CLW COMMERCIAL LAW WORLD MAGAZINE

JULY / AUGUST / SEPTEMBER 2019
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THE ANNUAL BANKRUPTCY ISSUE

WHY MCA?
ADDING HAVOC TO CHAOS

CO-AUTHORED BY:
BARBARA M. BARRON AND STEPHEN W. SATHER
BARRON & NEWBURGER, P.C.

Thirty-Three Years of Asking, "Are We There Yet?"
BY JOSEPH A. PEIFFER

Forum Shopping On A Global Scale
BY BILL BRANDT

Register for the

CLLA Luncheon at the NCBJ

Thursday, October 31st

1:00 - 3:00 pm
Marriott Marquis, Washington, DC

LAWRENCE P. KING AWARD AND EDUCATION PROGRAM FEATURED KEYNOTE SPEAKER:


Mark Weinberg

How Ronald Reagan Turned Around a Failing Economy and Ended the Cold War

Mark Weinberg will draw on his more than 10 years with Ronald Reagan (1980 presidential campaign, White House, and post-presidency) to identify "The Five Ps" which made President Reagan successful, and which can be used even today.

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Please email your comments to info@clla.org.

Tales from the Front, at the Front

FROM YOUR PRESIDENT TIMOTHY WAN, ESQ.

Timothy Wan, Esq.
President, CLLA

www.smithcarroad.com

Timothy Wan, Esq. is Senior Partner and the Chief Executive Officer (CEO) of Smith Carroad Levy Wan & Parikh. His areas of expertise include managing the creditor's rights and collection law practice, serving as General Counsel to various small businesses in the local business community, and spearheading practice in the area of entertainment law, music law, copyright, and intellectual property.

He was admitted to the New York State Bar in January 2001, after graduating from Brooklyn Law School for his Juris Doctor where he was a member of the Moot Court Honor Society, and from Vassar College with a double B.A. in Political Science and Theatre in 1997. Timothy is admitted to the United States District Court for the Southern and Eastern Districts, and is a member of the New York State and Suffolk County Bar Associations.

He served as Past Chair of the Eastern Region of the CLLA, and of the Young Member's Section, and past member of the Board of Governors. He also serves as the President of the New York State Creditors Bar Association. Mr. Wan is a two time Past President of the Infinite Exchange Chapter of BNI, a member of the National Association of the Remodeling Industry, and a member of the IACC. Mr. Wan is a published author of the New York chapter of the textbook, *Judgment Enforcement*, published by Aspen Publishing.

CLLA Upcoming Events

Check online at ***CLLA.org/events***

CLLA Luncheon at the NCBJ
October 31, 2019
Washington, D.C.

CLLA Eastern Region Conference
November 14, 2019
New York, NY

Agility Like Spiderman, not like The Thing

When you CLLA members bestowed upon me the honor of becoming President of our prestigious organization on its 125th Anniversary, you all should have known full well that the "President's Letter" was going to be unconventional at the least, and indubitably include references to pop culture. So, in the words of Jackie Gleason, "Awaaay we go!"

The first thing that occurred after I was inaugurated as your President, is that the CLLA Annual Convention at the Rosen Shingle Creek Resort in Orlando turned a profit. Ok, so I should not take credit for this, as a whole team of people worked their tails off to make it the success, not only as a valuable can't-miss meeting, but also a financially viable convention model. But how did we do it?

Being agile. Like Spiderman. Spiderman can swing on his webs, from building to building, dodging traffic, weaving in and out between buildings, and getting to battle Doctor Doom with speed, dexterity, and agility. He gets the job done. Is it always smooth sailing, free of risk and danger? Of course not. At any second, Spiderman could swing smack dab into an oncoming double decker bus. But with foresight, care, and the ability to think on his feet, er, on his web, he is able to navigate what he needs to navigate.

Now, in contrast, there's The Thing. No, not John Carpenter's nor Howard Hawks's, but the big orange rock monster from the Fantastic Four. The Thing is super strong, near indestructible, but he plods along. He gets bashed by villains, knocked around, but he stays on course. Pieces of him might go flying when Doctor Doom launches a missile at him. He may be sent flying backwards for 100 yards. But eventually gets back up, stays on course, and trudges forward, a little worse for wear, but eventually gets the job done.

In many ways, over the last 125 years, whether we started that way, or evolved into The Thing, the CLLA became The Thing, lumbering forwards. And what made Orlando a success? (See? It all came back together...) We were agile. We were decisive. We swung between the buildings. "Hey, we're in a beautiful area, at a beautiful resort, with beautiful weather and four outdoor swimming pools. Let's not do beef wellington and spanakopita in a stuffy cocktail room like we have done for decades, let's do a poolside cookout, complete with a steel drum band, burgers, hot dogs, and mac & cheese." And I dare you to find someone with a negative thing to say. ("The water was too wet!" "The CLLA logos on the cupcakes were too multicolor!")

You know what being agile has allowed us to do? Use technology, social media, even "old school" email, to make sure new members to the CLLA are welcomed, and connected to other members with whom they can do business and realize value. What am I talking about? Being agile and quick! So, let's say we get a new member to the League. They get a welcome from League staff, a welcome email from me inviting them to connect and discuss their practice area and needs. And then I find out whether they are interested in lobbying regarding the student loan bankruptcy legislation, or they are seeking to expand their commercial receiver base, or they are a consumer firm looking to make a move into a commercial practice because they are in an area that has a geographical dearth of CLLA members. And yes, if you guessed that the above run-on sentence represented three actual new members to the League, you'd be Ken Jennings.

In the not-too-distant past? Someone joined. Then all they see are standard e-blasts, and mailings for the next regional meeting. There was no immediate outreach and engagement. There may have been a welcome letter, but maybe it was snail mailed two weeks later.

Because we are not bogging ourselves down, or getting in our own way, we are able to provide instant value, new committee members, and create enthusiasm for the League's activities.

So, speaking of enthusiasm, the CLLA is proud to be hosting education seminars and a luncheon at the National Conference of Bankruptcy Judges (NCBJ) on October 31, where we will be presenting the King Award to G. Eric Brunstad, Jr.

The CLLA Eastern Region will also be hosting their annual Collections Conference, with education designed for practitioners and forwarding managers as it returns to New York City. This unique and innovative event format will be at the Upper Story by Charlie Palmer on November 14. There will be social events on the 13th, and in the evening, but if you can only make the one day, it's a 9-5 footprint, with a reasonable registration cost.

I am optimistic that this event is going to be a success for the attendees, and a positive one for the League. No, I am not optimistic, I am CONFIDENT. Why? I guess it's my spider-sense tingling. ■

Tim Wan

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Phil Lattanzio
Executive Vice President,
CLLA

VIEWPOINT
A MESSAGE FROM THE EVP

As I write this column today, I am reflecting on where CLLA was a year ago and where we are today. I must tell you – I am very excited about the direction of CLLA and you should be, too. As you know, CLLA has a historic past with many great leaders and members. Our future looks bright and promising with dynamic and engaged leaders as well as members. As we all work hard to put many new plans in place (while always respecting our current initiatives so very valued by our membership) we are thinking about you and your needs. Please consider the following as a few of the ways in which you can get the most out of your CLLA membership:

- Submit your biography for the CLLA website. This is a no cost opportunity to promote yourself and your business!
- Join us at one of our upcoming events – The CLLA Luncheon at the NCBJ on October 31st and the Eastern Region Collections Conference on November 13th & 14th.
- Hill Day II will take place in conjunction with the NCBJ Conference in Washington, DC. Please join us as CLLA meets with congressional leaders to discuss legislation that involves bankruptcy, creditor's rights and other issues affecting the League.
- Mark your calendars and save the date for the 2020 National Convention in Chicago: May 6-8, 2020.
- Did you know you can save on UPS costs? Keep an eye on the CLLA website and Newswire, as we will be adding more discount programs to save you time and money.

Just so you know you will see more communication from CLLA. I, along with the Board of Governors, am very interested in knowing more about you, your business and what is most important for you in terms of your CLLA membership. For instance, you will see surveys (I highly encourage you to respond), newsletters, updates and more. This CLLA communication is two-way – I am always open to hearing back from you. I welcome you to speak with me in person, call or email me. Your input is extremely helpful; and, I am always listening to what you are saying.

I want to thank you for your membership and very much appreciate your continued support of the Commercial Law League of America. I look forward to seeing you at our upcoming events!

Phil Lattanzio

Executive Vice President

AGENCYAction
e-NEWSLETTER FOR CLLA AGENCIES

Introducing...
AGENCYAction

It is my pleasure to introduce to you our premier CLLA exclusive agency *e*newsletter, *AGENCYAction*.

CLLA recognizes the importance of agencies to our association and this *e*newsletter was developed for that reason. The goal is to focus on CLLA agency members and their businesses by providing content that is relevant and timely for both certified and non-certified agencies.

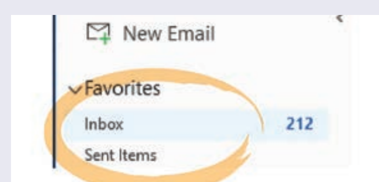
The initial and second blast of this monthly *e*newsletter was sent to all CLLA agency members in August and September. So if you are a CLLA agency member and do not recall seeing the *e*newsletter, check your email or email junk folder to make sure all CLLA eblasts arrive in your inboxes.

We are committed to providing all members with timely information and look forward to your participation and feedback. ■

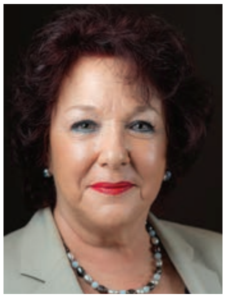
Renew Your CLLA Membership!

Don't miss out on valuable CLLA Member benefits, including exclusive rates for CLLA events! Contact us at info@clla.org

Member Tip



Don't miss out on valuable CLLA information and legal updates. Check your email and make sure CLLA.org emails are being delivered to your Inbox folder.



