat. 1086, 1087 (2019) was signed in to law and will become effective 180 days after the date of enactment or on February 19, 2020 (the "SBRA") also referred to in the statutory language as "subchapter V of Chapter 11" or sometimes just "Subchapter V." When viewed as a whole, the SBRA actually provides relief from the Absolute Priority Rule for small business cases as well as streamlining the overall Chapter 11 process.

The following explanation of eligibility for a Subchapter V small business reorganization case and how a debtor elects to be treated under this new section is quoted from a fine article by Professor Ralph Brubaker, University of Illinois College of Law, published in October, 2019 in Volume 39, in the 10th issue of the Bankruptcy Law Letter NL 1:

1. A Small's Business Debtor's Subchapter V Election

Eligibility for a Subchapter V small business reorganization case is confined to a "small business debtor" (statutorily defined in Code § 101(51D)) that "elects that subchapter V of chapter 11 shall apply." The SBRA also amends the pre-existing "small business case" definition in § 101(51C) as follows (additions are in italics):

> **(51C)** The term "small business case" means a case filed under chapter 11 of this title in which the debtor is a small business debtor [defined in § 101(51D)] *and has not elected that subchapter V of chapter 11 of this title shall apply*.
>
> § 101(51C) "small business case" is the statutory trigger for mandatory application of the BAPCPA small business reorganization provisions. Moreover, under the new law, all of those 2005 BAPCPA "small business case" provisions remain in place. Under the new law, however, a § 101(51D) "small business debtor" can *opt out* of the BAPCPA regime by electing for the case to proceed as a Subchapter V case. [emphasis added]

The statutory terminology is somewhat confusing, and the grammatical structure of the above-quoted operative provision is a bit convoluted, but the upshot of the new law is straightforward. Under the SBRA, a § 101(51D) "small business debtor" that files Chapter 11 has two options: (1) proceed as a Subchapter V case by electing Subchapter V, or (2) proceed as a BAPCPA "small business case" by *not* electing Subchapter V. That Subchapter V election will likely be effectuated in voluntary cases (which comprise virtually all Chapter 11 filings) by checking the appropriate box on the revised voluntary petition form (yet to be promulgated). Given the relatively disadvantageous BAPCPA "small business case" provisions, though, as compared to the much more advantageous provisions of Subchapter V (as discussed below), it can be expected that virtually all "small business debtors" filing Chapter 11 will elect to proceed under Subchapter V rather than as a § 101(51C) "small business case."

2. Subchapter V Eligibility: The "Small Business Debtor" Definition

The SBRA also amends the definition of "small business debtor" (now eligible for a Subchapter V case) in Code § 101(51D) as follows (additions are in italics; deletions are lined through):

> **(51D)** The term "small business debtor"—
>
> **(A)** subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning ~~or operating real property or activities incidental thereto~~ *single asset real estate*) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $2,725,625 (excluding debts owed to 1 or more affiliates or insiders) ~~for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and~~

~~representative to provide effective oversight of the debtor; and~~ *not less than 50 percent of which arose from the commercial or business activities of the debtor; and*

(B) ~~does not include any member~~ *does not include*

(i) any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $2,725,625 (excluding debt owed to 1 or more affiliates or insiders)*;*

(ii) any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)); or

(iii) any corporation that—

(I) is subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)); and

(II) is an affiliate of a debtor. [footnotes omitted].

There are several noteworthy aspects of those 2019 amendments to the "small business debtor" definition.

a. The Extent of Commercial and Business Activity Is Measured by Business Debt Percentage

The prior definition of "small business debtor" measured the "business" status of a debtor by simply asking whether that debtor is "engaged in commercial or business activities," which could mean *any* and perhaps even trivial "commercial or business activities," like a professor in a college town listing a spare bedroom on Airbnb for rentals during homecoming and graduation weekends (just to pick an example out of thin air). The new "small business debtor" definition helpfully removes that quantum ambiguity by specifying that a debtor will qualify for Subchapter V only if at least half of that debtor's liquidated, noncontingent debts are attributable to commercial or business activities.

b. Debt Limit

Perhaps the most significant aspect of the 2019 amendments to § 101(51D) is that which they do not do: they do *not* change the monetary debt limit to qualify for "small business debtor" status. The current inflation-adjusted debt limit to qualify as a small business debtor, under both the old and the new law, is aggregate liquidated, noncontingent debts of $2,725,625 or less.

Several provisions of the current Bankruptcy Code do not apply to Subchapter V cases, most of which have been replaced by new provisions of the SBRA.

§ 1181. Inapplicability of other sections

"(a) IN GENERAL.—Sections 105(d), 1101(1), 1104, 1105, 1106, 1107, 1108, 1115, 1116, 1121, 1123(a)(8), 1123(c), 1127, 1129(a)(15), 1129(b), 1129(c), 1129(e), and 1141(d)(5) of this title do not apply in a case under this subchapter.

"(b) COURT AUTHORITY.—Unless the court for cause orders otherwise, paragraphs (1), (2), and (4) of section 1102(a) and sections 1102(b), 1103, and 1125 of this title do not apply in a case under this subchapter.

"(c) SPECIAL RULE FOR DISCHARGE.—If a plan is confirmed under section 1191(b) of this title, section 1141(d) of this title shall not apply, except as provided in section 1192 of this title.

The following provides details on the omitted sections and their replacements under Subsection V.

Status Conference is now mandatory.

105(d), is amended to eliminate the optional status conference in Chapter 11 cases along with the ability to enter a scheduling order setting dates for the Trustee or DIP to (a) assume or reject an executory contract or unexpired lease; (b) file a disclosure statement and plan and setting dates for (i) solicitation of acceptances of a plan; (ii) by which a other parting in interest may file a plan and solicit acceptances of such plan; (c) regulating notices and setting hearings for the approval of the disclosure statement; and (d) combining the hearings on the approval of the disclosure statement and confirmation of the plan.

105(d) is replaced by new § 1188 requiring the court to hold a status conference to further the expeditious and economical resolution of a case under this subchapter not less than 60 days after the case is commenced, unless the court extends this period because such extension is needed as a result of circumstances for which the debtor should not justly be held accountable.

In addition, this provision requires the debtor, not later than 14 days before the date of the status conference, to file with the court and serve on the trustee and all parties in interest a report that details the efforts the debtor has undertaken and will undertake to attain a consensual reorganization plan.

The Status Conference and Debtor's Report on efforts to obtain a consensual plan is mandatory in Subchapter V cases.

§ 1188 states:

> "(a) IN GENERAL.—Except as provided in subsection (b), not later than 60 days after the entry of the order for relief under this chapter, the court shall hold a status conference to further the expeditious and economical resolution of a case under this subchapter.
>
> "(b) EXCEPTION.—The court may extend the period of time for holding a status conference under subsection (a) if the need for an extension is attributable to circumstances for which the debtor should not justly be held accountable.
>
> "(c) REPORT.—Not later than 14 days before the date of the status conference under subsection (a), the debtor shall file with the court and serve on the trustee and all parties in interest a report that details the efforts the debtor has undertaken and will undertake to attain a consensual plan of reorganization.

1101(1) "debtor in possession" which means debtor only and does not include the Chapter 11 Trustee in Chapter 11 cases is eliminated and replaced by §1182(2) of the SBRA providing the "term 'debtor in possession' means the debtor, unless removed as debtor in possession under section 1185(a) of this title."

Likewise, §1182(1) provides "The term 'debtor' means a small business debtor."

Elimination of the following sections:

1104, Appointment of Trustee or examiner.
1105, Termination of Trustee's appointment.
1106, Duties of Trustee or examiner.
1107, Rights, Powers and duties of DIP.
1108, Trustee's authority to operate business.

Read together, the elimination of these provisions means a traditional Chapter 11 Trustee or examiner may not be appointed in Subchapter V cases. These sections are replaced by § 1183 of the SBRA which provides there is always a Trustee in Subchapter V cases similar to Chapter 12 and 13 cases. New section 1183 directs the U.S. Trustee to appoint an individual serving as a standing trustee to serve as a trustee in any case under Subchapter V. The trustee must perform many of the same duties performed by a chapter 12 trustee. For example, in a chapter 12 case, the trustee serves as a fiduciary for creditors and is accountable for all property of the debtor, as well as ensuring that the debtor makes the payments as required by the debtor's reorganization plan. Pursuant to § 1183, the trustee must participate in certain conferences and hearings concerning matters pertaining to the value of property subject to a lien, confirmation of a reorganization plan and its modification post-confirmation, and the sale of property of the estate. Among other duties, the trustee must ensure that the debtor commences making timely payments required under a confirmed plan. The trustee's service terminates upon substantial consummation of the plan unless the plan is confirmed via cram-down.

§1116, Duties of trustee or debtor in possession in small business cases is eliminated in light of the mandatory standing Trustee in all Subchapter V cases under §1183(b) as follows:

> The trustee shall—
>
> "(1) perform the duties specified in paragraphs (2), (5), (6), (7), and (9) of section 704(a) of this title;[2]

[2] **§704(a)** The trustee shall--
(2) be accountable for all property received;
(5) if a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper;
(6) if advisable, oppose the discharge of the debtor;
(7) unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest;

"(2) perform the duties specified in paragraphs (3), (4), and (7) of section 1106(a)[3] of this title, if the court, for cause and on request of a party in interest, the trustee, or the United States trustee, so orders;

"(3) appear and be heard at the status conference under section 1188 of this title and any hearing that concerns—

"(A) the value of property subject to a lien;

"(B) confirmation of a plan filed under this subchapter;

"(C) modification of the plan after confirmation; or

"(D) the sale of property of the estate;

"(4) ensure that the debtor commences making timely payments required by a plan confirmed under this subchapter;

"(5) if the debtor ceases to be a debtor in possession, perform the duties specified in section 704(a)(8) and paragraphs (1), (2), and (6) of section 1106(a) of this title, including operating the business of the debtor;

"(6) if there is a claim for a domestic support obligation with respect to the debtor, perform the duties specified in section 704(c) of this title; and

"(7) facilitate the development of a consensual plan of reorganization.

"(c) TERMINATION OF TRUSTEE SERVICE.—

"(1) IN GENERAL.—<u>If the plan of the debtor is confirmed under section 1191(a) of this title, the service of the trustee in the case shall terminate when the plan has been substantially consummated,</u> except that the United States trustee may reappoint a trustee as needed for performance of duties under subsection (b)(3)(C) of this section and section 1185(a) of this title.

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(9) make a final report and file a final account of the administration of the estate with the court and with the United States trustee;

[3] §1106(a)

(**3)** except to the extent that the court orders otherwise, investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;

(4) as soon as practicable--

(A) file a statement of any investigation conducted under paragraph (3) of this subsection, including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate; and

(B) transmit a copy or a summary of any such statement to any creditors' committee or equity security holders' committee, to any indenture trustee, and to such other entity as the court designates;

(7) after confirmation of a plan, file such reports as are necessary or as the court orders;

"(2) SERVICE OF NOTICE OF SUBSTANTIAL CONSUMMATION.—Not later than 14 days after the plan of the debtor is substantially consummated, the debtor shall file with the court and serve on the trustee, the United States trustee, and all parties in interest notice of such substantial consummation.

When read together with §1194, Subchapter V does not provide for the Trustee to make payments when a consensual plan is confirmed, but in a cram-down case, the payments must go through the Trustee UNLESS the plan provides otherwise.

§ 1194. Payments.

This section is new to Chapter 11 cases and is in place to address part of the duties of the new Subchapter V Standing Trustee and provides:

"(a) RETENTION AND DISTRIBUTION BY TRUSTEE.—Payments and funds received by the trustee shall be retained by the trustee until confirmation or denial of confirmation of a plan. If a plan is confirmed, the trustee shall distribute any such payment in accordance with the plan. If a plan is not confirmed, the trustee shall return any such payments to the debtor after deducting—

"(1) any unpaid claim allowed under section 503(b) of this title;

"(2) any payment made for the purpose of providing adequate protection of an interest in property due to the holder of a secured claim; and

"(3) any fee owing to the trustee.

"(b) OTHER PLANS.—If a plan is confirmed under section 1191(b) of this title, except as otherwise provided in the plan or in the order confirming the plan, the trustee shall make payments to creditors under the plan.

"(c) PAYMENTS PRIOR TO CONFIRMATION.—Prior to confirmation of a plan, the court, after notice and a hearing, may authorize the trustee to make payments to the holder of a secured claim for the purpose of providing adequate protection of an interest in property.

This provision is similar to §1226 applicable to Chapter 12 cases, but adds protection for secured creditors to obtain adequate protection payments prior to confirmation and in the event no plan is confirmed. Unlike Chapter 12, the Trustee is not required to remain in place post confirmation, UNLESS the plan is confirmed under a cram-down HOWEVER, it appears the plan may provide otherwise.

§ 1184. Rights and powers of a debtor in possession.

§1107 is replaced by §1184, but is substantially the same as §1107, so no real change to the DIP one typically has seen in regular Chapter 11 cases. §1184 states:

> "Subject to such limitations or conditions as the court may prescribe, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all functions and duties, except the duties specified in paragraphs (2), (3), and (4) of section 1106(a) of this title, of a trustee serving in a case under this chapter, including operating the business of the debtor.
>
> *New § 1184 sets forth the rights and powers of a subchapter V debtor in possession (i.e., the debtor remains in control of the bankruptcy case).*

§ 1185. Removal of debtor in possession.

§1185 is virtually the same as §1204 in Chapter 12 cases and provides:

> "(a) IN GENERAL.—On request of a party in interest, and after notice and a hearing, the court shall order that the debtor shall not be a debtor in possession for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the date of commencement of the case, or for failure to perform the obligations of the debtor under a plan confirmed under this subchapter.
>
> "(b) REINSTATEMENT.—On request of a party in interest, and after notice and a hearing, the court may reinstate the debtor in possession.
>
> *New § 1185 provides that a subchapter V debtor may lose its status as a debtor in possession if the court finds, after notice and a hearing, that the debtor engaged in fraudulent, dishonest or incompetent behavior, or grossly mismanaged its financial affairs.*

§ 1187. Duties and reporting requirements of debtors

§1116 applicable to small business debtors in a regular Chapter 11 case is eliminated and replaced by §1187 which provides virtually the same requirements:

> "(a) FILING REQUIREMENTS.—Upon electing to be a debtor under this subchapter, the debtor shall file the documents required by subparagraphs (A) and (B) of section 1116(1) of this title.
>
> "(b) OTHER APPLICABLE PROVISIONS.—A debtor, in addition to the duties provided in this title and as otherwise required by law, shall comply with the

requirements of section 308 and paragraphs (2), (3), (4), (5), (6), and (7) of section 1116 of this title.

Subsections (a) & (b) are the same as §1116.

"(c) SEPARATE DISCLOSURE STATEMENT EXEMPTION.—If the court orders under section 1181(b) of this title that section 1125 of this title applies, section 1125(f) of this title shall apply.

New § 1187 specifies various duties and reporting requirements of a subchapter V debtor. In addition, it clarifies that the separate disclosure statement exemption applies unless the court orders otherwise

§1115, Property of the Estate

§1115 is in an individual debtor case under Chapter 11 is eliminated and replaced by §1186 which provides as to ALL Debtors, both individuals and entities:

"(a) INCLUSIONS.—If a plan is confirmed under section 1191(b) of this title, property of the estate includes, in addition to the property specified in section 541 of this title—

"(1) all property of the kind specified in that section that the debtor acquires after the date of commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13 of this title, whichever occurs first; and

"(2) earnings from services performed by the debtor after the date of commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13 of this title, whichever occurs first.

"(b) DEBTOR REMAINING IN POSSESSION.—Except as provided in section 1185 of this title, a plan confirmed under this subchapter, or an order confirming a plan under this subchapter, the debtor shall remain in possession of all property of the estate.

New § 1186 concerns property of the estate. Subsection (a) provides that if a plan is confirmed, property of the estate includes all property acquired by the debtor after the date of commencement of the case, but before the case is closed, dismissed, or converted to a case under chapter 7, 12 or 13, whichever occurs first. It also includes all earnings from services performed by the debtor during such period. Subsection (b) provides that the debtor remains in possession of all property of the estate unless the debtor is removed from possession

1121 Who may file a Plan.

This section is wholly eliminated, doing away with time limits for the debtor's exclusive rights to file and confirm a plan as well as the rights of non-debtors to file plans in regular Chapter 11 cases. It also eliminates the debtor's obligations in small business cases to file a Plan in 180 days and the ramifications of failing to do so.

§1189(a) replaces §1121 whereby only the debtor may file a plan Subchapter V and 1189(b) requires the plan to be filed "not later than 90 days after the order for relief under this chapter, except that the court may extend the period if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable."

§1129(e), imposing a 45 day time limit to confirm plan in small business case is eliminated and replaced by §1189(b) requiring the plan to be filed "not later than 90 days after the order for relief under this chapter, except that the court may extend the period if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable." <u>It is notable there is no time limit to confirm the plan once timely filed since §1121 is wholly eliminated.</u>

Contents of a Plan in Subchapter V Cases:

Two provisions of §1123 applicable to Individual Debtor cases are eliminated:

1123(a)(8), provision requiring all or such portion of earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor as is necessary for the execution of the plan.

1123(c), provision related to a plan proposed by an entity other than the debtor may not provide for the use, sale, or lease of exempt property without debtor's consent.

These provisions are replaced by §1190 which provides:

> "A plan filed under this subchapter—
>
> "(1) shall include—
>
> > "(A) a brief history of the business operations of the debtor;
> > "(B) a liquidation analysis; and
> > "(C) projections with respect to the ability of the debtor to make payments under the proposed plan of reorganization;
>
> "(2) shall provide for the submission of all or such portion of the future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan; and
>
> "(3) notwithstanding section 1123(b)(5) of this title, may modify the rights of the holder of a claim secured only by a security interest in real property that is the principal residence of the debtor if the new value received in connection with the granting of the security interest was—
>
> > "(A) not used primarily to acquire the real property; and
> > "(B) used primarily in connection with the small business of the debtor.

New § 1190 sets forth various requirements for the reorganization plan, including a brief history of the debtor's business operations, a liquidation analysis and projections with respect to the debtor's ability to make payments under the proposed reorganization plan. With the elimination of the requirement to file a Disclosure Statement, the addition of these additional provisions to the Plan seem quite appropriate.

In addition, the plan must provide for the submission of all or such portion of the debtor's future earnings or other future income to the supervision and control of the trustee as is necessary for the execution of the plan. Section 1190 permits the debtor to modify the rights of a holder of a claim secured only by a security interest in real property that is the principal residence of the debtor <u>if the new value received in connection with the granting of the security interest was not used primarily to acquire the real property, but was used primarily in connection with the small business of the debtor.</u>

Elimination of Disclosure Statement (mostly).

§1125 requiring a disclosure statement as part of the overall confirmation process does not apply to Subchapter V cases, "Unless the court for cause orders otherwise". This eliminates the need for a Disclosure Statement, which is in this author's opinion the most expensive and least useful document in small business and Individual Chapter 11 cases (or maybe any Chapter 11 case for that matter). It also means solicitation of binding acceptances of the plan may begin at any time pre or post petition.

1127, Modification of the Plan.

This provision allowing modification of a regular Chapter 11 Plan any time before confirmation and after confirmation but only before substantial consummation is wholly eliminated as it §1127(e) applicable to Individual Chapter 11 cases. These sections are replaced by new §1193 which provides:

> "(a) MODIFICATION BEFORE CONFIRMATION.—The debtor may modify a plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of sections 1122 and 1123 of this title, with the exception of subsection (a)(8) of such section 1123. After the modification is filed with the court, the plan as modified becomes the plan.
>
> *This section is essentially the same as a regular Chapter 11.*
>
> "(b) MODIFICATION AFTER CONFIRMATION.—If a plan has been confirmed under section 1191(a) of this title, the debtor may modify the plan at any time after confirmation of the plan and before substantial consummation of the plan, but may not modify the plan so that the plan as modified fails to meet the requirements of sections 1122 and 1123 of this title, with the exception of subsection (a)(8) of such section 1123. The plan, as modified under this subsection, becomes the plan only if circumstances warrant the modification and the court, after notice and a hearing, confirms the plan as modified under section 1191(a) of this title.
>
> *This section does not allow modification after substantial consummation if the plan was confirmed without resort to the cram-down provisions under §1191(b) except for subsection (a)(8) of such section 1123 which does not apply to cases under Subchapter V.*

> "(c) CERTAIN OTHER MODIFICATIONS.—If a plan has been confirmed under section 1191(b) of this title, the debtor may modify the plan at any time within 3 years, or such longer time not to exceed 5 years, as fixed by the court, but may not modify the plan so that the plan as modified fails to meet the requirements of section 1191(b) of this title. The plan as modified under this subsection becomes the plan only if circumstances warrant such modification and the court, after notice and a hearing, confirms such plan, as modified, under section 1191(b) of this title.
>
> *This section allows modification after substantial consummation if the plan was confirmed by resort to the cram-down provisions under §1191(b) for the entire 3-5 year term of the plan but, as usual, the modified plan still has to comply with §1191(b).*
>
> "(d) HOLDERS OF A CLAIM OR INTEREST.—If a plan has been confirmed under section 1191(a) of this title, any holder of a claim or interest that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless, within the time fixed by the court, such holder changes the previous acceptance or rejection of the holder.
>
> *This section is the same as regular Chapter 11 plans.*

Plan Confirmation.

§1129(a) is incorporated in to Subchapter V except for Individual Debtor cases and in such cases §1129(a)(15), requiring contribution of projected disposable income for 5 years upon objection by unsecured creditor is eliminated for consensual plans, but remains for cram-down plans. In cases where all classes vote to accept the plan, then traditional Chapter 11 confirmation standards are incorporated. Some additional comments from Prof. Brubaker's article[4] are appropriate here:

> With only a couple of minor exceptions, all of the provisions of §§ 1122, 1123, 1124, and 1126 regarding contents of the plan, classification, impairment, and voting are fully applicable to a Subchapter V plan. If all of the requirements of § 1129(a) are met with respect to a debtor's proposed Subchapter V plan—including the § 1129(a)(8) requirement that all impaired classes have voted to accept the plan—newly enacted § 1191(a) directs the court to confirm that plan, colloquially known among insolvency professionals, of course, as a consensual plan. And confirmation of that consensual plan

[4] Supra.

> gives the Subchapter V debtor an immediate discharge of pre-confirmation debts under § 1141(d), immediately revests all property of the estate in the debtor as a reorganized debtor under § 1141(b), and (as discussed above) upon substantial consummation of that consensual plan, the Subchapter V trustee's services in the case are terminated under newly enacted § 1183(c)(1).
>
> There are substantial incentives, therefore, for both Subchapter V debtors and their creditors to arrive at a consensual confirmation, if possible. A Subchapter V debtor will prefer to obtain an immediate discharge and regain exclusive control of its business, free of further trustee and court supervision, and creditors will prefer to avoid the fees the Subchapter V trustee will collect from the debtor's plan payments (before payments to creditors) if confirmation is via cram-down (as discussed below).
>
> The benefits from a § 1191(a) consensual confirmation are particularly significant for an individual Subchapter V debtor, which benefits are evident upon comparison with consensual confirmation for an individual Chapter 11 debtor who does *not* qualify as a "small business debtor" or elect Subchapter V. Even if every one of an individual Chapter 11 debtor's creditors votes to accept (and does not object to) the plan, § 1141(d)(5) provides that that individual debtor cannot receive a discharge until the debtor actually completes all plan payments (or enough payments to give all unsecured creditors full liquidation value, in the case of a hardship discharge). Moreover, all of that individual Chapter 11 debtor's post-petition earnings and any other non-exempt property acquired post-petition (and until the Chapter 11 case is closed, dismissed, or converted) become property of the debtor's bankruptcy estate under § 1115(a). Neither § 1141(d)(5) nor § 1115(a), however, are applicable in a Subchapter V case. Individual Chapter 11 debtors, therefore, can be expected to zealously elect Subchapter V and seek to qualify as "small business debtors."

§1129(b), Traditional Cram-Down Provisions are substantially modified and the Absolute Priority Rule is eliminated §1129(a)(15), requiring contribution of projected disposable income is essentially made part of the cram-down. This actually does want BAPCPA appears to have been attempting, but was unsuccessful. The cram-down provisions under Subchapter V are in §1191(b)-(e) as follows:

> "(b) EXCEPTION.—Notwithstanding section 510(a) of this title, if all of the applicable requirements of section 1129(a) of this title, other than paragraphs (8), (10), and (15) of that section, are met with respect to a plan, the court, on request of the debtor, shall confirm the plan notwithstanding the requirements of such paragraphs if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

This section eliminates for cram-down, the requirements of 1129(a)(8) (all classes vote for the plan); 1129(a)(10) (at least one impaired class votes for the plan); and 1129(a)(15) (all disposable income in an Individual Debtor case). In effect, a cram-down without any consenting class, which is effectively the same as Chapters 12 and 13.

"(c) RULE OF CONSTRUCTION.—For purposes of this section, the condition that a plan be fair and equitable with respect to each class of claims or interests includes the following requirements:

"(1) With respect to a class of secured claims, the plan meets the requirements of section 1129(b)(2)(A) of this title.

"(2) As of the effective date of the plan—

"(A) the plan provides that all of the projected *disposable income* of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date that the first payment is due under the plan *will be applied to make payments under the plan*; or

"(B) the value of the *property to be distributed* under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date on which the first distribution is due under the plan is not less than the projected disposable income of the debtor.

The actual disposable income is paid in and distributed under the plan OR property equal to or greater than such amount is to be distributed under the plan. The second alternative allows for partial liquidations of assets to pay what would otherwise be paid from future income.

"(3)(A)

(i) The debtor will be able to make all payments under the plan; or

(ii) there is a reasonable likelihood that the debtor will be able to make all payments under the plan; and

(B) the plan provides appropriate remedies, which may include the liquidation of nonexempt assets, to protect the holders of claims or interests in the event that the payments are not made.

This is the feasibility requirement and is somewhat like a regular Chapter 11 case but adds a provision requiring "appropriate remedies" if there is a default. The "appropriate remedies" MAY include what likely will be the mandatory liquidation of non-exempt assets in the event of a default.

"(d) DISPOSABLE INCOME.—For purposes of this section, the term 'disposable income' means the income that is received by the debtor and that is not reasonably necessary to be expended—

"(1) for—

"(A) the maintenance or support of the debtor or a dependent of the debtor; or

"(B) a domestic support obligation that first becomes payable after the date of the filing of the petition; or

"(2) for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor.

This section defines the term 'disposable income' to be virtually identical to the definition applicable in Chapter 12 cases found in §1225(b)(2).

"(e) SPECIAL RULE.—Notwithstanding section 1129(a)(9)(A) of this title, a plan that provides for the payment through the plan of a claim of a kind specified in paragraph (2) or (3) of section 507(a) of this title may be confirmed under subsection (b) of this section.

This section deals with claims under §507(a)(2) for (1) administrative expenses allowed under section 503(b) including professional fees; (2) certain types of unsecured claims of any Federal reserve bank; and (3) any fees and charges assessed against the estate under chapter 123 of title 28 including U.S. Trustee fees. In regular Chapter 11 cases, these administrative claims must be paid in full in cash at confirmation unless otherwise specifically agreed whereas under new Subchapter V, these claims may be paid out under the plan as it typically provided in Chapter 13 cases.

§1129(c), provisions addressing confirmation of competing plans is eliminated because only the Debtor may file a Plan under new Subchapter V.

Prof. Brubaker's article offers some additional comments on cram-down confirmation:

In cases in which not all impaired classes have voted to accept the debtor's plan, the court can confirm the plan under the cram-down provisions of newly enacted § 1191(b). The consequences of a § 1191(b) cram-down plan, though, are very different from those of a § 1191(a) consensual confirmation. A § 1191(b) cram-down plan is implemented via the Chapter 12 and Chapter 13 model of estate and plan administration.

If the Subchapter V plan is confirmed under the § 1191(b) cram-down provision, then (like in Chapter 12, Chapter 13, and individual-debtor Chapter 11 cases) property of the debtor's bankruptcy estate also includes all of the Subchapter V debtor's post-petition

earnings and any other non-exempt property acquired post-petition (and until the Subchapter V case is closed, dismissed, or converted) under newly enacted § 1186(a). The Subchapter V trustee's services continue post-confirmation if confirmation is by cram-down. And as is the case for all Chapter 12 and 13 plans, the Subchapter V debtor will make its cram-down plan payments to the trustee, and "the trustee shall make payments to creditors under the plan,"[86] from which the Subchapter V trustee should receive payment of trustee's fees.[87]

In addition, for a § 1191(b) cram-down confirmation, the debtor does not receive an immediate debt discharge. Under newly enacted § 1192, the Subchapter V debtor receives a cram-down discharge only "after completion by the debtor of all payments due" under the cram-down plan, as is the case for all Chapter 12 and 13 plans and for individual-debtor Chapter 11 cases. [most footnotes omitted]

Footnote 86

"[E]xcept as otherwise provided in the plan or in the order confirming the plan." Pub. L. No. 116-54, § 2(a) (2019) (enacting 11 U.S.C.A. § 1194(b)). Unlike Chapter 12 (in § 1225(c)) and Chapter 13 (in § 1325(c)), though, Subchapter V has no provision authorizing a direct-payment order, pursuant to which "[a]fter confirmation of a plan, the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee." 11 U.S.C.A. §§ 1225(c), 1325(c).

Footnote 87

There is a drafting error in the 2019 Act, however, as regards allowance of plan-payment fees to a Subchapter V trustee. The Act adds a general reference to "subchapter V of chapter 11" in the introductory clause of Code § 326(b). See Pub. L. No. 116-54, § 4(a)(4)(B) (2019) (amending 11 U.S.C.A. § 326(b)). But the 2019 Act does *not* amend the operative clause of § 326(b), which still *only* authorizes allowance of plan-payment fees to Chapter 12 and Chapter 13 trustees, *without* any reference to a Subchapter V trustee appointed under newly enacted § 1183(a). As amended (in italics), § 326(b) provides, in relevant part:

> In a case under *subchapter V of chapter 11 or* chapter 12 or 13 of this title, the court … may allow reasonable compensation under section 330 … of a trustee appointed under section 1202(a) or 1302(a) … for the trustee's services, payable after the trustee renders such services, not to exceed five percent upon all payments under the plan.

The omission of the percentage trustee fee for the standing Subchapter V Trustee is interesting. Did Congress intend Subchapter V Trustee file the standard fee applications like any other estate professional? For now at least, fee applications appear to be the only option for the standing Subchapter V Trustee to get paid.

Discharge of Individual Debtors.

1141(d)(5) Provisions dealing with Effect of Confirmation as to an Individual Debtor is replaced by §1192 addressing the issue of a Discharge for Individual Debtors. All other subsections of §1141 still apply to Entity Debtors. This new provision requires the court to grant the Individual Debtor a discharge as soon as practicable after completion by the debtor of all payments due within the first three years of the plan, or such longer period not to exceed five years as the court may fix. Such discharge pertains to all debts as provided under the plan except any debt (1) on which the last payment is due after the first three years of the plan, or such other time not to exceed five years fixed by the court; or (2) that is excepted from the Discharge under §523(a).

The Discharge of an Individual Debtor in Subchapter V cases has the same exceptions as in Chapter 7 but also does not provide for any discharge when a plan is only partially performed under §§1141(d)(5)(B) and 1328(b).

As noted above, the timing of the entry of the Discharge depends on whether the confirmation of the plan is consensual or via cram-down.

The post-confirmation provisions of regular Chapter 11 under §§ 1142 (Implementation of the Plan), 1143 (Distributions) and 1144 (revocation of confirmation order) still apply.

Creditors' Committee Eliminated (mostly).

§1102 and 1103 dealing with Creditors' Committees does not apply to Subchapter V cases, "Unless the court for cause orders otherwise". This should greatly reduce the risk of unbudgeted administrative claims attendant to Creditors' Committees and their professionals thereby reducing the overall cost of a Chapter under Subchapter V.

The phrase "Unless the court for cause orders otherwise" applies to the general elimination of both Creditors' Committees and Disclosure Statements. Subchapter V provides no definition of "for cause" thereby leaving this door wide open for creative creditor attorneys to dream up new and exciting ways to vex Debtors who elect to proceed under this new section.

§ 1195. Transactions with professionals

"Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title, by a debtor solely because that person holds a claim of less than $10,000 that arose prior to commencement of the case."

This section allows the DIP to retain professionals who hold small claims that would otherwise disqualify the professionals in a regular Chapter 11 case.

Small Business Reorganization Act of 2019

PL 116-54, 133 Stat. 1079

Statutes Affected by Conforming Amendments:

- 11 U.S.C. § 101
- 11 U.S.C. § 103
- 11 U.S.C. § 322
- 11 U.S.C. § 326
- 11 U.S.C. § 347
- 11 U.S.C. § 363
- 11 U.S.C. § 364
- 11 U.S.C. § 523
- 11 U.S.C. § 524
- 11 U.S.C. § 547
- 11 U.S.C. § 557
- 11 U.S.C. § 1102
- 11 U.S.C. § 1146
- 28 U.S.C. § 586
- 28 U.S.C. § 589b
- 28 U.S.C. 1409
- 28 U.S.C. 1930

The amendments in the following are indicated by underlined text.