Wanda Borges, Esq.
CHAIR, Commercial Law World
Principal Member of Borges and Associates, LLC

Heard & Overheard

It is summer and the living is easy! Well, for the members of the CLLA who attended the CLLA/IACC Joint Mid-Year Conference in San Diego in July, the living may not have been easy, but it certainly was interesting and exciting. At the airport in New York, there was a second TSA screening at the gate before boarding. It was unusual and my husband and I wondered as to the cause of this extra security check. Nothing was said by the airlines and so, off we went. Upon arriving at the hotel in San Diego, there were police everywhere and car services were not permitted on the property of the hotel. We had to get out at the street and proceed to the hotel on foot. Further, the instructions from the police were quite clear that we MUST proceed through the parking garage and enter the hotel at one specific level. We still had no clue as to the cause of this heightened security. Upon entering the hotel, there was a security screening like that at airports or at the courts. Finally, we discovered the cause – Vice-President Pence was in town and was staying at our hotel. No one could enter or exit the hotel except through the one heavily secured portal. The next morning, we watched as numerous state police, unmarked black SUV's, and at least twenty motorcycle police were gathered; and finally, the motorcade with Vice-President Pence left the premises. It was fun to speculate in which of the four Black SUV's Vice-President Pence actually rode!

Once that hype was over, we got down to the business of business. One of the important items that was finalized was the continued agreement between the IACC and the CLLA regarding the agency certification program, meetings and other matters of mutual significance. The educational programs were excellent. Tim Wan made the New Yorkers alternatively wince and applaud as he informed us why the Confession of Judgment may be abolished in New York. On August 30th, 2019, Governor Cuomo signed legislation which amends NYS CPLR CPLR 3218 (1)(a) severely restricting the ability to enter a judgment by confession against a non-resident. Prior to my program on GDPR, CFPB, TCPA, I had forewarned some members that they might be called upon during that program to give their input on their knowledge and view of these statutes, rules and regulations. Erwin Falkner, owner and managing director of VYNTO GmbH & Co. KG in Germany and managing director of DCG Portal B.V. in the Netherlands, informed us of the many trials and tribulations that the EU has encountered in moving forward with the GDPR. His organization has written a Code of Conduct based on the GDPR and he has agreed to share that with our members once it is completed. The GDPR has crossed the Atlantic and impacts any business in the U.S. who receives, maintains or utilizes personal information on an EU citizen.

The most fun was had during the evening "dance party" as our very own Don Sullivan and his band "Dark Desert Highway" entertained us into the night. At the end of the evening, to the shouts of "One More" the band played on until the hotel finally told us we had to vacate the deck. So, the music ended but the festivities continued. Many retreated, first to the pool bar until the hotel shut that down; and then to the lobby bar where the networking, camaraderie and just good old-fashioned "fun" continued until closing.■

Wanda Borges, Esq.
Chair of the Board of Associate Editors

WHY MCA?

Adding Havoc to Chaos

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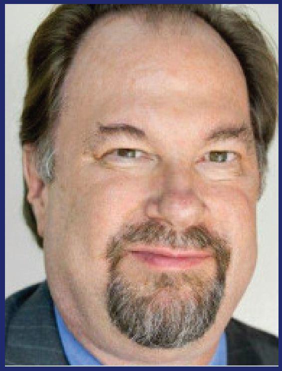

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In recent years, small businesses struggling with cash flow have turned to a controversial type of financing called Merchant Cash Advances (MCA). While MCAs provide a business with an immediate influx of cash, the consequences can often be devastating for the business, its owner and other creditors. One court recently described the merchant cash advance industry as "the merchant to merchant equivalent of consumer pay-day lending — an industry allegedly notorious for its predatory practices and extremely high interest rates."[1]

What Is an MCA?

An MCA is a kind of financing in which the finance company advances a lump sum of money to a business in exchange for repayment over time from the borrower's accounts receivable.[2]

MCA lending[3] is a relatively new phenomenon. According to a recent article

> In the aftermath of the financial crisis, banks were cutting back on lending just when small businesses most needed cash. Companies such as Yellowstone stepped in. They got around lending regulations by calling what they did "merchant cash advances," not loans — a distinction judges recognize though there's little practical difference.[4]

On its face, MCA lending is similar to factoring. In return for an upfront payment, a business sells the MCA lender a portion of its accounts receivable.[5] However, MCA transactions are different from factoring in several important respects.

In a factoring transaction, the factor purchases certain specific receivables at a discount and also retains a reserve to guard against the risk of non-payment. If the account debtor pays, the factor releases the reserve and keeps a portion of the receivable as its fee. Factoring arrangements often include recourse against the business selling in the event that the receivable turns out to be uncollectible.[6]

In an MCA transaction, the lender advances a sum of money to the business. In return, the business agrees that the MCA lender has purchased a percentage of its future receivables.[7] However, unlike in factoring, the receivables to be purchased are not identified and the business continues to collect its receivables. The MCA lender is permitted to debit the debtor's account for a fixed amount, often on a daily basis, until a much larger sum has been repaid.[8] Although MCA documents often prohibit the debtor from engaging in other MCA transactions, it is common for a business to have multiple MCA transactions at any given time.[9] An excerpt from a Merchant Agreement encountered by the authors is contained in the Appendix.[10]

A debtor can default under an MCA transaction if the debtor closes the account to stop the drain on its cash flow[11] or there are insufficient funds in debtor's account for the MCA lender to draft its payments. When a debtor defaults, MCA lenders have several remedies which can give them substantial advantages.

The first unique collection tool is the confession of judgment.[12] This is a controversial debt collection technique permitted by New York law until recently.[13] When a business takes out an MCA loan, both the business and the guarantors on the MCA agreement sign a Confession of Judgment for the full amount

1 *Fleetwood Services, LLC v. Complete Business Solutions Group,* 374 F.Supp. 3d 361, 366 (E.D. Pa. 2019).
2 *Professional Merchant Advance Capital, LLC v. Care Service, LLC,* 2013 U.S. Dist. LEXIS 203114 (D.S.D. N.Y. 2013).
3 Throughout this article we use the term "MCA lending" or "MCA loans" as a convenience. While MCA transactions are virtually always structured as sales of future receivables much of the litigation in this area is about whether the transaction is a sale or a loan.
4 Zachary Mider and Zeke Faux, *Sign Here to Lose Everything, Part 1: I Hereby Confess Judgment,* Bloomberg Business Week (Nov. 20, 2018), https://www.bloomberg.com/graphics/2018-confessions-of-judgment/?s-rnd=confessions-of-judgment
5 *Captain Bounce, Inc. v. Business Financial Services,* 2012 U.S. Dist. LEXIS 36750, at *3-4 (S.D. Cal. 2012); *Gecker v. LG Funding, LLC (In re Hill),* 589 B.R. 614, 619 (Bankr. N.D. Ill. 2018).
6 *Invoice Factoring Explained,* BOND STREET, https://bondstreet.com/what-is-invoice-factoring/
7 *Gecker v. LG Funding, supra* note 5.
8 *Id.*
9 In one case in which the authors were involved, a single debtor had over a dozen MCA agreements.
10 The language included is part of one page of a fifteen-page document. This language was included to illustrate how an MCA transaction works.
11 This is a common provision across multiple merchant agreements that the authors have reviewed.
12 *Sign Here to Lose Everything, Part 1, supra* note 4.
13 On August 30, 2019, Gov. Andrew Cuomo signed a bill to prohibit the use of confessions of judgment in New York against out of state parties. https://www.bloomberg.com/news/articles/2019-08-30/cuomo-signs-bill-cracking-down-on-small-business-loan-abuses

promised to be repaid. Upon default (or sometimes in the absence of a default),[14] the MCA lender takes the Confession of Judgment and files it with a court resulting in a legally enforceable judgment without prior notice to the defendant. In New York, where a large portion of MCA lenders have offices, the MCA lender then takes the Confession of Judgment to a quasi-public official called a City Marshall who seeks to collect the debt in return for a percentage of the recovery.[15] In essence, the City Marshall is a contingent fee collection agent with the official sanction of the judicial system. New York is the most used collection venue for these collection actions (even when neither the borrower or the MCA lender are based in New York) because the procedure is (at least for the time being) permitted by New York law and because most major banks have offices in New York which can be garnished.[16]

It is also common for the MCA lender to take a security interest in all of the debtor's assets. Thus, upon default, the MCA lender can seek to collect not just its hypothetical percentage of future receivables but *all* of the debtor's receivables and other assets. This can cause a conflict with traditional secured lenders and other MCA lenders who may all claim an interest in the same receivables.

Practical and Legal Issues Arising from MCAs

Because MCA lending is so costly and draconian in the repayment obligations it imposes, it can often lead to default and insolvency. As a result, many parties have tried to challenge MCA transactions albeit with limited levels of success.

IS THE TRANSACTION A LOAN OR A SALE?

On their face, MCA agreements look like they could be loans. A merchant receives an advance of funds and agrees to repay a much larger sum in return. However, many courts have held that MCA agreements constitute bona fide sales of future receivables.[17] The critical issue is whether the MCA lender has an absolute right to payment. As one court explained:

> The only source of payment is deposited receipts from future transactions. Plaintiff assumes the risk that there will be no receipts, and therefore no payment.[18]

An example of a contractual provision designed to preclude recourse is:

> MCA has purchased and shall own all the Receipts described in this Agreement up to the full Purchased Amount as the Receipts are created. Payments made to MCA in respect to the full amount of the Receipts shall be conditioned upon Merchant's sale of products and services and the payment therefore by Merchant's customers in the manner provided in Section 1.1.[19]

On the other hand, where the recourse provisions in an invoice purchase agreement placed the risk of non-collection on the borrower, the agreement was a disguised loan rather than a true sale.