11 U.S.C. § 101

(51C) The term "small business case" means a case filed under chapter 11 of this title in which the debtor is a small business debtor.

(51C) of this section is amended by inserting ''and has not elected that subchapter V of chapter 11 of this title shall apply'' after ''is a small business debtor''.

(51D) The term "small business debtor"--
(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $2,000,000[1] (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor;

(51D)(A) of this section is amended-- (I) by striking "or operating real property or activities incidental thereto" and inserting "single asset real estate"; and (II) by striking "for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and" and inserting "not less than 50 percent of which arose from the commercial or business activities of the debtor; and".

(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $2,000,000[1] (excluding debt owed to 1 or more affiliates or insiders).

(51D)(B) of this section is amended-- (I) by striking the period at the end and inserting a semicolon; (II) by striking "does not include any member" and inserting the following: "does not include--(i) any member"; and (III) by adding at the end the following: (ii) any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)); or (iii) any corporation that-- (I) is subject to

the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78(d)); and (II) is an affiliate of a debtor.

11 U.S.C. § 103

(a) Except as provided in section 1161 of this title, chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, 12, or 13 of this title, and this chapter, sections 307, 362(o), 555 through 557, and 559 through 562 apply in a case under chapter 15.

(b) Subchapters I and II of chapter 7 of this title apply only in a case under such chapter.

(c) Subchapter III of chapter 7 of this title applies only in a case under such chapter concerning a stockbroker.

(d) Subchapter IV of chapter 7 of this title applies only in a case under such chapter concerning a commodity broker.

(e) Scope of application.--Subchapter V of chapter 7 of this title shall apply only in a case under such chapter concerning the liquidation of an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409[1] of the Federal Deposit Insurance Corporation Improvement Act of 1991.

(f) Except as provided in section 901 of this title, only chapters 1 and 9 of this title apply in a case under such chapter 9.

(g) Except as provided in section 901 of this title, subchapters I, II, and III of chapter 11 of this title apply only in a case under such chapter.

(h) Subchapter IV of chapter 11 of this title applies only in a case under such chapter concerning a railroad.

(i) Chapter 13 of this title applies only in a case under such chapter.

(j) Chapter 12 of this title applies only in a case under such chapter.

(k) Chapter 15 applies only in a case under such chapter, except that--

(1) sections 1505, 1513, and 1514 apply in all cases under this title; and

(2) section 1509 applies whether or not a case under this title is pending.

subsec. (i) to (l) of this section is amended--

(A) by redesignating subsections (i) through (k) as subsections (j) through (l), respectively; and

(B) by inserting after subsection (h) the following:

(i) Subchapter V of chapter 11 of this title applies only in a case under chapter 11 in which a small business debtor elects that subchapter V of chapter 11 shall apply.

11 U.S.C. § 322

(a) Except as provided in subsection (b)(1), a person selected under section 701, 702, 703, 1104, 1163, 1202, or 1302 of this title to serve as trustee in a case under this title qualifies if before seven days after such selection, and before beginning official duties, such person has filed with the court a bond in favor of the United States conditioned on the faithful performance of such official duties.

(b)(1) The United States trustee qualifies wherever such trustee serves as trustee in a case under this title.

(2) The United States trustee shall determine--

(A) the amount of a bond required to be filed under subsection (a) of this section; and

(B) the sufficiency of the surety on such bond.

(c) A trustee is not liable personally or on such trustee's bond in favor of the United States for any penalty or forfeiture incurred by the debtor.

(d) A proceeding on a trustee's bond may not be commenced after two years after the date on which such trustee was discharged.

subsec. (a) of this section is amended by inserting ‘‘1183,’’ after ‘‘1163,”.

11 U.S.C. § 326

(a) In a case under chapter 7 or 11, the court may allow reasonable compensation under section 330 of this title of the trustee for the trustee's services, payable after the trustee renders such services, not to exceed 25 percent on the first $5,000 or less, 10 percent on any amount in excess of $5,000 but not in excess of $50,000, 5 percent on any amount in excess of $50,000 but not in excess of $1,000,000, and reasonable compensation not to exceed 3 percent of such moneys in excess of $1,000,000, upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims.

subsec. (a) of this section is amended by inserting ‘‘, other than a case under subchapter V of chapter 11’’ after ‘‘7 or 11’’

(b) In a case under chapter 12 or 13 of this title, the court may not allow compensation for services or reimbursement of expenses of the United States trustee or of a standing trustee appointed under section 586(b) of title 28, but may allow reasonable compensation under section 330 of this title of a trustee appointed under section 1202(a) or 1302(a) of this title for the trustee's services, payable after the trustee renders such services, not to exceed five percent upon all payments under the plan.

subsec. (b) of this section is amended by inserting ‘‘subchapter V of chapter 11 or’’ after ‘‘In a case under”.

(c) If more than one person serves as trustee in the case, the aggregate compensation of such persons for such service may not exceed the maximum compensation prescribed for a single trustee by subsection (a) or (b) of this section, as the case may be.

(d) The court may deny allowance of compensation for services or reimbursement of expenses of the trustee if the trustee failed to make diligent inquiry into facts that would permit denial of allowance under section 328(c) of this title or, with knowledge of such facts, employed a professional person under section 327 of this title.

11 U.S.C. § 347

(a) Ninety days after the final distribution under section 726, 1226, or 1326 of this title in a case under chapter 7, 12, or 13 of this title, as the case may be, the trustee shall stop payment on any check remaining unpaid, and any remaining property of the estate shall be paid into the court and disposed of under chapter 129 of title 28.

subsec. (a) of this section is amended--
(i) by inserting "1194," after "726,"; and
(ii) by inserting "subchapter V of chapter 11," after "chapter 7,"

(b) Any security, money, or other property remaining unclaimed at the expiration of the time allowed in a case under chapter 9, 11, or 12 of this title for the presentation of a security or the performance of any other act as a condition to participation in the distribution under any plan confirmed under section 943(b), 1129, 1173, or 1225 of this title, as the case may be, becomes the property of the debtor or of the entity acquiring the assets of the debtor under the plan, as the case may be.

subsec. (b) of this section is amended by inserting "1194," after "1173,".

11 U.S.C. § 363

(c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

subsec. (c)(1) of this section is amended by inserting ‘‘1183, 1184,’’ after ‘‘1108,’’.

11 U.S.C. § 364

(a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1203, 1204, or 1304 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

subsec. (a) of this section is amended by inserting ‘‘1183, 1184,’’ after ‘‘1108,’’.

11 U.S.C. § 523

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt--

subsec. (a) of this section is amended in the matter preceding paragraph (1), by inserting ‘‘1192’’ after ‘‘1141,’’.

11 U.S.C. § 524

(a) A discharge in a case under this title-- **(1)** voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived;

subsec. (a)(1) of this section is amended by inserting "1192,'' after ''1141,''.

(3) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect or recover from, or offset against, property of the debtor of the kind specified in section 541(a)(2) of this title that is acquired after the commencement of the case, on account of any allowable community claim, except a community claim that is excepted from discharge under section 523, 1228(a)(1), or 1328(a)(1), or that would be so excepted, determined in accordance with the provisions of sections 523(c) and 523(d) of this title, in a case concerning the debtor's spouse commenced on the date of the filing of the petition in the case concerning the debtor, whether or not discharge of the debt based on such community claim is waived.

subsec. (a)(3) of this section is amended by inserting "1192,'' after ''523,

(c) An agreement between a holder of a claim and the debtor, the consideration for which, in whole or in part, is based on a debt that is dischargeable in a case under this title is enforceable only to any extent enforceable under applicable nonbankruptcy law, whether or not discharge of such debt is waived, only if-- **(1)** such agreement was made before the granting of the discharge under section 727, 1141, 1228, or 1328 of this title;

subsec. (c)(1) of this section is amended by inserting "1192,'' after ''1141

(d) In a case concerning an individual, when the court has determined whether to grant or not to grant a discharge under section 727, 1141, 1228, or 1328 of this title, the court may hold a hearing at which the debtor shall appear in person. At any such hearing, the court shall inform the debtor that a discharge has been granted or the reason why a discharge has not been granted. If a discharge has been granted and if the debtor desires to make an agreement of the kind specified in subsection (c) of this section and was not represented by an attorney during the course of negotiating such agreement, then the court shall hold a hearing at which the debtor shall appear in person and at such hearing the court shall

subsec. (d) of this section is amended by inserting "1192,'' after ''1141,".

11 U.S.C. § 547

(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property--

subsec. (b) of this section is amended by inserting ‘‘, based on reasonable due diligence in the circumstances of the case and taking into account a party’s known or reasonably knowable affirmative defenses under subsection (c),’’ after ‘‘may’’.

11 U.S.C. § 557

(d) The procedures that may be expedited under subsection (c) of this section include-- **(3)** subject to sections 701, 702, 703, 1104, 1202, and 1302 of this title, the appointment of a trustee or examiner and the retention and compensation of any professional person required to assist with respect to matters relevant to the determination of interests in or disposition of such grain or the proceeds of grain

subsec. (d)(3) of this section is amended by inserting ‘‘1183,’’ after ‘‘1104,’’.

11 U.S.C. § 1102

(3) On request of a party in interest in a case in which the debtor is a small business debtor and for cause, the court may order that a committee of creditors not be appointed.

subsec. (a)(3) of this section is amended by striking paragraph (3) and inserting the following:
(3) Unless the court for cause orders otherwise, a committee of creditors may not be appointed in a small business case or a case under subchapter V of this chapter.

11 U.S.C. § 1146

(a) The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.

subsec. (a) of this section is amended by inserting "or 1191'' after ''1129''.

28 U.S.C. § 586

(a) Each United States trustee, within the region for which such United States trustee is appointed, shall--**(3)** supervise the administration of cases and trustees in cases under chapter 7, 11, 12, 13, or 15 of title 11 by, whenever the United States trustee considers it to be appropriate--

subsec. (a)(3) of this section is amended by inserting "(including subchapter V of chapter 11)'' after "7, 11''.

(b) If the number of cases under chapter 12 or 13 of title 11 commenced in a particular region so warrants, the United States trustee for such region may, subject to the approval of the Attorney General, appoint one or more individuals to serve as standing trustee, or designate one or more assistant United States trustees to serve in cases under such chapter. The United States trustee for such region shall supervise any such individual appointed as standing trustee in the performance of the duties of standing trustee.

subsec. (b) of this section is amended by inserting "subchapter V of chapter 11 or" after "cases under" the first place it appears.

(d)(1) The Attorney General shall prescribe by rule qualifications for membership on the panels established by United States trustees under paragraph (a)(1) of this section, and qualifications for appointment under subsection (b) of this section to serve as standing trustee in cases under chapter 12 or 13 of title 11. The Attorney General may not require that an individual be an attorney in order to qualify for appointment under subsection (b) of this section to serve as standing trustee in cases under chapter 12 or 13 of title 11.

subsec. (d)(1) of this section is amended by inserting "subchapter V of chapter 11 or" after "cases under" each place that term appears.

(e)(1) The Attorney General, after consultation with a United States trustee that has appointed an individual under subsection (b) of this section to serve as standing trustee in cases under chapter 12 or 13 of title 11, shall fix--

subsec. (e)(1) of this section is amended by inserting "subchapter V of chapter 11 or" after "cases under".

(2) Such individual shall collect such percentage fee from all payments received by such individual under plans in the cases under chapter 12 or 13 of title 11 for which such individual serves as standing trustee. Such individual shall pay to the United States trustee, and the United States trustee shall deposit in the United States Trustee System Fund--

subsec. (e)(2) of this section is amended by inserting "subchapter V of chapter 11 or" after "cases under" each place that term appears.

subsec. (e)(5) of this section is **enacted** to read--
(5) In the event that the services of the trustee in a case under subchapter V of chapter 11 of title 11 are terminated by dismissal or conversion of the case, or upon substantial consummation of a plan under section 1183(c)(1) of that title, the court shall award compensation to the trustee consistent with services performed by the trustee and the limits on the compensation of the trustee established pursuant to paragraph (1) of this subsection.

28 U.S.C. § 589B

(a) Rules.--The Attorney General shall, within a reasonable time after the effective date of this section, issue rules requiring uniform forms for (and from time to time thereafter to appropriately modify and approve)--
(1) final reports by trustees in cases under chapters 7, 12, and 13 of title 11

subsec. (a)(1) of this section is amended by inserting "subchapter V of chapter 11 and" after "cases under".

(d) Final reports.--The uniform forms for final reports required under subsection (a) for use by trustees under chapters 7, 12, and 13 of title 11 shall, in addition to such other matters as are required by law or as the Attorney General in the discretion of the Attorney General shall propose, include with respect to a case under such title--

(1) information about the length of time the case was pending;
(2) assets abandoned;
(3) assets exempted;
(4) receipts and disbursements of the estate;
(5) expenses of administration, including for use under section 707(b), actual costs of administering cases under chapter 13 of title 11;
(6) claims asserted;
(7) claims allowed; and
(8) distributions to claimants and claims discharged without payment,

in each case by appropriate category and, in cases under chapters 12 and 13 of title 11, date of confirmation of the plan, each modification thereto, and defaults by the debtor in performance under the plan.

subsec. (d) of this section is amended in the matter preceding paragraph (1), by inserting "subchapter V of chapter 11 and'' after "trustees under".

subsec. (d) of this section is amended in the undesignated matter following paragraph (8), by inserting "subchapter V of chapter 11 and" after "cases under".

28 U.S.C. § 1409

(b) Except as provided in subsection (d) of this section, a trustee in a case under title 11 may commence a proceeding arising in or related to such case to recover a money judgment of or property worth less than $1,000[1] or a consumer debt of less than $15,000[1], or a debt (excluding a consumer debt) against a noninsider of less than $10,000[1], only in the district court for the district in which the defendant resides.

subsec. (b) of this section is amended by striking ‘‘$10,000’’ and inserting ‘‘$25,000’’.

28 U.S.C. § 1930

(6)(A) Except as provided in subparagraph (B), in addition to the filing fee paid to the clerk, a quarterly fee shall be paid to the United States trustee, for deposit in the Treasury, in each case under chapter 11 of title 11 for each quarter (including any fraction thereof) until the case is converted or dismissed, whichever occurs first. The fee shall be $325 for each quarter in which disbursements total less than $15,000; $650 for each quarter in which disbursements total $15,000 or more but less than $75,000; $975 for each quarter in which disbursements total $75,000 or more but less than $150,000; $1,625 for each quarter in which disbursements total $150,000 or more but less than $225,000; $1,950 for each quarter in which disbursements total $225,000 or more but less than $300,000; $4,875 for each quarter in which disbursements total $300,000 or more but less than $1,000,000; $6,500 for each quarter in which disbursements total $1,000,000 or more but less than $2,000,000; $9,750 for each quarter in which disbursements total $2,000,000 or more but less than $3,000,000; $10,400 for each quarter in which disbursements total $3,000,000 or more but less than $5,000,000; $13,000 for each quarter in which disbursements total $5,000,000 or more but less than $15,000,000; $20,000 for each quarter in which disbursements total $15,000,000 or more but less than $30,000,000; $30,000 for each quarter in which disbursements total more than $30,000,000. The fee shall be payable on the last day of the calendar month following the calendar quarter for which the fee is owed.

subsec. (a)(6)(A) of this section is amended by inserting ", other than under subchapter V," after "chapter 11 of title 11".

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116TH CONGRESS
1ST SESSION

H. R. 3311

To amend chapter 11 of title 11, United States Code, to address reorganization of small businesses, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JUNE 18, 2019

Mr. CLINE (for himself, Mr. CICILLINE, Mr. COLLINS of Georgia, and Mr. COHEN) introduced the following bill; which was referred to the Committee on the Judiciary

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A BILL

To amend chapter 11 of title 11, United States Code, to address reorganization of small businesses, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Small Business Reorganization Act of 2019".

SEC. 2. REORGANIZATION OF SMALL BUSINESS DEBTORS.

(a) IN GENERAL.—Chapter 11 of title 11, United States Code, is amended by adding at the end the following:

''SUBCHAPTER V—SMALL BUSINESS DEBTOR REORGANIZATION

''§ 1181. Inapplicability of other sections

''(a) IN GENERAL.—Sections 105(d), 1101(1), 1104, 1105, 1106, 1107, 1108, 1115, 1116, 1121, 1123(a)(8), 1123(c), 1127, 1129(a)(15), 1129(b), 1129(c), 1129(e), and 1141(d)(5) of this title do not apply in a case under this subchapter.

''(b) COURT AUTHORITY.—Unless the court for cause orders otherwise, paragraphs (1), (2), and (4) of section 1102(a) and sections 1102(b), 1103, and 1125 of this title do not apply in a case under this subchapter.

''(c) SPECIAL RULE FOR DISCHARGE.—If a plan is confirmed under section 1191(b) of this title, section 1141(d) of this title shall not apply, except as provided in section 1192 of this title.

''§ 1182. Definitions

''In this subchapter:

''(1) DEBTOR.—The term 'debtor' means a small business debtor.

''(2) DEBTOR IN POSSESSION.—The term 'debtor in possession' means the debtor, unless removed as debtor in possession under section 1185(a) of this title.

"§ 1183. Trustee

''(a) IN GENERAL.—If the United States trustee has appointed an individual under section 586(b) of title 28 to serve as standing trustee in cases under this subchapter, and if such individual qualifies as a trustee under section 322 of this title, then that individual shall serve as trustee in any case under this subchapter. Otherwise, the United States trustee shall appoint 1 disinterested person to serve as trustee in the case or the United States trustee may serve as trustee in the case, as necessary.

''(b) DUTIES.—The trustee shall—

''(1) perform the duties specified in paragraphs (2), (5), (6), (7), and (9) of section 704(a) of this title;

''(2) perform the duties specified in paragraphs (3), (4), and (7) of section 1106(a) of this title, if the court, for cause and on request of a party in interest, the trustee, or the United States trustee, so orders;

''(3) appear and be heard at the status conference under section 1188 of this title and any hearing that concerns—

''(A) the value of property subject to a lien;

''(B) confirmation of a plan filed under this subchapter;

"(C) modification of the plan after confirmation; or

"(D) the sale of property of the estate;

"(4) ensure that the debtor commences making timely payments required by a plan confirmed under this subchapter;

"(5) if the debtor ceases to be a debtor in possession, perform the duties specified in section 704(a)(8) and paragraphs (1), (2), and (6) of section 1106(a) of this title, including operating the business of the debtor;

"(6) if there is a claim for a domestic support obligation with respect to the debtor, perform the duties specified in section 704(c) of this title; and

"(7) facilitate the development of a consensual plan of reorganization.

"(c) TERMINATION OF TRUSTEE SERVICE.—

"(1) IN GENERAL.—If the plan of the debtor is confirmed under section 1191(a) of this title, the service of the trustee in the case shall terminate when the plan has been substantially consummated, except that the United States trustee may reappoint a trustee as needed for performance of duties under subsection (b)(3)(C) of this section and section 1185(a) of this title.

"(2) SERVICE OF NOTICE OF SUBSTANTIAL CONSUMMATION.—Not later than 14 days after the plan of the debtor is substantially consummated, the debtor shall file with the court and serve on the trustee, the United States trustee, and all parties in interest notice of such substantial consummation.

"§ 1184. Rights and powers of a debtor in possession

"Subject to such limitations or conditions as the court may prescribe, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all functions and duties, except the duties specified in paragraphs (2), (3), and (4) of section 1106(a) of this title, of a trustee serving in a case under this chapter, including operating the business of the debtor.

"§ 1185. Removal of debtor in possession

"(a) IN GENERAL.—On request of a party in interest, and after notice and a hearing, the court shall order that the debtor shall not be a debtor in possession for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the date of commencement of the case, or for failure to perform the obligations of the debtor under a plan confirmed under this subchapter.

"(b) REINSTATEMENT.—On request of a party in interest, and after notice and a hearing, the court may reinstate the debtor in possession.

"§ 1186. Property of the estate

"(a) INCLUSIONS.—If a plan is confirmed under section 1191(b) of this title, property of the estate includes, in addition to the property specified in section 541 of this title—

"(1) all property of the kind specified in that section that the debtor acquires after the date of commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13 of this title, whichever occurs first; and

"(2) earnings from services performed by the debtor after the date of commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13 of this title, whichever occurs first.

"(b) DEBTOR REMAINING IN POSSESSION.—Except as provided in section 1185 of this title, a plan confirmed under this subchapter, or an order confirming a plan under this subchapter, the debtor shall remain in possession of all property of the estate.

"§ 1187. Duties and reporting requirements of debtors

"(a) FILING REQUIREMENTS.—Upon electing to be a debtor under this subchapter, the debtor shall file the documents required by subparagraphs (A) and (B) of section 1116(1) of this title.

"(b) OTHER APPLICABLE PROVISIONS.—A debtor, in addition to the duties provided in this title and as otherwise required by law, shall comply with the requirements of section 308 and paragraphs (2), (3), (4), (5), (6), and (7) of section 1116 of this title.

"(c) SEPARATE DISCLOSURE STATEMENT EXEMPTION.—If the court orders under section 1181(b) of this title that section 1125 of this title applies, section 1125(f) of this title shall apply.

"§ 1188. Status conference

"(a) IN GENERAL.—Except as provided in subsection (b), not later than 60 days after the entry of the order for relief under this chapter, the court shall hold a status conference to further the expeditious and economical resolution of a case under this subchapter.

"(b) EXCEPTION.—The court may extend the period of time for holding a status conference under subsection (a) if the need for an extension is attributable to circumstances for which the debtor should not justly be held accountable.

''(c) REPORT.—Not later than 14 days before the date of the status conference under subsection (a), the debtor shall file with the court and serve on the trustee and all parties in interest a report that details the efforts the debtor has undertaken and will undertake to attain a consensual plan of reorganization.

''§ 1189. Filing of the plan

''(a) WHO MAY FILE A PLAN.—Only the debtor may file a plan under this subchapter.

''(b) DEADLINE.—The debtor shall file a plan not later than 90 days after the order for relief under this chapter, except that the court may extend the period if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable.

''§ 1190. Contents of plan

''A plan filed under this subchapter—

''(1) shall include—

''(A) a brief history of the business operations of the debtor;

''(B) a liquidation analysis; and

''(C) projections with respect to the ability of the debtor to make payments under the proposed plan of reorganization;

''(2) shall provide for the submission of all or such portion of the future earnings or other future

income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan; and

''(3) notwithstanding section 1123(b)(5) of this title, may modify the rights of the holder of a claim secured only by a security interest in real property that is the principal residence of the debtor if the new value received in connection with the granting of the security interest was—

''(A) not used primarily to acquire the real property; and

''(B) used primarily in connection with the small business of the debtor.

''§ 1191. Confirmation of plan

''(a) TERMS.—The court shall confirm a plan under this subchapter only if all of the requirements of section 1129(a), other than paragraph (15) of that section, of this title are met.

''(b) EXCEPTION.—Notwithstanding section 510(a) of this title, if all of the applicable requirements of section 1129(a) of this title, other than paragraphs (8), (10), and (15) of that section, are met with respect to a plan, the court, on request of the debtor, shall confirm the plan notwithstanding the requirements of such paragraphs if the plan does not discriminate unfairly, and is fair and equi-

table, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

"(c) RULE OF CONSTRUCTION.—For purposes of this section, the condition that a plan be fair and equitable with respect to each class of claims or interests includes the following requirements:

"(1) With respect to a class of secured claims, the plan meets the requirements of section 1129(b)(2)(A) of this title.

"(2) As of the effective date of the plan—

"(A) the plan provides that all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date that the first payment is due under the plan will be applied to make payments under the plan; or

"(B) the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date on which the first distribution is due under the plan is not less than the projected disposable income of the debtor.

"(3)(A)(i) The debtor will be able to make all payments under the plan; or

"(ii) there is a reasonable likelihood that the debtor will be able to make all payments under the plan; and

"(B) the plan provides appropriate remedies, which may include the liquidation of nonexempt assets, to protect the holders of claims or interests in the event that the payments are not made.

"(d) DISPOSABLE INCOME.—For purposes of this section, the term 'disposable income' means the income that is received by the debtor and that is not reasonably necessary to be expended—

"(1) for—

"(A) the maintenance or support of the debtor or a dependent of the debtor; or

"(B) a domestic support obligation that first becomes payable after the date of the filing of the petition; or

"(2) for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor.

"(e) SPECIAL RULE.—Notwithstanding section 1129(a)(9)(A) of this title, a plan that provides for the payment through the plan of a claim of a kind specified

in paragraph (2) or (3) of section 507(a) of this title may be confirmed under subsection (b) of this section.

"§ 1192. Discharge

"If the plan of the debtor is confirmed under section 1191(b) of this title, as soon as practicable after completion by the debtor of all payments due within the first 3 years of the plan, or such longer period not to exceed 5 years as the court may fix, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title, and all other debts allowed under section 503 of this title and provided for in the plan, except any debt—

"(1) on which the last payment is due after the first 3 years of the plan, or such other time not to exceed 5 years fixed by the court; or

"(2) of the kind specified in section 523(a) of this title.

"§ 1193. Modification of plan

"(a) MODIFICATION BEFORE CONFIRMATION.—The debtor may modify a plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of sections 1122 and 1123 of this title, with the exception of subsection (a)(8) of such

section 1123. After the modification is filed with the court, the plan as modified becomes the plan.

''(b) MODIFICATION AFTER CONFIRMATION.—If a plan has been confirmed under section 1191(a) of this title, the debtor may modify the plan at any time after confirmation of the plan and before substantial consummation of the plan, but may not modify the plan so that the plan as modified fails to meet the requirements of sections 1122 and 1123 of this title, with the exception of subsection (a)(8) of such section 1123. The plan, as modified under this subsection, becomes the plan only if circumstances warrant the modification and the court, after notice and a hearing, confirms the plan as modified under section 1191(a) of this title.

''(c) CERTAIN OTHER MODIFICATIONS.—If a plan has been confirmed under section 1191(b) of this title, the debtor may modify the plan at any time within 3 years, or such longer time not to exceed 5 years, as fixed by the court, but may not modify the plan so that the plan as modified fails to meet the requirements of section 1191(b) of this title. The plan as modified under this subsection becomes the plan only if circumstances warrant such modification and the court, after notice and a hearing, confirms such plan, as modified, under section 1191(b) of this title.

''(d) HOLDERS OF A CLAIM OR INTEREST.—If a plan has been confirmed under section 1191(a) of this title, any holder of a claim or interest that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless, within the time fixed by the court, such holder changes the previous acceptance or rejection of the holder.

''§ 1194. Payments

''(a) RETENTION AND DISTRIBUTION BY TRUSTEE.—Payments and funds received by the trustee shall be retained by the trustee until confirmation or denial of confirmation of a plan. If a plan is confirmed, the trustee shall distribute any such payment in accordance with the plan. If a plan is not confirmed, the trustee shall return any such payments to the debtor after deducting—

''(1) any unpaid claim allowed under section 503(b) of this title;

''(2) any payment made for the purpose of providing adequate protection of an interest in property due to the holder of a secured claim; and

''(3) any fee owing to the trustee.

''(b) OTHER PLANS.—If a plan is confirmed under section 1191(b) of this title, except as otherwise provided in the plan or in the order confirming the plan, the trustee shall make payments to creditors under the plan.

"(c) PAYMENTS PRIOR TO CONFIRMATION.—Prior to confirmation of a plan, the court, after notice and a hearing, may authorize the trustee to make payments to the holder of a secured claim for the purpose of providing adequate protection of an interest in property.

"§ 1195. Transactions with professionals

"Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title, by a debtor solely because that person holds a claim of less than $10,000 that arose prior to commencement of the case.".

(b) CLERICAL AMENDMENT.—The table of subchapters at the beginning of chapter 11 of title 11, United States Code, is amended by adding at the end the following:

"SUBCHAPTER V—SMALL BUSINESS DEBTOR REORGANIZATION

"1181. Inapplicability of other sections.
"1182. Definitions.
"1183. Trustee.
"1184. Rights and powers of a debtor in possession.
"1185. Removal of debtor in possession.
"1186. Property of the estate.
"1187. Duties and reporting requirements of debtors.
"1188. Status conference.
"1189. Filing of the plan.
"1190. Contents of plan.
"1191. Confirmation of plan.
"1192. Discharge.
"1193. Modification of plan.
"1194. Payments.
"1195. Transactions with professionals.".

SEC. 3. PREFERENCES; VENUE OF CERTAIN PROCEEDINGS.

(a) PREFERENCES.—Section 547(b) of title 11, United States Code, is amended by inserting ", based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c)," after "may".

(b) VENUE OF CERTAIN PROCEEDINGS.—Section 1409(b) of title 28, United States Code, is amended by striking "$10,000" and inserting "$25,000".

SEC. 4. CONFORMING AMENDMENTS.

(a) TITLE 11.—Title 11, United States Code, is amended—

(1) in section 101—

(A) in paragraph (51C), by inserting "and has not elected that subchapter V of chapter 11 of this title shall apply" after "is a small business debtor"; and

(B) in paragraph (51D)—

(i) in subparagraph (A)—

(I) by striking "or operating real property or activities incidental thereto" and inserting "single asset real estate"; and

(II) by striking "for a case in which" and all that follows and insert-

ing ''not less than 50 percent of which arose from the commercial or business activities of the debtor; and''; and

(ii) in subparagraph (B)—

(I) by striking the period at the end and inserting a semicolon;

(II) by striking ''does not include any member'' and inserting the following: ''does not include—

''(i) any member''; and

(III) by adding at the end the following:

''(ii) any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)); or

''(iii) any corporation that—

''(I) is subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)); and

''(II) is an affiliate of a debtor.'';

(2) in section 103—

(A) by redesignating subsections (i) through (k) as subsections (j) through (l), respectively; and

(B) by inserting after subsection (h) the following:

''(i) Subchapter V of chapter 11 of this title applies only in a case under chapter 11 in which a small business debtor elects that subchapter V of chapter 11 shall apply.'';

(3) in section 322(a), by inserting ''1183,'' after ''1163,'';

(4) in section 326—

(A) in subsection (a), by inserting '', other than a case under subchapter V of chapter 11,'' after ''7 or 11''; and

(B) in subsection (b), by inserting ''subchapter V of chapter 11 or'' after ''In a case under'';

(5) in section 347—

(A) in subsection (a)—

(i) by inserting ''1194,'' after ''726,''; and

(ii) by inserting ''subchapter V of chapter 11,'' after ''chapter 7,''; and

(B) in subsection (b), by inserting ''1194,'' after ''1173,'';

(6) in section 363(c)(1), by inserting ''1183, 1184,'' after ''1108,'';

(7) in section 364(a), by inserting ''1183, 1184,'' after ''1108,'';

(8) in section 523(a), in the matter preceding paragraph (1), by inserting ''1192,'' after ''1141,'';

(9) in section 524—

(A) in subsection (a)—

(i) in paragraph (1), by inserting ''1192,'' after ''1141,''; and

(ii) in paragraph (3), by inserting ''1192,'' after ''523,'';

(B) in subsection (c)(1), by inserting ''1192,'' after ''1141,''; and

(C) in subsection (d), by inserting ''1192,'' after ''1141,'';

(10) in section 557(d)(3), by inserting ''1183,'' after ''1104,'';

(11) in section 1102(a), by striking paragraph (3) and inserting the following:

''(3) Unless the court for cause orders otherwise, a committee of creditors may not be appointed

in a small business case or a case under subchapter V of this chapter.''; and

(12) in section 1146(a), by inserting ''or 1191'' after ''1129''.

(b) TITLE 28.—Title 28 United States Code, is amended—

(1) in section 586—

(A) in subsection (a)(3), by inserting ''(including subchapter V of chapter 11)'' after ''7, 11'';

(B) in subsection (b), by inserting ''subchapter V of chapter 11 or'' after ''cases under'';

(C) in subsection (d)(1), by inserting ''subchapter V of chapter 11 or'' after ''cases under'' each place that term appears; and

(D) in subsection (e)—

(i) in paragraph (1), by inserting ''subchapter V of chapter 11 or'' after ''cases under'';

(ii) in paragraph (2), by inserting ''subchapter V of chapter 11 or'' after ''cases under'' each place that term appears; and

(iii) by adding at the end the following:

''(5) In the event that the services of the trustee in a case under subchapter V of chapter 11 of title 11 are terminated by dismissal or conversion of the case, or upon substantial consummation of a plan under section 1183(c)(1) of that title, the court shall award compensation to the trustee consistent with services performed by the trustee and the limits on the compensation of the trustee established pursuant to paragraph (1) of this subsection.'';

(2) in section 589b—

(A) in subsection (a)(1), by inserting ''subchapter V of chapter 11 and'' after ''cases under''; and

(B) in subsection (d)—

(i) in the matter preceding paragraph (1), by inserting ''subchapter V of chapter 11 and'' after ''trustees under''; and

(ii) in the undesignated matter following paragraph (8), by inserting ''subchapter V of chapter 11 and'' after ''cases under''; and

(3) in section 1930(a)(6)(A), by inserting ", other than under subchapter V," after "chapter 11 of title 11".

SEC. 5. EFFECTIVE DATE.

This Act and the amendments made by this Act shall take effect 180 days after the date of enactment of this Act.

○

Pending Changes in the Bankruptcy Forms

Forms effective October 1, 2019

On August 26, 2019, the President signed into law the Honoring American Veterans in Extreme Need Act of 2019 (the HAVEN Act) Public Law No. 116-52. The HAVEN Act amended 11 U.S.C. § 101(10A) to exclude from the definition of Current Monthly Income certain payments made under title 10, 37, or 38 of the United States Code in connection with a disability, combat-related injury or disability, or death of a member of the uniformed services.

At its September 26, 2019 meeting, the Advisory Committee on Bankruptcy Rules made minor conforming amendments to lines 9 and 10 of Official Forms 122A-1, 122B, and 122C-1 to address the HAVEN Act.

- Official Form 122A-1 (/file/26712/download)
- Official Form 122B (/file/26715/download)
- Official Form 122C-1 (/file/18794/download)
- Official Form 122 Committee Note (/file/26711/download)
- Individual Debtor Instructions (/file/22710/download) (updated to address HAVEN Act at pages 34, 35, and 36).

Forms Effective December 1, 2019

Two bankruptcy forms are on track to go into effect this December.

The proposed change to Official Form 122A-1 adds an instruction to line 14a to remind a debtor that if there is no presumption of abuse, that Official Form 122A-2 should not be filled out or filed. The form will go into effect if approved by Judicial Conference at its September 2019 meeting.

Director's Form 1340, Application for Payment of Unclaimed Funds, is a new form issued by the Director of the Administrative Office of the United States that bankruptcy courts may adopt or revise as needed to facilitate requests for unclaimed funds.

- Official Form 122A-1 (/file/26713/download)

    - Committee Note (/file/26714/download)
- Director's Form 1340, Application for Payment of Unclaimed Funds (/file/26420/download)
    - Form Instructions (/file/26421/download)
    - Propose Order Approving (/file/26423/download)
    - Proposed Order Denying (/file/26422/download)

COMMITTEE NOTE

Official Forms 122A-1, 122B, and 122C-1 are amended in response to the enactment of the Honoring American Veterans in Extreme Need Act of 2019 (the "HAVEN Act"), Pub. L. No. 116-52, 133 Stat. 1076. That law modifies the definition of "current monthly income" in § 101(10A) to exclude certain amounts payable "in connection with a disability, combat-related injury or disability or death of a member of the uniformed services." The exclusion for servicemember retired pay is limited, however, and the debtor should exclude from current monthly income only that amount of retired pay that exceeds the amount that the recipient would otherwise be entitled to receive had the recipient retired for a reason other than disability. Each form is modified to expressly exclude these amounts from lines 9 and 10.

HAVEN Act – Frequently Asked Questions

Question: What does the Honoring American Veterans in Extreme Need Act of 2019 ("HAVEN Act" or the "Act") do?

Answer: The Act excludes certain benefits paid to veterans or their family members from the definition of Current Monthly Income ("CMI") found in the Bankruptcy Code. 11 U.S.C. § 101(10A). The types of compensation excluded from CMI under the Act include, but are not limited to, the following:

- Disability and death benefits paid by the Veterans Administration under title 38 of the United States Code.
- Monthly special compensation for catastrophic injuries or illnesses paid to servicemembers under 37 U.S.C. § 439.
- Any combat-related special compensation paid by the Department of Defense under 10 U.S.C. § 1413a.
- Disability severance pay paid by the Department of Defense under 10 U.S.C. § 1212.
- Any payment by the Department of Defense to a survivor in connection with the death of a member of the uniformed services. *See* 10 U.S.C. §§ 1431-1456.
- Disability-related military retired pay paid by the Department of Defense to a servicemember retired under 10 U.S.C. §§ 1201-1202, 1204-1205, except that such payments are excluded from CMI only to the extent that they exceed the military retired pay that the servicemember would have received if the servicemember had retired without a disability.

It should be noted, however, that certain benefits to current servicemembers are included in the CMI calculation, for example monthly special compensation from DOD, and retirement pay for people on the temporary disability retired list.

Question: How does the Act affect enforcement under section 707(b)(2) of the Bankruptcy Code and the determination of whether the presumption of abuse arises for veterans or their family members filing for chapter 7 relief under the Bankruptcy Code?

Answer: Veterans or their family members who file for bankruptcy relief under chapter 7 should exclude income covered by the Act from the calculation of CMI. The calculation of CMI is the starting point for determining whether a chapter 7 bankruptcy case is presumed abusive under section 707(b)(2).

Question: How does the Act affect chapter 13 cases?

Answer: Veterans and their family members who file for bankruptcy relief under chapter 13 should exclude income covered by the Act from the calculation of CMI, which may affect the determination of projected disposable income available for a chapter 13 plan.

Question: Will the USTP require debtors to produce documentation to support any veterans' benefits that they exclude from the calculation of CMI?

Answer: The USTP will limit its requests for documents related to income excluded from CMI under the HAVEN Act so as to not unduly burden debtors. The USTP does not routinely request from debtors documents not otherwise required by the Bankruptcy Code or Rules without a specific need for additional information.

Question: How does the Act affect the USTP's enforcement under section 707(b)(3) of the Bankruptcy Code (bad faith and the totality of the circumstances), and the determination of a debtor's actual ability to repay creditors?

Answer: By modifying the definition of "current monthly income," the HAVEN Act does not directly impact section 707(b)(3)'s provisions providing for dismissal of cases based on the debtor's bad faith or under the totality of the circumstances.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO
The Honorable Michael E. Romero

In re:	
WAY TO GROW, INC.,	Case No. 18-14330 MER
PURE AGROBUSINESS, INC.,	Case No. 18-14334 MER
GREEN DOOR AGRO, INC.,	Case No. 18-14333 MER
Debtors.	Chapter 11 **Jointly Administered Under Case No. 18-14330**

ORDER

THIS MATTER comes before the Court upon the Motion to Dismiss or Abstain[1] filed by Secured Creditor Corey Inniss ("**Inniss**"); the Objection to the Motion to Dismiss[2] filed by Debtors Way to Grow, Inc., Pure Agrobusiness, Inc. and Green Door Agro, Inc. ("**Debtors**"); Inniss's Reply in support of the Motion to Dismiss;[3] and the Debtors' Response to the Reply.[4] The Court held a four day evidentiary hearing on the Motion to Dismiss on October 15-16, 2018, and November 8-9, 2018.

BACKGROUND

As of the Petition Date, Way to Grow, Inc. ("**Way to Grow**") and Green Door Agro, Inc. ("**Green Door**") owned and operated seven retail outlets in Colorado and an internet sales presence. Green Door has a sales facility in California. Way to Grow and Green Door are both subsidiaries of Pure Agrobusiness, Inc. ("**Pure Agro**"). Pure Agro also owns 100% of a non-debtor affiliate, Crop Supply, Inc., which caters to the Debtors' commercial clients, but is funded by Debtors.[5] Richard Byrd ("**Byrd**") is the owner and principal manager of the Debtors.

[1] ECF No. 93 ("**Motion to Dismiss**").

[2] ECF No. 122 ("**Objection**").

[3] ECF No. 139 ("**Reply**").

[4] ECF No. 166 ("**Response**").

[5] Exh. E p. 15.

Debtors' business involves the sale of equipment for indoor hydroponic and gardening-related supplies. As to their customers' uses of their products, Debtors have represented "[w]hile the hydroponic gardening equipment may and is used for many types of crops, the Debtors' future business expansion plan is tied to the growing cannabis industry which is heavily reliant on hydroponic gardening."[6]

Byrd acquired ownership and control of the Debtors through a sale transaction with Inniss, who founded Way to Grow in Colorado in 2002. During Inniss's ownership, Way to Grow grew from a single store in Fort Collins to a chain of seven retail stores throughout Colorado's Front Range. Several of the Debtors' seven storefronts were in locations leased to the Debtors by Susan Inniss, the mother of Corey Inniss. James Blaha ("**Blaha**"), Susan Inniss's former husband, also leased a location to the Debtors through his wholly-owned entity, Blue Moose, LLC ("**Blue Moose**").

The events leading to this bankruptcy case began on January 1, 2016, when Byrd and Inniss entered into an agreement for the sale of Way to Grow ("**Purchase Agreement**").[7] As set forth in Section 2.2 of the Purchase Agreement, the consideration for the sale consisted of: 1) a cash payment to Inniss of $2,500,000; 2) a secured promissory note to Inniss ("**Note**") for the principal amount of $22,500,000; and 3) 12,500,00 shares of Byrd's common stock in Pure Agro, Debtors' holding company, with a par value of $0.001.[8] According to Debtors' Amended Schedules and Statement of Financial Affairs, Inniss owns approximately 21.26% of the stock in Pure Agro.[9] Pursuant to Section 3 of the Note, Debtors' pledged collateral securing its obligations to Inniss consists of "any and all property and assets" of the Debtors, including after-acquired property, accounts receivable and inventory.[10]

A short time after the sale closed, on April 6, 2018, Inniss, individually and derivatively on behalf of Pure Agro as a shareholder, filed a complaint against the Debtors and Byrd in the District Court for Larimer County, Colorado.[11] On April 9, 2018, Inniss moved to appoint a receiver over Pure Agro and its subsidiaries in the State Case, seeking to oust Byrd as the

[6] Exh. 3, at ¶ 1.

[7] Exh. 8.

[8] *Id.* at ¶ 2.2.

[9] Exh. E, p. 11.

[10] Exh. A, ¶ 3.

[11] Case No. 2018CV30331 ("**State Case**").

Debtors' manager. Debtors filed bankruptcy before a receiver was appointed.

Because Debtors filed this bankruptcy in the face of a receivership, Inniss argues this case is no more than a continuation of the two-party dispute between Inniss and Debtors arising from the pending receivership proceedings. Inniss asserts this Court should dismiss or abstain from these bankruptcy proceedings in favor of allowing the State Case to proceed through conclusion.

From the beginning of this case, Debtors represented an intent to reorganize by rejecting over-market leases and otherwise reducing expenses. Through August 2018, Debtors' Monthly Operating Reports disclosed cumulative net cash flow of $109,320 on revenues of $2,027,246 and expenses of $1,917,928.[12] Meanwhile, Debtors' profit and loss statements reveal a total net operating loss of $607,865 through August 2018.[13]

Inniss argues these net operating losses, together with other financial performance issues, constitute violations of this Court's orders on the Debtors' use of Inniss's cash collateral. In response, Debtors maintain their gradual progress towards reorganization, including rejecting over-market leases, will result in significant savings not yet reflected in its financial disclosures. It is true during the case, Debtors rejected four leases for its Colorado retail locations in Lakewood, Colorado Springs, Pueblo, and Fort Collins, and closed its location in Silverthorne.[14] A motion to reject one of Debtors' Denver leases remains pending.[15] One of Debtors' store managers also testified Debtors reduced their workforce as part of its cost-saving measures.

These first two issues – Debtors' alleged violations of the cash collateral order and the purported two-party nature of the dispute – are essentially secondary issues to the main event, namely, the Debtors' connections to the marijuana industry. As discussed extensively below, bankruptcy courts nationwide have wrestled with the issue whether companies connected to marijuana businesses legal under state law are

[12] Exh. EE, p. 2.

[13] *Id.* at p. 11.

[14] *See* ECF Nos. 151, 244, 333 and 335. Debtors filed a motion to reject the lease for their location in Silverthorne at ECF No. 51, but an order on that motion does not appear on the docket. However, Byrd testified at trial the Silverthorne location has been closed.

[15] ECF No. 336.

eligible for bankruptcy protection, where those connections constitute continuing violations of federal law.

ANALYSIS

A. LEGAL FRAMEWORK FOR MARIJUANA RELATED BANKRUPTCY CASES

Pursuant to the Controlled Substances Act of 1970 ("**CSA**"),[16] marijuana[17] is designated a Schedule I controlled substance under federal law.[18] Therefore, under the CSA, it is a federal crime to "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance[.]"[19] Further, the CSA prohibits any person from possessing or distributing "any equipment . . . product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance" in violation of federal law.[20] The CSA also expressly provides any person who "conspires to commit any offense" under the CSA shall be subject to the same penalties as the principal.[21]

Notwithstanding the absolute federal prohibition on the use, sale or cultivation of marijuana, several states, including Colorado, have legalized marijuana for both medical and recreational use.[22] In *Gonzales v. Raich*, the U.S. Supreme Court definitively held the federal government's designation of marijuana as a controlled substance supersedes contrary state law through application of the commerce clause.[23] As a result, there remains an ever-

[16] Unless otherwise specified, all references herein to "Section," "§,"and "CSA" refer to Title 21 U.S.C. § 101, *et seq*.

[17] The CSA refers to cannabis and marijuana products as "marihuana."

[18] § 812.

[19] § 841(a)(1).

[20] § 843(a)(6) refers to possession of drug manufacturing equipment while § 843(a)(7) refers to distribution of such equipment. As discussed in detail below, the *scienter* required for conviction under either sub-section is the same.

[21] § 846.

[22] *See* Colo. Const., Art. XVIII, Sections 14 and 16 (legalizing marijuana for medical and recreational use, respectively).

[23] *Gonzales v. Raich*, 545 U.S. 1 (2005).

shifting landscape of federal enforcement of marijuana criminalization where the same activity is fully legal under state law.[24]

Of course, bankruptcy laws and bankruptcy courts are purely creatures of federal law. Accordingly, bankruptcy courts have consistently dismissed cases where debtors engaged in ongoing CSA violations, or where a debtor's reorganization efforts depend on funds which can be considered proceeds of CSA violations.

The seminal case on the issue from this District is Judge Howard Tallman's (Ret.) decision in *In re Rent-Rite Super Kegs West Ltd.*[25] There, the court considered a motion to dismiss a Chapter 11 case in which the debtor derived 25% of its revenue from leasing warehouse space to marijuana businesses.[26] Finding this activity plainly prohibited under § 856(a), the court concluded the debtor was in continuing violation of federal law during its bankruptcy case.[27] Analyzing Colorado's legal framework for marijuana legalization, Judge Tallman noted Colorado law "make[s] it clear that their provisions apply to state law only. Absent from either enactment is any effort to impede the enforcement of federal law."[28] Accordingly, the court concluded:

> [E]ven if the Debtor is never charged or prosecuted under the CSA, it is conducting operations in the normal course of its business that violate federal criminal law. Unless and until Congress changes that law . . . a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime.[29]

As additional grounds for dismissal, Judge Tallman further concluded the debtor was barred from bankruptcy relief by the clean hands doctrine:

> The Debtor freely admits that it leases space to those who are engaged in the cultivation of marijuana. Even if the Debtor's [*sic*]

[24] *See, e.g.,* James M. Cole, Deputy Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: GUIDANCE REGARDING MARIJUANA ENFORCEMENT (Aug. 29, 2013) (commonly known as the "**Cole Memo**"); *but see* Jeffrey B. Sessions, Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: MARIJUANA ENFORCEMENT (January 4, 2018) (revoking Cole Memo).

[25] 484 B.R. 799 (Bankr. D. Colo. 2012).

[26] *Id*.

[27] *Id.* at 810.

[28] *Id.* at 806.

[29] *Id.* at 805.

> holds a good faith — albeit misguided — belief that Colorado state law would prevail over the federal law or that the federal law is unlikely to be enforced, that is quite beside the point. The Debtor has knowingly and intentionally engaged in conduct that constitutes a violation of federal criminal law and it has done so with respect to its sole income producing asset."[30]

Based on these conclusions, the *Rent-Rite* court found it necessary to dismiss the bankruptcy case pursuant to 11 U.S.C. § 1112(b).[31]

Two years later, in *In re Arenas*, Judge Tallman expanded the holding of *Rent-Rite* to dismiss a bankruptcy case where the bankruptcy trustee would be required to administer marijuana-related assets.[32] In *Arenas*, the debtors, who operated a marijuana grow facility, filed for relief under Chapter 7 of the Bankruptcy Code. A Chapter 7 trustee was appointed in the ordinary course.[33] The Office of the United States Trustee ("**UST**") moved to dismiss. Assessing the ability of a Chapter 7 trustee to administer marijuana assets, Judge Tallman reasoned:

> Here, the Debtors' chapter 7 trustee cannot take control of the Debtors' Property without himself violating § 856(a)(2) of the CSA. Nor can he liquidate the inventory of marijuana plants Mr. Arenas possessed on the petition date because that would involve him in the distribution of a Schedule I controlled substance in violation of § 841(a) of the CSA. The Court finds that administration of this case under chapter 7 is impossible without inextricably involving the Court and the Trustee in the Debtors' ongoing criminal violation of the CSA. . . . To allow the Debtors to remain in a chapter 7 bankruptcy case under circumstances where their Trustee is unable to administer valuable assets for the benefit of creditors would allow them to receive discharges without turning over their non-exempt assets to the Trustee. That would give the Debtors all of the benefits of a chapter 7 bankruptcy discharge while allowing them to avoid the attendant burdens. The impossibility of lawfully administering the Debtors'

[30] *Id.* at 807.

[31] *Id.* at 811.

[32] 514 B.R. 887 (Bankr. D. Colo. 2014).

[33] *Id.*

> bankruptcy estate under chapter 7 constitutes cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a).[34]

The *Arenas* debtors further sought to avoid dismissal by seeking to convert their case from Chapter 7 to Chapter 13. Denying that request, the court concluded the debtors' plan payments would necessarily be funded by proceeds of a criminal enterprise under federal law, and therefore conversion was not in good faith.[35] The court reasoned a plan could not be administered by a Chapter 13 trustee who would be prohibited from receiving or distributing funds derived from CSA violations.[36]

On appeal, the Bankruptcy Appellate Panel for the Tenth Circuit ("**BAP**") affirmed Judge Tallman's opinion dismissing the Arenas' bankruptcy case.[37] The question presented to the BAP was whether "a debtor in the marijuana business [can] obtain relief in the federal bankruptcy court?"[38] The BAP answered this question with a resounding "No."

The BAP agreed with Judge Tallman "that while the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes."[39] Applying the eleven factors to determine good faith set forth by the U.S. Court of Appeals for the Tenth Circuit in *Flygare v. Boulden*,[40] the BAP agreed the debtors could not show an employment history to support future income unrelated to marijuana, the trustee could not legally administer and

[34] *Id.* at 891.

[35] *Id.* at 894.

[36] *Id.*

[37] 535 B.R. 845 (10th Cir. BAP 2015)

[38] *Id.* at 847.

[39] *Id.* at 849-50.

[40] 709 F.2d 1344 (10th Cir. 1983) (the ten factors are "(1) the amount of the proposed payments and the amount of the debtor's surplus; (2) the debtor's employment history, ability to earn and likelihood of future increases in income; (3) the probable or expected duration of the plan; (4) the accuracy of the plan's statements of the debts, expenses and percentage repayment of unsecured debt and whether any inaccuracies are an attempt to mislead the court; (5) the extent of preferential treatment between classes of creditors; (6) the extent to which secured claims are modified; (7) the type of debt sought to be discharged and whether any such debt is non-dischargeable in Chapter 7; (8) the existence of special circumstances such as inordinate medical expenses; (9) the frequency with which the debtor has sought relief under the Bankruptcy Reform Act; (10) the motivation and sincerity of the debtor in seeking Chapter 13 relief; and (11) the burden which the plan's administration would place upon the trustee.").

distribute marijuana derived assets, and, while their motives were not improper, the debtors were not acting in good faith according to an objective standard.[41] That is, the inability to propose a confirmable plan made it "objectively unreasonable" for the debtors to seek Chapter 13 relief.[42]

Finally, the BAP addressed the Arenas' argument the case should not be *per se* dismissed or converted, but rather, the trustee should simply abandon the marijuana assets:

> It is not clear that a bankruptcy court may order a trustee to abandon assets *sua sponte*. And even if the court can do that, this bankruptcy estate, shorn of its marijuana assets, would likely yield no dividend to the creditors. The debtors would get a discharge and get to keep (via abandonment) their marijuana assets while being protected from collection activities. This also strikes us as prejudicial delay that amounts to cause for dismissal.[43]

This Court addressed a marijuana-related issue only once, in *B Fischer Industries, LLC*.[44] There, debtor manufactured allegedly knowingly sold butane for use in manufacturing marijuana concentrates.[45] The Court dismissed the bankruptcy case on March 8, 2017, on the debtor's motion. However, a creditor pursued a motion for sanctions relating to the bankruptcy filing and the Court retained jurisdiction for purposes of adjudicating the creditor's motion.[46] A discovery dispute arose requiring the Court to analyze the applicability of the crime-fraud exception to the attorney-client privilege where the alleged crime involves a marijuana-related offense.[47] Relevant to the issues in this case, the Court in *B. Fischer* found debtor's pre-petition sale of butane "*may*" have violated the CSA, but regardless, the inquiry should not focus strictly on pre-petition activities.[48]

[41] 535 B.R. at 852-53.

[42] *Id*.

[43] *Id.* at 854.

[44] *In re B Fischer Industries, LLC*, No. 16-20863-MER, ECF No. 147 (Bankr. D. Colo. Sept. 27, 2017).

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *Id.*

Rather, the focus should be on the time wherein debtor sought bankruptcy relief and thereafter.[49]

On a post-petition basis, the Court concluded it could not find the debtor's sales of butane to a pass-through non-debtor affiliate necessarily violated the CSA.[50] Of course, this was the correct inquiry as pertaining to a potential exception to the attorney-client privilege, but, nonetheless, the Court agreed "a debtor's pre-petition involvement in the marijuana industry is not a *per se* bar to relief under the Bankruptcy Code."[51] Finding the creditor failed to meet her burden of establishing the debtor's violation of the CSA, the Court denied her crime-fraud motion.[52]

Taken together, the decisions in *Rent-Rite*, *Arenas* and *B. Fischer* elucidate three basic propositions. First, a party cannot seek equitable bankruptcy relief from a federal court while in continuing violation of federal law. Second, a bankruptcy case cannot proceed where the court, the trustee or the debtor-in-possession will necessarily be required to possess and administer assets which are either illegal under the CSA or constitute proceeds of activity criminalized by the CSA. And third, the focus of this inquiry should be on debtor's marijuana-related activities during the bankruptcy case, not necessarily before the bankruptcy case is filed.

Certainly, many other bankruptcy courts in marijuana-legalization states have addressed similar issues and, for the most part, have reached similar conclusions.

In *In re McGinnis*,[53] debtor proposed Chapter 13 plan to be funded by: 1) a business leasing a warehouse to a marijuana grower; 2) the debtor's own marijuana grow operation; and 3) rental income from property housing tattoo artists.[54] Because the plan was to be funded through operations dependent "on a product the cultivation and sale of which violates federal law[,]" the court held the plan was proposed by means forbidden by law and could not be confirmed pursuant to 11 U.S.C. § 1325(a)(3).[55] Further, due

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] 453 B.R. 770 (Bankr. D. Or. 2011).

[54] *Id.* at 771.

[55] *Id.* at 772.

to the federal illegality of the operations, the court found "the predicted income stream from the marijuana operations is [not] reasonably certain to produce sufficient income to fund the Plan[,]" and therefore concluded the plan failed the feasibility requirement of 11 U.S.C. § 1325(a)(6).[56]

In *Northbay Wellness Group v. Beyries (In re Beyries)*, plaintiff sold medical marijuana.[57] Debtor was their attorney.[58] Plaintiff sought a non-dischargeability judgment based on the attorney's knowing misrepresentations concerning plaintiff's sales tax obligations.[59] While the court held the debt met the elements of 11 U.S.C. § 523(a)(4), the court ruled it could not enter a judgment for plaintiff because they engaged in unlawful activity.[60] Even though the activity was legal under state law, in a federal court the parties were "conspiring to sell contraband."[61] The court found the plaintiff *in pari delicto* and dismissed the adversary.[62]

On appeal, the U.S. Court of Appeals for the Ninth Circuit reversed and remanded the bankruptcy court's order dismissing the adversary.[63] The Ninth Circuit determined the parties' engagement in a marijuana business did not automatically require application of *in pari delicto*.[64] Instead, *in pari delicto* requires a balancing test of the parties' respective wrongdoing.[65] Had the bankruptcy court properly conducted the required balancing test, the Ninth Circuit would have concluded the debtor's wrongdoing outweighed the plaintiff's. Debtor misappropriated client trust funds, and could not

[56] *Id.* at 773.

[57] No. 10-1181, 2011 WL 5975445 (Bankr. N.D. Cal. Nov. 29, 2011).

[58] *Id.* at *1.

[59] *Id.*

[60] *Id.*

[61] *Id.* at *2.

[62] *Id.*

[63] 789 F.3d 956 (9th Cir. 2015).

[64] *Id.* at 959-60.

[65] *Id.* at 960.

escape liability for that theft through a bankruptcy discharge simply because the creditor-plaintiff's business is marijuana.[66]

In re Medpoint Management LLC[67] involved an involuntary Chapter 7 petition filed against a medical marijuana business. The debtor's assets consisted entirely of marijuana products and related intellectual property.[68] The petitioning creditors' claims arose from credit extended or services knowingly provided in furtherance of debtor's marijuana business. Upon debtor's opposition to an order for relief, the court dismissed the involuntary bankruptcy case.[69] The court reasoned the possibility of forfeiture of the debtor's marijuana assets pursuant to CSA imposed an unacceptable risk to a Chapter 7 estate and trustee.[70] Further, the court held it could not issue an order for relief which would effectively order a Chapter 7 trustee to possess and administer assets in violation of federal law.[71] The court also found the petitioning creditors were not eligible to file the involuntary petition because of *in pari delicto.* The creditors knew the debtor was in the marijuana business, voluntary chose to engage in that business with them, and therefore had unclean hands precluding them from petitioning a federal court for relief.[72] Finally, the court declined to sanction the creditors, finding no bad faith in filing the involuntary petition, because the marijuana business presented a novel issue, and the debtor appeared insolvent and properly in bankruptcy but for the marijuana issue.[73]

In *In re Johnson*,[74] a Chapter 13 debtor was a licensed "caregiver" and marijuana grower operating legally under Michigan law. The UST filed a motion to dismiss. Debtor's income was $1,203 per month from social

[66] *Id.*

[67] 528 B.R. 178 (Bankr. D. Ariz. 2015).

[68] *Id.* at 181-82.

[69] *Id.* at 188.

[70] *Id.* at 185.

[71] *Id.*

[72] *Id.* at 186-87.

[73] *Id.* at 187-88.

[74] 532 B.R. 53 (Bankr. W.D. Mich. 2015).

security and $1,000 per month from his marijuana business.[75] First, the court noted all federal judges take an oath to uphold federal law, and allowing a marijuana case to proceed in federal court violates this oath.[76] No matter what precautions were taken, allowing the case to remain in bankruptcy would result in both trustee and the court supporting the debtor's criminal enterprise.[77] Second, the court looked to 28 U.S.C. § 959(b), which prohibits federal officers from holding contraband or proceeds or instrumentalities of federal criminal activity.[78] The court held this prohibition applies to trustees in bankruptcy cases.[79] Third, the debtor's intent to continue his marijuana business post-petition constituted being "engaged in business" for purposes of 11 U.S.C. § 1304, requiring court approval for expenditure of funds pursuant to 11 U.S.C. § 363(c).[80] The court could not approve any expenditures related to a marijuana business.[81] Nonetheless, the court declined to dismiss the case and gave the debtor a shot at a discharge, but enjoined him from conducting his marijuana business or using any property of the estate in furtherance of illegal activity.[82] The court further ordered the trustee to abandon all marijuana plants within the estate and ordered the debtor to destroy all his marijuana plants and byproducts as a condition remaining in bankruptcy.[83]

In *In re ARM Ventures, LLC,*[84] debtor proposed a plan which would be funded through income generated by the sale of marijuana products. The court held a plan cannot be confirmed unless the business generating the income is legal under both state law and federal law.[85] That is, a reorganization plan dependent on marijuana income can *per se* be proposed

[75] *Id.* at 55.

[76] *Id.* at 56.

[77] *Id.*

[78] *Id.*

[79] *Id.* at 57.

[80] *Id.*

[81] *Id.*

[82] *Id.* at 59.

[83] *Id.*

[84] 564 B.R. 77 (S.D. Fla. 2017).

[85] *Id.* at 85.

in bad faith.[86] Indeed, debtor's tenant was not licensed by the state of Florida to grow marijuana, and was very unlikely to get a federal license.[87] Therefore, the court concluded debtor's plan was not feasible and the bankruptcy case was ripe for dismissal.[88] However, given the significant non-insider unsecured debt, the court declined to dismiss.[89] Instead, based on the debtor's bad faith arising from his illegal activities, the court granted stay relief to the debtor's major secured creditor.[90] However, the court stayed any foreclosure sale for 14 days to provide debtor an opportunity to file a plan that would not depend on the sale of marijuana as a source of income.[91]

In *NW, SPNWY, LLC v. Cook Investments NW*,[92] debtor leased commercial property to a marijuana grower. As part of its plan, debtor proposed to reject the marijuana grower's lease. Because debtor's plan did not depend on future income derived from illegal activity, the court concluded the debtor's plan was confirmable.[93] On appeal and upon an objector's motion for stay pending appeal, the U.S. District Court for the Western District of Washington began with the simple observation "[b]ankruptcy courts are neither regulatory nor criminal courts."[94] The court continued "[a] rudimentary search of relevant authorities reveals that numerous courts have confirmed plans regardless of whether actual provisions of the plans result in the violation of federal or state laws."[95] Because the plan itself would not violate federal law, but instead would be funded through proceeds of purely legal activity (because debtor rejected

[86] *Id. at 86.*

[87] *Id.* at 84.

[88] *Id.*

[89] *Id.*

[90] *Id.* at 86-87.

[91] *Id.*

[92] No. 17-5516, 2017 WL 3641914 (W.D. Wash. August 24, 2017).

[93] *Id.* at *1.

[94] *Id.* at *2.

[95] *Id.*

the marijuana lease), the district court denied the motion for stay pending appeal.[96]

Finally, in *Olson v. Van Meter*,[97] the debtor filed Chapter 13 to prevent foreclosure on commercial property leased to the operator of a marijuana dispensary.[98] Debtor's plan called for sale of this real property to pay off creditors, and as a result required rejection of the lease with the marijuana dispensary.[99] Nonetheless, the court dismissed the case *sua sponte* on grounds the debtor's post-petition acceptance of rents from the dispensary business was ongoing criminal violation precluding federal bankruptcy relief.[100]

The Bankruptcy Appellate Panel for the Ninth Circuit reversed and remanded.[101] First, the appellate panel held the bankruptcy court did not sufficiently articulate the legal basis for its ruling or make findings to support its conclusion the debtor was violating federal law.[102] The appellate panel held the court could not summarily dismiss the bankruptcy case, but rather was required to take evidence and make findings on issues of bad faith and unclean hands, as well as whether the debtor was actually committing a controlled substances act violation.[103] The appellate panel reasoned "[a]lthough debtors connected to marijuana distribution cannot expect to violate federal law in their bankruptcy case, the presence of marijuana near the case should not cause mandatory dismissal."[104]

[96] *Id.* at *6.

[97] No. NV-17-1168-LTiF, 2018 WL 989263 (9th Cir. BAP Feb. 5, 2018).

[98] *Id.* at *1.

[99] *Id.* at *3.

[100] *Id. at *6.*

[101] *Id.*

[102] *Id.*

[103] *Id.* at *7.

[104] *Id.*

B. DEBTORS' POTENTIAL VIOLATIONS OF THE CSA

1. Complicity - Aiding and Abetting and Conspiracy

Based on these authorities, this Court's first inquiry must be whether the Debtors are engaged in ongoing violations of federal law. If the analysis is answered in the affirmative, Debtors' bankruptcy cases may not proceed and would be ripe for dismissal.

There is no evidence before the Court that the Debtors directly "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance[.]"[105] Therefore, if the Debtors are violating § 841(a)(1), they are doing so indirectly, through one or more theories of legal complicity.

The first such allegation of Debtors' indirect criminal activity is Inniss's assertion Debtors' sale of hydroponic equipment to marijuana grow operations constitutes aiding and abetting CSA violations by its customers. Under federal law, aiding and abetting criminal activity is itself criminalized pursuant to 18 U.S.C. § 2, which provides "[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal." This is not to say aiding and abetting is an independent crime. Rather, 18 U.S.C. § 2 "simply abolishes the common-law distinction between principal and accessory."[106]

"'[U]nder § 2, those who provide knowing aid to persons committing federal crimes, with the intent to facilitate the crime, are themselves committing a crime.'"[107] "[A] person is liable under § 2 for aiding and abetting a crime if (and only if) he (1) takes an affirmative act in furtherance of that offense, (2) with the intent of facilitating the offense's commission," i.e., "with full knowledge of the circumstances constituting the charged offense."[108] "Mere presence at a crime scene or knowledge alone that a

[105] 21 U.S.C. § 841(a)(1).