On the other hand, where the recourse provisions in an invoice purchase agreement placed the risk of non-collection on the borrower, the agreement was a disguised loan rather than a true sale.[20] Recourse provisions may include "repurchase obligations, collectibility guarantees, or reserves from the purchase price to be released only as receivables come in."[21]

The cases examining whether recourse exists rely upon the terms of the agreements. However, there may be cases where the MCA lender's conduct may create recourse. For example, a default provision frequently found in MCA agreements states that it is a default if the merchant "interrupts the operation of this business (other than

14 *Sign Here to Lose Everything, Part 1, supra* note 4.
15 Zachary R. Mider and Zeke Faux, *Sign Here to Lose Everything, Part 2: The $1.7 Million Man,* BLOOMBERG BUSINESS WEEK (November 27, 2018), https://www.bloomberg.com/graphics/2018-confessions-of-judgment-millionaire-marshal/?srnd=confessions-of-judgment
16 *Id.*
17 *Official Committee of Unsecured Creditors v. LG Funding, LLC (In re Cornerstone Tower Services),* 2018 Bankr. LEXIS 3562 (Bankr. D. Neb. 2018); *Colonial Funding Network, Inc. v. Epazz, Inc.,* 252 F.Supp. 3d 274 (S.D.N.Y. 2017); *Gecker v. LG Funding, LLC, supra* note 5; *LG Funding, LLC v. Branson Getaways, Inc.,* 2017 NY Misc. LEXIS 4381 (Sup. Ct. Nassau County 2017) (unpublished).
18 *Colonial Funding Network, Inc., supra* note 17, at 283.
19 Agreement on file with authors.
20 *Lange v. Inova Capital Funding, LLC (In re Qualia Clinic Services, Inc.),* 441 B.R. 325 (8th Cir. BAP 2011), *aff'd* 652 F.3d 933 (8th Cir. 2011).
21 *Official Committee of Unsecured Creditors v. LG Funding, LLC, supra* note 17, at *15.

adverse weather, natural disasters or acts of God)." Along with this default provision, there will usually be a provision that upon the occurrence of an event of default "(t)he full uncollected Purchase Amount plus all fees due under this Agreement and the attached Security Agreement become due and payable in full immediately."[22] This would appear to create absolute recourse. Further, while MCA agreements provide for the collection of a specified percentage of future receivables, in practice, this is often estimated to be a fixed daily amount. If the fixed daily amount is not available due to poor collections or a daily payment is missed because the credit card processor's software is down, the MCA lender may declare a default since it does not know the reason for the non-payment. This may constitute a *de facto* imposition of recourse and transform the obligation into a loan.

WHAT PARTICULAR TYPES OF ISSUES ARISE IF THE TRANSACTION IS A SALE?

There are a multitude of issues that can arise even if a transaction constitutes a sale.

The first is whether the debtor retains an interest in the accounts being sold. Under the Uniform Commercial Code, the debtor does not retain a legal or equitable interest in an account which has been sold.[23] However, if the buyer's interest is unperfected, "the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold."[24] The issue of perfection arises because the UCC defines the term "security interest" to include the interest of a buyer of accounts.[25] Thus, a buyer of accounts receivable must perfect its interest in the receivable being sold to divest the debtor of all interest. In *Official Committee of Unsecured Creditors v. LG Funding, LLC,*[26] the court found that the MCA transaction was a *bona fide* sale but that the debtor retained its rights because the MCA lender did not perfect its security interest.

Assuming that the MCA lender perfects its security interest, how would its interest be enforced in the event of a dispute with the debtor or another creditor? Under the typical MCA agreement, the debtor receives payment on its accounts and the MCA lender debits the funds from the debtor's account. However, money is fungible.[27] How can the parties determine which money in the debtor's account constitutes the receivables purchased? Under the UCC, a security interest "continues in collateral notwithstanding sale . . . or other disposition unless the secured party authorized the disposition free of the security interest."[28] This provision would certainly protect the secured lender if the MCA lender obtained payment directly from the account debtor. However, if funds are received by the debtor and deposited into its bank account, they must constitute identifiable proceeds in order for the secured lender to retain its lien position.[29] Because a sale of accounts is treated as a security interest under the UCC, it stands to reason that disputes between claimants with an interest in receivables would be governed by the priority rules of the UCC so that the party which perfected first would have the first claim to the funds.[30]

Boilerplate provisions in MCA agreements, especially choice of law and forum selection clauses, are almost always the nemesis of borrowers.

WHAT DEFENSES HAVE BEEN RAISED IN LITIGATION WHEN AN MCA GOES BAD?

Boilerplate provisions in MCA agreements, especially choice of law and forum selection clauses, are almost always the nemesis of borrowers. These provisions commonly establish New York law as controlling, which may or may not have any relation to where the parties are located. Fortunately, the courts have not always given effect to these clauses. When a federal court is exercising diversity jurisdiction, it will apply the choice of law rules of the state in which the court is located.[31] Many states follow the Restatement of Conflicts of Law which provides that the law of the state selected by the parties will be followed unless "the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice" or "(a)pplication of the law of the chosen state

22 Agreement on file with the authors.
23 Uniform Commercial Code § 9.318(a). The authors have relied on the Texas Uniform Commercial Code in preparing this paper. We assume that these provisions are generally applicable across different states.
24 Uniform Commercial Code § 9.318(b).
25 Uniform Commercial Code § 1.201(b)(35).
26 *Official Committee of Unsecured Creditors v. LG Funding, LLC, supra* note 17.
27 *Gecker v. LG Funding, supra* note 5, at 628. *See also Boyer vs. Belavillas,* 474 F.3d. 375 (7th Cir. 2007); In *re Qyade,* 496 B.R. 520 (Bankr. N.D. Ill. 2013).
28 Uniform Commercial Code § 9.315(a)(1).
29 Uniform Commercial Code § 9.315(a)(2).
30 Uniform Commercial Code § 9.322.
31 *Hoffman v. Citibank (S.D.), N.A.,* 546 F.3d 1078 (9th Cir. 2008).

would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue."[32]

Courts have also avoided a contractual choice of law provision by narrowing its scope. In *All Trac Transportation, Inc. vs. Transp. Alliance Bank,*[33] the Court held that a suit for tortious interference is not a suit on the agreement or on a transaction contemplated under the agreement and therefore the contractual choice of law provision did not apply.

Fleetwood Services, LLC v. Complete Business Solutions Group[34] is a good example as to how a choice of law clause plays out in practice. Fleetwood sued Complete Business Solutions in Pennsylvania. The contract had a Pennsylvania choice of law provision. As a result, the District Court applied Pennsylvania choice of law rules. CBSG argued that the choice of law provision should apply. The Fleetwood parties, who were from Texas, argued that Texas law should apply. The Court found that the strong Texas policy against high interest rates mandated application of Texas law because application of Pennsylvania law would have been contrary to a fundamental policy of the State of Texas. Ironically, application of Texas law resulted in dismissal of one of the plaintiff's causes of action on the basis that Texas did not recognize a claim for specific performance of a contract.

A debtor may also attempt to gain some advantage by filing its "home" forum rather notwithstanding the forum selection clause in the MCA agreement. If the MCA lender seeks to transfer the case alleging a forum selection clause, the threshold consideration is whether the action might have been brought in the transferee court. Next, assuming that the answer to the initial inquiry is in the affirmative, the court will evaluate whether the clause in question is mandatory, permissive, or ambiguous, "applying principles of contract law as necessary."[35] As with choice of law provisions discussed above, the resolution at the end of this analysis could be outcome determinative.

Debtors have attempted to bring class actions against MCA lenders. This strategy has not worked when there is a class action waiver in the MCA agreement. In *Korea Week v. GOT Capital, LLC,*[36] the court denied certification of a class action because each of the proposed class representatives had signed a class action waiver, which was not unconscionable, and therefore they could not be a class representatives.

Frequently, the high interest rates charged by MCA lenders will result in a claim of usury by a debtor. However, determining that an agreement constitutes a *bona fide* sale eliminates the debtor's ability to claim usury, since usury can only arise in the context of a loan and not a sale.[37] Further, there can be no usury unless the principal sum advanced is repayable absolutely; when payment or enforcement rests on a contingency, the agreement is valid though it provides for a return in excess of the legal rate of interest.[38]

Whether a transaction is a loan or a sale, however, does not affect the ability of a borrower to assert RICO claims against the lender. Section 1962(c) of title 18, U.S.C. makes it unlawful

> for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate...commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprises' affairs through a pattern of racketeering activity of collection of unlawful debt.[39]

A person must also establish an injury resulting from the violation for standing to file.[40] RICO is being increasing alleged by borrowers as an offensive defense to suits by factors and MCA lenders. It has withstood dispositive motions to eliminate the claim.[41]

Issues in Bankruptcy Proceedings

There are many more issues that can be raised with MCA transactions in bankruptcy than have been decided by the courts. This section of the article discusses how a

32 Restatement (Second) of Conflict of Laws § 187(2).
33 306 B.R. 859 (Bankr. N.D. Texas 2004).
34 374 F. Supp. 3d 361 (E.D. Pa. 2019).
35 *Fleetwood Services, LLC v. Complete Business Solutions Group, supra* note 1 (citing *LeBlanc v. C.R. England, Inc.,* 961 F. Supp. 2d 819, 828 (N.D. Tex.2013)).

36 2016 U.S. Dist. LEXIS 69646 (E.D. Pa. 2016).
37 *Colonial Funding Network, Inc. v. Epazz, Inc., supra* note 17; *Gecker v. LG Funding, LLC, supra* note 5; *LG Funding, LLC v. Branson Getaways, Inc., supra* note 17.
38 *Colonial Funding Network, Inc. v. Epazz, Inc., supra* note 17 (citing *Transmedia Rest. Co. v. 33 E. 61st St. Rest. Corp.,* 710 N.Y.S. 2d 756, 760 (Sup. Ct. 2000); *Kelly, Grossman & Flanagan, LLP v. Quick Cash, Inc.,* 950 N.Y.S.2d 723).
39 *See also Brokerage Antitrust Litig.,* 618 F.3d 300 (3d Cir. 2010); *Anderson vs. Ayling,* 396 F.3d 269 (3d Cir. 2005).
40 *Anderson vs. Ayling, supra* note 39.
41 *See Fleetwood Servs, LLC vs. Complete Business Solutions Group,* 374 F. Supp. 301 (E.D. Pa. 2019).

few of the critical issues should be analyzed along with some of the limited case law available.

THE AUTOMATIC STAY AND PROPERTY OF THE ESTATE

The automatic stay of 11 U.S.C. §362(a) is fundamental to bankruptcy. It grants the debtor a breathing spell and protects creditors from efforts by other creditors to get "first in line" for payment.[42] The stay applies to property of the debtor and property of the estate.[43]

Thus, if an MCA lender has a properly perfected purchase of future accounts from the debtor, its argument will very likely be that since these accounts are not debts, they are not property of the estate[44] and therefore the stay therefore does not apply. Multiple courts have described the money owed by a merchant in a cash advances transaction as a debt.[45] The Bankruptcy Code defines "debt" as "liability on a claim," [46] which includes a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment." [47] It also includes "all legal or equitable interests of the debtor in property as of the commencement of the case.[48]

Moreover, the application of the "not property of the estate" argument is more difficult in real life than in theory. Assume that a debtor has assigned 15% of its future receivables to an MCA lender and the debtor has funds in its accounts from collection of receivables on the date of filing. Given that cash is fungible, it would be extremely difficult to determine which funds are property of the estate subject to the automatic stay and which are not. As a result, a court will likely rule that the stay applied until such time as the relative rights of the parties have been sorted out.