[106] *United States v. Cooper*, 375 F.3d 1041, 1049 (10th Cir. 2004).

[107] *United States v. Deiter*, 890 F.3d 1203, 1214 (10th Cir. 2018) (quoting *Rosemond v. United States*, 572 U.S. 65 (2014)).

[108] *Deiter*, 890 F.3d at 1203 (quoting *Rosemond*, 572 U.S. at 71, 75-77); *see also Nye & Nissen v. United States*, 336 U.S. 613, 619 (1949) ("[T]o aid and abet another to commit a crime it is necessary that a defendant in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." (quotation marks omitted)); *United States v. Rosalez*, 711 F.3d 1194, 1205 (10th Cir. 2013) (for an aiding and abetting conviction, the government must prove the defendant "shared in the intent to commit the underlying offense, willfully associated

crime is being committed is insufficient."[109] "[A] defendant must share in the intent to commit the underlying offense."[110]

Concomitant with his assertion the Debtors are aiding and abetting CSA violations, Inniss invokes conspiracy as an alternate theory of complicit liability pursuant to § 846. In the Tenth Circuit, to obtain a conviction for conspiracy in violation of § 846, the government must establish beyond a reasonable doubt: 1) there was an agreement to violate the law; 2) the defendant knew the essential objectives of the conspiracy; 3) the defendant knowingly and voluntarily took part in the conspiracy; and 4) the co-conspirators were interdependent.[111] "[T]he evidence that supports a conviction for conspiracy can also be used to support a conviction for aiding and abetting in the possession of illegal narcotics with intent to distribute."[112] The main difference between conspiracy and aiding and abetting is unlike co-conspirator liability, in that "liability as an aider and abetter is not contingent upon a prior 'agreement or conspiracy to perform' a criminal act."[113]

"A conviction for aiding and abetting can rest on a wide range of underlying conduct, including 'acts, words or gestures encouraging the commission of the offense,' either before or at the time of the offense."[114] "Some mental state beyond 'mere assent' or 'acquiescence' is also required."[115] "Even mere 'words or gestures of encouragement' constitute affirmative acts capable of rendering one liable under this theory."[116] Because of this, the Tenth Circuit has held "a defendant may not stumble

with the criminal venture, and aided the venture through affirmative action" (quotation marks omitted)).

[109] *Rosalez*, 711 F.3d at 1205.

[110] *Id*.

[111] *United States v. Isaac-Sigala* , 448 F.3d 1206, 1210 (10th Cir. 2006).

[112] *United States v. Carter,* 130 F.3d 1432, 1441 (10th Cir. 1997) (internal citation and quotation omitted).

[113] *U.S. v. Bowen*, 527 F.3d 1065, 1078 (10th Cir. 2008) (quoting *U.S. v. Pursley*, 474 F.3d 757, 759 (10th Cir. 2007)).

[114] *Williams v. Trammell*, 782 F.3d 1184, 1192 (10th Cir. 2015).

[115] *Id.* at 1193 (quoting *Wingfield v. Massie*, 122 F.3d 1329, 1332 (10th Cir. 1997)).

[116] *Id.*

into aiding and abetting liability by inadvertently helping another in a criminal scheme unknown to the defendant."[117]

Of course, there are limitations to both theories of complicit liability. Importantly, Byrd testified Debtors are not "in" the marijuana industry but are instead "riding the wave." Debtors' position is they are not participating in violations of the CSA, but rather, merely providing general information to their customers which is useful and applicable to growing almost any type of crop, not just marijuana. There is case law supporting Debtors' theory providing information to customers does not violate the CSA.

In *Mann v. Gulickson*,[118] a dispute arose over a contract for hydroponic and licensing consulting to the marijuana industry. The business was to "provide consulting and information services to persons desiring to engage in hydroponic farming" and to "provide consulting and documentation preparation services to persons or entities desiring to establish medical cannabis dispensaries and related businesses in states where such activities were legal."[119] At no time did these companies possess, cultivate or distribute cannabis plants.[120] Instead, its income was derived solely from the sale of consulting services and information packs and document preparation.[121]

The question before the court in *Gulickson* was whether a contract for these services was enforceable notwithstanding the CSA.[122] The court held the contract could be enforced because of California's liberal policy of the "legality" element of contracts.[123] In a footnote the court observed:

> [The] object of the contract here is not *necessarily* illegal. The parties agreed Gullickson would pay Mann to purchase the Companies. . . . There is no evidence in the record that the Companies actually possess, use, cultivate, or distribute marijuana—medical or otherwise.

[117] *U.S. v. Rufai*, 732 F.3d 1175, 1190 (10th Cir. 2013).

[118] No. 15-CV-03630-MEJ, 2016 WL 6473215, at *7 (N.D. Cal. Nov. 2, 2016).

[119] *Id.* at *1.

[120] *Id.* at *2.

[121] *Id.*

[122] *Id.* at *3.

[123] *Id.* at *4.

> Moreover, while Gullickson argues the businesses "conspire" to do so, this so-called conspiracy appears to be based entirely on providing information to customers. In *Conant v. Walters*, the Ninth Circuit affirmed an injunction prohibiting federal officials from revoking a physician's registration, or even investigating a physician's conduct, based on the physician's recommendation that a patient use marijuana.[124]

In *Green Earth Wellness Center, LLC v. Atain Specialty Insurance Co.*,[125] the U.S. District Court for the District of Colorado addressed another breach of contract claim against this backdrop. Green Earth operated a medical marijuana business, for which Atain provided commercial liability insurance.[126] Green Earth made two claims under its policy, both of which Atain denied.[127] The first claim was for damage to Green Earth's marijuana plants because of a wildfire; the second was for the theft of some of its marijuana plants.[128]

Green Earth sued Atain for breach of contract, among other things.[129] Atain moved for summary judgment, arguing public policy based on the federal prohibition on marijuana required denying coverage for Green Earth's losses.[130] The court noted that "the nominal federal prohibition against possession of marijuana conceals a nuanced (and perhaps even erratic) expression of federal policy."[131] The *Green Earth* court explained that because of "a continued erosion of any clear and consistent federal public policy in this area. . . . the Court declines Atain's indirect invitation to declare the Policy void on public policy grounds."[132] The court found that "Atain, having entered into the Policy of its own will, knowingly and intelligently, is obligated to comply with its terms or pay damages for having

[124] *Id.* at *7 n.4 *(*citing *Cnuant v. Walters*, 309 F.3d 629, 639 (9th Cir. 2002) (indicating rejection of government's argument that a doctor's "recommendation" of marijuana encourages illegal conduct by the patient)).

[125] 163 F. Supp. 3d 821, 823 (D. Colo. 2016).

[126] *Id.* at 823.

[127] *Id.* at 823-24.

[128] *Id.* at 824.

[129] *Id.*

[130] *Id.*

[131] *Id.* at 832.

[132] *Id.* at 834.

breached it."[133] The court consequently denied Atain's summary judgment motion.

Pursuant to these authorities, to determine whether Debtors are complicit through aiding and abetting their customers' violations or conspiring with them to do so, the Court must decide whether Debtors' conduct rises above the level of merely providing information to customers, and instead, evidences a specific intent for the Debtors to assist their customers in violating § 841(a)(1). Additionally, to find conspiracy liability under § 846 the Court must further find an agreement between Debtors' and their customers to violate the law.

The Court concludes the Debtors are violating neither § 846 nor 18 U.S.C. § 2. As to conspiracy liability, there is insufficient evidence before the Court concerning an actual agreement between Debtors and their customers to violate the CSA. While, as discussed in further detail below, the Debtors may be aware at least some of their customers will use equipment purchased from the Debtors to manufacture a controlled substance (and this may give rise to a separate violation of the CSA), the Debtors' sales are never contingent or directly affected by the crop being grown. As in *Gullickson*, the contracts between Debtors and their customers, if any, do not specifically contemplate, depend upon, or require any activity that is *necessarily* illegal.

Likewise, the Court concludes the Debtors' business activities do not evidence a specific intent to violate the CSA. Under *Rosalez*, which this Court is bound to follow, aiding and abetting liability requires more than "knowledge alone that 'a crime is being committed[.]'"[134] Instead, the Court would need to conclude Debtors share the same intent as their customers to violate the CSA and willfully associate themselves with their customers' criminal ventures.[135] The Debtors' *mens rea* does not meet this exacting standard.

The Debtors' business is not limited in scope to marijuana sales. The evidence certainly shows many of the Debtors' customers are in the marijuana industry. As discussed below, this fact is no secret to the Debtors. However, by its nature and as shown by the evidence, the Debtors' business serves a broad customer base consisting of both commercial and individual horticulturalists, growing a variety of legal crops. Debtors' intent is to sell its product to any clientele engaged in hydroponic horticulture, and Debtors'

[133] *Id.* at 835.

[134] *Rosalez*, 711 F.3d at 1205.

[135] *Id.*

products are generally applicable to those activities regardless the specific crop grown. Without sharing its marijuana-connected customers' specific intent to cultivate and distribute marijuana, Debtors are not aiding and abetting violations of the CSA.

2. Sale of Drug Manufacturing Equipment

While the Debtors are not violating the CSA through complicity in their marijuana growing customers' crimes, another provision of the CSA produces violations based upon a lesser *mens rea* of simply knowing how Debtors' products will be used. Specifically, § 843(a)(7) makes it a federal crime to "manufacture" or "distribute" any "equipment, chemical, product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance . . . ."[136]

In *U.S. v. Truong*,[137] the Tenth Circuit analyzed the "reasonable cause to believe" element of § 843(a)(6), which makes it unlawful to possess any equipment, chemical or product which may be used to manufacture a controlled substance knowing, intending, or having reasonable cause, that it will be used to manufacture a controlled substance. Sections 843(a)(6) and (7) are nearly identical, with sub-section (a)(6) criminalizing possession of drug manufacturing equipment, and sub-section (a)(7) criminalizing manufacture, distribution or exportation of drug manufacturing equipment. While both seem applicable in this case because Debtors both possess and sell their hydroponic equipment, the Court will refer primarily to sub-section (a)(7) as it is the sale of equipment which concerns the Court. In any event, according to *Truong* and other cases cited below, the *scienter* requirement of each sub-section (and, separately, possession and distribution of chemical precursors charged under § 841(c)(2)) are the same, so the distinction is practically without a difference.

In *Truong*, the defendant sold large quantities of pseudoephedrine, which can be used to manufacture methamphetamine.[138] Observing § 843(a)(6) contains "an unusually specific *mens rea* requirement[,]" the Court of Appeals held "[i]t is not sufficient for the government to prove that the defendant knew, intended, or had reasonable cause to believe that the substance would be abused or would be used illegally. Nor is it sufficient for

[136] 21 U.S.C. § 843(a)(7).

[137] 425 F.3d 1282 (10th Cir. 2005). As discussed *supra*, the distinction between sub-sections (a)(6) and (a)(7) has no substantive bearing on the Court's analysis, and therefore *Truong's* references to sub-section (a)(6) apply equally to the Court's analysis under sub-section (a)(7).

[138] *Id.* at 1284.

the government to prove that the defendant was negligent or reckless with respect to the risk . . . . The government must prove the defendant was aware, or had reasonable cause to believe, that the substance would be used for the specific purpose" of manufacturing drugs.[139]

Thus, under the law of this Circuit the "reasonable cause to believe" standard employed by both §§ 843(a)(6) and (a)(7) is "akin to actual knowledge."[140] That is, the inquiry is "entirely subjective, the inquiry is not to be viewed from the perspective of a hypothetical reasonable person."[141] In *Truong*, to convict, the jury was required to infer the defendant "had actual knowledge, or something close to it, that the pseudoephedrine and ephedrine he sold would be used to manufacture methamphetamine."[142] "A defendant's own actions or words may . . . reveal his knowledge that he is selling" material which will be used to manufacture a controlled substance.[143]

Ultimately, the Tenth Circuit held the government had not sufficiently proven actual knowledge the products sold would be used to manufacture drugs, reversing the defendant's conviction.[144] The only evidence the government presented to prove the defendant had actual knowledge pseudoephedrine could be used to manufacture methamphetamine was the defendant's statement he did not know how the pseudoephedrine he sold would be used.[145] There was no evidence the defendant had ever learned of any connection between pseudoephedrine and methamphetamine production, and no evidence any of defendant's statements indicated he knew the his pseudoephedrine would be used for such a purpose.[146] Even though there was evidence to permit the jury to infer defendant was "up to no good[,]" and even though the evidence showed a reasonable person would be on notice "something nefarious was going on[,]" the "unusually specific *mens rea* requirement of 21 U.S.C. §§ 841 and 843" requires more.

[139] *Id.* at 1289.

[140] *Id.* (citing *United States v. Saffo*, 227 F.3d 1260, 1269 (10th Cir. 2000)).

[141] *United States v. Buonocore*, 416 F.3d 1124, 1133 (10th Cir. 2005).

[142] *Truong*, 425 F.3d at 1289.

[143] *Id.* at 1290.

[144] *Id.* at 1291.

[145] *Id.*

[146] *Id.*

Notably, *Truong* is considered as reflecting the minority view of the *mens rea* required to violate § 843(a)(6) or (a)(7), and § 841(c)(2)[147]. At least three other circuits have held these statutes allow conviction either upon subjective knowledge or an objective "cause to believe."[148] In *U.S. v. Williamson*, the Tenth Circuit Court of Appeals mildly distinguished *Truong*, without changing the court's interpretation of the "reasonable cause to believe" standard, by explaining *Truong* depended on the court's view "based on only the information known to the specific defendant, a reasonable person would not have had reason to believe that the pseudoephedrine would be used to make methamphetamine."[149]

Even as the minority view, the Court is bound to follow *Truong* and apply its interpretation of the *scienter* requirement under § 843(a)(6) and 841(c)(2) to this Court's analysis under § 843(a)(7). In this case, however, the rules delineating the "reasonable cause to believe" standard may have little effect, because the Court finds the Debtors indeed have actual knowledge they are selling equipment which will be used to manufacture a controlled substance.

As the Court reads § 843(a)(7), the important distinction for purposes of criminality is not the specific product being sold, but whether the seller of such product knows how equipment will be used. There is little doubt hydroponic supplies are "equipment" related to marijuana cultivation. Indeed the Tenth Circuit has held evidence of the existence of a hydroponic grow operation supports a warrant for search and seizure on a charge of producing a controlled substance with intent to distribute.[150]

There is ample evidence in this case proving Debtors have "reasonable cause to believe" the equipment they sell to at least some of their customers

[147] Section 841(c)(2) criminalizes knowingly or intentionally possessing or distributing "a listed chemical knowing, or having reasonable cause to believe, that the listed chemical will be used to manufacture a controlled substance . . . ." The "reasonable cause to believe" standard set forth in § 841(c)(2) uses the exact same language as § 843(a)(6) and (a)(7), and therefore the *scienter* requirement is the same.

[148] *Cf. Truong*, 425 F.3d 1282 with *U.S. v. Galvan*, 407 F.3d 954, 957 (8th Cir. 2005) (rejecting jury instruction that required actual knowledge for conviction under Section 841(c)(2)), *U.S. v. Kaur*, 382 F.3d 1155. 1157-58 (9th Cir. 2004) (holding the "reasonable cause to believe" standard of Section 841(c)(2) incorporates both subjective and objective considerations), and *U.S. v. Prather*, 205 F.3d 1265, 1270 (11th Cir. 2000) ("[T]he jury thus needed to find either that he knew the pseudoephedrine would be used to manufacture methamphetamine or that he had reasonable cause to believe that it would be."). *See also U.S. v. Khattab*, 536 F.3d 765, 769 (7th Cir. 2008) (discussing circuit split).

[149] 746 F.3d 987, 994 n.2 (10th Cir. 2014).

[150] *U.S. v. Montgomery*, 262 Fed. Appx. 80, 84 (10th Cir. 2008) (unpublished).

will be used to manufacture marijuana. First, Inniss testified meeting the needs of cannabis growers is essential to Debtors' business, because those growers will simply buy their hydroponic equipment elsewhere if Debtors cannot meet their needs. Inniss also testified Debtors' business increased significantly and immediately upon the federal government issuing the Cole Memo.[151] Inniss testified negotiations for the sale of the business to Byrd were "very specific in terms of cannabis." Inniss referred to Byrd as "Mr. Marijuana Entrepreneur" and testified the "whole thesis" of the transaction was to combine Byrd's California marijuana-related operations with the Debtors' operations in Colorado. Inniss testified the Debtors have always chosen products based on their favorability of use in marijuana cultivation, including by customizing Debtors' pesticide inventory to provide products approved for use in marijuana cultivation by the Colorado Department of Agriculture. Debtors even sell some products that Inniss testified would be cost-prohibitive for use in cultivating any crop except marijuana, because marijuana is the highest yielding cash crop which can be grown. Even further, Inniss testified Debtors sell so-called "bubble bags" which are specifically used to make "water hash," a concentrated marijuana derivative.

The Court finds Inniss's testimony credible. Despite the acrimony in the parties' relationship, Inniss based his testimony on personal experience both as the founder and principal operator of the Debtors' business for many years before the sale to Byrd. Inniss's testimony confirms the Debtors' business model and operations have not materially changed since the sale to Byrd, and as a result Inniss's testimony regarding the business of what were once his companies is both credible and based upon first-hand, personal knowledge.

Many of Debtors' largest customers use aliases with Debtors rather the real name of their business.[152] While the Court can simply infer the use of aliases knowingly disguises some nefarious activity, Innis gave unrebutted testimony linking the aliases on Debtors' customer lists to specifically identified dispensaries and grow operations, all of which Inniss said he has disclosed to Byrd.

Debtors have participated, in some fashion, in the "Cannabis Cup" since at least 2016. The Cannabis Cup is a cannabis industry trade show and the world's biggest marijuana grow competition. Other "grow offs" attended by Debtors include the Indo Expo, The Grow Off, and Max Yields. At these and similar events, Debtors have given away promotional materials

[151] The enforcement of federal marijuana laws in the District of Colorado has not materially changed since the Cole Memo was revoked by Attorney General Jeffrey Sessions in early 2018.

[152] Exh. 8, p. 19.

bearing the Way to Grow name in the form of lighters and rolling papers, which, together, are strongly associated with marijuana use.[153] Debtors have booths at the events and use them to build closer relationships to marijuana dispensaries and growers. Debtors have contributed prize money to be awarded to the winners of the grow-offs. Debtors do "cross-promotions" with dispensaries and advertise deals on a cannabis talk show.

Bradley Hale, who has been the store manager for the Debtors' Boulder location since May 2011, testified he, and all of his co-workers, were themselves marijuana growers who bought supplies from the Debtors before becoming employees. Most of Hale's interactions with customers have been about cannabis. Hale described Way to Grow stores as having a "Cheers Bar" atmosphere, where everyone knows your name and forming personal relationships is key to sales. Hale confirmed Debtors choose products based on favorability of use in marijuana cultivation. Hale also confirmed the "trim bags" and "bubble bags" sold by Debtors are specifically intended for use with cannabis. As recently as August 2018, Hale testified Debtors engaged in cross-promotions with dispensaries at local grow-offs. Hale testified as much as 95% of customers in his store are using Debtors' products to grow marijuana.[154]

Cody Ross, manager of Debtors' Fort Collins location for the past five years, and with experience in other of the Debtors' stores, testified "everybody just assumes" customers talking generally about help with plants are talking about marijuana plants. Ross testified Debtors have a reputation for being experts in "advising on cannabis growing and . . . in selling products that are geared toward cannabis[.]" Ross has even visited cannabis growing facilities which are also Debtors' customers. A list of approved products for use in cannabis cultivation is made available in the store; Debtors do not have that for any other plants. Customers sometimes bring marijuana plants, or, more commonly, photographs of marijuana grow operations, to Debtors' stores, and Debtors' employees "typically" offer products to those customers based on those photographs. If there was any doubt remaining from his testimony, Ross expressly stated, "I know what a lot of them grow" and then, when asked if they grow cannabis, responded "Yes, sir" as to the "vast majority" of those customers.

Next, the Court reviewed press statements and so-called "investor decks" prepared by an investment banking firm on behalf of the Debtors. These show Byrd has commented to Bloomberg Markets, "[w]e are the picks

[153] Exhs. 40 and 41.

[154] Byrd later disputed this figure as being closer to 65%.

and shovels play for what we're calling the Green Rush."[155] In a statement to Business Wire, Byrd stated, "[w]ith the merger of Way to Grow completed in January 2016, Pure Agro is now the leading one-stop solution for indoor plant, product and cannabis growers in Colorado and California."[156] In March 2016, Byrd commented to the BusinessDen publication that Debtors' new location would "cater to commercial cannabis growers instead of private hobbyists growing at home."[157]

An investor deck prepared on behalf of the Debtors by an investment banking firm specifically refers to marijuana as "the catalyst for hydroponic R&D."[158] The investor decks said the company would "take advantage of the current growth of the marijuana industry" and will "leverage the marijuana industries profitability[.]"[159] A second investor deck gave statistics on marijuana legalization and growth trends.[160] Yet another, dated January 2018, identifies, by name (and logo), five marijuana dispensaries as Debtors' "Notable Customers."[161]

Finally, the Court reviewed a very-telling e-mail drafted by Joe Pyle, Debtors' VP of Operations, to all of Debtors' store managers.[162] In the e-mail, dated June 28, 2018, Pyle instructed the managers to "remove from sight" anything "MJ related in your stores" such as "tv screens with MJ related content, the 3 a light book, pictures, posters, anything."[163] Pyle further instructed the managers to "not discuss MJ directly with any customers and do not allow customers to bring anything plant related into your stores."[164] While, on the one hand, the e-mail evidences what may be post-petition remedial measures, it clearly demonstrates Debtors' prior use of marijuana related signage in their stores, as well as consciousness of the

[155] Exh. 11, p. 1.

[156] *Id.* p. 2.

[157] Exh. 18; *see also* Exh. 19 (press release touting advances in marijuana legalization as relating to hydroponics supply industry).

[158] Exh. 24.

[159] *Id.* p. 12.

[160] Exh. 25 pp. 20-21.

[161] Exh. 59, p. 20.

[162] Exh. 52.

[163] *Id.*

[164] *Id.*

negative effects continued use of marijuana signage may have on Debtors' ability to remain in bankruptcy.

Considering this abundant evidence, Debtors' efforts to distance themselves from knowledge of their customers' use of their products is simply not credible. Even though the Court concludes Debtors do not share their customers' specific intent to violate the CSA, Debtors certainly know they are selling products to customers who will, and do, use those products to manufacture a controlled substance in violation of the CSA. Debtors tailor their business to cater to those needs, tout their expertise in doing so, and market themselves consistent with their knowledge. There is no evidence this business model has materially changed post-petition.

The Court concludes Debtors' business model and execution thereof fundamentally violates § 843(a)(7). These violations continue post-petition, placing this case squarely within the rule adopted by Judge Tallman in *Rent-Rite Super Kegs*. To use Judge Tallman's words, even if the Debtors "are never charged or prosecuted under the CSA,[they] are conducting operations in the normal course of [their] business that violate federal criminal law."[165] This Court cannot enforce federal law in aid of the Debtors because Debtors' ordinary course activities constitute a continuing federal crime. The Court finds this is, inescapably, cause to dismiss this bankruptcy case under 11 U.S.C. § 1112(b).

Having reached this conclusion, the Court nevertheless considered whether any alternative to outright dismissal, or other post-petition changes to Debtors' business, could cure the ongoing violations of federal law in this case. However, unlike *In re Johnson*[166] and *In re ARM Ventures, LLC,*[167] the evidence demonstrates extreme improbability the Debtors could survive if they were to sever all ties to their marijuana customers. Debtors' business activities constituting violations of the CSA are a major part of Debtors' ordinary course of business. Whether marijuana-related customers account for 65% or 95% of Debtors' revenue, eliminating all such revenue would be devastating to the Debtors. It is inconceivable Debtors could terminate any sales to known marijuana cultivators and still operate profitably.

In any event, the Court does not believe such an order, or the remediation it would require, would be effective in this case. The Court cannot simply order Debtors to cease all sales to customers known to be involved in marijuana cultivation, because the usefulness of Debtors'

[165] *Rent-Rite*, 484 B.R. at 805.

[166] 532 B.R. at 53.

[167] 564 B.R. at 77.

products in illegal grow operations will continue to attract marijuana horticulturalists to Debtors' business, including those growing marijuana solely for personal use. Debtors have already acquired a venerable reputation for expertise in hydroponic marijuana growing, and it is difficult to imagine how Debtors could prevent customers from continuing to patronize Debtors' stores because of this reputation. Indeed, the evidence does not show Debtors' essential business model has changed post-petition, which, of course, is the relevant time to determine whether Debtors may remain in bankruptcy. In any event, any such order would require the Court, and interested parties, to monitor the Debtors' sales and customers, which would be very difficult and inefficient. Further, in light of the acrimonious nature of Inniss's relationship with the Debtors, the Court can be reasonably certain such an order would lead to costly and time-consuming future litigation over the Debtors' compliance.

To prevent this Court from violating its oath to uphold federal law, under the specific facts of this case, the Court sees no practical alternative to dismissal.

C. Other Arguments for Dismissal

Inniss raises several further issues allegedly supporting dismissal or abstention. These include Debtors' alleged violations of the Court's cash collateral orders and the two-party nature of the dispute between Debtors and Inniss. Having found cause to dismiss upon the Debtors' continuing violations of the CSA, the Court need not address the remainder of these issues. The Court notes, however, it found the testimony of Debtors' financial advisor, John Thomspon, to be very credible, and the Court likely would have concluded based on Thompson's testimony the Debtors are not violating the Court's cash collateral orders. The Court also notes, having taken judicial notice of the claims registers in this case, this bankruptcy is far from a two-party dispute.

CONCLUSION

A bankruptcy court, as a court of limited and equitable jurisdiction, very rarely finds itself analyzing potential violations of federal criminal law. In this case, such analysis is unavoidable due to the divergence between the non-enforcement of federal marijuana laws. This Court is bound to follow the law as written and may not depart therefrom based on enforcement decisions made by the executive branch.

The result in this case may be viewed by many as inequitable. The Debtors are insolvent, and their business could benefit significantly from reorganization under the Bankruptcy Code. The Debtors likely did not seek bankruptcy relief in bad faith on a subjective standard. But for the marijuana issue, this would be a relatively run-of-the-mill Chapter 11

proceeding. As stated, even following those courts which have crafted alternatives to dismissal when debtors were violating the CSA would produce no practical or efficient alternative to dismissal in this case. At bottom, if the result in this case is unjust, Congress alone has power to legislate a solution.

Ironically, if Inniss, as the party arguing Debtors are violating federal law, wrests control of the Debtors back from Byrd in the State Case, he will almost certainly continue, and perhaps expand, the Debtors' ongoing marijuana-related operations. This irony is not lost on the Court but provides no legal basis for an alternate outcome. The Court casts no aspersions upon the Debtors or their businesses. The result in this case is dictated by federal law, which this Court is bound to enforce.

Accordingly, it is ORDERED the, Court's previous orders for joint administration of Debtors' cases are TERMINATED, the Motion to Dismiss is GRANTED, and Debtors' cases are DISMISSED. All pending motions are DENIED as moot and any scheduled hearings are VACATED.

Dated December 14, 2018.

BY THE COURT:

Michael E. Romero, Chief Judge
United States Bankruptcy Court

United States Department of Justice

THE UNITED STATES ATTORNEY'S OFFICE
NORTHERN DISTRICT of OKLAHOMA

U.S. Attorneys » Northern District of Oklahoma » News

Department of Justice

U.S. Attorney's Office

Northern District of Oklahoma

FOR IMMEDIATE RELEASE Friday, June 21, 2019

Tulsa Man Sentenced for Defrauding Bank of Nearly $5 Million

United States Attorney Trent Shores announced today that a Tulsa man was ordered to federal prison for defrauding a bank of nearly $5 million and for bankruptcy fraud. In December, Zealand Benjamin Thigpen III, 68, pleaded guilty in U.S. District Court to defrauding Arvest Bank of $4,754,488 from 2015 to 2017.

U.S. District Judge Claire V. Eagan sentenced Thigpen to 33 months in prison to be followed by five years of supervised release. Judge Eagan further ordered a criminal forfeiture money judgement in the sum of $4,754,488.40 representing proceeds obtained through his crimes.

"Thigpen swindled millions. He perpetrated a fraud on both Arvest Bank and the Small Business Administration. While he sits in federal prison for the next 33 months, the United States Attorney's Office will return his illegally begotten proceeds to the victims of his fraud," said U.S. Attorney Shores. "I commend the investigators from the Department of Treasury and Small Business Administration, along with Assistant U.S. Attorney Kevin Leitch. They discovered and exposed Thigpen's scheme, then brought him to justice."

As part of his scheme, Thigpen owned and operated Julimar Trading, LLC., which bought and sold refined metal alloys, principally for the production of steel. Julimar's operations were funded by Avrest Bank and, in part, guaranteed by the Small Business Administration. The bank financing was secured by his company's inventory and accounts receivable, as well as Thigpen's personal guarantees. When submitting financial documentation to the bank on October 4, 2016, Thigpen provided false information about the value of Julimar's inventory and accounts receivable, explaining the inventory was worth $5,816,335. As a result, Arvest and Small Business Administration continued his line of credit under false pretenses. In fact, the accounts receivable and inventory were nearly non-existent.

Later, on November 18, 2016, Thigpen filed pursuant to Chapter 7 in U.S. Bankruptcy Court, and once again lied about Julimar's inventory, stating that it was worth just over $3.3 million, when he was fully aware it only totaled only a few thousand dollars.

Thigpen was remanded int0 the custody of the U.S. Marshals Service until transfer into a U.S. Bureau of Prisons facility.

This case resulted from a joint investigation performed by the Offices of Inspectors General of the Department of the Treasury and the Small Business Administration and was prosecuted by Assistant U.S. Attorney Kevin C. Leitch

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Topic(s):
Financial Fraud

Component(s):
USAO - Oklahoma, Northern

Contact:
Public
Affairs 918-382-2755

Updated June 21, 2019

Admissibility of Electronic Evidence

PAUL W. GRIMM AND KEVIN F. BRADY ©2018

Potential Authentication Methods

Email, Text Messages, and Instant Messages

- Witness with personal knowledge (901(b)(1))
- Expert testimony or comparison with authenticated examples (901(b)(3))
- Distinctive characteristics including circumstantial evidence (901(b)(4))
- System or process capable of proving a reliable and dependable result (901(b)(9))
- Trade inscriptions (902(7))
- Certified copies of business record (902(11))
- Certified records generated by an electronic process or system (902(13))
- Certified data copied from an electronic device, storage medium, or file (902(14))

Chat Room Postings, Blogs, Wikis, and Other Social Media Conversations

- Witness with personal knowledge (901(b)(1))
- Expert testimony or comparison with authenticated examples (901(b)(3))
- Distinctive characteristics including circumstantial evidence (901(b)(4))
- System or process capable of proving a reliable and dependable result (901(b)(9))
- Official publications (902(5))
- Newspapers and periodicals (902(6))
- Certified records generated by an electronic process or system (902(13))
- Certified data copied from an electronic device, storage medium, or file (902(14))

Digitally Stored Data and Internet of Things

- Witness with personal knowledge (901(b)(1))
- Expert testimony or comparison with authenticated examples (901(b)(3))
- Distinctive characteristics including circumstantial evidence (901(b)(4))
- System or process capable of proving a reliable and dependable result (901(b)(9))
- Certified records generated by an electronic process or system (902(13))
- Certified data copied from an electronic device, storage medium, or file (902(14))

Computer Processes, Animations, Virtual Reality, and Simulations

- Witness with personal knowledge (901(b)(1))
- Expert testimony or comparison with authenticated examples (901(b)(3))
- System or process capable of proving a reliable and dependable result (901(b)(9))
- Certified records generated by an electronic process or system (902(13))

Digital Photographs

- Witness with personal knowledge (901(b)(1))
- System or process capable of providing reliable and dependable result (901(b)(9))
- Official publications (902(5))
- Certified records generated by an electronic process or system (902(13))
- Certified data copied from an electronic device, storage medium, or file (902(14))

Social Media Sites (Facebook, LinkedIn, Twitter, Instagram, and Snapchat)

- Witness with personal knowledge (901(b)(1))
- Expert testimony or comparison with authenticated examples (901(b)(3))
- Distinctive characteristics including circumstantial evidence (901(b)(4))
- Public records (901(b)(7))
- System or process capable of proving a reliable and dependable result (901(b)(9))
- Official publications (902(5))
- Certified records generated by an electronic process or system (902(13))
- Certified data copied from an electronic device, storage medium, or file (902(14))

Know Which Approach Your Jurisdiction Follows

Maryland Approach to Rules 104 and 901:

A higher standard for authentication for social media evidence. In this approach, the burden is on the admitting party to show that the social media evidence was not falsified or created by another user through either:

- Testimony of the creator of the website page or the post
- Search of the internet history or hard drive of the purported creator's computer
- Information obtained directly from social media site

See, Griffin v. State, 19 A. 3d 415, 423 (Md. 2011).

Texas Approach to Rules 104 and 901:

A lower standard for authentication of social media evidence. In this approach, the burden is on the admitting party to show evidence sufficient to support a finding by a reasonable juror that the social media evidence is what its proponent claims it to be through either:

- Direct testimony of a witness with personal knowledge
- Expert testimony or comparison with authenticated evidence
- Circumstantial evidence

See, Tienda v. State, 358 S. W. 3d 633 (Tex. Crim. App. 2012)

Preliminary Rulings on Admissibility

Before evidence goes to jury, judge must determine whether proponent has offered satisfactory foundation (preponderance of the evidence) from which jury could reasonably find that evidence is authentic. (104(a)) (FRE, except for privilege, do not apply).

When relevance of evidence depends on a disputed antecedent fact being established ("conditional relevance"), judge determines whether a reasonable jury could find that the fact has been proved, then submits the question to jury to decide. If jury finds that the antecedent fact has been proved, it considers the evidence. If not, it does not consider it. Example: dispute on authenticity (104(b)).

Is Evidence Relevant?

Does it have a tendency to make some fact that is of consequence to the litigation more or less probable than it otherwise would be?

YES | **NO**

FRE 401:
ADMISSIBLE – Go to FRE 402

FRE 401:
INADMISSIBLE

FRE 402:
Does Constitution, Statute, or Rule Require Exclusion?

YES: INADMISSIBLE

NO: ADMISSIBLE
GO TO FRE 403

FRE 403: Is probative value substantially outweighed by:

- Danger of unfair prejudice?
- Confusion of the issues?
- Misleading the jury?
- Undue delay?
- Waste of time?
- Needless presentation of cumulative evidence?

YES: INADMISSIBLE

NO: ADMISSIBLE

If Relevant, is it Authentic? FRE 901-902

FRE 901(a)

Is the evidence sufficient to support a finding that the matter in question is what proponent claims? Determining the degree of foundation required to authenticate electronic evidence depends on the quality and completeness of the data input, the complexity of the computer processing, the routines of the computer operation, and the ability to test and verify the results.

FRE 901(b)

Non-exclusive list of examples include:

- (1) Testimony of witness with knowledge
- (3) Comparison by trier or expert witness
- (4) Distinctive characteristics and the like (email address, hash values, "reply" doctrine)
- (7) Public records or report
- (9) Process or system capable of producing a reliable and dependable result

FRE 902 – Evidence That is Self-Authenticating*

Methods by which information may be authenticated **WITHOUT EXTRINSIC EVIDENCE:**

- (1)-(4) Public records/documents
- (5) Official Publications
- (6) Newspapers, magazines, similar publications
- (7) Trade inscriptions
- (11) Certified Domestic Records of Regularly Conducted Activity (authenticate business records under FRE 803(6))
- (13) Certified Record Generated by an Electronic Process or System
- (14) Certified Data Copied from an Electronic Device, Storage Medium, or File

** 902(11) - (14) are not self-authenticating methods per se; they require a certification.*

Is Evidence Hearsay?

FRE 801 (a-c)

- Is it a statement? (written/ spoken assertion, non-verbal/ non-assertive verbal conduct intended to be assertive.)
- Is statement made by "Declarant?" (person, not generated by machine.)
- Is statement offered for proving truth of assertion? NOTE: Statement is not offered for substantive truth if offered to prove:
  - Communicative/ comprehension capacity of declarant
  - Effect on the hearer
  - Circumstantial evidence of state of mind of declarant
  - Verbal acts/parts of acts
  - Utterances of independent legal significance

Is statement excluded from definition of hearsay by 801(d)(1) and (2)?

Prior witness statements – 801(d)(1)

- Prior testimonial statement 801(d)(1)(A)
- Prior consistent statement 801(d)(1)(B) to rebut allegations of recent fabrication or rehabilitate a witness that has been impeached
- Statement of identification 801(d)(1)(C)

Admission by party opponents – 801(d)(2)*

- Individual admission 801(d)(2)(A)
- Adoptive admission 801(d)(2)(B)
- Admission by person with authority 802(d)(2)(C)
- Admission by agent/ employees 802(d)(2)(D)
- Co-conspirator statements 801(d)(2)(E)

** Documents produced in discovery by opposing party are presumed to be authentic under 801(d)(2). Certification of business records under 902(11) and (12) must meet requirements of 803(6).*

If **HEARSAY**, then it is **INADMISSIBLE** unless covered by a recognized exception.

Hearsay Exception

Availability of Declarant Irrelevant – 803

- Present sense impression 803(1)
- Excited utterance 803(2)
- State of mind exception 803(3)
- Statements for purposes of medical diagnosis or treatment 803(4)
- Past recollection recorded 803(5)
- Business records 803(6)
- Absence of an entry in records kept in the regular course of business 803(7)
- Public records or reports 803(8)
- Records of vital statistics 803(9)
- Absence of public record or entry 803(10)
- Records/ documents affecting interest in property 803(14) & (15)
- Statements in ancient documents 803(16)
- Market reports and commercial publications 803(17)
- Learned treatises 803(18)
- Character reputation testimony 803(21)
- Record of felony convictions 803(22)

Declarant Unavailable – 804

- Unavailability – 804(a)(1-5) (privilege, refused to testify, lack of memory, death/illness, beyond subpoena power)
- Unavailability Exceptions – 804(b):
  - Former Testimony 804(b)(1)
  - Dying Declaration 804(b)(2)
  - Statement Against Interest 804(b)(3)
  - Statement of personal or family history 804(b)(4)
  - Forfeiture by wrongdoing 804(b)(6)
- Residual "Catchall" Exception – 807

A hearsay statement is not excluded by Rule 802 even if the statement is not specifically covered by Rule 803 or 804 under the following circumstances:

- Statement has equivalent circumstantial guarantees of trustworthiness
- Offered as evidence of a material fact
- More probative on the point for which it is offered than any other evidence that the proponent can obtain through reasonable efforts
- Admitting it will best serve the purposes of these rules and the interest of justice

The statement is admissible only if, before the trial or hearing, the proponent gives reasonable notice of intent to offer the statement and its particulars, and the opposing party has a fair opportunity to meet it.

Original Writing Rule FRE 1001-1008

- Is the evidence "original," "duplicative," "writing," or "recording" (Rule 1001)
- Rule 1002 requires the original to prove the contents of a writing, recording, or photograph unless "secondary evidence" (any evidence other than original or duplicative) is admissible. (Rules 1004, 1005, 1006, and 1007)
- Duplicates are co-extensively admissible as originals, unless there is a genuine issue of authenticity of the original or circumstances indicate that it would be unfair to admit duplicate in lieu of original (Rule 1003)
- Permits proof of the contents of writing, recording or paragraph by use of "secondary evidence"—any proof of the contents of a writing, recording or photograph other than the original or duplicate (Rule 1004) if:
  - Non-bad faith loss/destruction of original/duplicate
  - Inability to subpoena original/duplicate
  - Original/duplicate in possession, custody, or control of opposing party
  - "Collateral record" (i.e., not closely related to controlling issue in the case)
- Admission of summary of voluminous books, records, or documents (Rule 1006)
- Testimony or deposition of party against whom offered or by that party's written admission (FRCP 30, 33, 36) (Rule 1007)
- If admissibility depends on the fulfillment of a condition or fact, question of whether condition has been fulfilled is for fact finder to determine under Rule 104(b) (Rule 1008)
- But, the issue is for the trier of fact, if it is a question:
  - Whether the asserted writing ever existed
  - Whether another writing, recording, or photograph produced at trial is the original; or reflects the contents, the issue is for the trier of fact

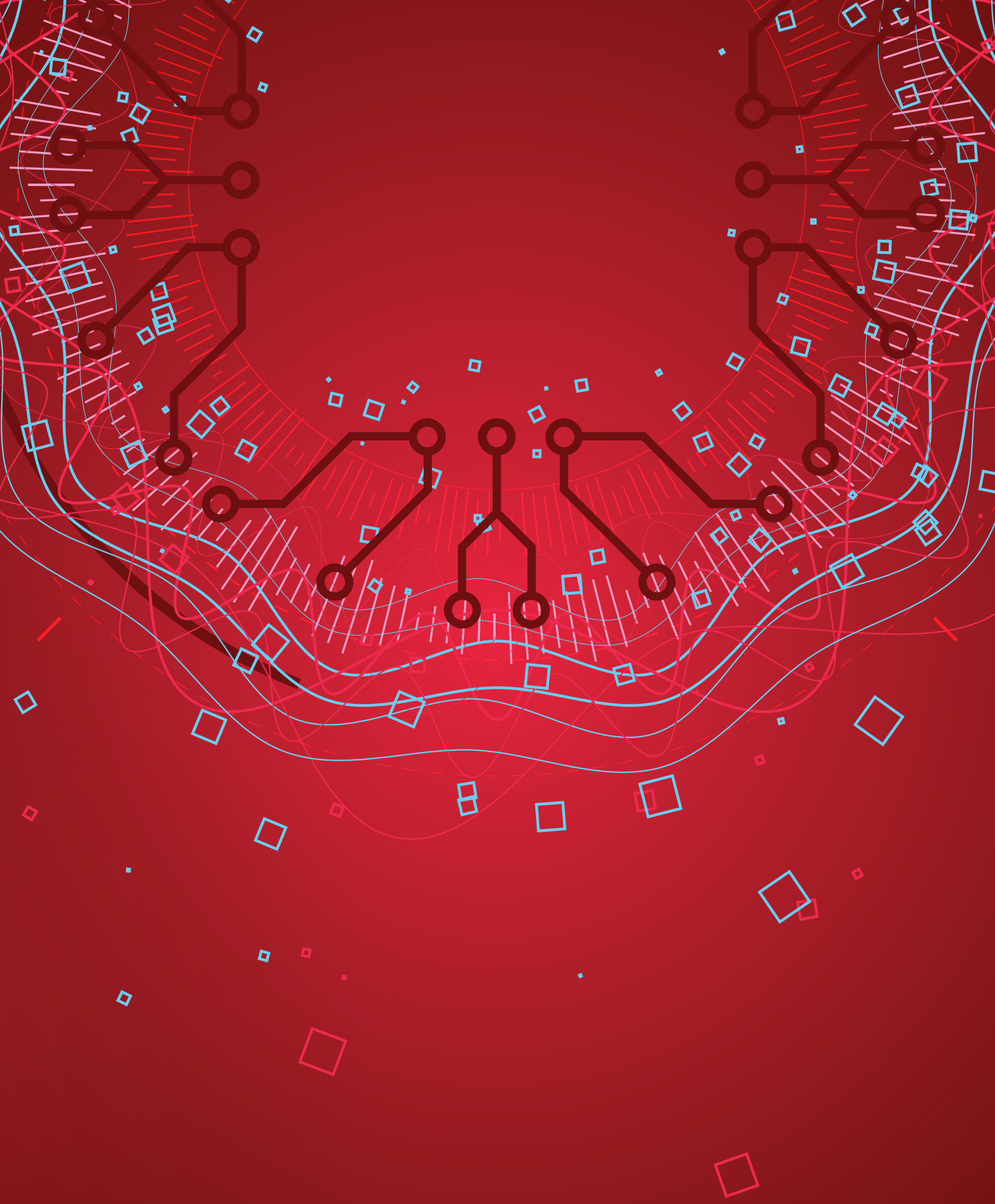
Practice Tips

- Be prepared and start with a defensible and comprehensive records management program
- Think strategically about the case and the evidence from the beginning of the case
- Memorialize each step of the collection and production process to bolster reliability
- Use every opportunity during discovery to authenticate potential evidence

Examples:

- For pretrial disclosures under FRCP 26(a)(3), you have 14 days to file objections or possible waiver
- Document produced by opposing party are presumed to be authentic under Rule 801(d)(2) – burden shifts
- FRCP 36 Requests for Admissions
- Request stipulation of authenticity from opposing counsel

- Be prepared to provide the court with enough information to understand the technology issues as they relate to the reliability of the evidence at hand
- Be creative and consider whether there are case management tools that might assist the court and the other parties in addressing evidentiary problems concerning some of the more complex issues (such as "dynamic" data in a database or what is a "true and accurate copy" of ESI)
- Keep your audience in mind. Will this be an issue for the judge or the jury? (e.g. Rule 104(a) or (b)



Electronic copies of the chart are available at no charge. To obtain a copy or for more information, contact Kevin Brady, Redgrave LLP, at kbrady@redgravellp.com.

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RECENT CHANGES TO FEDERAL RULES OF EVIDENCE: WILL THEY MAKE IT EASIER TO AUTHENTICATE ESI?

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While there was great fanfare for the changes to the Federal Rules of Civil Procedure in 2006 and 2015 and the changes to Rule 502 of the Federal Rules of Evidence ("Fed. R. Evid." or "Rule(s)") in 2011, there has been little attention paid to the December 1, 2017, changes to Fed. R. Evid. 803(16) as well as Rule 902(13) and (14), which are intended to positively influence how parties manage electronically stored information (ESI). The changes to Rule 803(16) address authentication of digital information that has been stored for more than 20 years, eliminating the concern that factual assertions made in massive volumes of ESI will be admissible for the truth contained in the documents simply because of their age. The concurrent addition of new subsections (13) and (14) to Rule 902 provide for streamlined authentication of ESI, and potentially eliminate the need to call a witness at trial to authenticate the evidence. In addition, more changes to the Fed. R. Evid. are coming. The Advisory Committee on the Rules of Evidence is considering proposed changes to Rule 807.

I. THE ESI EVIDENCE ADMISSIBILITY CHART

Notwithstanding these helpful additions to the litigator's toolkit, many challenges remain for attorneys handling evidence from the rapidly-evolving landscape of data sources such as bitcoin, blockchain, smart contracts, social media, Internet of Things (IoT), mobile devices, and cloud computing services.

Moreover, the ever-expanding use of social media like Facebook, LinkedIn, and Instagram, as well as social messaging applications like WhatsApp, Viber, and Messenger present significant challenges for lawyers trying to authenticate digital evidence using the traditional rules of evidence. The ESI Evidence Admissibility Chart ("Chart") offers discovery lawyers and trial attorneys a quick reference guide for handling diverse sources of ESI evidence. From Rule 104 to Rule 803(6) to Rule 901 and Rule 902, the Chart provides a step-by-step approach for authenticating digital information and successfully getting that information admitted into evidence. The 2018 edition of the Chart, which has been updated to reflect the changes to Rules 803 and 902, is provided in Appendix A (*Admissibility of Electronic Evidence*).

II. FED. R. EVID. 803(16)—MODIFICATION OF THE ANCIENT DOCUMENTS EXCEPTION TO THE HEARSAY RULE

When it was enacted, Rule 803 was intended to address exceptions to the hearsay rule that were premised on the theory that "under appropriate circumstances a hearsay statement may possess circumstantial guarantees of trustworthiness sufficient to justify nonproduction of the declarant in person at the trial even though he may be available."[1] Under former Rule 803(16), commonly referred to as the "ancient document" exception to the hearsay rule, a document that would normally be excluded as hearsay is nonetheless admissible and may be introduced at trial or summary judgment for the truth of its content if the document was created more than 20 years earlier and the proponent of the document can prove the document is authentic under Rule 902. Historically, an "ancient document" theoretically

1. FED. R. EVID. 803(16), Notes of Advisory Committee on Proposed Rules (1972).

could be deemed more trustworthy because "age affords assurance that the writing antedates the present controversy."[2] Under that rationale, something mystical happens to a document when it turns 20 years old; it acquires a hearsay-defeating level of trustworthiness that it did not have one day earlier. The reality is that, based on anecdotal evidence, this exception was rarely used; and, when it was used, it was for hardcopy documents.[3] The recent concern leading to the amendment was that Rule 803(16) could someday apply to the ever-expanding volume of digital information that currently exceeds four zettabytes (four trillion gigabytes) of data.[4] Given the increasing reliance on computers and the creation of significant amounts of digital information in the mid- to late-1990s (launch dates for big data generators: Yahoo (1994), Amazon (1995), eBay (1995), Google and PayPal (1998)) and early 2000s,[5] some jurists and commentators were concerned about a tsunami of ESI turning 20 years old in the near future[6] and the real risk that substantial

2. *Id*.

3. Professor Daniel J. Capra found that Rule 803(16) was used to admit documents in fewer than 100 reported cases since the Federal Rules of Evidence were enacted. *See* Daniel J. Capra, *Electronically Stored Information and the Ancient Documents Exception to the Hearsay Rule: Fix It Before People Find Out About It*, 17 YALE J. L. & TECH. 1, 12 (2015). The Advisory Committee also noted that "[a] party will often offer hardcopy that is derived from ESI." May 7, 2016 Report of the Advisory Committee on Evidence Rules to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Standing Committee Agenda Book at 73 (June 6–7, 2016), http://www.uscourts.gov/sites/default/files/2016-06-standing-agenda-book.pdf (Hereinafter May 2016 Advisory Committee Report).

4. Daniel J. Capra, *supra* note 3, at 13 & n.46.

5. Gil Press, *A Very Short History of Big Data*, FORBES (May 9, 2013), https://www.forbes.com/sites/gilpress/2013/05/09/a-very-short-history-of-big-data/#2608231b65a1.

6. Daniel J. Capra, *supra* note 3, at 3–4.

amounts of unreliable ESI would be subject to near-automatic admissibility under the existing exception.

Indeed, the looming problem with Rule 803(16) remained under the radar until 2015 when Professor Daniel Capra of Fordham Law School, who serves as the reporter to the Judicial Conference Advisory Committee on Evidence Rules ("Advisory Committee"), highlighted the problem in his article, *Electronically Stored Information and the Ancient Documents Exception to the Hearsay Rule: Fix It Before People Find Out About It*.[7] As Professor Capra pointed out:

> The question, then, is whether the explosion of electronic information has separated ESI from the original justifications for the hearsay exception for ancient documents. As stated above, the primary justification for the ancient documents exception is necessity, which comes down to the premise that it is likely that all reliable evidence (such as business records) has been destroyed within the twenty-year time period, and thus we have to make do with more dubious evidence. This necessity assumption is substantially undermined by the growth of ESI. Because ESI is prevalent and easily preserved, whatever reliable evidence existed at the time of a twenty-year-old event *probably* still exists. Indeed, the probability that most or all ESI records (emails, text messages, receipts, scanned documents, etc.) will be available is certainly higher than the probability that hardcopy documents or eyewitnesses will still be available

7. Daniel J. Capra, *Electronically Stored Information and the Ancient Documents Exception to the Hearsay Rule: Fix It Before People Find Out About It*, 17 YALE J. L. & TECH. 1.

> and useful several decades after a contested event. There is no reason to admit *unreliable* ESI on necessity grounds if it is quite likely that there will be *reliable* ESI that is admissible under other hearsay exceptions.[8]

The Advisory Committee considered four proposals for addressing the problem: (1) abrogation of Rule 803(16); (2) limiting the exception to hardcopy; (3) adding the necessity requirement from the residual exception (Rule 807); and (4) adding the Rule 803(6) requirement that the document would be excluded if the opponent could show that the document was untrustworthy under the circumstances. In concluding that Rule 803(16) had to be abrogated, the Advisory Committee noted that the problems presented by the ancient documents exception could not be fixed by tinkering with it—the appropriate remedy is to abrogate the exception and leave the field to other hearsay exceptions such as the residual exception (Rule 807) and the business records exception (Rule 803(6)). In particular:

> [t]here was no support for the proposal that would limit the exception to hardcopy, as the distinction between ESI and hardcopy would be fraught with questions and difficult to draw. For example, is a scanned copy of an old document, or a digitized version of an old book, ESI or hardcopy? As to the proposals to import either necessity or reliability requirements into the rule, Committee members generally agreed that they would be problematic because they would draw the ancient documents exception closer to the residual

8. *Id.* at 15 (citations omitted).

> exception, thus raising questions about how to distinguish those exceptions.[9]

As the Advisory Committee also concluded, hearsay that is in fact reliable will very likely be admissible under other reliability-based exceptions.[10]

However, the public reaction to that approach was largely negative. Many of the comments complained that without Rule 803(16), "important documents in certain specific types of litigation would no longer be admissible—or would be admissible only through expending resources that are currently not necessary under Rule 803(16). Examples of litigation cited by the public comment include cases involving latent diseases; disputes over the existence of insurance; cases involving environmental cleanups; and title disputes."[11]

In light of the public sentiment, the Advisory Committee went back to the drawing board and ultimately decided to limit the "ancient documents" exception to documents prepared before 1998 because that would not affect any of the specific cases raised in the public comments because those cases involved records prepared well before 1998. The Advisory Committee also recognized "that any cutoff date will have a degree of arbitrariness, but . . . the ancient documents exception itself set an arbitrary time period for its applicability."[12]

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9. April 17, 2015 Meeting Minutes of the Advisory Committee on Evidence Rules, Standing Committee Agenda Book at 492 (May 28–29, 2015), http://www.uscourts.gov/sites/default/files/2015-05-standing-agenda-book_1.pdf.

10. May 2016 Advisory Committee Report, *supra* note 3, at 46.

11. *Id.*

12. *Id.* at 47.

As a result, under new Rule 803(16), *documents (hard copy and ESI) that were prepared prior to January 1, 1998, and whose authenticity has been established will qualify as a hearsay exception, regardless of whether the preparer or declarant is available as a witness*.

III. FED. R. EVID. 902(13) AND (14)—NEW OPTIONS FOR AUTHENTICATING ESI

When the proponents of evidence want to offer a document into evidence either at the summary judgment stage or at trial in a civil case or criminal case, there are some evidentiary steps they have to climb before the judge or jury can consider the information. First, it has to be relevant: Does the evidence logically relate to what is at issue in the case? Second, it has to be authentic: Is the evidence what it purports to be? For example, if someone took a forensic image of a hard drive from a laptop computer as part of discovery in a case and, a year later, they wanted to introduce that forensic image into evidence, the proponent must be able to show that the forensic image that the proponent wants to show the jury is what it purports to be—namely, a document in the identical condition as it was when the image of the hard drive was made a year earlier that has not been altered, doctored or manipulated.

Rule 902 identifies evidence that is "self-authenticating," i.e., information that can be admitted at trial without being authenticated by a witness. Self-authenticating evidence is admissible without extrinsic evidence of authenticity "sometimes for reasons of policy but perhaps more often because practical considerations reduce the possibility of unauthenticity to a very small dimension."[13] Most of the items listed in Rule 902 are self-authenticating on their face, thus requiring no extrinsic evidence

13. FED. R. EVID. 902, Notes of Advisory Committee on Proposed Rules (1972). *See also In re* Miller, No. 10–25453, 2012 WL 6041639, at *7 (Bankr. D.

of authenticity for the document to be admitted. Other items, such as those listed in Rule 902(11) and Rule 902(12) (for records of regularly conducted activity, domestic and foreign, respectively), are self-authenticating *only* to the extent the party seeking to introduce them into evidence certifies their authenticity and provides notice to the opposing party to give them a fair opportunity to challenge the certification. In conjunction with the amendment of Rule 803(6) in 2000, the enactment of Rule 902(11) that same year streamlined the process by which business records could be admitted into evidence under the business records exception to the hearsay rule.[14]

The Advisory Committee in 2017 supplemented Rule 902 by adding two subsections permitting similar certifications to authenticate electronic evidence. The amendments should eliminate the need for a live witness to testify as to the authenticity

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Colo. Dec. 4, 2012) ("Rule 902 strikes a balance in favor of self-authentication for certain enumerated evidence because the likelihood of fabricating such evidence is slight versus the time and expense which would be required for authentication through extrinsic evidence. When a self-authenticating document is offered under Rule 902, the proponent is relieved of the requirement to lay foundation or present testimony through a witness. In other words, if a document is self-authenticating, the general authentication requirement of Rule 901 is deemed satisfied." (citation omitted)); Leo v. Long Island R. Co., 307 F.R.D. 314, 325 (S.D.N.Y. 2015) (in rejecting the applicability of Rule 902 to videotapes, the court explained that "the drafters of the Federal Rules of Evidence anticipated that, in specified circumstances, certain types of exhibits may be so evidently that which the proponent claims them to be that they may be deemed authentic without extrinsic evidence."); United Asset Coverage, Inc. v. Avaya Inc., 409 F. Supp. 2d 1008, 1052 (N.D. Ill. 2006) (describing new Rule 902(11) as "[o]ne of the most useful (though perhaps least noticed) accomplishments" of the Committee during that court's tenure, and lamenting that "[t]oo few lawyers have caught up with that valuable amendment").

14. *See generally* Lorraine v. Markel Am. Ins. Co., 241 F.R.D. 534, 552 (D. Md. 2007).

of ESI, thereby streamlining the process at trial. New subsection 13 addresses certifying information generated by an electronic process or system, and new subsection 14, which is narrower than Rule 902(13), addresses certifying data copied from an electronic device, storage medium, or file.[15] The new subsections to Rule 902 are:

> **(13) Certified Records Generated by an Electronic Process or System.** A record generated by an electronic process or system that produces an accurate result, as shown by a certification by a qualified person that complies with the certification requirements of Rule 902(11) or Rule 902(12). The proponent must also meet the notice requirements of Rule 902(11).
>
> **(14) Certified Data Copied from an Electronic Device, Storage Medium, or File.** Data copied from an electronic device, storage medium, or file, if authenticated by a process of digital identification, as shown by a certification by a qualified person that complies with the certification requirements of Rule 902(11) or (12). The proponent also must meet the notice requirements of Rule 902(11).

As with the provisions on business records in Rules 902(11) and 902(12), the Advisory Committee noted that the expense and inconvenience of producing a witness to authenticate an item of electronic evidence is often unnecessary because the adversary either stipulates to authenticity before the witness is called or fails to challenge the authentication testimony once it is presented. Under the amendments to Rule 902, the parties are now able to determine in advance of trial whether a real challenge to authenticity will be made.

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15. May 2016 Advisory Committee Report, *supra* note 3, at 54–57 (discussing proposed new subsections (13) and (14)).

It is important to note that Rule 902(11) relates "only to the procedural requirements" of authentication.[16] Likewise, new Rules 902(13) and 902(14) are designed to do "nothing more than authenticate" ESI.[17] Therefore, the proponent of the evidence sought to be admitted still must prove the requirements of Rule 803(6) after clearing the authenticity hurdle. Put more simply, the new rules are intended merely to simplify the process of proving that ESI sought to be admitted constitute true and accurate copies of electronic information maintained in the ordinary course of business by the proponent or a third party. What is important to note from Rule 902(13) and (14) is that the references to Rule 902(11) and (12) are simply to the form of the declaration—the affidavit you want to introduce must have the same formality and style as the certifications referred to in Rule 902(11) and (12). Rule 902(13) and (14) are not saying that the certification for subsections (13) and (14) has to include the substantive certification of Rule 902(11), which is tied to Rule 803(6)(A)(B)(C) elements for the business record exception.

New subsections 13 and 14, like Rule 902(11) and (12), permit a foundation witness or "qualified person" to establish the authenticity of information by way of certification.[18] Subsection

16. May 2016 Advisory Committee Report, *supra* note 3, at 55.

17. April 29, 2016 Meeting Minutes of the Advisory Committee on Evidence Rules, Advisory Committee Agenda Book at 25 (Oct. 21, 2016), http://www.uscourts.gov/sites/default/files/2016-10-evidence-agenda-book.pdf.

18. Pursuant to Rule 901(11) and (12), a "qualified person" is a custodian or other individual who has the ability to establish the authenticity of the ESI as if that person would have testified at trial such as under Fed. R. Evid. 901(b)(1) [Testimony of a Witness with Knowledge] or 901(b)(4) [Distinctive Characteristics and the Like]. The threshold question for a court to determine the authenticity of a document is not whether the evidence is necessarily what the proponent says it is, but rather whether the evidence is sufficient

13 provides for self-authentication of machine-generated information—such as system metadata—upon the submission of a certification prepared by a qualified person. Subsection 14 provides for authentication of data copied from an electronic device, medium, or file—such as an email or Excel spreadsheet that was stored on a computer—through digital identification. The Advisory Committee noted, in most instances, digital identification involves authentication of data copied from electronic devices by comparing the "hash value" of the proffered copy to that of the original document. A hash value is a unique alphanumeric sequence of characters that an algorithm determines based upon the digital contents of the device.[19] The hash value serves as the digital fingerprint that a qualified person uses to compare the numeric value of the proffered item with the numeric value of the original item. If the hash values for the original and copy are identical, the information can be proffered, and the court can rely on them as authentic copies. The Advisory Committee also noted that "the rule is flexible enough to allow certifications through processes other than comparison of hash value, including by other reliable means of identification provided by future technology."[20]

The new Rules 902(13) and 902(14) have the same effect as other Rule 902 provisions of shifting to the opponent the burden of going forward, but not the burden of proof, on authenticity disputes regarding the electronic evidence at issue. Shifting the burden of questioning the authenticity of such records to the opponent who has a fair opportunity to challenge both the certification and the records streamlines the process by which these

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that a jury ultimately might be able to so determine. *See* U.S. v. Safavian, 435 F. Supp. 2d 36, 38 (D.D.C. 2006).

19. May 7, 2016, Advisory Committee Report, *supra* note 3, at 56.

20. *Id.*

items can be authenticated, reducing the time, cost, and inconvenience of presenting this evidence at trial or summary judgment. The proponent of the evidence bears the burden of establishing a prima facie case that the ESI is what it purports to be and establishing authenticity if challenged, but need not go through the expense and inconvenience of using a witness to establish authenticity in the first instance. The opponent, of course, is able to object to the admissibility of the evidence on any other applicable ground.

Rule 902(13) is designed to permit the proponent to show that the evidence in question is authentic by attaching an affidavit under oath by the person or people with the technical or specialized knowledge of how the system or process works certifying that the evidence is reliable and accurate. Rule 902(14) allows for a certification—an affidavit or declaration by someone who has first-hand, personal knowledge (or expertise, if qualified as provided by Rule 702)—that would explain the process by which that person took a forensic copy of the evidence such as a hard drive of a laptop, hashed it, and then compared the hash value of the forensic copy with the hash value of the original hard drive. If the original hash value and the hash value of the forensic copy are the same, then the information in the copy is identical to the information in the original.

For example, if an individual takes a picture with his smart phone, embedded within the electronic metadata of that photograph are Global Position System (GPS) coordinates of the location where that photograph was taken. In a criminal case, where the prosecution must prove that the defendant was in a specific location by virtue of photographs taken from that defendant's cell phone, the metadata from that electronic photograph that shows the GPS coordinates is evidence of where the smartphone and, by extension, where the person was located when the picture was taken. Now, the prosecutor can put that information in

an affidavit and offer the affidavit to the defendant with the request to voice any objection regarding authenticity. If the defendant objects, the prosecutor must actually prove the authenticity and will need to bring one or more witnesses—persons with the scientific, technical, or specialized knowledge—to the trial to testify under oath how the system and processes produce reliable results. If the defendant does not object, the prosecutor has established authenticity and no authenticating witness would be needed at trial. Unless the affiant qualifies as an expert under Rule 702, she must provide information based on direct personal knowledge. The affiant's testimony cannot be based on what someone else told the affiant. Moreover, if the proponent has a system or process that requires explanation by multiple persons in order to be complete, affidavits are needed from each of those persons.

In a situation where the proponent wants to authenticate a process that predates any current employee at the organization, the proponent will need an expert to provide an affidavit. That expert must be able to testify that they have knowledge, training, experience, education, or skill which constitutes scientific, technical, or other specialized knowledge—and, based upon that, they can state how the process operates. Experts may base their opinions on information derived from other sources so long as the sources are reliable.[21]

21. Under Fed. R. Evid. 702, if the jury lacks the subject matter knowledge in an area involving scientific, technical, or other specialized knowledge, the proponent can have a subject matter expert base their opinion on information which is provided to them by others as long as the source of information they rely upon is generally recognized as reliable by other people with that degree of specialty or expertise.

Fed. R. Evid. 902(13) and (14) Certifications

The Rule 902 certification is intended to take the place of the testimony traditionally required to establish the authenticity of the ESI sought to be admitted; therefore, it should follow the same pattern as the testimony it is intended to replace. The certification should start by establishing the background, education, training, and expertise of the affiant in order to establish that she is a "qualified person" as required by Rule 902(11) and (12). Although Rule 902(13) and (14) do not refer to Rule 702, careful lawyers would be wise to ensure that the affiant providing the certificate meets the requirements of an expert witness under Rule 702 if the underlying facts to be authenticated involve scientific, technical, or specialized knowledge, as the underlying facts often do. The added benefit of showing that the affiant meets these Rule 702 requirements is that the affiant may base her certification on information beyond her personal knowledge, provided it is reliable, as described in Rule 703. The certification should then describe the affiant's role in the case, i.e., that she was retained by the party as a computer forensics expert in order to assist the party and its counsel in the identification, preservation, collection, and production of ESI. The certification should describe in detail the evidence in question and establish its authenticity consistent with the formality requirements of Rule 901(11) and (12). The certification need not meet the requirements of Rule 803(6)(A–C), unless the proponent also seeks to qualify the evidence as a business record. Rather, the certification must provide the information required by Rule 902(13) and (14), as discussed below.