What if the debtor has generated accounts receivable that it has not yet collected on the petition date? Can the MCA lender seek to collect its percentage interest directly from the account debtors? In theory, it could. However, if the account debtor is facing multiple claims, it would be wise to pay such funds to the debtor and avoid the risk that its actions might violate the stay[49] or that the money will eventually have to be disgorged to a perfected lienholder with a higher priority.

The analysis would be different for receivables created post-petition. Under 11 U.S.C. §552(a), unless otherwise ordered, a lien does not attach to property acquired by the estate after the commencement of the case. Because the UCC treats a sale of accounts as a security interest, this provision may effectively void the sale of receivables created after the petition date.

MCA lenders should keep in mind that they can be found in violation of the automatic stay even if the court accepts their argument that their transactions with the debtor are sales.

MCA lenders should keep in mind that they can be found in violation of the automatic stay even if the court accepts their argument that their transactions with the debtor are sales. All collection activities in connection with purchased receivables may not necessarily be exempt from the prohibitions in Section 362. For a comprehensive analysis of one such lender's being found in contempt for violations of the stay, see *All Trac. Transp., Inc. v. Transp. Alliance Bank.* [50]

CASH COLLATERAL

Cash collateral is another tricky issue. MCA lenders have taken the position that since their purchased receivables are not property of the estate they do not constitute cash collateral and the bankruptcy court cannot authorize their use. This position was accepted by a Texas bankruptcy judge in an interim cash collateral order, which held that accounts purchased pursuant to a factoring agreement were not cash collateral which could be utilized by the debtor and the funds on these

42 *Chugach Timber Corp. v. Northern Stevedoring & Handling Corp. (In re Chugach Forest Products),* 23 F.3d 241 (9th Cir. 1994).
43 11 U.S.C. §362(a)(2)-(5).
44 Uniform Commercial Code § 9.318(a).
45 *E.g. L.G. Funding, LLC vs. Fla. Tilt, Inc.,* 2015 U.S. Dist. LEXIS 92061, 2015 WL 4390453 (E.D. N.Y. 2016).
46 11 U.S.C. §101(12).
47 11 U.S.C. §101(5). The authors have been unable to locate a case where the MCA lender asserts that it does not have a "right to payment."
48 11 U.S.C. 11 U.S.C. § 541(a)(1); *see Capital Factors v. Empire for Him,* 1 F.3d 1156 (11th Cir. 1993). While not a bankruptcy case, *see Congress Talcott Corp. v. Gruber,* 993 F.2d 315 (3d Cir. 1993), which discusses this type of interest

49 The Supreme Court has recently held that a creditor may be held in contempt for violation of the discharge order if there was no "fair ground" of doubt that the discharge order applied. *Taggart v. Lorenzen,* 139 S.Ct. 1795 (2019). Because a corporation may not seek relief under 11 U.S.C. §362(k), it also must rely on contempt to enforce the automatic stay, just as with a discharge violation. Given the ambiguities around MCAs, a court might find that there was a "fair ground" of doubt as to whether the stay applied.
50 306 B.R. 859 (Bankr. N.D. Tex. 2014).

receivables had to be turned over to the factor.[51] However, what would have happened if the MCA lender had never appeared in that case or generally decides it does not need to appear at for cash collateral hearings and a final order is entered? Under principles of *res judicata,* the MCA lender would be bound by the order. If the MCA lender does appear and object, the court would need to develop a mechanism for separating cash collateral from non-cash collateral.

Another issue which becomes even more confusing with the introduction of an MCA lender into the mix is the issue of lien priority and, in particular, whether payments made to an MCA lender are made subject a secured creditors' lien. A transferee (including an MCA lender) of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party.[52] However, if the MCA lender successfully collect these receivables directly from the account debtor, it arguably does take subject to a senior security interest and could be liable for disgorgement by the secured creditor. Whether the MCA lender has filed a UCC-1, on what it has the UCC-1 and the date on which it was filed become crucial in addressing whether its receivables are cash collateral, it has a right to adequate protection and, if so, from what assets.

VOIDABLE PREFERENCES

To recover a preference, the debtor must transfer property to a creditor.[53] An MCA lender defending a preference suit could claim that it was not owed a "debt" and did not receive property of the debtor. While that sounds reasonable, courts which have written on the issue have said that a payment to an MCA lender could be a preference.[54]

In *Gecker v. LG Funding,* the Bankruptcy Court for the Northern District of Illinois concluded that the MCA lender asserted a right to payment when it debited the debtor's account. The Bankruptcy Code defines "claim" as a right to payment.[55] Therefore, the court concluded that the MCA lender was a creditor and that payments made during the preference period were transfers made on account of debt antecedent to the time of the transfers. The court also found that the debtor had an interest in the property which was debited because it was property which the debtor could have utilized if the debit had not been made. On the evidence presented, however, it found based that the payments were made in the ordinary course of business and denied the avoidance of the transfers.[56]

In *Official Committee of Unsecured Creditors v. LG Funding,* the Bankruptcy Court for the District of Nebraska found that the debtor retained an interest in the property because the MCA lender had failed to perfect its interest in the purchased receivables. It also adopted the reasoning of the Court in *Gecker v. LG Funding.* However, the Court did not rule on the ordinary course of business defense because the case was pending on a motion for summary judgment and ordinary course is a fact issue.

The transfer on an MCA debt may be subject to recovery as a preference even though the nature of the transaction complicates the analysis. However, if the court determines the transfer is a preference, the MCA lender may be able to assert one of the affirmative defenses provided by 11 U.S.C. §547(b).[57]

FRAUDULENT TRANSFERS

Under 11 U.S.C. §548, a trustee may avoid a transfer of property made or an obligation incurred for "less than reasonably equivalent value" if the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer. "Reasonably equivalent value" depends on all the facts of a case, including fair market value of what was transferred and received, whether the transaction took place at arm's length, and the good faith of the transferee.[58] It is not necessary that there be an exact change of value but both direct and indirect benefits should be considered in the analysis.[59]

51 *In re Sand Hill Foundation, LLC,* 2010 Bankr. LEXIS 6223 (Bankr. E.D. Texas 2010). *But see Capital Factors v. Empire for Him, supra* note 48, which reversed the bankruptcy court's refusal to provide adequate protection to a factor while permitting the debtor to used its purchased receivables.

52 *See* Uniform Commercial Code § 9.332; *Gecker v. LG Funding, supra* note 5, at 12

53 11 U.S.C. §547(b).

54 *Official Committee of Unsecured Creditors v. LG Funding, LLC, supra* note 17; Gecker v. LG Funding, supra note 5.

55 11 U.S.C. §101(5)(A).

56 As part of its analysis as to whether the transfers were made in the ordinary course of business, the *Gecker* court considered the commonly applied factors (e.g. length of time of the business relationship, the amount and form of the tender and how it differed from past practices) but also whether the creditor or debtor had engaged in any unusual collection or payment activity and whether the creditor took advantage of the debtor's deteriorating financial condition.

57 *Dots, LLC v. Milberg Factors, inc., 5*62 B.R. 286 (Bankr. D. N.J. 2017).

58 *Gecker v. LG Funding, supra* note 5 (citing *Smith vs. SIPI, LLC et al,* 811 F.3d 228 (7th Cir. 2016)).

59 *Grossman v. Durham Commer. Capital Corp,* 597 B.R. 700 (citing *In re*

The analysis under these factors oftentimes yields dramatically different results. In the *Gecker* case discussed above, the trustee argued that the payments made by the debtor to the lender were fraudulent transfers under 11 U.S.C. 548 and was required to prove, *inter alia,* that the debtor received less than reasonably equivalent value from the lender through the transactions. While Debtor had received $125,000 and agreed to pay back $176,432, it only paid back $112,979. The Court found that the debtor received more value than it repaid, the agreement was entered into in good faith, and the lender had assumed the risk of non-payment if the debtor ceased producing income. The Court held that under these circumstances the debtor had received reasonably equivalent value and the transfer was not constructively fraudulent.[60]

In contrast, the Court in *Grossman v. Durham Commercial Capital Corp,*[61] held that while the debtor was insolvent, it transferred sums in the amounts of $198,100.22, $200,000, and $95,719 to the factor, the factor had failed to remit the sum of $626,000 and therefore the debtor did not receive reasonably equivalent value and granted summary judgment on the trustee's fraudulent transfer claim.

The *Gecker* court also addressed the larger issue of whether the agreements themselves constituted a fraudulent transfer. The agreement in question in that case provided that the parties agreed that the purchase price received for the receivables constituted reasonably equivalent value. The court relied upon its findings as to good faith and assumption of risk by the transferee. Thus, the same facts used to establish reasonably equivalent value caused the court to find that the MCA agreement was a bona fide sale. ■

An Introductory Checklist for Reviewing MCA Issues

The following is intended as a guide to analyzing the issues that arise when a loan is not a traditional lending instrument but an alternative, particularly a factoring agreement or MCA.

Luciani, 584 B.R. 449 (Bankr. D. Mass. 2018)).
60 *Gecker v. LG Funding, supra* note 5.
61 *Grossman vs. Durham Commer. Capital Corp., supra* note 59.

☐ WHAT IS THE NATURE OF THE AGREEMENT: A *BONA FIDE* SALE OR A LOAN?

- Is the lender's purchase based on the creditworthiness of account debtors or the cash flow of the borrower?
- Does the language of the agreement create an absolute obligation to pay the purchase price?
- Does the seller have a right to excess collections?
- Does the seller retain an option to repurchase the accounts?
- Can the buyer unilaterally alter the pricing terms?
- Does the seller have the absolute power to alter or compromise the terms of the underlying assets?
- What is the direct benefit to the seller? Indirect benefit?

☐ TERMS OF THE AGREEMENT

- Origination Fee
- Holdback
- Payment—when? how much?
- Who collects receivables?
- Security interest? In what?
- Is there a forum selection clause in the agreement? If so, is it mandatory, permissive or ambiguous?
- Is there a choice of law provision in the agreement? Is it substantive v procedural?
- Which state's law most benefits the client?
- Benefit to borrower—direct? Indirect?

☐ IS LENDER HOLDING AN INTEREST IN PROPERTY OF THE ESTATE?