If the certificate seeks to authenticate evidence under Rule 902(13), the affiant should describe in detail the "electronic process or system" that was used to generate the information in question. For example, if the information in question is a series

of monthly sales reports, the affiant should describe: (i) the system from which the reports were generated; (ii) the process by which the data that was used to generate the statements was gathered, processed, and stored; and (iii) the process by which the statements or reports sought to be admitted were generated and produced for the litigation. The Rule 902(13) certificate should establish that the information sought to be admitted has not been altered from the form in which it was maintained in the ordinary course of business. While the process of preparing a certification under Rule 902 is seemingly straightforward, the affiant must be careful to describe the "electronic process or system" with enough specificity to satisfy the court and the opponent of the authenticity of the evidence sought to be admitted, and to avoid a hearing during which the opponent of the evidence may cross-examine the affiant.

If the certificate seeks to authenticate evidence under Rule 902(14), the affiant also should describe in detail the electronic information that was copied from its original location and now offered into evidence, as well as the steps taken by the affiant at the time of duplication (including recording the date, time, surrounding circumstances, and hardware and software tools as well as versions utilized). For example, if the information sought to be admitted is a series of Excel and PowerPoint files that were stored on the departmental file share for the client's accounting department, the affiant should list the files in question and include the hash value of each of the files as they existed on the file share as well as the hash value for the copy of each of the files sought to be admitted in order to establish that the files sought to be admitted are authentic copies of the files as they were maintained in the ordinary course of business. The identical hash values will attest that the information sought to be admitted into evidence is a true and correct copy of the information as it existed in its original state.

As final practice pointers, the proponent should keep in mind that the certifications required by Rules 902(13) and Rule 902(14) must be substantive and not boilerplate. As a rule of thumb, they should be as detailed and specific as they would have to be if the witness was testifying in court to authenticate the digital evidence. And, because neither Rule 902(13) or Rule 902(14) provide a deadline by which the party receiving the certification must indicate its objection to the use of the certificate to authenticate the evidence, the cautious lawyer will seek a stipulation as to when the opponent will assert an objection, or ask the court to set a deadline, so that, if an objection is made, the proponent has sufficient time to arrange to bring in a live witness or witnesses.

Sample certifications under Rules 902(13) and 902(14) are provided in Appendices B and C, respectively.

IV. FED. R. EVID. 807—PROPOSED AMENDMENT TO RESIDUAL EXCEPTION TO THE HEARSAY RULE

In 2016 and 2017, the Advisory Committee considered whether to propose an amendment to Rule 807, the residual exception to the hearsay rule, and specifically whether to expand the exception to allow the admission of reliable hearsay even absent "exceptional circumstances." On October 21, 2016, the Advisory Committee met at Pepperdine University School of Law in Los Angeles[22] and held a symposium to review, among other things, possible amendments to Rule 807, including a working draft of an amendment that had been prepared in advance.

22. March 2017 Report of the Committee on Rules of Practice and Procedure to the Judicial Conference of the United States, Standing Committee Agenda Book at 72–73 (June 12–13, 2017), http://www.uscourts.gov/sites/default/files/2017-06-standing-agenda_book_0.pdf.

After the symposium, the Advisory Committee decided against expansion of the residual exception, but concluded that several problems with the current Rule 807 could be addressed by rule amendment.[23] In April 2017, the Advisory Committee proposed and the Standing Committee approved an amendment to Rule 807 for publication in August 2017.[24] The amendment eliminates the "equivalence" standard in the existing rule in favor of a more direct focus on circumstantial guarantees of trustworthiness for proffered statements, taking into account the presence or absence of corroboration. In addition, the proposed amendment eliminates the "materiality" and "interests of justice" requirements as duplicative, while retaining the "more probative" requirement in the existing rule.

The proposed amendment to Rule 807 was published for public comment, with the comment period officially closing on February 15, 2018.[25] At its April 2018 meeting, the Advisory Committee approved a proposed amendment to Rule 807 and submitted it to the Standing Committee for final approval. The current text of Rule 807 is restated in Section A, below, followed by: the main issues that the Advisory Committee identified with

23. September 2017 Report of the Committee on Rules of Practice and Procedure to the Judicial Conference of the United States, Standing Committee Agenda Book at 99–100 (Jan. 4, 2018), http://www.uscourts.gov/sites/default/files/2018-01-standing-agenda-book.pdf. The proposed amendment addresses several issues with the current notice requirements that are not discussed here.

24. Draft Minutes of the June 12–13, 2017 Meeting of the Committee on Rules of Practice and Procedure, Standing Committee Agenda Book at 52–53 (Jan. 4, 2018), http://www.uscourts.gov/sites/default/files/2018-01-standing-agenda-book.pdf.

25. October 26, 2017 Meeting Minutes of the Advisory Committee on Evidence Rules, Advisory Committee Agenda Book at 15 (April 26–27, 2018), http://www.uscourts.gov/sites/default/files/agenda_book_advisory_committee_on_rules_of_evidence_-_final.pdf.

current Rule 807 (Section B); comments regarding proposed changes published by the Advisory Committee following their October 2017 meeting (Section C); and the proposed amended Rule 807 including the proposed Committee Note (Section D).

A. Current Rule 807:

Rule 807. Residual Exception

(a) In General. Under the following circumstances, a hearsay statement is not excluded by the rule against hearsay even if the statement is not specifically covered by a hearsay exception in Rule 803 or 804:

(1) the statement has equivalent circumstantial guarantees of trustworthiness;

(2) it is offered as evidence of a material fact;

(3) it is more probative on the point for which it is offered than any other evidence that the proponent can obtain through reasonable efforts; and

(4) admitting it will best serve the purposes of these rules and the interests of justice.

(b) Notice. The statement is admissible only if, before the trial or hearing, the proponent gives an adverse party reasonable notice of the intent to offer the statement and its particulars, including the declarant's name and address, so that the party has a fair opportunity to meet it.

B. Issues[26] with Current Rule 807 as Identified by The Advisory Committee:

- The requirement that the court find trustworthiness "equivalent" to the circumstantial guarantees in the Rule 803 and 804 exceptions is difficult to apply because there is no unitary standard of trustworthiness in the Rule 803 and 804 exceptions.
- The requirements in Rule 807 that the residual hearsay must be proof of a "material fact" and that admission of residual hearsay be in "the interests of justice" have not served any purpose.
- Is the requirement that the hearsay statement must be "more probative than any other evidence that the proponent can obtain through reasonable efforts" necessary?

C. Comments Regarding the Proposed Changes to Rule 807 Published by the Advisory Committee Following Their October 2017 Meeting:

> The requirement that the court find trustworthiness "equivalent" to the circumstantial guarantees in the Rule 803 and 804 exceptions should be deleted—without regard to expansion of the residual exception. That standard is exceedingly difficult to apply, because there is no unitary standard of trustworthiness in the Rule 803 and 804 exceptions. It is common ground that statements falling

26. May 7, 2017 Report of the Advisory Committee on Evidence Rules to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Standing Committee Agenda Book at 736–737 (June 12–13, 2017), http://www.uscourts.gov/sites/default/files/2017-06-standing-agenda_book_0.pdf.

within the Rule 804 exceptions are not as reliable as those admissible under Rule 803; and it is also clear that the bases of reliability differ from exception to exception. Moreover, one of the exceptions subject to "equivalence" review—Rule 804(b)(6) forfeiture—is not based on reliability at all. Given the difficulty of the "equivalence" standard, a better approach is simply to require the judge to find that the hearsay offered under Rule 807 is trustworthy. This is especially so because a review of the case law indicates that the "equivalence" standard has not fulfilled the intent of the drafters to limit the discretion of the trial court. Given the wide spectrum of reliability found in the hearsay exceptions, it is not difficult to find a statement reliable by comparing it to a weak exception, or to find it unreliable by comparing it to a strong one.

Trustworthiness can best be defined in the Rule as requiring an evaluation of both 1) circumstantial guarantees surrounding the making of the statement, and 2) corroborating evidence. Most courts find corroborating evidence to be relevant to the reliability enquiry, but some do not. An amendment would be useful to provide uniformity in the approach to evaluating trustworthiness under the residual exception—and substantively, that amendment should specifically allow the court to consider corroborating evidence, as corroboration is a typical source for assuring that a statement is reliable. Adding a requirement that the court consider corroboration is an improvement to the rule independent of any decision to expand the residual exception.

> The requirements in Rule 807 that the residual hearsay must be proof of a "material fact" and that admission of residual hearsay be in "the interests of justice" and consistent with the "purpose of the rules" have not served any good purpose. The inclusion of the language "material fact" is in conflict with the studious avoidance of the term "materiality" in Rule 403—and that avoidance was well-reasoned, because the term "material" is so fuzzy. The courts have essentially held that "material" means "relevant"—and so nothing is added to Rule 807 by including it there. Likewise nothing is added to Rule 807 by referring to the interests of justice and the purpose of the rules because that guidance is already provided by Rule 102.
>
> The requirement in the residual exception that the hearsay statement must be "more probative than any other evidence that the proponent can obtain through reasonable efforts" should be retained. This will preserve the principle that proponents cannot use the residual exception unless they need it. And it will send a signal that the changes proposed are modest—there is no attempt to allow the residual exception to swallow the categorical exceptions, or even to permit the use the residual exception if the categorical exceptions are available.[27]

27. April 21, 2017 Meeting Minutes of the Advisory Committee on Evidence Rules; Advisory Committee Agenda Book at 13–14 (Oct. 26–27. 2017), http://www.uscourts.gov/sites/default/files/a3_0.pdf.

D. Proposed Amended Rule 807 and Committee Note:

Rule 807. Residual Exception[28]

(a) In General. Under the following ~~circumstances~~ conditions, a hearsay statement is not excluded by the rule against hearsay even if the statement is not ~~specifically covered by~~ admissible under a hearsay exception in Rule 803 or 804:

> **(1)** the statement ~~has equivalent circumstantial~~ is supported by sufficient guarantees of trustworthiness—after considering the totality of the circumstances under which it was made and evidence, if any, corroborating the statement; and
>
> ~~**(2)** it is offered as evidence of a material fact;~~
>
> **(3~~2~~)** it is more probative on the point for which it is offered than any other evidence that the proponent can obtain through reasonable efforts~~; and~~
>
> ~~**(4)** admitting it will best serve the purposes of these rules and the interests of justice~~.

(b) Notice. The statement is admissible only if~~, before the trial or hearing,~~ the proponent gives an adverse party reasonable notice of the intent to offer the statement ~~and its particulars, including the declarant's name and address,~~—including its substance and the declarant's name—so that the party has a fair opportunity to meet it. The notice must be provided in writing before the trial or

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28. May 14, 2018 Report of the Advisory Committee on Evidence Rules to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Standing Committee Agenda Book at 409–410 (June 12, 2018), http://www.uscourts.gov/sites/default/files/2018-06_standing_agenda_book_final.pdf. New material is underlined; matter to be omitted is lined through.

hearing—or in any form during the trial or hearing if the court, for good cause, excuses a lack of earlier notice.

Committee Note[29]

Rule 807 has been amended to fix a number of problems that the courts have encountered in applying it.

Courts have had difficulty with the requirement that the proffered hearsay carry "equivalent" circumstantial guarantees of trustworthiness. The "equivalence" standard is difficult to apply, given the different types of guarantees of reliability, of varying strength, found among the categorical exceptions (as well as the fact that some hearsay exceptions, e.g., Rule 804(b)(6), are not based on reliability at all). The "equivalence" standard has not served to guide a court's discretion to admit hearsay, because the court is free to choose among a spectrum of exceptions for comparison. Moreover, experience has shown that some statements offered as residual hearsay cannot be compared usefully to any of the categorical exceptions and yet might well be trustworthy. Thus the requirement of an equivalence analysis has been eliminated. Under the amendment, the court should proceed directly to a determination of whether the hearsay is supported by guarantees of trustworthiness. See Rule 104(a). As with any hearsay statement offered under an exception, the court's threshold finding that admissibility re-

29. May 14, 2018 Report of the Advisory Committee on Evidence Rules to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Standing Committee Agenda Book at 410–414 (June 12, 2018), http://www.uscourts.gov/sites/default/files/2018-06_standing_agenda_book_final.pdf.

quirements are met merely means that the jury may consider the statement and not that it must assume the statement to be true.

The amendment specifically requires the court to consider corroborating evidence in the trustworthiness enquiry. Most courts have required the consideration of corroborating evidence, though some courts have disagreed. The rule now provides for a uniform approach, and recognizes that the existence or absence of corroboration is relevant to, but not dispositive of, whether a statement should be admissible under this exception. Of course, the court must consider not only the existence of corroborating evidence but also the strength and quality of that evidence.

The amendment does not alter the case law prohibiting parties from proceeding directly to the residual exception, without considering admissibility of the hearsay under Rules 803 and 804. A court is not required to make a finding that no other hearsay exception is applicable. But the opponent cannot seek admission under Rule 807 if it is apparent that the hearsay could be admitted under another exception.

The rule in its current form applies to hearsay "not specifically covered" by a Rule 803 or 804 exception. The amendment makes the rule applicable to hearsay "not admissible under" those exceptions. This clarifies that a court assessing guarantees of trustworthiness may consider whether the statement is a "near-miss" of one of the Rule 803 or 804 exceptions. If the court employs a "near-miss" analysis it should—in addition to evaluating all relevant guarantees of trustworthiness—take into account the reasons that the hearsay misses the admissibility requirements of the standard exception.

In deciding whether the statement is supported by sufficient guarantees of trustworthiness, the court should not consider the credibility of any witness who relates the declarant's hearsay statement in court. The credibility of an in-court witness does not present a hearsay question. To base admission or exclusion of a hearsay statement on the witness's credibility would usurp the jury's role of determining the credibility of testifying witnesses. The rule provides that the focus for trustworthiness is on circumstantial guarantees surrounding the making of the statement itself, as well as any independent evidence corroborating the statement. The credibility of the witness relating the statement is not a part of either enquiry.

Of course, even if the court finds sufficient guarantees of trustworthiness, the independent requirements of the Confrontation Clause must be satisfied if the hearsay statement is offered against a defendant in a criminal case.

The Committee decided to retain the requirement that the proponent must show that the hearsay statement is more probative than any other evidence that the proponent can reasonably obtain. This necessity requirement will continue to serve to prevent the residual exception from being used as a device to erode the categorical exceptions.

The requirements that residual hearsay must be evidence of a material fact and that its admission will best serve the purposes of these rules and the interests of justice have been deleted. These requirements have proved to be superfluous in that they are already found in other rules. See Rules 102, 401.

The notice provision has been amended to make four changes in the operation of the rule:

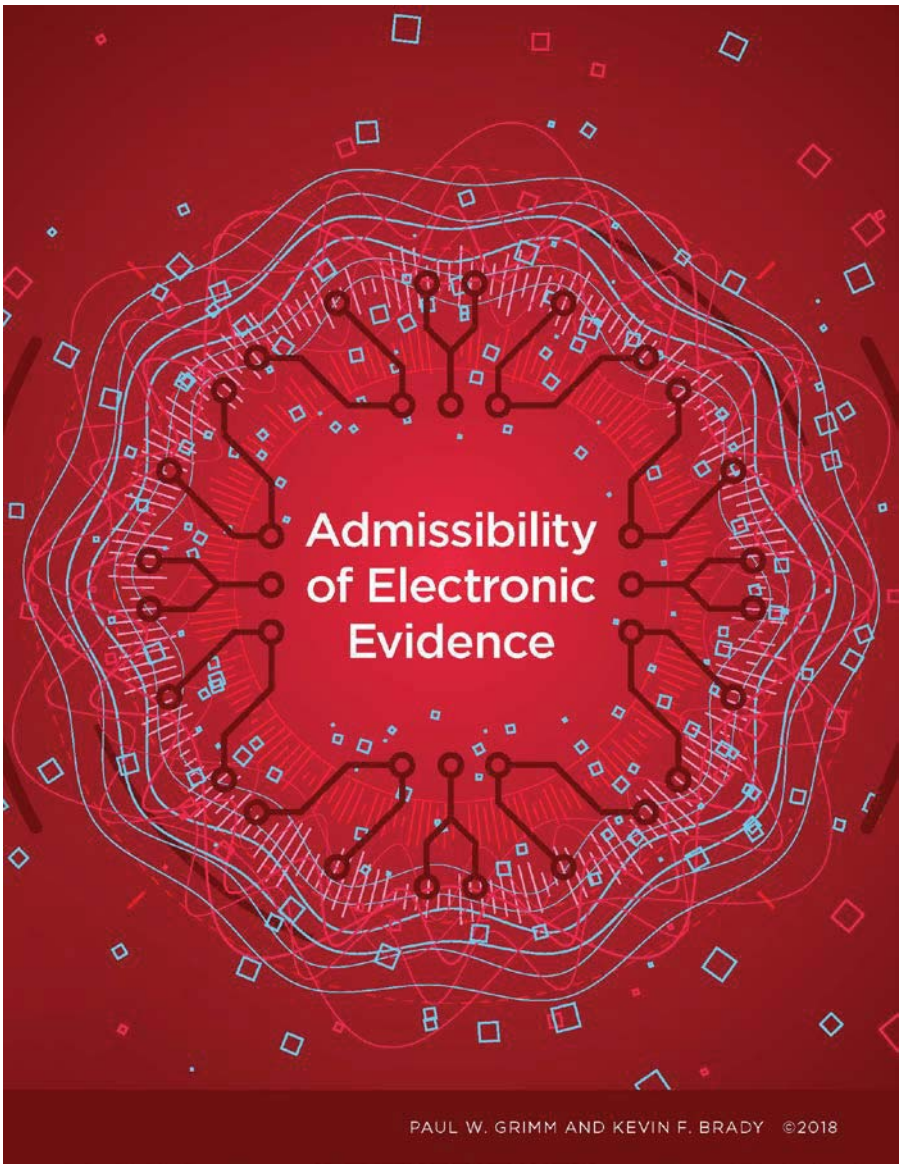
- First, the amendment requires the proponent to disclose the "substance" of the statement. This term is intended to require a description that is sufficiently specific under the circumstances to allow the opponent a fair opportunity to meet the evidence. See Rule 103(a)(2) (requiring the party making an offer of proof to inform the court of the "substance" of the evidence).
- Second, the prior requirement that the declarant's address must be disclosed has been deleted. That requirement was nonsensical when the declarant was unavailable, and unnecessary in the many cases in which the declarant's address was known or easily obtainable. If prior disclosure of the declarant's address is critical and cannot be obtained by the opponent through other means, then the opponent can seek relief from the court.
- Third, the amendment requires that the pretrial notice be in writing—which is satisfied by notice in electronic form. See Rule 101(b)(6). Requiring the notice to be in writing provides certainty and reduces arguments about whether notice was actually provided.
- Finally, the pretrial notice provision has been amended to provide for a good cause exception. Most courts have applied a good cause exception under Rule 807 even though the rule in its current form does not provide for it, while some courts have read the rule as it was written. Experience under the residual exception has shown that a

good cause exception is necessary in certain limited situations. For example, the proponent may not become aware of the existence of the hearsay statement until after the trial begins; or the proponent may plan to call a witness who without warning becomes unavailable during trial, and the proponent might then need to resort to residual hearsay.

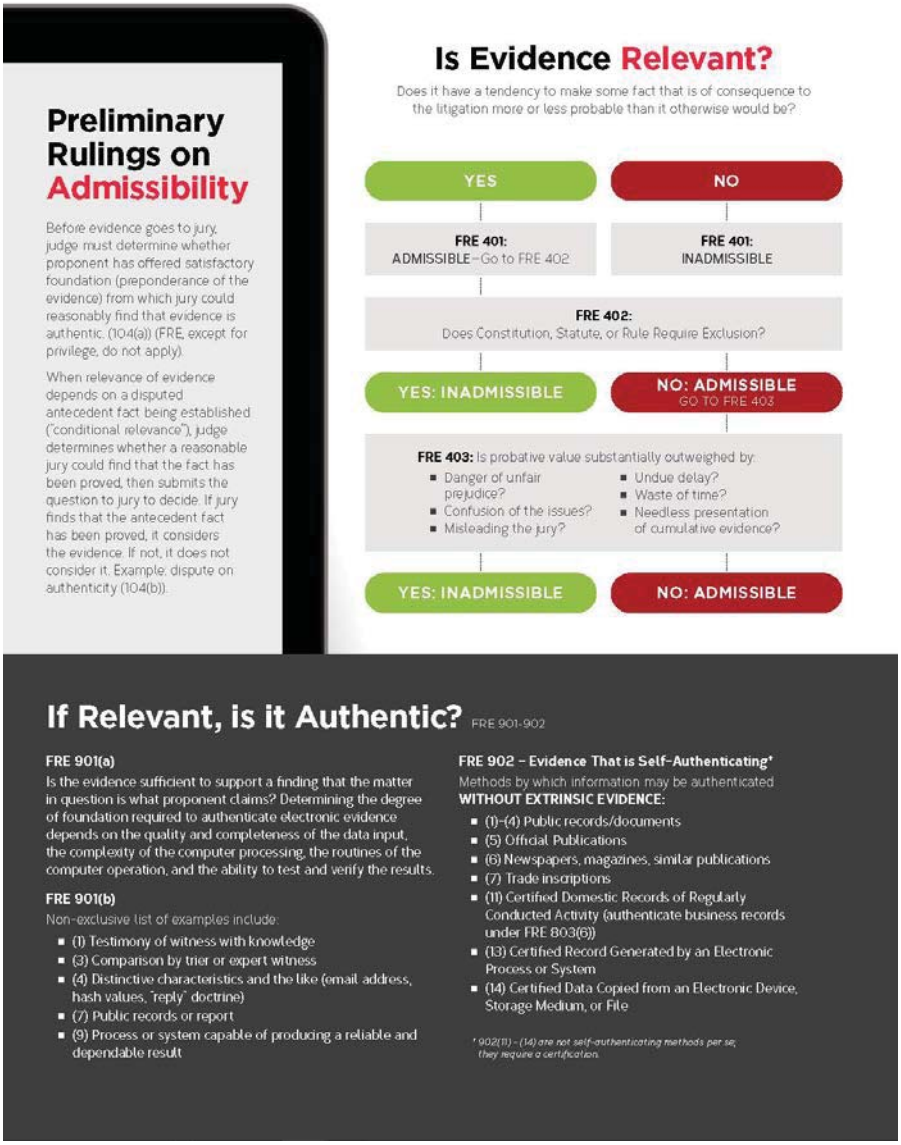
- The rule retains the requirement that the opponent receive notice in a way that provides a fair opportunity to meet the evidence. When notice is provided during trial after a finding of good cause, the court may need to consider protective measures, such as a continuance, to assure that the opponent is not prejudiced.

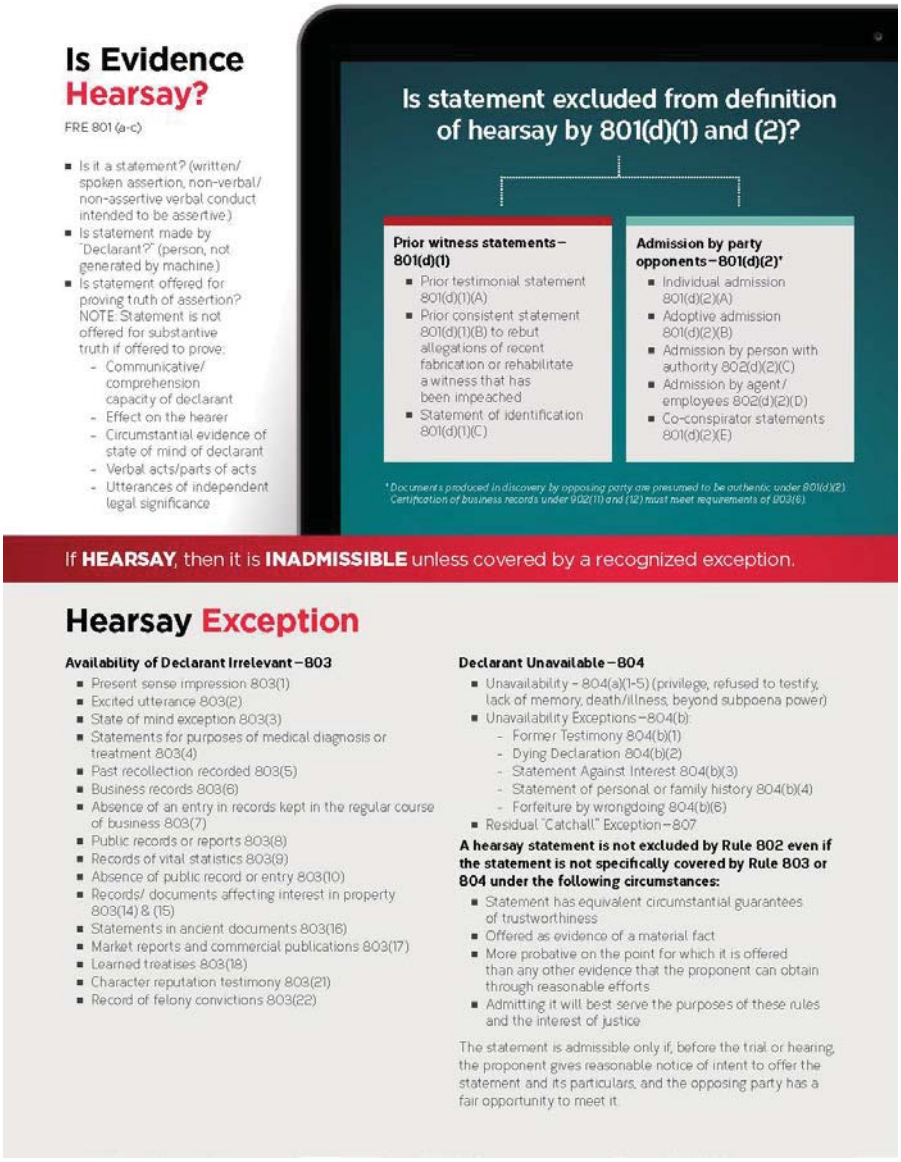
APPENDIX A:
ESI EVIDENCE ADMISSIBILITY CHART

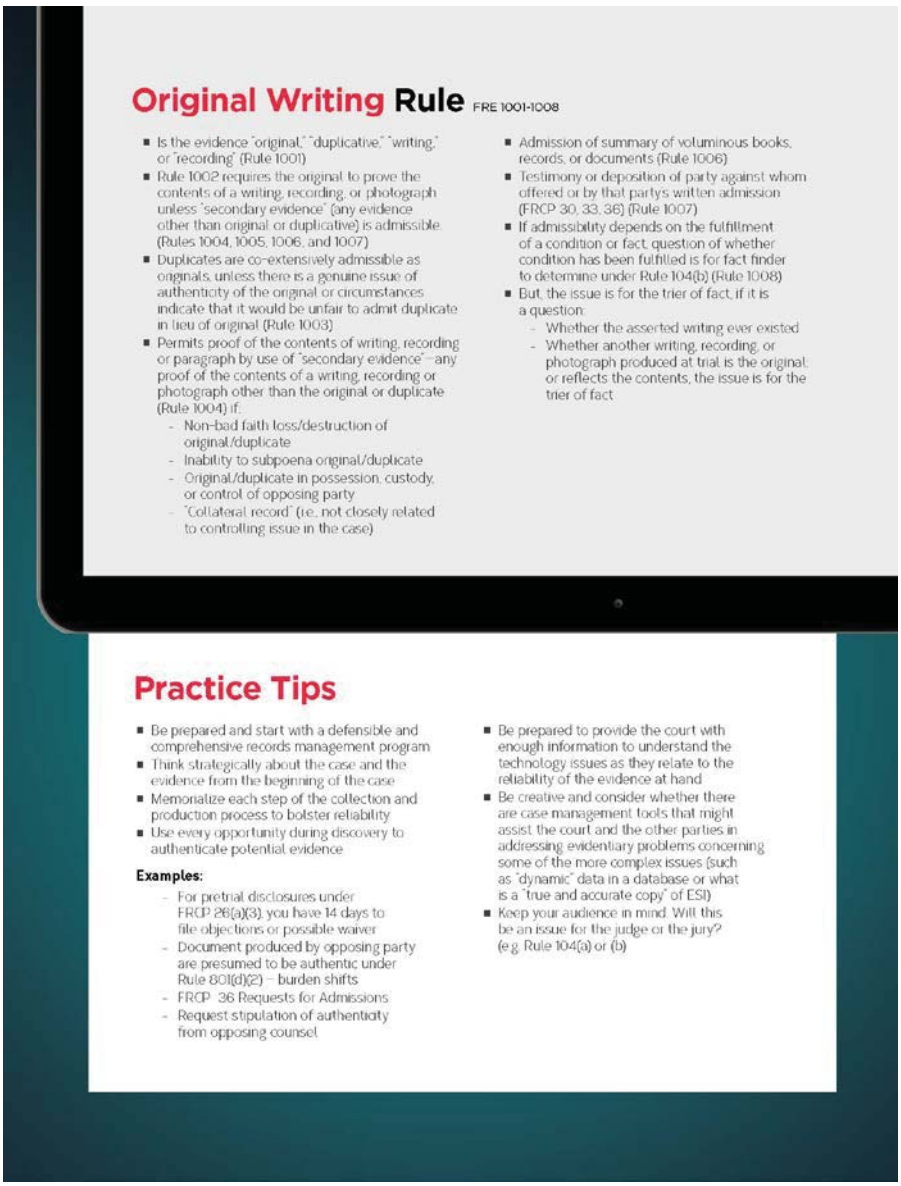
Admissibility of Electronic Evidence has been reprinted with permission from the Honorable Paul W. Grimm and Kevin F. Brady. To download an enlarged version, *see* https://bit.ly/2NFWlp0.