- Is there a UCC-1?
- Blanket or specific lien to receivables purchased?
- Security interest in all accounts or specific accounts or a percentage of accounts?
- Date of filing in relation to other UCC-1's and in particular to traditional secured lenders.

☐ OTHER MCA'S WITH THE SAME DEBTOR

☐ IS THE CREDITOR A CREDITOR FOR PURPOSES OF AVOIDABLE PREFERENCES?

- Who benefitted?
- Antecedent debt.
- How much received in comparison to what would be received in chapter 7?
- Transfers made in ordinary course of business?

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Thirty-Three Years of Asking, “Are We There Yet?”[1]

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With no fanfare regarding the topic of this article, on August 23, 2019 President Trump signed H.R. 2336, the Family Farmer Relief Act of 2019, now enrolled as Pub. L. 116-51. This law increased the debt limit for Chapter 12 from $4,411,400 to $10,000,000 while continuing the pre-existing inflation adjustments.[2] This is the second major change to Chapter 12 in the past two years. On October 26, 2017 Pub. L. 115-72 was enacted. Buried at the end of that law was a significant change regarding how family farmers could utilize Chapter 12 to de-prioritize tax claims resulting from the sale of farm assets used in the farming operation, treating them as unsecured claims. Pub. L. 115-72 prevented tax authorities from blocking confirmation of Chapter 12 plans that did this. Understanding the seismic nature of these changes requires reviewing the bankruptcy options available to family farmers beginning with the Farm Crisis of the 1980s.

The Problem of Family Farm Bankruptcy

For family farmers, the 1980s were a time of crisis unparalleled since the Great Depression. Beleaguered family farmers (BFFs) shared story after story with Senator Chuck Grassley (R-IA) relating how Chapter 11 failed to help them save their farms. The problems cited were the absolute priority rule,[3] the expense of creditors’ committees, and the two-part class votes.[4] Senator Grassley and other concerned lawmakers listened. Chapter 12 was drafted in the waning hours of the 99th

1 By Joseph A. Peiffer of Ag & Business Legal Strategies, P.C. of Cedar Rapids, IA. The author thanks Austin Peiffer for his valuable editing suggestions.

2 11 U.S.C. § 104. Increasing the debt limit in Chapter 12 cases was first suggested to Congress by the author in 2008.

3 11 U.S.C. § 1129(b)(2)(B)(ii).

4 The confirmation requirement in a Chapter 11 for approval from greater than half the class votes and over two-thirds in amount of the creditors voting for the plan allowed a single under-secured creditor to defeat many farm Chapter 11s. 11 U.S.C. § 1126(c).

Congress October of 1986. Congressional staffers holed up in a conference room of the Hart Senate Office Building with smoke billowing out the doors, listening to various constituent groups make pitches for what should be included in the legislation.[5] Chapter 12 was passed and enacted with an effective date of November 26, 1986.[6] After Chapter 12's enactment, much like a child on a car trip, BFFs asked, "Are we there yet?" referring to a workable bankruptcy solution to save their farms. Congress and bankruptcy attorneys believed the answer to the question was, "Yes."

The First Hurdle: Taxes

Early Chapter 12 cases raised a significant question: How would the income taxes occasioned by BFFs' sale of farm assets, both pre- and post-petition, be satisfied? The sale of assets to "right-size" the farming operation during the case generated significant capital gain taxes payable as a second-priority administrative expense.[7] BFFs' cash flows were insufficient to pay these taxes in full. The plans were not confirmable, and the answer to the BFFs' question was, "We're not there yet."

LEGISLATION, ROUND 1

Congressmen said they forgot to address the tax problem. Given Congress' rush to leave Washington, the drafters lacked time to run the proposed legislation by the Senate Finance Committee to consider tax questions. The 1986 election saw the balance of power in the Senate change, and the new Senate leadership had little desire to fix the tax problem faced by BFFs.

The tax problems faced by BFFs rendered Chapter 12 far less effective than originally envisioned by its drafters. Even after the 99th Congress, progress on a better solution for BFFs was slow. One early idea was to reduce secured creditors' claims to pay tax claims. The bankers' lobby rejected that approach. Thirteen years passed before Senator Grassley and co-sponsors introduced a bill to address the tax problems with Chapter 12, S. 260, Safeguarding America's Farms Entering the Year 2000 Act. S. 260 resulted from a suggestion that tax claims of BFFs arising from "right-sizing" be de-prioritized,[8] which Congress implemented by adding § 1222(a)(2)(A). However, the language introduced was imprecise, and Senator Grassley's Judiciary aide was advised the proposed language would not survive a Supreme Court review. Despite that, the answer to the BFFs' question was, "I hope so."

S. 260 was incorporated in H.R. 833, the Bankruptcy Reform Act of 2000. At a breakfast in the spring of 2000 Senator Grassley answered questions from thirty people about H.R. 833, without notes. The attendees offered many suggestions, but the only one adopted came when one attendee reminded the Senator that many BFFs needed immediate relief from the tax burdens of "right-sizing" their operations. Senator Grassley responded by instructing his Judiciary staffer to change the bill making the tax provision effective upon enactment. The provisions of H.R. 833 were eventually incorporated into H.R. 2415, and Congress passed it by a veto-proof margin. Unfortunately for BFFs, President Clinton pocket vetoed it. The answer to the BFFs' question was, "Not yet."

However, this was not the final answer. Five years later, in 2005, President Bush signed the Bankruptcy Abuse Protection Consumer Protection Act of 2005 (BAPCPA), Pub. L. 109-8. To the relief of BFFs, BAPCPA included § 1222(a)(2)(A) from H.R. 2415, so the special deprioritization tax provisions of § 1222(a)(2)(A) were immediately available to BFFs.

ADJUDICATION, ROUND 1

The first BFFs to utilize § 1222(a)(2)(A) were the Knudsens, in the Northern District of Iowa.[9] The questions surrounding § 1222(a)(2)(A) were daunting. Since neither debtors' counsel nor the IRS' counsel had faced litigating a new statute, they collaborated to identify potential issues. An IRS attorney, an IRS Special Procedures Agent, and debtors' counsel met and spent the afternoon whiteboarding potential issues, including:

Which "farm assets" qualified for the special tax provision?

What did it mean for farm assets to be "used in" the farming operation?

5 Drafters considered and discarded requests by creditor groups to include a provision like § 1111(b) and shared appreciation in favor of a modified Chapter 13 on steroids to help save BFFs. Senator Grassley's Judiciary Committee aide from that time, Sam Gerdano, provided valuable insight into the drafting of Chapter 12.

6 Pub. L. No. 99-554, titled Bankruptcy Judges, United States Trustee, and Family Farmer Bankruptcy Act of 1986.

7 11 U.S.C. § 507(a)(2).

8 This suggestion came from the author in December of 1999. The legislative drafters were unwilling to consider allowing Chapter 12 debtors to utilize a short tax year allowed by 26 U.S.C. § 1398(d), which would have ensured that post-petition tax claims would be administrative expense claims easily de-prioritizeable by changes to § 1222(a)(2).

9 *In re Knudsen,* No. 05–03136M (Bankr. N.D. Iowa, July 1, 2005). The author had the privilege of serving as debtors' counsel.

What was the debtor's "farming operation?"

How was the tax to be de-prioritized to be calculated?

While they did not agree on the answers to these questions, they outlined the parameters of their disagreements. The primary difference was the methodology used to calculate the tax that could be de-prioritized. The IRS proposed utilizing a proportional methodology, while debtors' counsel proposed using a marginal methodology adapted from special use valuation used in estate tax. The proportional method valued each type of tax proportionately, resulting in a higher priority, non-dischargeable tax. The marginal methodology resulted in a lower priority, non-dischargeable and a much higher de-prioritized, dischargeable tax.

In *Knudsen,* debtors' counsel also faced the question of ensuring that the IRS would be forced to litigate its issues with the plan at the confirmation hearing rather than attacking the plan after confirmation. The plan delineated the marginal methodology for the assets sold in the tax year before filing. The plan was feasible without the further sales of assets; however, if the income taxes could be deprioritized and discharged in the Chapter 12 it was more feasible if additional land was sold. Given debtors' counsel's belief that § 1222(a)(2)(A) would not survive a strict statutory interpretation to de-prioritize taxes on post-petition sales, the plan provided there would be no post-petition sales without a final court ruling that the tax occasioned by the post-petition sale of land would qualify for de-prioritization and discharge.

In July of 2006 Judge Edmonds held a three-day confirmation hearing in *Knudsen* and denied confirmation of the plan.[10] Judge Edmonds held that the debtors could only use § 1222(a)(2)(A) for capital gains taxes owing on the disposition of capital assets of the farm, not market hogs; the tax claims subject to § 1222(a)(2)(A) would be discharged upon completion of the payments under the plan; and the debtors could sell assets post-petition and have the taxes qualify for treatment under § 1222(a)(2)(A). After this ruling the answer to the BFFs' question was, "I'm not sure."

The Knudsens and the IRS both appealed Judge Edmonds' ruling. District Court Judge Bennett heard the three-and-a-half hour appellate argument and reversed the bankruptcy court's ruling denying plan confirmation.[11] Judge Bennett held among other things that the portion of the federal tax debt to be paid in full as a priority tax claim and the portion to be treated as a mere unsecured claim was to be determined utilizing the "marginal method" of allocation; post-petition sales of farm assets qualified for treatment as an unsecured claim; and taxes on income earned by the debtors during their Chapter 12 case were taxes "incurred by the estate," even though the Chapter 12 estate was not a separate taxable entity. After this ruling the answer to the BFFs' question was, "Yes, we have arrived."

The IRS appealed Judge Bennett's decision to the Eighth Circuit Court of Appeals. The Circuit Court ruled on several issues, including that § 1222(a)(2)(A) was not restricted to pre-petition claims owed to creditors and that taxes on post-petition sales qualified for de-prioritization.[12] After this ruling the answer to the Eighth Circuit BFFs' question was, "Yes, we certainly have arrived."

ADJUDICATION, ROUND 2

Unfortunately for BFFs, dark clouds were on the horizon in the Ninth Circuit, where the Bankruptcy Court in *In re Hall*[13] held that the post-petition sale of the Halls' farm, which generated significant taxes, did not qualify for de-prioritization. The Bankruptcy Court relied on *In re Brown,*[14] a Chapter 13 case in which the debtor sold his interest in rental real estate to his ex-spouse after confirmation of a Chapter 13 plan providing for payment of 100% of the unsecured claims. If the Chapter 13 Trustee were required to pay the capital gains taxes due to the Commonwealth of Massachusetts and the federal government, there were insufficient funds to pay the balance of the unsecured claims in full.

10 *In re Knudsen,* 356 B.R. 480 (Bankr. N.D. Iowa 2006).
11 *In re Knudsen*, 389 B.R. 643 (N.D. Iowa 2008).

12 *Knudsen v. Internal Revenue Service,* 581 F.3d 696 (8th Cir. 2008).
13 376 B.R. 741 (Bankr. D. Ariz. 2007)
14 No. 05-41071, 2006 Bankr. LEXIS 3156 (Bankr. D. Mass. Nov. 20, 2006).

The Bankruptcy Court in *Hall* adopted the *Brown* court's reasoning in determining that the analysis in *Knudsen* was flawed regarding the post-petition applicability of § 1222(a)(2)(A). On appeal, the District Court reversed the Bankruptcy Court.[15] The IRS appealed the District Court's decision to the Ninth Circuit, which reversed the District Court and affirmed the Bankruptcy Court's decision.[16] . After this ruling, the answer to the Ninth Circuit BFFs' question was, "No."

With a split in the circuits regarding the post-petition de-prioritization of governmental claims, the Supreme Court granted *certiorari* to *Hall v. United States.*[17] On May 14, 2012, in a 5–4 ruling containing a strong dissent, the Supreme Court affirmed the Ninth Circuit's decision.[18] The Court held that the taxes arising from the post-petition sale of the Halls' farm did not qualify for de-prioritization because no separate bankruptcy estate[19] was created in a Chapter 12. The Court stated:

> Certainly, there may be compelling policy reasons for treating post[-]petition income tax liabilities as dischargeable. But if Congress intended that result, it did not so provide in the statue. Given the statute's plain language, context, and structure, it is not for us to rewrite the statute, particularly in this complex terrain of interconnected provisions and exceptions enacted over nearly three decades. * * * As the Court of Appeals noted, "Congress is entirely free to change the law by amending the text."[20]

After the Supreme Court ruling in *Hall*, the answer to all the BFFs' question was, "No."

LEGISLATION, ROUND 2

Suggestions to amend the Bankruptcy Code to rectify the effects of *Hall* were presented to Senator Grassley the afternoon it was decided. Beginning in June of 2012, Senate staffers, Susan Freeman (the attorney who argued *Hall*), and the Knudsens' counsel discussed drafting a bill to address the holding in *Hall* and other issues. However, Senator Grassley chose to address only *Hall* in his corrective legislation. In September of 2012, Senators Grassley and Franken (D-MN) introduced S. 3545, which was referred to the Senate Finance Committee, where it died when the 112th Congress adjourned.

In December of 2012, the National Bankruptcy Conference sent its comments regarding S. 3545 to Senator Grassley. The comments were very insightful and assisted the drafters in revising and crafting a better bill for the 113th Congress.

On August 1, 2013, Senators Grassley and Franken introduced S. 1427, the Family Farmer Bankruptcy Clarification Act of 2013. This bill was not merely a reintroduction of S. 3545. Rather, it was a redrafted bill designed to avoid the death that S. 3545 experienced in the Senate Finance Committee. Its goal was to provide a legislative basis to allow family farmers to utilize Chapter 12 to de-prioritize taxes incurred on the disposition of farm assets and treat them as pre-petition general unsecured claims. S. 1427 was initially assigned to the Senate Finance Committee and later reassigned to the Senate Judiciary Committee. Unfortunately, it did not progress from there.

On January 20, 2015, Senators Grassley and Franken introduced S. 194, a reintroduction of S. 1427. It was assigned to the Senate Judiciary Committee and suffered the same fate as its predecessor.

On May 25, 2017, Senators Grassley and Franken introduced S. 1237, the Family Farmer Bankruptcy Clarification Act. It was assigned to the Senate Judiciary Committee. However, it avoided the fate of its predecessors. In the two prior Congresses, the "give" required of Senator Grassley had been deemed too great for the "get" of progressing a statutory reversal of *Hall* out of committee. This time, in early August 2017 Senators Grassley and Coons (D-DE) discussed their legislative wants. Senator Coons wanted the House-passed bankruptcy judges bill making the temporary bankruptcy judgeships in Delaware permanent and Senator Grassley wanted *Hall* reversed. They compromised — Senator Coons received a five-year extension of the Delaware temporary bankruptcy judgeships and Senator Grassley received the statutory reversal of *Hall.* Finally, the "give" was not too great for the "get."

After Congress's August recess, S. 1107, the Senate version of the bankruptcy judges bill with the anti-*Hall* language included, passed the Senate by unanimous consent. However, the Administrative Office of the United States Courts found issues in the judgeship language. To address these problems the Senate used H.R. 136, which had passed the House earlier. The Administrative Office's

15 *In re Hall,* 393 B.R. 857 (D. Ariz. 2008).
16 *United States v. Hall,* 617 F.3d 1161 (9th Cir. 2010).
17 564 U.S. 1003 (June 13, 2011).
18 *Hall v. United States,* 132 S. Ct. 1882 (2012)
19 A separate bankruptcy estate is established for debtors that can have a short tax year by 26 U.S.C. § 1398(d).
20 132 S. Ct. 1893 (citiation omitted)

preferred language was added, S. 1107 was passed, and it was sent to the House for action. On October 12, 2017, H.R. 2266 passed the House. The House used S. 1107 as a vehicle to attach the hurricane and wildfire supplemental appropriations bill. It was then sent to the Senate, which passed it on October 24, 2017, by an 82–17 vote after significant parliamentary gamesmanship. Two days later President Trump signed the bill into law. Interestingly, the White House Press Release referred to the disaster relief appropriations and the bankruptcy judges' provisions and ignored the Chapter 12 provisions of the bill. However, the answer to the BFFs' question, "Are we there yet?" was only, "We've overcome this hurdle, but another has arisen."

The Second Hurdle: The Debt Limit

When Chapter 12 was created it was estimated that 86% of farmers would satisfy its debt limits. However, as time passed the size of family farms grew much faster than inflation, while Congress only raised the Chapter 12 debt limit sporadically until 2005, when the limit was indexed merely to inflation as part of BAPCPA. This led to more and more farmers being ineligible for Chapter 12 because they exceeded the debt limit.

On December 6, 2018, Senators Grassley and Klobushar (D-MN) introduced S. 3721 to increase the Chapter 12 debt limit to $10,000,000. It died without action in the 115th Congress. On March 27, 2019, Senators Grassley, Klobushar and ten other bi-partisan Senators introduced S. 897, the Family Farmer Relief Act of 2019. That bill did not progress to the full Senate. However, its companion bill, H.R. 2336, was introduced by freshman Congressman Delgado (D-NY). It was marked-up on July 11, 2019, debated on July 25, 2019 and passed by the House.

In the Senate H.R. 2336 faced a hold from Senator Durbin (D-IL), who had taken the position that no bankruptcy bills would pass the Senate unless issues regarding student loans were addressed. Farm-era supporting the legislation brought significant pressure on their senators to pass the it and request that Senator Durbin remove his hold. During the last week of July Senator Durbin announced that he would he would release his hold on the three Democrat bankruptcy bills, including H.R. 2336, but would not release his hold on H.R. 3311, the Small Business Reorganization Act of 2019, sponsored by Representative Ben Cline (R-VA). The Republican-controlled Senate refused to bring any bankruptcy bills up for passage unless all four bankruptcy bills—the Democrat-sponsored H.R. 2336 Family Farmer Debt Relief Act of 2019, H.R. 2938 HAVEN Act, and H.R. 3304 National Guard and Reservists Debt Relief Extension Act of 2019; and the Republican-sponsored H.R. 3311 Small Business Reorganization Act of 2019—were considered at the same time. Public pressure from the farm sector and the military sectors was immense. Ultimately Senator Durbin released his hold on H.R. 3311, all four bills passed on August 1, 2019, and President Trump signed them on August 23, 2019.

Conclusion

While continued farm size growth at rates exceeding inflation may necessitate future debt limit increases and other issues may arise from court decisions or changed farm circumstances, at least for now the answer for BFFs asking, "Are we there yet?" with a workable bankruptcy solution to save their farms is, "Yes." ■

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Bill Brandt is the founder and Executive Chairman of Development Specialists, Inc. (DSI), and has advised Congress on insolvency policy, including as the principal author of the amendment to the Bankruptcy Code which permits the election of trustees in Chapter 11 cases. He served on the American Bankruptcy Institute's Commission regarding the reform of Chapter 11, and also served as Chair of the Illinois Finance Authority. Mr. Brandt currently is the Chapter 11 Trustee in the China Fishery Group matter, which has him actively involved before courts in New York, Hong Kong, Singapore and Windhoek, Namibia.

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It always seems there are several "hot" topics abroad in the land of insolvency and restructuring and the current era is certainly no exception. While topics such as the health care industry and the rise of cryptocurrencies are getting their fair share of attention and their day in the sun, the steady growth in the trend toward the "globalization" of our industry continues to be an issue that truly permeates the daily practice. From my perspective, one overlooked and mostly unnoticed aspect of this trend in our business is the quiet but increasing competition over the future venues of large and mid-sized cases.

It's not just in the United States that venue continues to be a feverishly debated topic as this issue, too, has gone global. Much of this seems driven not so much by the choices practitioners in our industry make but, rather, by the dictates and desires of those who control the large pools of capital waiting to be deployed in the service of distressed investing, always hoping for outsized returns in what otherwise appears to be a globally slow era for investment returns.

My contention has always been that changes to the practice in our industry in the 1990s caused an evolution in the restructuring process whereby larger cases became more of a vehicle for a "financial play" and less of an opportunity for an operationally-driven reorganization. While this development was not necessarily a bad thing, many in our field spent a good bit of time thereafter bemoaning the fact that claims trading seemed to have hijacked the process. Now, this many years on, and despite the initial reluctance to embrace claims trading, such activity — and the ever-expanding pools of international capital that are now routinely committed to it — has become not only the norm but, in fact, the expectation in most mid-sized and large cases. Retail insolvency, to cite just one example, is a segment in our industry that's become strongly dependent on these distressed investment funds.