Potential Authentication Methods
Email, Text Messages, and Instant Messages
Witness with personal knowledge (901(b)(1))
Expert testimony or comparison with authenticated examples (901(b)(3))
Distinctive characteristics including circumstantial evidence (901(b)(4))
System or process capable of proving a reliable and dependable result (901(b)(9))
Trade inscriptions (902(7))
Certified copies of business record (902(11))
Certified records generated by an electronic process or system (902(13))
Certified data copied from an electronic device, storage medium, or file (902(14))
Chat Room Postings, Blogs, Wikis, and Other Social Media Conversations
Witness with personal knowledge (901(b)(1))
Expert testimony or comparison with authenticated examples (901(b)(3))
Distinctive characteristics including circumstantial evidence (901(b)(4))
System or process capable of proving a reliable and dependable result (901(b)(9))
Official publications (902(5))
Newspapers and periodicals (902(6))
Certified records generated by an electronic process or system (902(13))
Certified data copied from an electronic device, storage medium, or file (902(14))
Digitally Stored Data and Internet of Things
Witness with personal knowledge (901(b)(1))
Expert testimony or comparison with authenticated examples (901(b)(3))
Distinctive characteristics including circumstantial evidence (901(b)(4))
System or process capable of proving a reliable and dependable result (901(b)(9))
Certified records generated by an electronic process or system (902(13))
Certified data copied from an electronic device, storage medium, or file (902(14))
Computer Processes, Animations, Virtual Reality, and Simulations
Witness with personal knowledge (901(b)(1))
Expert testimony or comparison with authenticated examples (901(b)(3))
System or process capable of proving a reliable and dependable result (901(b)(9))
Certified records generated by an electronic process or system (902(13))
Digital Photographs
Witness with personal knowledge (901(b)(1))
System or process capable of providing reliable and dependable result (901(b)(9))
Official publications (902(5))
Certified records generated by an electronic process or system (902(13))
Certified data copied from an electronic device, storage medium, or file (902(14))
Social Media Sites (Facebook, LinkedIn, Twitter, Instagram, and Snapchat)
Witness with personal knowledge (901(b)(1))
Expert testimony or comparison with authenticated examples (901(b)(3))
Distinctive characteristics including circumstantial evidence (901(b)(4))
Public records (901(b)(7))
System or process capable of proving a reliable and dependable result (901(b)(9))
Official publications (902(5))
Certified records generated by an electronic process or system (902(13))
Certified data copied from an electronic device, storage medium, or file (902(14))
Know Which Approach Your Jurisdiction Follows
Maryland Approach to Rules 104 and 901:
A higher standard for authentication for social media evidence. In this approach, the burden is on the admitting party to show that the social media evidence was not falsified or created by another user through either:
Testimony of the creator of the website page or the post
Search of the internet history or hard drive of the purported creator's computer
Information obtained directly from social media site
See, Griffin v. State, 19 A. 3d 415, 423 (Md. 2011).
Texas Approach to Rules 104 and 901:
A lower standard for authentication of social media evidence. In this approach, the burden is on the admitting party to show evidence sufficient to support a finding by a reasonable juror that the social media evidence is what its proponent claims it to be through either:
Direct testimony of a witness with personal knowledge
Expert testimony or comparison with authenticated evidence
Circumstantial evidence
See, Tienda v. State, 358 S.W. 3d 633 (Tex. Crim. App. 2012)


Preliminary Rulings on Admissibility
Before evidence goes to jury, judge must determine whether proponent has offered satisfactory foundation (preponderance of the evidence) from which jury could reasonably find that evidence is authentic. (104(a)) (FRE, except for privilege, do not apply).
When relevance of evidence depends on a disputed antecedent fact being established ("conditional relevance"), judge determines whether a reasonable jury could find that the fact has been proved, then submits the question to jury to decide. If jury finds that the antecedent fact has been proved, it considers the evidence. If not, it does not consider it. Example: dispute on authenticity (104(b)).
Is Evidence Relevant?
Does it have a tendency to make some fact that is of consequence to the litigation more or less probable than it otherwise would be?
YES
NO
FRE 401: ADMISSIBLE – Go to FRE 402
FRE 401: INADMISSIBLE
FRE 402: Does Constitution, Statute, or Rule Require Exclusion?
YES: INADMISSIBLE
NO: ADMISSIBLE GO TO FRE 403
FRE 403: Is probative value substantially outweighed by:
Danger of unfair prejudice?
Confusion of the issues?
Misleading the jury?
Undue delay?
Waste of time?
Needless presentation of cumulative evidence?
YES: INADMISSIBLE
NO: ADMISSIBLE
If Relevant, is it Authentic? FRE 901-902
FRE 901(a)
Is the evidence sufficient to support a finding that the matter in question is what proponent claims? Determining the degree of foundation required to authenticate electronic evidence depends on the quality and completeness of the data input, the complexity of the computer processing, the routines of the computer operation, and the ability to test and verify the results.
FRE 901(b)
Non-exclusive list of examples include:
(1) Testimony of witness with knowledge
(3) Comparison by trier or expert witness
(4) Distinctive characteristics and the like (email address, hash values, "reply" doctrine)
(7) Public records or report
(9) Process or system capable of producing a reliable and dependable result
FRE 902 – Evidence That is Self-Authenticating*
Methods by which information may be authenticated WITHOUT EXTRINSIC EVIDENCE:
(1)-(4) Public records/documents
(5) Official Publications
(6) Newspapers, magazines, similar publications
(7) Trade inscriptions
(11) Certified Domestic Records of Regularly Conducted Activity (authenticate business records under FRE 803(6))
(13) Certified Record Generated by an Electronic Process or System
(14) Certified Data Copied from an Electronic Device, Storage Medium, or File
* 902(11) - (14) are not self-authenticating methods per se; they require a certification.


Is Evidence Hearsay?
FRE 801 (a-c)
Is it a statement? (written/ spoken assertion, non-verbal/ non-assertive verbal conduct intended to be assertive)
Is statement made by "Declarant?" (person, not generated by machine)
Is statement offered for proving truth of assertion? NOTE: Statement is not offered for substantive truth if offered to prove:
Communicative/ comprehension capacity of declarant
Effect on the hearer
Circumstantial evidence of state of mind of declarant
Verbal acts/parts of acts
Utterances of independent legal significance
Is statement excluded from definition of hearsay by 801(d)(1) and (2)?
Prior witness statements – 801(d)(1)
Prior testimonial statement 801(d)(1)(A)
Prior consistent statement 801(d)(1)(B) to rebut allegations of recent fabrication or rehabilitate a witness that has been impeached
Statement of identification 801(d)(1)(C)
Admission by party opponents – 801(d)(2)*
Individual admission 801(d)(2)(A)
Adoptive admission 801(d)(2)(B)
Admission by person with authority 802(d)(2)(C)
Admission by agent/ employees 802(d)(2)(D)
Co-conspirator statements 801(d)(2)(E)
* Documents produced in discovery by opposing party are presumed to be authentic under 801(d)(2). Certification of business records under 902(11) and (12) must meet requirements of 803(6).
If HEARSAY, then it is INADMISSIBLE unless covered by a recognized exception.
Hearsay Exception
Availability of Declarant Irrelevant – 803
Present sense impression 803(1)
Excited utterance 803(2)
State of mind exception 803(3)
Statements for purposes of medical diagnosis or treatment 803(4)
Past recollection recorded 803(5)
Business records 803(6)
Absence of an entry in records kept in the regular course of business 803(7)
Public records or reports 803(8)
Records of vital statistics 803(9)
Absence of public record or entry 803(10)
Records/ documents affecting interest in property 803(14) & (15)
Statements in ancient documents 803(16)
Market reports and commercial publications 803(17)
Learned treatises 803(18)
Character reputation testimony 803(21)
Record of felony convictions 803(22)
Declarant Unavailable – 804
Unavailability – 804(a)(1-5) (privilege, refused to testify, lack of memory, death/illness, beyond subpoena power)
Unavailability Exceptions – 804(b):
Former Testimony 804(b)(1)
Dying Declaration 804(b)(2)
Statement Against Interest 804(b)(3)
Statement of personal or family history 804(b)(4)
Forfeiture by wrongdoing 804(b)(6)
Residual "Catchall" Exception – 807
A hearsay statement is not excluded by Rule 802 even if the statement is not specifically covered by Rule 803 or 804 under the following circumstances:
Statement has equivalent circumstantial guarantees of trustworthiness
Offered as evidence of a material fact
More probative on the point for which it is offered than any other evidence that the proponent can obtain through reasonable efforts
Admitting it will best serve the purposes of these rules and the interest of justice
The statement is admissible only if, before the trial or hearing, the proponent gives reasonable notice of intent to offer the statement and its particulars, and the opposing party has a fair opportunity to meet it.


Original Writing Rule FRE 1001-1008
Is the evidence "original," "duplicative," "writing," or "recording" (Rule 1001)
Rule 1002 requires the original to prove the contents of a writing, recording, or photograph unless "secondary evidence" (any evidence other than original or duplicative) is admissible. (Rules 1004, 1005, 1006, and 1007)
Duplicates are co-extensively admissible as originals, unless there is a genuine issue of authenticity of the original or circumstances indicate that it would be unfair to admit duplicate in lieu of original (Rule 1003)
Permits proof of the contents of writing, recording or paragraph by use of "secondary evidence" – any proof of the contents of a writing, recording or photograph other than the original or duplicate (Rule 1004) if:
Non-bad faith loss/destruction of original/duplicate
Inability to subpoena original/duplicate
Original/duplicate in possession, custody, or control of opposing party
"Collateral record" (i.e., not closely related to controlling issue in the case)
Admission of summary of voluminous books, records, or documents (Rule 1006)
Testimony or deposition of party against whom offered or by that party's written admission (FRCP 30, 33, 36) (Rule 1007)
If admissibility depends on the fulfillment of a condition or fact, question of whether condition has been fulfilled is for fact finder to determine under Rule 104(b) (Rule 1008)
But, the issue is for the trier of fact, if it is a question:
Whether the asserted writing ever existed
Whether another writing, recording, or photograph produced at trial is the original; or reflects the contents, the issue is for the trier of fact
Practice Tips
Be prepared and start with a defensible and comprehensive records management program
Think strategically about the case and the evidence from the beginning of the case
Memorialize each step of the collection and production process to bolster reliability
Use every opportunity during discovery to authenticate potential evidence
Examples:
For pretrial disclosures under FRCP 26(a)(3), you have 14 days to file objections or possible waiver
Document produced by opposing party are presumed to be authentic under Rule 801(d)(2) – burden shifts
FRCP 36 Requests for Admissions
Request stipulation of authenticity from opposing counsel
Be prepared to provide the court with enough information to understand the technology issues as they relate to the reliability of the evidence at hand
Be creative and consider whether there are case management tools that might assist the court and the other parties in addressing evidentiary problems concerning some of the more complex issues (such as "dynamic" data in a database or what is a "true and accurate copy" of ESI)
Keep your audience in mind. Will this be an issue for the judge or the jury? (e.g. Rule 104(a) or (b))

Electronic copies of the chart are available at no charge. To obtain a copy or for more information,
contact Kevin Brady, Redgrave LLP, at kbrady@redgravellp.com.

APPENDIX B:
CERTIFICATION OF AUTHENTICITY UNDER FEDERAL RULE OF EVIDENCE 902(13)

I, _____, being duly sworn, hereby certify that:

1. I have been requested by [organization] to provide an [affidavit/certification] under Federal Rule of Evidence 902(13) that the [information/records/data] described below were generated by an electronic process/system that produces an accurate result consistent with the requirements of Federal Rules of Evidence 902(11) [or 902(12)] and 803(6)(A-C) [only if also seeking to qualify the records as business records in addition to authenticating them].
2. I am an adult, over the age of 21 years, and I am competent to testify. [Note: If the affiant would qualify to give opinion testimony on a topic of scientific, technical, or specialized knowledge under Federal Rule of Evidence 702, insert a description of his/her qualifications, as noted in No. 3, below. If not, establish that the information used to certify the evidence is based on the affiant's personal knowledge.]
3. Describe: educational background and relevant work experience including current job description, professional training, and membership in professional organizations.
4. Describe prior certification experience.
5. Identify and describe prior testimony.
6. I am currently a [title], [organization].
7. Describe knowledge and experience in information systems in general and in particular the "electronic process or system" that was used to generate the information in question or system at issue. [Note: Person signing affidavit or certification must have personal knowledge of the facts and systems [hardware and software] that are at issue and they

must describe the "electronic process or system" with enough specificity to satisfy the court and the opponent that the evidence sought to be admitted is authentic.]

I declare under penalty of perjury that the foregoing is true and correct.

Dated: _____

_____

Name of Affiant/Declarant

[For Affidavits - Insert Notary Public Notarization Here]

APPENDIX C:
CERTIFICATION OF AUTHENTICITY UNDER FEDERAL RULE OF EVIDENCE 902(14)

I, _____, being duly sworn, hereby certify that:

1. I have been requested by [organization] to provide an [affidavit/certification] under Federal Rule of Evidence 902(14) that the [records/data] described below were generated by an electronic process/system that produces an accurate result consistent with the requirements of Federal Rules of Evidence 902(11) [or 902(12)] and 803(6) (A-C) [only if also seeking to qualify the records as business records in addition to authenticating them].
2. I am an adult, over the age of 21 years, and I am competent to testify. [Note: If the affiant would qualify to give opinion testimony on a topic of scientific, technical, or specialized knowledge under Federal Rule of Evidence 702, insert a description of his/her qualifications, as noted in No. 3, below. If not, establish that the information used to certify the evidence is based on the affiant's personal knowledge.]
3. Describe: educational background, relevant work experience, professional training, and membership in professional organizations.
4. Describe prior certification experience.
5. I am currently a [title], [organization].
6. Describe knowledge and experience in information systems in general and the particular system at issue.
7. I performed the following [X]. Attached as Exhibit "A" is a list of items that I examined. Describe in detail the electronic information that was copied from its original location and the steps the affiant took (including date, time, circumstances, hardware and software tools as well as

versions utilized) regarding the information to be offered into evidence. [Note: To prove that the information to be admitted into evidence is a true and correct copy of the original information, it is important to list the files or data in question and show the hash value of each on the original source and then the hash value of the file or data sought to be admitted into evidence. If the hash values are identical, that is proof that the information sought to be admitted into evidence is a true and correct copy of the information as it originally existed.]

I declare under penalty of perjury that the foregoing is true and correct.

Dated: _____

_____

Name of Affiant/Declarant

[For Affidavits - Insert Notary Public Notarization Here]

The Case for Bankruptcy Venue Reform

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Introduction

Representatives Zoe Lofgren (D-Calif. 19th District) and Jim Sensenbrenner (R-WI 5th District) introduced H.R. 4421, a new bipartisan bankruptcy venue reform bill. It is substantially similar to S. 2282 introduced last year in the Senate by Senators John Cornyn (R-TX) and Elizabeth Warren (D-MA). The proposed law will eliminate the place of incorporation in favor of filing where the debtor's principal place of business or principal assets are located. It will also eliminate the affiliate-filing loophole. The result of this effort will make it more likely that chapter 11cases are decided at home where they belong.

Historical Perspective[1]

The story of venue options for corporate debtors begins with Section 2(1) of the Bankruptcy Act of 1898, Ch. 541, 30 Stat. 544, *repealed by* Bankruptcy Reform Act of 1978, P.L. No. 95-598, 92 Stat. 2549. That section did not make a distinction between natural persons and business entities.

> [T]he district courts of the United States in several States . . . are hereby [enabled] to exercise original jurisdiction in bankruptcy proceedings . . . to (1) adjudge persons bankrupt who have had their principal place of business, resided, or had their domicile within their respective territorial jurisdictions for the preceding six months, or the greater portion thereof, or who do not have their principal place of business, reside, or have their domicile within the United States, but have property within their jurisdictions, or who have been adjudged bankrupts by the courts of competent jurisdiction without the United States and have property within their jurisdictions . . . .

Id. The term "domicile" was not defined in the Bankruptcy Act. It was left to the courts to interpret the words "resided" and "domicile" and determine whether either could apply to a business entity. The few courts that considered the question in the context of bankruptcy ruled that the term "domicile" could apply to business entities and found that a business entity was

[1] This section is based generally on research done in connection with the *NCBJ Special Commission on Venue: Report on Proposal for Revision of the Venue Statute in Commercial Bankruptcy Cases*, November 27, 2018 ("NCBJ Report") and *Testimony of Douglas B. Rosner before the American Bankruptcy Institute Commission to Study the Reform of Chapter 11*, (Nov. 22, 2013), http://commission.abi.org/sites/default/files/statements/22nov2013/Venue-Statement-ABI-Commission.pdf.

domiciled in the state of its formation. *See, e.g., In re Hudson River Nav. Corp.*, 59 F.2d 971, 973 (2d Cir. 1932) (finding that corporation had its "residence and domicile" in Delaware, its state of incorporation); *In re R.C. Stanley Shoe Co.*, 8 F. Supp. 681, 683 (D.N.H. 1934) ("[A] corporation may be organized under the laws of one state and have its principal place of business in another state and there be jurisdiction in both states to adjudge the corporation a bankrupt."). The issue arose in federal cases more often when interpreting the meaning of "residence" and "domicile" in the context of determining diversity jurisdiction. *See Suttle v. Reich Bros. Constr. Co.*, 333 U.S. 163, 166 (1948) ("[T]he 'residence' of a corporation, within the meaning of the venue statutes, is only in 'the State and district in which it has been incorporated.'") (quoting Shaw v. Quincy Mining Co., 145 U.S. 444, 449 (1892)).

In 1934, Congress added a new provision expressly adopting the common law view that proper venue for a corporate bankruptcy reorganization includes its state of formation. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 912, *repealed by* Chandler Act, ch. 575, 52 Stat. 840 (1938). However, four years later, in 1938, Congress reversed itself when it enacted the Chandler Act. The Chandler Act established two alternatives for corporate bankruptcies – chapter X for public companies (public debt or equity) and chapter XI for non-public companies. *See* Chandler Act of 1938, ch. 575, 52 Stat. 840, 886, *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549. The Act limited corporations with outstanding public debt or securities to file only in a jurisdiction where the corporation had its principal place of business or its principal assets. *See id*. The House Report on the Chandler Act explained the reason for the change:

> In general, the bill sets up as the only valid criterion for jurisdiction the company's principal place of business, or the place of location of its principal assets. Selection of any other jurisdiction usually means conducting the reorganization at great distances from the place or places where the corporation does its business. It means putting investors to great expenses and difficulty if they wish to appear and participate in the proceedings. It means, also, that inside groups who may be in control of a reorganization are able to search around for the jurisdiction in which they estimate it is least likely, for a number of reasons, that their conduct of the corporation will be examined; that they will be exposed to liability, and their perpetuation in office endangered. These defects have been met and corrected by the bill, in limiting the venue of reorganization proceedings to the principal place of business or the location of the corporation's principal assets . . . .

H.R. Rep. No. 75-1409, at 40 (1937). In contrast, Chapter XI continued to permit venue for bankruptcy filings in the state of incorporation. *Chandler Act* at 886. Public or private corporations were permitted to file under chapter XI. *See Gen. Stores Corp. v. Shlensky*, 350 U.S. 462 (1956) (not a venue related decision).

In 1973, the United States Supreme Court promulgated new Rules of Bankruptcy Procedure (order dated April 24, 1973, effective October 1, 1973). Rule 116 distinguished between natural persons and business entities. It limited venue for a corporate debtor to the

district where it had its principal place of business or principal assets or where an affiliate of the debtor had already filed. The new Rule eliminated domicile as a venue choice for corporations but left it in for individuals:

> (a) Proper Venue.
>
> > (1) Natural Person. A petition by or against a natural person may be filed in the district where the bankrupt has had his principal place of business, residence, or domicile for the preceding 6 months or for a longer portion thereof than in any other district. A petition by or against a natural person who has had no principal place of business, residence, or domicile within the United States during the preceding 6 months may be filed in a district wherein he has property.
> >
> > (2) Corporation or Partnership. A petition by or against a corporation or partnership may be filed in the district (A) where the bankrupt has had its principal place of business or its principal assets for the preceding 6 months or for a longer portion thereof than in any other district; or (B) if there is no such district, in any district where the bankrupt has property.

Bankruptcy Rules and Official Bankruptcy Forms, R. 116 (1973). The Advisory Committee Notes that accompanied the change expressly acknowledged the Committee's intent to "eliminate the notion that residence or domicile may serve as a useful basis for determining venue of a corporation or partnership." *Comm. on the Rules of Practice and Procedure of the Judicial Conference of the U.S., Preliminary Draft of Proposed Bankruptcy Rules and Official Forms under Chapters I to VII of the Bankruptcy Act 35* (Comm. Print 1971). The Committee reasoned that "[t]he place of incorporation [had] no relation to the business activity of the corporation . . . ." 12 *COLLIER ON BANKRUPTCY* § 116.03[2] (James W. Moore & Lawrence P. King eds., 14th ed. 1979).

In 1978, in connection with the enactment of the Bankruptcy Code, Congress once again combined natural persons and business entities in a single venue provision. *See* 28 U.S.C. § 1472 (later re-designated as 28 U.S.C. § 1408). The section provided that a bankruptcy petition could be filed in the district in which: (i) the person or entity was domiciled, resided, or had its principal place of business or principal assets; or (ii) the person's affiliate, general partner, or partnership had a pending case. *Id*.

Section 1472's legislative history provided no explanation for the consolidation of previously distinct venue provisions. In a 2013 law review article, Professor Samir Parikh surmised that if it were Congress's intent to return to the venue rules of the 1898 Act, the shift

was drastic and it is unlikely such a drastic change would have been made without any discussion or explanation in the legislative history. *See Modern Forum Shopping in Bankruptcy*, 46 Conn. L.R. 159, 169 (November 2013) ("Parikh"). *But see In re Landmark Capital Co.*, 19 B.R. 342, 346 (Bankr. S.D.N.Y.), *aff'd*, 20 B.R. 220 (S.D.N.Y. 1982) (bound by the plain language of the 1978 venue statute, court found that "though it is true that Rule 116(a) of the Bankruptcy Rules eliminated domicile and residence as useful bases for determining venue of a corporation or partnership, Congress did not see fit to carry this scheme forward in new 28 U.S.C. §1472.")

"More likely, the genesis for section 1472 was the desire to simplify the language of the 1978 Bankruptcy Act, with unintended consequences regarding forum shopping." *Id*.

> However, in context, this oversight may not be as glaring as it first appears. At the time section 1472 was enacted, there were few large, multimillion-dollar bankruptcy cases, and forum shopping by such debtors was not a concern because venue provisions had not been abused. Without an understanding of the risk of forum shopping and lacking an appreciation of the unique harm that forum shopping in bankruptcy could pose, Congress, legal commentators, and scholars may have all viewed section 1472's changes as mere streamlining of an unnecessarily detailed provision.

Id.

Modern Venue

Section 1472 was later re-designated as 28 U.S.C. §1408 but otherwise remained the same. The text of the section 1408, which continues to govern bankruptcy cases provides:

> §1408. Venue of cases under title 11
>
> Except as provided in section 1410 of this title, a case under title 11 may be commenced in the district court for the district—
>
> (1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one-hundred-and-eighty-day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of such person were located in any other district; or
>
> (2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership.

In summary, section 1408 provides four possible locations where an entity can file for bankruptcy protection: 1) the debtor's domicile, 2) the location of the debtor's principal place of business, 3) the location of the debtor's principal assets, or 4) the district in which an affiliate's

case is pending. Current venue rules give "corporate debtors . . . the option of filing just about anywhere . . [D]ecision-makers . . . can easily change states of incorporation, move assets and offices, or make other maneuvers to facilitate a filing in their chosen district." *Parikh* at 192. "[Section 1408] focuses on the convenience of the debtor who alone chooses where to file its case, rather than on the convenience of the creditors who are forced to deal with the debtor at its chosen place of filing." *Hearing on H.R. 2533 before the Subcomm. on Courts, Commercial and Administrative Law of the House Judiciary Committee,* 112th Cong. 12 (2011) (testimony of Judge Bailey, Chief Judge, United States Bankruptcy Court for the District of Mass.).

Notably, it has been the courts, not Congress, that expanded the meaning of "domicile" to apply to corporate entities and include the state of incorporation. *See, e.g.*, *In re Dunmore Homes, Inc.*, 380 B.R. 663, 670 (Bankr. S.D.N.Y. 2008); *In re Segno Commc'ns, Inc.*, 264 B.R. 501 (Bankr. N.D. Ill. 2001). *See also, e.g., Hudson River,* 59 F.2d at 973; *Stanley Shoe,* 8 F. Supp. at 683. When Congress has explicitly spoken to the issue, it has rejected this interpretation and limited the application of the terms "residency" and "domicile" to natural persons. As noted, unlike in 1938 and 1973, the enactment of the modern venue provision in 1978 which consolidates individuals and entities was done without any debate or discussion about whether it would permit corporate debtors to file in their state of formation.

Supporters of allowing debtors to file in their state of incorporation make the analogy to 28 U.S.C. § 1391(c), the venue statute for civil litigation. *See* REPORT OF THE DELAWARE STATE BAR ASSOCIATION TO THE NATIONAL BANKRUPTCY REVIEW COMMISSION IN SUPPORT OF MAINTAINING EXISTING VENUE CHOICES, pp. 18-19 (1996); NCBJ Report at pp. 61-62. That statute defines an entity's residency to mean:

> An entity . . . shall be deemed to reside, *if a defendant*, in any judicial district in which such defendant is subject to the court's personal jurisdiction with respect to the civil action in question and, *if a plaintiff*, only in the judicial district in which it maintains its principal place of business.[2]

However, Section 1391(c)'s definition explicitly provides that it applies only to a defendant in a civil action; this is not the case in bankruptcy. A debtor in bankruptcy is more analogous to a plaintiff in a civil action; namely, the party that commences the proceeding and forces other parties to participate. If viewed in that light, limiting bankruptcy venue to principal place of business or principal assets should be viewed as consistent with the meaning of a plaintiff's residence under the general federal venue provisions.

In a non-bankruptcy context, the leading authority in determining an entity's principal place of business is *Hertz Corp. v. Friend*, 130 S. Ct. 1181 (2010), in which the Supreme Court held that:

[2] *Compare* its predecessor statute: "[a] corporation may be sued in any judicial district in which it is incorporated or licensed to do business or doing business, and such judicial district shall be regarded as the residence of such corporation for venue purposes." 28 U.S.C. § 1391(c) (1948).

> `principal place of business' is best read as referring to the place where the corporation's officers direct, control, and coordinate the corporation's activities. It is the place that Courts of Appeals have called the corporation's 'nerve center.' And in practice it should normally be the place where the corporation maintains its headquarters - provided that the headquarters is the actual center of direction, control, and coordination, i.e., the `nerve center,' and not simply an office where the corporation holds its board meeting (for example, attended by directors and officers who have traveled there for the occasion).

Id. at 1192. A corporation's principal place of business is the place where general supervision is given; not necessarily where the managers, or controlling shareholders or directors, happen to be located or meet. *See, e.g., In re Newport Creamery, Inc.*, 265 B.R. 614, 617 (Bankr. M.D. Fla. 2001); *In re Standard Tank Cleaning Corp.*, 133 B.R. 562, 564 (Bankr. E.D.N.Y. 1991).

The location of an entity's principal assets is the place where those assets principally used in the operation of the debtor's business (the debtor's significant assets) are located. *See In re EquiMed, Inc.*, 253 B.R. 391 (D. Md. 2000); *In re Handel*, 242 B.R. 789 (Bankr. D. Mass. 1999).

Lastly, a debtor can file in a district where its affiliate has a pending case, even one filed only moments before it files. There is no requirement that a case must be filed in the district in which an affiliate's case is pending. It is permissive. *But see* Fed. R. Bankr. P. 1014(b) (the court in the district in which the first-filed petition is pending may determine the district or districts in which any of the cases should proceed). The term "affiliate" is defined in U.S.C. § 101(2).

Venue Transfer

Current law does allow for a transfer of venue in bankruptcy cases. Pursuant to 28 U.S.C. § 1412, "A district court may transfer a case or proceeding under title 11 to a district court for another district, in the interest of justice or for the convenience of the parties." Since the statute is written in the disjunctive, only one prong need be satisfied for a court to transfer venue. *Dwight v. Titlemax of Tennessee, Inc.*, 2010 LEXIS 4767 at *5 (E.D. Tenn. 2010). The party moving for change of venue has the burden of proof. The standard is preponderance of the evidence but at least one court held the burden to be clear and convincing proof. *Compare In re Peachtree Lane Assoc., Ltd.*, 150 F.3d 788 (7th Cir. 1998) with *In re Northwest Airlines Corp.*, 384 B.R. 51,70 (S.D.N.Y. 2008) (applying the clear and convincing standard). Failure to raise the issue in a timely manner results in a waiver of any objection to venue. *See In re Moss*, 249 B.R. 200, 202 (Bankr. W.D. Mo. 2000). If petitions are filed in different districts by or against the same debtor or a debtor and an affiliate, the court in the district in which the first-filed petition is pending may determine the district or districts in which any of the cases should proceed. *See* Fed. R. Bankr. P. ("Bankruptcy Rule") 1014(b).

Where the original venue is proper, Bankruptcy Rule 1014(a)(1) provides that:

> If a petition is filed in a proper district, the court on the timely motion of a party in interest or on its own motion, and after hearing on notice to the petitioners, the United States trustee, and other entities as directed by the court, may transfer the case to any other district if the court determines that the transfer is in the interest of justice or for the convenience of the parties.

Criteria courts have considered in determining whether a transfer is in the "interest of justice" include:

(1) Whether transfer will promote economic and efficient administration of the estate;
(2) whether interests of judicial economy will be served;
(3) whether parties will be able to receive a fair trial;
(4) whether either forum has an interest in having the controversy decided in its borders;
(5) the enforceability of any judgment; and
(6) whether the original forum should be disturbed.

See In re Commonwealth Oil Ref. Co., 596 F. 2d 1239, 1247 (5th Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980); *In re West Coast Interventional Pain Medicine, Inc.*, 435 B.R. 569, 579 (Bankr. N.D. Ind. 2010); *In re B.L. McCandless, L.P.*, 417 B.R. 80, 82 (Bankr. N.D. Ill. 2009); *In re Dunmore Homes*, 380 B.R. 663, 672 (Bankr. S.D.N.Y. 2008); *Irwin v. Beloit Corp. (In re Harnischfeger Indus., Inc.)*, 246 B.R. 421, 435-37 (Bankr. N. D. Ala. 2000).

The factors commonly considered by courts in weighing the "convenience of the parties" include:

(1) the proximity of creditors to the court;
(2) the proximity of the debtor;
(3) the proximity of witnesses necessary for the administration of the estate;
(4) the location of the assets;
(5) the economic administration of the estate; and
(6) the necessity for ancillary administration if liquidation should result.

See id. The debtor's choice of venue is in many cases taken into consideration. *In re Caesar's Entm't Operating Co.*, 2015 Bankr. LEXIS 314 (Bankr. D. Del. Feb. 2, 2015). *See also In re Ocean Properties of Delaware, Inc.*, 95 B.R. 304, 305 (Bankr. D. Del. 1988); *In re Del. & Hudson Ry. Co.*, 96 B.R. 467, 467 (Bankr. D. Del. 1988) (Debtor’s choice of venue is entitled to great weight).

Bankruptcy Rule 1014(a)(2) applies when venue is improper. That Rule uses the same “interest of justice” or “convenience of the parties” standard but also gives the court the discretion to dismiss the case:

> (2) *Cases Filed in Improper District*. If a petition is filed in an improper district, the court, on the timely motion of a party in interest or on its own motion, and after hearing on notice to the petitioners, the United States trustee, and other entities as directed by the court, may dismiss the case or

> transfer it to any other district if the court determines that transfer is in the interest of justice or for the convenience of the parties.

Bankruptcy Rule 1014(a)(2). The majority view is that if venue is contested and found to be improper, a bankruptcy court may not retain the case. *See, e.g., Thompson v. Greenwood*, 507 F.3d 416 (6th Cir. 2007); *In re Great Lakes Hotel Assoc.*, 154 B.R. 667 (E.D. Va. 1992); *In re Petrie*, 142 B.R. 404 (Bankr. D. Nev. 1992). Some courts, however, have reached the opposite conclusion. *See, e.g., In re Leonard*, 55 B.R. 106 (Bankr. D.D.C. 1985); *In re Boeckman*, 54 B.R. 110 (Bankr. D.S.D. 1985).

The Floodgates Open

It took a few years, but commercial debtors soon began to take advantage of state of incorporation and the affiliate loophole in choosing the situs of their chapter 11 cases. Some point to 1988 as a turning point in the frequency of bankruptcy forum shopping. At that time, Delaware had only one bankruptcy judge, Judge Helen S. Balick, thereby increasing the ability of advisors to predict outcomes on issues where she has already ruled. In 1988, she ratified that venue was proper in a corporate debtor's state of incorporation, and then held without any explanation that "the debtor's choice of forum is entitled to 'great weight.'" *In re Ocean Properties of Delaware, Inc.*, 95 B.R. 304, 305 (Bankr. D. Del. 1988); *In re Del. & Hudson Ry. Co.*, 96 B.R. 467, 467 (Bankr. D. Del. 1988). An unintended consequence of Judge Balick's decisions was that they made it easier for debtors to forum shop, and they did. Some critics viewed her decision with skepticism:

> From a purely economic perspective, Judge Balick's interpretation was practically preordained. Indeed, 89% of the large public companies that filed for bankruptcy reorganization from 1980 to 1997 were incorporated or had a subsidiary that was incorporated in Delaware. Eisenberg & LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations, 84 CORNELL L. REV. 967 (1999).* Judge Balick's ruling allowed all of these debtors to file in Delaware. A contrary ruling would have precluded 99% of these debtors from doing so. In light of the amount of revenues large bankruptcy cases infuse into local communities, such a ruling would have been clearly against the interests of the Delaware legal and business communities. Parikh, *supra*, p. 188, n. 142.

Similarly, some look to the *Eastern Airlines* chapter 11 case as the start of the corporate debtors' use of the affiliate filing loophole to open up additional venues for bankruptcy filings. In 1989, Eastern Airlines, which was headquartered in Florida, filed its chapter 11 case in New York. It established its venue there by first filing one of its minor affiliates, Ionosphere Club, which had a New York office. The other entities comprising Eastern Airlines then followed.

The data is irrefutable. Forum shopping in bankruptcy has become rampant.

- Nationwide, 75% of chapter 11 cases with more than $100 million in assets and more

than 1,000 creditors filed in Delaware or SDNY between 2009 and 2014 (Administrative Office, U.S. Courts);

- Similarly, between 2010 and 2014, nearly 71% of large companies (assets and liabilities of $50 million or more) filed their chapter 11 cases in the District of Delaware or the Southern District of New York (2015 GAO Report on Corporate Bankruptcy – Stakeholders Have Mixed Views on Attorneys; Fee Guidelines and Venue Selection for Large Chapter 11 Cases (GAO-15-839) ("GAO Report") at p. 35);

- 7 out of 10 "Megacases" filed between January 1, 2007 and June 30, 2012 forum shopped, a statistical increase in frequency of 14% from the early 1990's and an absolute increase of 130% in the number of Megacases that forum shopped (*Parikh*, supra at pp. 159, 177-181).[3]

- 80% of the Mega cases that forum shopped between 2007 and 2012 filed in Delaware or Southern District of New York (*Id.* at p. 179);

- 88% of the Megacases that forum shopped relied on state of incorporation or the affiliate filing hook (*Id.*);

- From 2004 through 2018, 796 business debtors filed in the District of Delaware notwithstanding that their principal places of business and principal assets were situated outside of Delaware.[4] In the same timeframe, 137 business debtors filed in the Southern District of New York notwithstanding that their principal places of business and principal assets were situated elsewhere; and

- It is not only "Megacases;" almost a third of the 796 forum-shopped Delaware cases since 2004 involved smaller businesses with less than $20 million in assets at the time of filing.