My experience is that the firms that raise and deploy this kind of capital thrive by excelling in the contest of analyzing and pricing risk, and therefore also prize a level of predictability in the investment equation. Once courts in a certain area establish a reputation for competence in complex matters, as well as a track record in the application of consistent themes and practices in how cases are managed, these locales tend to thrive. It also doesn't hurt if these courts are geographically proximate to where those who raise and invest these sums tend to live and work. In my opinion, the courts in New York and Delaware have long benefited from this association and, of late, the courts in Houston and Richmond are having their moments, as well. I make these observations to neither endorse nor oppose any particular point of view within the ongoing debate about venue, but merely to discuss, as a part of this overall presentation, my observations on where the current state of play resides.

Similarly, and overseas, for years certain foreign jurisdictions have attracted a disproportionate share of restructuring matters. This is due to the fact that, again, at least from my observation, they are situated near where the larger financial centers and the capital pools exist or have reputations as dependable, business friendly and predictable locales with proven legal and procedural regimes. In this category, both London and Hong Kong have long been obvious centers of such efforts and, of late, Singapore and the Cayman Islands have seen a decent rise in activity.

Much as is the case with the venue argument within the US, a bit of a backlash occasionally develops regarding the perceived unfair dominance of several of these international financial centers. In particular, and with regard to the evolution of the insolvency practice on the European continent, the European countries, seeking a greater degree of control over their own matters, have long been one of the most fervent backers of the concept of Center Of Main Interest ("COMI") which, in short, defines the venue of any insolvency as that location where the endeavor traditionally has had its operating headquarters.

Many believe that this concept evolved and was espoused by the Europeans as a counterweight to the tendency of many Continental businesses to look to the UK and its extremely well-defined and well-regarded practical and legal regimes, the famous English "Scheme of Arrangement" being one strong example, when they consider their options for reorganization. Indeed, some who seek to alter the current venue selection tendencies in the US have pushed to get something akin to a COMI definition recognized, in either law or practice, as a determining factor regarding where businesses may situate their insolvencies.

But what I'm seeing more and more is that the vast capital pools, both the ones that are well-established and the ones that are ever still being raised by those in the hedge fund, private equity and claims trading businesses, are to a large degree still dictating both where the "action" is and where it's likely going to continue to be. In my opinion, while the COMI argument still rages on, most pointedly in Europe in an attempt to hinder the UK as a focal point for filings (aided by Brexit casting a shadow over the near-term viability of the English practice), the EU has decided that imitation may be the sincerest form of flattery. Their latest directive to the remaining 27 member countries of the EU is that they all will be required to promulgate and implement their own version or copy of one of the UK's best-known and most often employed restructuring vehicles, the aforementioned English Scheme of Arrangement.

... Singapore, ...has implied that the longer-term political issues and related uncertainty that may affect Hong Kong as a suitable focus of venue may play out to the Lion City's advantage.

Likewise, Singapore, seeking to raise its competitive position and visibility in the industry, has implied that the longer-term political issues and related uncertainty that may affect Hong Kong as a suitable focus of venue may play out to the Lion City's advantage. In furtherance of gaining an edge not just on their Southeast Asian rival, but also on other international jurisdictions as well, Singapore is deeply into a well-oiled public relations campaign touting the reform of its insolvency statutes and regime, all designed to sell itself to the broader worldwide business and legal communities as a destination of choice for corporate restructurings. At first glance, many of the changes to the Singaporean insolvency regime will remind observers of selected aspects of the American Chapter 11 structure. As an example, and in opposition to what exists in most foreign jurisdictions, these new changes to the Singaporean laws offer, for the first time, protections to new capital seeking to prime existing creditors and creating, in effect, the structure for DIP lending.

That said, while these attempts to modernize regimes around the world are certainly welcomed by all who practice, they should be recognized for what they are — plainly the first shots in the next war over competition for venue location for large and mid-sized restructurings worldwide and, along with it, all the dollars, pounds and yuan that will flow into corresponding local economies in support of that work. From my perspective, and much like what has happened in the US, it will be the decision of those who control the capital pools, as well as the perceived ease and predictability of doing a restructuring under a given system, that will likely determine the "winners" in this contest. Clearly, existing financial centers where this capital is largely raised and deployed will prove to be a strong factor in which locales succeed, as will the geographic location of the firms that tend to dominate in this distressed investing business.

Given all of that, I tend to believe that five main locales will emerge as the overwhelming winners in the venue battle for worldwide restructuring activity by the middle of the next decade: New York, Delaware, London, Hong Kong and Singapore. While many other venues will still get a good share of the smaller and mid-sized cases, I believe that with both the increasingly global component seen in most large bankruptcies, as well as the locations of the capital investment pools that are dominant in the industry, these five jurisdictions are likely to leave others far behind.

For select matters, such as oil and gas or those that involve certain international financial aspects, such locales as Houston and the Caymans will still see their share of cases but, on balance, it's hard to avoid the conclusion that, as the industry continues to globalize, the arc of events that is placing these five dominant venues in the forefront will not in any way measurably change. Of course, each of these locales still possesses some structural infirmities which will need to be smoothed over or dealt with if they are to continue to prosper. For example the "Legends" decision, limiting the ability of Joint Provisional Liquidators to do a financial restructuring under Hong Kong law, or the "Gibbs" rule in the UK, which inhibits the disposition of liabilities incurred under English law, in my opinion still present hurdles to be overcome with respect to the conduct of restructurings in those particular jurisdictions.

In conclusion, the point I am trying to make in this article is to let the reader know that not only do I expect these five current centers of activity to flourish as the location of venue for larger cases as the worldwide restructuring industry continues to evolve, but I predict, as well, that competition among these five locales to land ever larger and more complex cases will grow measurably more intense in the coming years. The competition between, say, New York and Hong Kong will seem as vigorous in the future as the past competition between New York and Delaware has been for US practitioners. My recommendation, therefore, to all who are now confronted with matters that cross a wide range of geographic locales is to carefully analyze, as you already do for your cases within the US, which venue best suits the outcome you're trying to obtain for your client, and which venue has a regime that capital pools of investment will find most attractive. The world grows ever smaller in business and those of us in the insolvency industry are about to have that experience brought home in the next wave of bankruptcies as the current era of economic expansion inevitably comes to a close. ■

SCOTUS Rejects Strict Liability Standard for Violations of Discharge Injunction

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TAGGART v LORENZEN, __ U.S. __, (No. 18-489, June 3, 2019)

A unanimous Supreme Court has announced a standard of review for contempt actions based upon the discharge injunction in §524(a)(2), which standard differs from the standard which had been applied by any court previously considering the question: A creditor may be in civil contempt for violating the discharge injunction if there is "no fair ground for doubt" that the creditor believed that the discharge order applied to the creditor's conduct. The Court specifically labeled the limits of this doubt as being "when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful."

Previous to this decision, courts had generally been applying what was generally called a "strict liability" standard – a simple two-prong test of (1) was the creditor aware of the discharge order and (2) did the creditor intend the action which violated the Order. This standard was applied to determine contempt in automatic stay violation cases, and then applied to discharge injunction contempt actions: "[T]his court adopted a two-pronged test to determine willfulness in violating the automatic stay provision of § 362. Under this test the court will find the defendant in contempt if it: '(1) knew that the automatic stay was invoked and (2) intended the actions which violated the stay.' This test is likewise applicable to determining willfulness for violations of the discharge injunction of § 524." *In re Hardy,* 97 F.3d 1384, 1390 (11th Cir., 1996). In the *Taggart* case, the Bankruptcy Court for District of Oregon followed the "strict liability" standard in sanctioning the creditor's conduct; the good faith belief of the creditor that its actions were not a violation of the discharge injunction was irrelevant to the analysis.

This flaw in this mechanistic approach is evident from the facts in the *Taggart* case. The decision by the Ninth

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The Ongoing Battle for Recognition and Payment of 503(b)(9) Claims

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Your client is a vendor with unpaid invoices from one of its customers and receives the dreaded Notice of Commencement of Bankruptcy Case. Your client has checked its records and determined that it made a large product delivery (or series of deliveries) to the customer – now Debtor – within a short period of time prior to the filing of the bankruptcy case. Is your client out of luck? You advise your client that depending on what was delivered to the Debtor and when it made those deliveries, it may be able to assert a 20-day administrative priority claim as to the portion of your claim that fits within the requirements of 11 U.S.C. §503(b)(9). Your client is excited to hear that a portion of its claim against the Debtor may change from a general unsecured claim (potentially paid only pennies on the dollar if at all) to an administrative claim which has a higher level of priority in the claim distribution process. Your client is also excited to hear that its 503(b)(9) claim will be paid prior to general unsecured creditors due to its priority status and, as such, in Chapter 11 cases, will be payable as of the effective date of a confirmed Plan (unless other arrangements are made consensually) as opposed to being made over time (i.e. quarterly or annually) after the Plan is confirmed. The benefits for a creditor to hold a 20-day administrative priority claim under §503(b)(9) are obvious.

Section 503(b)(9) of the Bankruptcy Code provides for an administrative expense status for "the value of any goods received by the Debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor the ordinary course of such Debtor's business." Parsing apart this provision, a vendor must establish four elements to establish such a claim – the value of goods that were sold to the Debtor in the ordinary course of the Debtor's business and received by the Debtor within 20 days immediately prior to the bankruptcy filing. The specific circumstances of a transaction or series of transactions can determine whether a claim fits within this section and will be allowed as an administrative priority claim in the bankruptcy case.