- Even some critics of venue reform acknowledge that forum shopping has thrived. *See Mary Garvey Algero, In Defense of Forum Shopping: a Realistic Look at Selecting Venue*, 78 Neb. L. Rev. 79, 83 (1999)

Some who have studied bankruptcy forum shopping identify three primary motivations for corporate debtors to seek venues outside of their principal places of business. *Parikh* at pp. 193-196 (citing Debra Lyn Bassett, *the Forum Game*, 84 N.C.L. rev. 333 (2006); Douglas B. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 Yale L.J. 648 (2010); *Richard M. Cieri, Forum Shopping, First Day Orders and Case Management Issues in Bankruptcy*, 1 DePaul Business & Com.L.J. 515 (2003)). The primary reason given is that corporate debtors and their

[3] In Parikh's study, "Megacases" is defined as a public company with $1.2 billion or more in assets; a debtor was considered to have forum shopped if it did not file in the district where its principal place of business or principal assets were located or if it filed where an affiliate had filed and such affiliate's assets were miniscule in comparison to the primary debtor's. Id. at pp. 176-177.

[4] Figures are based on an examination of petitions, schedules and/or first day pleadings. Where multiple affiliated companies filed petitions, it was counted as a single case.

professionals are shopping for favorable law. *Id*. A second reason is that corporate debtors and their professionals believe or at least perceive that there exists a different level of experience, knowledge and/or personality among judges in different districts. *Id*. A third reason is that corporate debtors and their professionals perceive procedural or administrative benefits from filing in one venue over another. *Id*.

Although too small of a sample to be scientific, as part of the GAO Report, the Government Accounting Office polled 39 professionals and judges as to the most important factors considered in selecting venue. Thirty-three cited prior local or circuit court rulings as a significant factor when selecting the venue in which to file a large chapter 11 bankruptcy case, in part because understanding prior court rulings allows attorneys to better predict and advise clients on the possible outcomes of a case. GAO Report at p. 23. Twenty of the 39 attorneys and judges cited the preferences of lenders as a significant factor. *Id*. at 24. Sixteen cited judge experience as a significant factor in venue selection. *Id*. Eight of the 39 attorneys and judges we interviewed identified perceived court attitudes on professional fees as a significant factor in venue selection (another 14 saw fees a minor factor). *Id*.

Negative Consequences of Forum Shopping

a. <u>The Appearance of Venue Manipulation Undermines Public Confidence in the Bankruptcy System.</u>

The threat of forum shopping to the integrity of the bankruptcy system is and should be of paramount concern. "Rampant forum shopping undermines the perception and integrity of the bankruptcy system." *Parikh* at p. 197. "The process appears to be manipulable." *Id*. This perception erodes public confidence and calls into question the fairness of the bankruptcy system.

The perception is that the deck is stacked in favor of debtors and the institutional players. Judges in more favored venues certainly strive to hear the voices of all interested parties who want to speak, but the suspicion that a debtor chose a particular venue for a reason nonetheless hangs over the proceedings and such skepticism is not irrational. Why else, a creditor located far from where the case was filed must ask itself, did my customer file for bankruptcy in a district where it does not do business or have any meaningful connection if not to obtain an advantage over the other parties in its bankruptcy case? The Wall Street Journal described the frequency of forum shopping in an article about the *Patriot Coal* case: "Lenders and lawyers who get the big cases like taking their troubles to courts in New York and Delaware, which are convenient to their homes and offices and attuned to their concerns." Peg Brickley, *Patriot's Chapter 11*, WSJ (9/28/12).

This cynical view of the system is growing. The authors of a recent Wall Street Journal article on the bankruptcy system introduced the topic by observing "The fate of trillions of dollars in corporate assets—as well as millions of employees, pensioners, shareholders, investors and suppliers—is concentrated in the hands of an elite group of bankruptcy professionals and judges from just two states, according to data analyzed by The Wall Street Journal." Tom Corrigan, Joel Eastwood and Jennifer S. Forsyth, *The Power Players that Dominate Chapter 11 Bankruptcy*, WSJ (5/24/19).

> New York and Delaware, which hosted more [large] bankruptcy cases than the rest of the country combined . . . Rulings from the 15 judges sitting on the bench at the U.S. Bankruptcy Court in Delaware and in the Southern District of New York often reverberate across the country. Lawmakers are considering legislation that would force struggling companies to file for bankruptcy in a courtroom close to their principal place of business, potentially closing the loophole that has enabled most of the country's largest bankruptcy cases to unfold in New York and Delaware. For now, major corporations are allowed access to those bankruptcy courts through affiliates, however small, located within the court's jurisdiction.

Id. The article also highlighted how corporate bankruptcy is dominated by a small group of law firms, "which hold enormous influence over the allocation of bankruptcy assets." *Id*. *See also Parikh*, *supra*. This is contrary to what Congress intended when it enacted the Bankruptcy Code in 1978. "Congress intended to eliminate the perception that there was a "bankruptcy ring" of professionals controlling bankruptcy practice." *NCBJ Report* at p. 30 (*citing* H.R. Rep. No. 95-595 at 50 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6011). The current climate of venue shopping by a small group of professionals reinstitutes that untoward perception. *Id*.

Admittedly it is difficult to measure the erosion in public confidence caused by forum shopping. However, when 7 out of 10 Megacases forum shop, and 80% of those cases are filed in two districts and only a handful of judges and professionals hold such enormous influence over trillions of dollars of assets, a reasonable person can conclude that cynicism is rising while confidence in our bankruptcy system is eroding.

b. Venue Shopping Disenfranchises Creditors, Employees and Other Parties.

Whether it is the geographic distance or the perception that the debtor is manipulating the system, the mass concentration of chapter 11 cases in two districts disenfranchises smaller creditors, employees, retirees and other "local" parties with an interest in a bankruptcy case. This concern has long been recognized by proponents of venue reform and independent commissions studying bankruptcy reform. In 1998, the National Bankruptcy Review Commission recognized that forum shopping and the concentration of cases in Delaware made it more difficult for small creditors and employees to actively participate in a bankruptcy case. *See* Bankruptcy Review Commission at pp. 776-778. Others have argued that the channeling of commercial cases to Delaware and the SDNY, to the inconvenience and detriment of parties located more central to the nexus of the debtor's activities, implicates the norm of equal access to justice. Patricia B. Tomasco and Emilio Nicolas, "*Let My People Go…to Delaware": Paupers, Vagabonds and Fugitives from Justice Excepted*, XXXII ABI Journal 2, 16-17, 51, March 2013.

By choosing to file a chapter 11 case in a distant venue, the debtor is depriving local constituents of their due process. One example is the *Delphi* chapter 11 case, in which retirees in Michigan were disadvantaged by the distance they had to travel to participate in the case, which was filed in New York. *In re DPI Holding Corp.*, Case No. 05-44481 (RDD) (Bankr. SDNY). At *Delphi's* confirmation hearing in New York, only one retiree located in Michigan participated, and his participation was by telephone. There is no record of any employees

participating in person at the confirmation hearing. Had the bankruptcy case been administered closer to *Delphi's* headquarters, the retirees would have likely had a greater opportunity to participate in the case. *See* Ivan Reich, *Making the Case for Bankruptcy Venue Reform*, Florida Bar State-To-State Newsletter (flabaroutofstaters.org), p. 12 (Spring 2013).

In his 2011 testimony before the House Judiciary Committee, Chief Judge Bailey recognized that if *Polaroid Corp.* had stayed home in Massachusetts instead of filing in Delaware, stakeholders, large and small, would have had an opportunity to participate in the proceedings. "At a minimum, stakeholders would have received notices that told them that they could participate in the proceeding at a courthouse near where they live and work before a judge that lives in the same community as they do. This is to say there would have been the perception that their opportunity was real and accessible. And perception is often paramount." *Testimony of the Hon. Frank J. Bailey, Chief Judge, United States Bankruptcy Court for the District of Massachusetts*, Hearing on Chapter 11 Bankruptcy Reform Act of 2011, H.R. 2533, p. 11 (September 8, 2011). "The ability of smaller stakeholders to attend proceedings, or at least to feel they could if they so desired, is central to their belief that they are being dealt with fairly." *Id*. at p. 13. This sentiment was shared by employees and retirees in *Patriot Coal*:

> Shirley Inman of Madison, W.V., is also anxiously awaiting word from Chapman. That's because Ms. Inman, who used to drive a truck at a coal mine, believes Patriot intends to strip her of the retiree benefits that pay for the heart medication that keeps her alive. She wants the company's lawyers to look her in the eye when they do it.
>
> "If someone is going to take my health care away from me, I think I ought to be able to watch them do it with my own eyes. And I think they ought to have to see me sitting there while they do it," Ms. Inman wrote in a letter this week.

Brickley, supra, (WSJ 9/28/12).

Filing cases far from where the debtor conducts its business tilts the playing field toward financially sophisticated and represented parties who regularly appear in large bankruptcy cases, and away from smaller creditors. Creditors and parties in interest who are drawn into a bankruptcy and who do not regularly ply in the bankruptcy process lack the time and the financial resources to actively participate in a faraway venue. *See Testimony of Joe Chiavone, Chief Financial Officer, CPA, Wisenbaker Builder Services, Inc.*, ABI Commission at p. 6 (complains that faraway venues "frustrates my ability to participate in the process."). Joe Chiavone is just one example of creditors around the country growing more and more frustrated and disillusioned with the bankruptcy system and the tendency of business debtors to file cases in faraway jurisdictions.

Disenfranchisement is not only about geographic distance. Vendors, employees, retirees, landlords and other parties doing business with a company understand and expect that they can be sued or may need to file suit in the state in which their customer, employer or business relationship is headquartered. They do not have a reasonable expectation that their substantive rights will be adjudicated in a district with no connection to the debtor's principal place of business or assets.

c. The Centralization of Cases in Two Districts Impairs the Evolution of Bankruptcy Law.

The concentration of business filings in Delaware and SDNY have enabled them to become a duopoly on chapter 11 jurisprudence. *See* Peter Califano, *Bankruptcy Reform – Everything You Need to Know is in this Article*, 29 Com. L. World at p. 13-14 (Oct.-Nov. 2015). By capturing a large swath of large and middle market cases, these two districts have become magnet courts controlling the creation and evolution of chapter 11 bankruptcy law. This is a problem. "A cornerstone of our judicial system is that the law be subject to a variety of interpretations at the trial level . . . ." *National Bankruptcy Review Commission*, at p. 782. When decisions are made by a select few judges, "without discourse, the review process ceases." *See Parikh* at p. 198. Debtors may be selecting Delaware and the SDNY as their preferred choice of venue to voice approval of those courts' interpretation of bankruptcy issues. However, there is no assurance that these interpretations of the law are the only correct ones. Absent the benefit of contrary views from other courts, these decisions may be left unchallenged "and are actually strengthened by repeated application to a long string of cases" filed in the same district. *See id*.

The absence of checks and balances may be more exacerbated when judges consider predictability and consistency within a district as important justifications to support a particular holding. *See, e.g.*, *In re Adelphia Communications Corp.*, 359 B.R. 65, 72 n.13 (Bankr. S.D.N.Y. 2007) ("This Court has been on record for many years as having held that the interests of predictability in this District are of great importance, and that where there is no controlling Second Circuit authority, it follows the decisions of other bankruptcy judges in this district in the absence of clear error.") *See also In re General Motors Corp.*, Case No. 09-50026, DECISION ON DEBTORS' MOTION FOR APPROVAL OF (1) SALE OF ASSETS TO VEHICLE ACQUISITION HOLDINGS LLC; (2) ASSUMPTION AND ASSIGNMENT OF RELATED EXECUTORY CONTRACTS; AND (3) ENTRY INTO UAW RETIREE SETTLEMENT AGREEMENT, p.28 (Bankr. S.D.N.Y., July 5, 2009). The Code provides for a national bankruptcy court system. "Like the federal judicial system as a whole, the evolution of the law benefits from the input of judges from multiple jurisdictions, which over time reach consensus." *Reich* at p. 13. Absent widespread input, legal discourse begins to decline, predictability becomes paramount and constituents (including the general public) become more disillusioned and indifferent.

Debtor in possession financing is an example of the impact on the development of jurisprudence when cases are concentrated in one or two districts leading to the same courts being asked repeatedly to enter substantially similar financing orders. In the first year of the financial crisis, private capital markets virtually froze. The few lenders providing debtor in possession financing began requiring more excessive and burdensome terms. Bankruptcy courts felt compelled to approve more expensive debtor in possession financing and enter orders containing extraordinary lender protections (e.g., roll ups, quick sales, excessive fees and interest rates, liens on avoidance recoveries, etc.). *See* Steven B. Levine, et al., *The New Rules of the Game for DIP Financing*, The secured Lender, p. 34 (May 2013). In the subsequent years as the economy recovered, the same judges in later cases began seeing again and again their own prior orders or those of their colleagues containing the extraordinary terms that had once been relatively rare. *See Id*. at p. 36 (the authors did not mention the concentration of chapter 11 cases

as a possible cause, but it is difficult to ignore it as a likely reason).

By many accounts, extraordinary DIP financing terms became customary after 2009 even when financing was readily accessible and remain the norm today at least in Delaware and the Southern District of New York. The Loan Syndication and Trading Association acknowledged that "to be sure, the terms of DIP loans are customized to the bankruptcy process." Elliot Ganz and Allison Hester-Haddad, *DIP Loans: A Common-sense Assessment of "Extraordinary Provisions,"* The Secured Lender, p. 34 (October 2013). Had chapter 11 cases been more widely disseminated over the last few years, proposed DIP financing orders would have been scrutinized by a wider and more varied group of bankruptcy judges who would not have been bound to adhere to principles of predictability and consistency within a single judicial district. One could reasonably conclude that under those circumstances, the extraordinarily burdensome DIP financing provisions would not have become the norm after credit markets improved.

Lastly, there is no basis for the argument that judges and professionals in Delaware and SDNY are more experienced than their counterparts in the 88 other federal districts in administering large, complex chapter 11 cases. Bankruptcy judges and professionals in other districts are more than capable of administering complex chapter 11 cases. Indeed, the competency of the national bankruptcy bench was on display from 2000-2006 when 21 visiting judges from 15 states ably presided over approximately 50% of the chapter 11 cases filed in Delaware and continues to be on display in large chapter 11 cases filed in districts other than Delaware and SDNY.

Further, bankruptcy judges are chosen based on merit and qualifications. Consequently, bankruptcy courts across the country have developed a deep bench of efficient and competent judges. See NCBJ Report at p. 39. Moreover, many districts have adopted case management procedures for chapter 11 cases, thus creating efficient forums to administer business reorganizations. *See id*. Lastly, knowledge of state and local law is critical even to larger chapter 11 cases. *See Butner v. United States*, 440 U.S. 48 (1979). Although bankruptcy is governed by federal law, courts look to state law to determine property rights and adjudicate claim objections and fraudulent transfer actions. *NCBJ Report* at p. 40.

d. Local Concerns Often Dominate Bankruptcy Cases.

The consequences of a corporate bankruptcy are often most profound in the region and community in which the debtor's principal place of business or principal assets are located. Simply stated, bankruptcy is local. Not only are there jobs involved, but the local economy might depend to a large extent on business from that debtor. Many critical issues of local importance arise. The debtor may be, for example, one of the community's larger employers or it may sustain many small businesses that provide various goods and services. The consequences could extend even further, affecting the number of hospital beds that are available, the quality of elder care, or even waste removal. These are just a few of the countless local issues that might be engaged, and of course will require local subject matter expertise for example in real property, local taxes, environmental or health and safety issues, along with the treatment of real and personal security interests.

Bankruptcies filed in remote jurisdictions draw cases away from the parties with the most

familiarity with the debtor's operations and who have an important stake in the case's outcome. For example, employees, local vendors and retirees will be unable to attend hearings without incurring insurmountable time and travel expenses. There will also be little or no local media coverage on the progress of the debtor's efforts to reorganize and the interest of local constituents will wane. Absent active participation, public confidence in the process will likely erode leading to cynicism and skepticism among smaller creditors, employees and other local constituencies.

At the very heart of the concept of venue is the idea that those affected by a court proceeding should have access to the proceeding. Whether access means an actual ability to attend the hearings, the ability of the local press to follow the proceedings first hand and then to pass on developments to the local population, or the perception that the events in the case are occurring in the court with the most ties to all constituencies, the important goal of judicial transparency is served by the proposed amendments. *See Judge Bailey Testimony, supra*, at p. 21.

e. The Centralization of Cases in Two Districts Drives Up the Costs of Commercial Bankruptcy Cases.

The professional fees and costs associated with large corporate chapter 11 cases have increasingly been the subject of concern to courts, the Office of the United States Trustee, and creditors.

Professor Lynn LoPucki has been studying professional fees and complex business bankruptcy cases for some time and has published numerous articles and compiled databases on the fees charged and awarded in numerous cases. In *Routine Illegality in Bankruptcy Court, Big-Case Fee Practices*, 83 Am. Bankr. L.J. 423, 425 (2009), Professor LoPucki posits that lax venue rules are in part responsible for higher professional fees.

While certain of LoPucki's assertions and conclusions on forum shopping have been criticized, it cannot be denied that the overwhelming concentration of chapter 11 cases in two districts may breed complacency among participants with respect to professional fees. Professor Rapoport in her article *Rethinking Professional Fees in Chapter 11 Cases*, J. Business & Technology Law Vol.5, Issue 2, p. 263 (2010), explored the idea that peer pressure among like situated law firms may limit the scrutiny that fee applications receive and the relative scarcity of fee request objections. When the same large law firms are in the same two forums playing numerous roles (counsel to debtor, creditor, lender, bondholders) depending on the case, the principal of "what goes around, comes around" limits the amount of scrutiny of fees. *See id*.

This is not to say that the concentration of large and complex business cases in Delaware and New York are the only reason for increasing fees in chapter 11 cases – certainly the complexity of the case is a driver and the sophistication and complexity of the financing both prepetition and postpetition that is involved in large businesses these days increases the costs. However, it is reasonable to assume that familiarity breeds complacency.

Greater dissemination of chapter 11 cases should inherently reduce the professional fees in cases not only for estate professionals but for all constituents. Attorneys outside of the largest cities generally charge lower rates for their legal services, thereby reducing the overall costs of

administering a case in chapter 11 and enabling certain debtors for whom a bankruptcy filing in New York or Delaware is cost-prohibitive to have an opportunity to reorganize instead of liquidate.

f. Impact on local economy.

There is another important consequence that arises out of where a bankruptcy case is filed that cannot be ignored – the financial impact on a local economy when a mid-sized or large company decides to file their chapter 11 bankruptcy case in a different and remote court. The repercussions can be significant.

The survival and reorganization of the distressed company will impact local jobs and wages for years to come. Further, the presence of a large Chapter 11 bankruptcy case can generate significant revenues, taxes and jobs for the local economy. Hotels, restaurants, transportation and business services benefit from the bankruptcy case as attorneys and restructuring professionals attend hearings and meetings in the district. These economic benefits are diverted from the local economy when a company flees to a another jurisdiction to file bankruptcy.

A 2012 Bloomberg Businessweek article estimated that the Delaware and the New York City economies benefit by the amount of approximately $300 million per year from legal fees and other spending from these non-local bankruptcy cases. McCarty and Milford, *Delaware Bankruptcy Capital Status May End With Proposed Law*, BloombergBusinessweek.com (Feb. 10, 2012). Based on the number of out-of-state cases filed in Delaware and SDNY during the period 2004-2016, the loss of those cases translates into a loss for each state of approximately $4.54 million in revenue per case.

From 2004-2018, 10 Oklahoma companies fled the state and filed in DE and SDNY. These cases involved more than $13.3 Billion of assets and $24 Billion of liabilities and impacted almost 10,000 employees and more than 70,000 creditors, all of whom had their rights adjudicated by courts with no connection to Oklahoma. The loss of these 10 chapter 11 cases also meant that Oklahoma lost more than $45 million of revenue during this time period.

g. Right to Request a Transfer of Venue not the Answer.

Advocates of the status quo frequently point to the availability of the right of a party to seek a change of venue as the solution to forum shopping. There is no empirical study of motions to transfer venue of bankruptcy cases. However, the burden on creditors to transfer venue under the existing mechanism make it inadequate.

There is a substantial cost that any creditor would incur to move to change venue in a particular case. While a venue change contest might seem easily handled in a summary manner, some have turned into extended proceedings with evidentiary trials and extensive briefing costing hundreds of thousands of dollars. In the *Patriot Coal* case, filed in the SDNY, it took the court over four months and 61 pages of rulings to decide a venue challenge involving facts that were largely beyond contest. *In re Patriot Coal Corporation*, Case No. 12-12900 (SCC) (Bankr. SDNY). Based on a review of the interim fee applications filed in the *Patriot Coal* case, it can be estimated that the debtor spent around $2 million and the creditors an additional $1 million to

litigate the venue challenge.[5] The court's opinion "demonstrates the near impossibility of having venue transferred away from New York." Bill Rochelle, *Patriot Shows Futility of Moving Cases from NY*, Bloomberg (11/29/12).

As recognized by earlier commissions that have evaluated this venue abuse problem, few creditors will bother with this fight. It is just too much trouble and too expensive, and the creditor is forced to bear the burden of this cost without recompense, much less prospects for ultimate success. *See Testimony of Joe Chiavone* at p. 5 (complains that it is too expensive for a vendor to fight "abusive" forum shopping).

Further discouraging parties from bringing motions to change venue is the perception that such motions are not likely to be granted, regardless of the strength of the case in favor of moving the case to another court. *See, e.g. In re Banning Lewis Ranch Co. LLC*, 10-13445 (Bkrtcy. Del. 2010). As discussed above, the burden is on the creditors to prove that the debtor's choice of venue was inappropriate or not convenient. It is a heavy burden in light of the deference given by courts to the debtor's choice.

The timing of a motion to change venue is also critical and in many instances it is not realistic or practical for average creditors to prosecute a venue challenge in the first days or weeks of a case. First day orders can grant sweeping relief. By the time a motion to change venue would even be considered most of the important first day or "second day" motions relating to DIP financing, sale procedures, break-up fees and the like would have already been entered and have become final. The case would have progressed forward so far and taken such a direction that it bears the indelible imprint of the first court. Such was the case with *In re Jitney Jungle*, Case No. 99-3602 (Bankr. D. Del.). By the time this case was transferred to New Orleans there was little that the New Orleans bankruptcy judge said that he could do because of the actions taken or orders previously entered in Delaware. Similarly, in *Winn-Dixie*, by the time the Florida judge received the case, so much of substance had already been ordered in the case that there was little the Florida judge could do but administer the orders of the Delaware judge.

In the *Houghton Mifflin* case, the SDNY found no statutory basis for venue in that court. Nonetheless the court deferred the transfer of venue until after confirmation of the plan. *In re Houghton Mifflin Harcourt Publishing Co.*, Case No. 12-12171 (RFG), Decision on U.S. Trustee Motion to Transfer Venue of these Cases, (June 22, 2012, Bankr. SDNY). Notably, although the court found no basis for venue in the SDNY, it chided the United States Trustee for bringing the motion and for not exercising the "prosecutorial discretion" it had to disregard the venue fault in light of the fast pace of the case.

In *In re Enron Corp.*, 274 B.R. 327, 350 (Bankr. S.D.N.Y. 2002), the court stressed the importance of case administration, and the "learning curve" the court acquired in the first month of the case in denying a motion to change venue filed shortly after the filing of the case. Of course judicial economy and orderly case administration are important goals of the court system,

[5] Although the debtor's counsel's fee statements did not isolate fees incurred just in the venue fight, in a broader fee category labeled "Automatic stay/litigation" the debtor was charged more than $4.1 million for the months that covered the venue litigation. Assuming generously that just half of that related to venue, and that the movants spent one-half of what the debtor spent on the issue, it still cost the non-debtor movant an estimated million dollars in legal fees to move the case.

but in the context of a motion to change venue they make the outcome of every such a motion a foregone conclusion. In nearly every case the court will have become familiar with the debtor before the time it takes a creditor to file, litigate, and try a motion to change venue.

h. Reliance on Creditors' Committees is not the Answer.

In response to the National Review Commission in the mid 1990's, the Delaware State Bar Association noted that because Delaware cases usually had creditors' committees represented by experienced committee counsel to protect the interest of individual creditors, remote creditors were protected. *Report of the Delaware State Bar Association*, supra, at p. 13.

The problem with the Bar Association's point is that the direct contact most creditors have with a bankruptcy case concern matters for which a committee will provide no help. Claim objections, Section 503(b)(9) claims, preference actions, the assumption or rejection of contracts, stay relief motions, and objections to sales (to protect a particular interest in the item sold, not a general objection) make up most of matters that involve individual creditors. A creditor is on its own in dealing with these issues.

***The Solution*.**

Venue Reform has been the subject of debate for decades. Two attempts have already been made this decade: the Chapter 11 Bankruptcy Reform Act of 2011, H.R. 2533; and the Bankruptcy Venue Reform Act of 2018, S. 2282. Currently before the House is the bipartisan bill known as the Bankruptcy Venue Reform Act of 2019, H.R. 4421, which was introduced on September 19, 2019 by Representatives Zoe Lofgren (D-Calif. 19th District) and Jim Sensenbrenner (R-Wisc, 5th District). Similar to S. 2282, H.R. 4421 would eliminate state of incorporation and the affiliate loophole. A company would instead have to file either where its principal place of business or principal assets are located. Entities would no longer be able to follow their subsidiaries or sister affiliates into a jurisdiction. Instead, the affiliate rule will be limited to subsidiaries following their parent. In addition, venue transfer motions would have to be decided quickly. The bill will also close loopholes such as using depositary accounts as an anchor to establish venue in a particular court. A copy of the bill is attached as Exhibit A.

Passage of H.R. 4421 will ensure that companies stay home to resolve their financial problems and give all of their constituents the opportunity to be heard. The bill closes the affiliate loophole, which has continually been abused to justify chapter 11 forum shopping. The result should be a fair allocation of cases and resources consistent with a national federal bankruptcy system.

EXHIBIT A

I

116TH CONGRESS
1ST SESSION

H. R. 4421

To amend title 28, United States Code, to modify venue requirements relating to bankruptcy proceedings.

IN THE HOUSE OF REPRESENTATIVES

SEPTEMBER 19, 2019

Ms. LOFGREN (for herself, Mr. SENSENBRENNER, Mr. CRIST, and Mr. STEUBE) introduced the following bill; which was referred to the Committee on the Judiciary

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A BILL

To amend title 28, United States Code, to modify venue requirements relating to bankruptcy proceedings.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Bankruptcy Venue Reform Act of 2019".

SEC. 2. FINDINGS AND PURPOSE.

(a) FINDINGS.—Congress finds that—

(1) bankruptcy law provides a number of venue options for filing bankruptcy under chapter 11 of

title 11, United States Code, including, with respect to the entity filing bankruptcy—

(A) any district in which the place of incorporation of the entity is located;

(B) any district in which the principal place of business or principal assets of the entity are located; and

(C) any district in which an affiliate of the entity has filed a pending case under title 11, United States Code;

(2) the wide range of permissible bankruptcy venue options has led to an increase in companies filing for bankruptcy outside of their home States—the district in which the principal place of business or principal assets of the company is located;

(3) the practice described in paragraph (2) is known as ''forum shopping'';

(4) forum shopping has resulted in a concentration of bankruptcy cases in a limited number of districts;

(5) forum shopping—

(A) prevents small businesses, employees, retirees, creditors, and other important stakeholders from fully participating in bankruptcy

cases that have tremendous impacts on their lives, communities, and local economies; and

(B) deprives district courts of the United States of the opportunity to contribute to the development of bankruptcy law in the jurisdictions of those district courts; and

(6) reducing forum shopping in the bankruptcy system will strengthen the integrity of, and build public confidence and ensure fairness in, the bankruptcy system.

(b) PURPOSE.—The purpose of this Act is to prevent the practice of forum shopping in cases filed under chapter 11 of title 11, United States Code.

SEC. 3. VENUE OF CASES UNDER TITLE 11.

Title 28, United States Code, is amended—

(1) by striking section 1408 and inserting the following:

"§ 1408. Venue of cases under title 11

"(a) PRINCIPAL PLACE OF BUSINESS WITH RESPECT TO CERTAIN ENTITIES.—

"(1) IN GENERAL.—Except as provided in paragraph (2), for the purposes of this section, if an entity is subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), the term 'principal

place of business', with respect to the entity, means the address of the principal executive office of the entity as stated in the last annual report filed under that Act before the commencement of a case under title 11 of which the entity is the subject.

"(2) EXCEPTION.—With respect to an entity described in paragraph (1), the definition of the 'principal place of business' under that paragraph shall apply for purposes of this section unless another address is shown to be the principal place of business of the entity by clear and convincing evidence.

"(b) VENUE.—Except as provided in section 1410, a case under title 11 may be commenced only in the district court for the district—

"(1) in which the domicile, residence, or principal assets in the United States of an individual who is the subject of the case have been located—

"(A) for the 180 days immediately preceding such commencement; or

"(B) for a longer portion of the 180-day period immediately preceding such commencement than the domicile, residence, or principal assets in the United States of the individual were located in any other district;

"(2) in which the principal place of business or principal assets in the United States of an entity, other than an individual, that is the subject of the case have been located—

"(A) for the 180 days immediately preceding such commencement; or

"(B) for a longer portion of the 180-day period immediately preceding such commencement than the principal place of business or principal assets in the United States of the entity were located in any other district; or

"(3) in which there is pending a case under title 11 concerning an affiliate that directly or indirectly owns, controls, or holds 50 percent or more of the outstanding voting securities of, or is the general partner of, the entity that is the subject of the later filed case, but only if the pending case was properly filed in that district in accordance with this section.

"(c) LIMITATIONS.—

"(1) IN GENERAL.—For the purposes of paragraphs (2) and (3) of subsection (b), no effect shall be given to a change in the ownership or control of an entity that is the subject of the case, or of an affiliate of the entity, or to a transfer of the principal place of business or principal assets in the United

States of an entity that is the subject of the case, or of an affiliate of the person entity, to another district, that takes place—

"(A) within 1 year before the date on which the case is commenced; or

"(B) for the purpose of establishing venue.

"(2) PRINCIPAL ASSETS.—

"(A) PRINCIPAL ASSETS OF AN ENTITY OTHER THAN AN INDIVIDUAL.—For the purposes of subsection (b)(2) and paragraph (1) of this subsection—

"(i) the term 'principal assets' does not include cash or cash equivalents; and

"(ii) any equity interest in an affiliate is located in the district in which the holder of the equity interest has its principal place of business in the United States, as determined in accordance with subsection (b)(2).

"(B) EQUITY INTERESTS OF INDIVIDUALS.—For the purposes of subsection (b)(1), if the holder of any equity interest in an affiliate is an individual, the equity interest is located in the district in which the domicile or residence in the United States of the holder of

the equity interest is located, as determined in accordance with subsection (b)(1).

"(d) BURDEN.—On any objection to, or request to change, venue under paragraph (2) or (3) of subsection (b) of a case under title 11, the entity that commences the case shall bear the burden of establishing by clear and convincing evidence that venue is proper under this section.

"(e) OUT-OF-STATE ADMISSION FOR GOVERNMENT ATTORNEYS.—The Supreme Court shall prescribe rules, in accordance with section 2075, for cases or proceedings arising under title 11, or arising in or related to cases under title 11, to allow any attorney representing a governmental unit to be permitted to appear on behalf of the governmental unit and intervene without charge, and without meeting any requirement under any local court rule relating to attorney appearances or the use of local counsel, before any bankruptcy court, district court, or bankruptcy appellate panel."; and

(2) by striking section 1412 and inserting the following:

"§ 1412. Change of venue

"(a) IN GENERAL.—Notwithstanding that a case or proceeding under title 11, or arising in or related to a case under title 11, is filed in the correct division or district,

a district court may transfer the case or proceeding to a district court for another district or division—

"(1) in the interest of justice; or

"(2) for the convenience of the parties.

"(b) INCORRECTLY FILED CASES OR PROCEEDINGS.—If a case or proceeding under title 11, or arising in or related to a case under title 11, is filed in a division or district that is improper under section 1408(b), the district court shall—

"(1) immediately dismiss the case or proceeding; or

"(2) if it is in the interest of justice, immediately transfer the case or proceeding to any district court for any district or division in which the case or proceeding could have been brought.

"(c) OBJECTIONS AND REQUESTS RELATING TO CHANGES IN VENUE.—Not later than 14 days after the filing of an objection to, or a request to change, venue of a case or proceeding under title 11, or arising in or related to a case under title 11, the court shall enter an order granting or denying the objection or request.".

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