First, the vendor's claim will only be allowed for goods sold to the Debtor. The Bankruptcy Code does not define what "goods" are, so the Courts have come up with various decisions as to what are or are not 'goods" under this section. In some cases the determination is clear – for example goods are tangible supplies provided to the Debtor such as machinery, equipment or parts. Likewise, Courts have found chemicals provided as fertilizer to a farming enterprise[1] and produce delivered to a restaurant supplier [2] to be goods meeting the requirements of this section. What has proved difficult for the Courts to determine is whether a vendor is entitled to §503(b)(9) claim when the vendor supplies goods and services at the same time – for example the chemicals delivered to the farming operation above are also loaded by the vendor into fertilizer sprayers at the time of delivery for the farm's use. Should the value of the fertilizer loading be part of the administrative priority claim? There is little consistency in Court decisions in this area. For example, in a mixed transaction involving the provision of goods and services, one Court has held that the value of *any* goods provided will be afforded a §503(b)(9) administrative expense priority as the statute specifically includes the word "any" and does not require that a transaction be made up entirely or even predominately for goods versus services.[3] Other Courts have determined that in a hybrid transaction the appropriate inquiry is to determine the predominate purpose of the transaction. For example, when the service component is a necessary part of a vendor's supply of the goods and the supply of goods is the predominant purpose of the transaction then the entire claim will be allowed.[4] However, when the service portion is logically separable or separately charged then such claim will not be allowed.[5]

The second element of an administrative priority claim requires that the goods actually be sold to the Debtor in the ordinary course of the Debtor's business operations. The Bankruptcy Code does not define what the term "sold" entails, though it has been held that a vendor's administrative priority claim is limited to goods sold on credit as opposed to goods that are leased, licensed or consigned Unfortunately for vendors, certain vendor-debtor relationships can be unclear in regards to whether there is a lease, sale or other business arrangement. Likewise, the Bankruptcy Code does not define what is "ordinary course" for a Debtor's business operations. However, what is "ordinary course" is often not an issue in an administrative priority claim determination and this language has been interpreted broadly in regards to other Bankruptcy Code provisions.

The third element requires that the Debtor have actually received the goods in the 20 day period prior to the filing of the bankruptcy case. Vendors are cautioned to understand the difference between invoicing and actual delivery and receipt by the Debtor. Invoicing can occur before, at the same time, or after delivery and receipt so a vendor should have a clear understanding of its course of dealings with the Debtor in order to determine when the Debtor came into physical possession of the goods. Oftentimes the vendor-debtor relationship can be murky in this regard requiring a very fact-dependent analysis in order to ascertain whether a vendor's claim fits into an administrative priority status.

Finally, the administrative priority claim would be for the value of the goods that meet all of the above requirements. The Courts will often look to the invoice and consider the value of the goods to be the invoice price of such goods though this is not always the case, especially in a situation where, as set forth above, there is a combination of goods and services provided as part of a vendor's delivery to a Debtor or a question as to whether the goods described on the invoice or invoices were what was actually delivered to the Debtor.

Section 503(b)(9) clearly affords a qualified vendor a priority claim but is silent as to when such claim is to be paid. A vendor can request an immediate payment of its claim but the Bankruptcy Courts have considered the timing of the payments to be a matter that is to be determined on a case by case basis considering prejudice to the debtor, hardship to the claimant and potential detriment to other creditors in the case. *In re Global Home Products, LLC,* 06-10340 KG, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006). Generally, distributions to administrative claimants are disallowed prior to confirmation in order to prevent a race to a debtor's assets and preserve the goal of an orderly distribution to creditors. Id. at 3. Accordingly, it is unlikely that a vendor will receive payment of its 20-day administrative priority claim prior to the effective date of the confirmed Plan.

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1 *In re C&D Fruit and Vegetable Co., Inc.,* No. 8:18-bk-997, slip op. at 1 (Bankr. M.D. Fla. May 17, 2018) (Doc. No. 179).
2 *In re Posto 9 Lakeland, LLC,* No. 8:17-bk-07887, slip op. at 1 (Bankr. M.D. Fla. January 12, 2018) (Doc. No. 103).
3 *In re Plastech Engineered Products, Inc., et al., 397 B.R. 828 (Bankr. E.D. Mich. 2008)*
4 *In re Circuit City Stores, Inc.,* 416 B.R. 531 (Bankr. E.D. Va., 2009).
5 E.g. *In re Goody's Family Clothing Inc.,* 401 B.R. 131, 135 (Bankr. D. Del. 2009) (Vendor's services provided to debtor including inspection, ticketing, and repackaging of apparel and delivery of goods that debtor had purchased from other vendors, did not qualify as "goods," to support administrative expense claim).

Bankruptcy Protections For The Non-Debtor Former Spouse And The Gap Between A5 and A15

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To the bankruptcy practitioner, classifying divorce-related debts is relatively straightforward. If the debtor owes alimony, maintenance, and/or child support, the debt is nondischargeable and is afforded priority status. If the debt is not alimony, maintenance, and/or child support but nevertheless arises from a divorce settlement, it is nondischargeable in Chapters 7 and 11 and possibly dischargeable in a Chapter 13.

For the creditor's attorney, however, the treatment of divorce-related debts can be more complicated. When the debtor spouse seeks to discharge divorce-related debts and the creditor spouse objects to discharge, the practitioner must carefully examine the available options. In many cases an adversary action is not necessary, but in some situations it is necessary to protect the creditor spouse's interests.

Ex-spouses are involuntary creditors. For this and other public policy reasons, debts owed to former spouses are afforded special protection by the Bankruptcy Code. The Code recognizes two separate categories of divorce-related debts: DSOs and (a)(15) debts. Domestic support obligations (DSOs) essentially consist of alimony, maintenance, and support. They are defined by 11 USC § 101(14A) as debts that are

(A) Owed to or recoverable by –
   i. A spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative; or
   ii. A governmental unit;

(B) In the nature of alimony, maintenance or support (including assistance provided by a governmental unit) of such spouse, former spouse, or child of the debtor or such child's parent, without regard to whether such debt is expressly so designated;

(C) Established or subject to establishment before, on, or after the date of the order for relief in a case under this title, by reason of applicable provisions of –

i. An order of a court of record; or
ii. A determination made in accordance with applicable nonbankruptcy law by a governmental unit; and

(D) Not assigned to a nongovernmental entity, unless that obligations is assigned voluntarily by the spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative for the purpose of collecting the debt.

(a)(15) debts are incurred as part of a divorce settlement, but are not alimony, maintenance, or support. Examples include a post-divorce agreement to repay a joint loan *In re Hardesty,* 553 B.R. 86 (2016), a car loan *In re Swiczkowski,* 84 B.R. 487 (Bankr. N.D. Ohio 1988), mortgage payments *Breibart v. Breibart* (*In re Breibart)*, 325 B.R. 724 (Bankr. D.S.C. 2004), a child's student loans, *In re Burns* 306 B.R. 274 (Bankr. E.D. Mo. 2004), and children's private school tuition *Luppino v. Evans (In re Evans),* 278 B.R. 407 (Bankr. D. Md. 2002). The Code defines these (a)(15) debts as those owed

> to a spouse, former spouse, or child of the debtor and not of the kind described in paragraph (5) that is incurred by the debtor in the court of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, or a determination made in accordance with State or territorial law by a governmental unit
>
> 11 U.S.C. § 523(a)(15).

Because DSOs are so straightforward, their treatment in bankruptcy is not often disputed. In Chapter 7 bankruptcies, DSO debts are not dischargeable and are afforded first priority status. 11 U.S.C. § 523(a)(5); 11 U.S.C. § 507(a)(1)(A).

Likewise, in Chapter 11 bankruptcies, DSO debts are not dischargeable and are afforded first priority status. *Id.* A Chapter 11 debtor cannot receive confirmation of his or her plan of reorganization if the debtor is not current on his or her DSO payments. 11 U.S.C. § 1129(a)(14).

In Chapter 13 bankruptcies, DSO debts are not dischargeable and must be paid in full under the plan. 11 U.S.C. § 523(a)(5); 11 U.S.C. § 1322(a)(2). Furthermore, a Chapter 13 debtor's plan cannot be confirmed if the debtor is not current on all DSO payments, the case can be converted or dismissed if the debtor falls behind on DSO payments, and discharge may be denied if DSOs are owing. 11 U.S.C. § 1325(a) and (a)(8).

Non-DSO debts, those that fall within the definition of § 523(a)(15), are also protected. They are not dischargeable in Chapter 7 or 11 bankruptcies, but are dischargeable in Chapter 13. It is for these reasons that litigation over DSO and (a)(15) debts can arise.

Adversary Actions

Prior to BAPCPA, creditors were required by 11 U.S.C. §523(c)(1) to file an adversary in order to keep the debtor from discharging the (a)(15) non-DSO debt. BAPCPA specifically eliminated this requirement. But, if there is a risk of improper classification of a DSO or (a)(15) debt, an adversary may become necessary.

The burden of proof falls on the creditor spouse to show, by a preponderance of the evidence, that a claim falls within (a)(5) or (a)(15). *Tilley v. Jessee,* 789 F.2d 1074, 1077 (4th Cir. 1986); *In re Crosswhite,* 148 F.3d 879 (CA7 Ind. 1998); *Hill v. Hill (In re Hill),* 184 B.R. 750 (Bankr. N.D. Ill. 1995). Although the divorce would have been governed by state law, the analysis of whether the debt is a DSO or (a)(15) debt is conducted under federal bankruptcy law. *In re Johnson,* 397 B.R. 289, 296 (Bankr. M.D.N.C. 2008) (citing *Strickland v. Shannon (In re Strickland),* 90 F.3d 444, 446 (11th Cir. 1996)). Case law demonstrates that the intent of the parties at the time of the divorce controls. The Fourth Circuit, for example, has adopted an unofficial test for the intent inquiry. Under this test, courts will consider the language of the agreement, the financial situation of the parties, the function of the monetary obligation, and whether there is evidence of overbearing. *In re Krueger,* 457 B.R. 465 (Bankr. D.S.C., 2001).

In a Chapter 13 scenario, if the creditor spouse has met its burden and it is determined that the debt falls within (a)(15), the burden shifts to the debtor who is then required to demonstrate that he or she lack the ability to pay the debt in question from income and property not necessary for support of debtor and debtor's dependents, or that, pursuant to 11 U.S.C. § 523(a)(15)(B), allowance of discharge would produce benefits exceeding and consequent harm to the creditor. *Humiston v. Huddelston (In re Huddelston),* 194 B.R. 681 (Bankr. N.D. Ga. 1996); *Armstrong v. Armstrong (In re Armstrong)*, 205 B.R. 386 (Bankr. W.D. Tenn. 1996).

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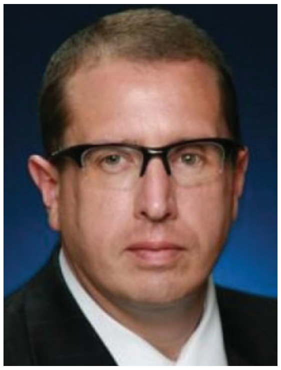
Understanding The Elements Of The UVTA Tests For A Voidable Transaction



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The Uniform Voidable Transactions Act ("UVTA") lists five distinct tests for determining whether a voidable transaction (*was:* fraudulent transfer) occurred. Largely due to the poor statutory structure of the UVTA, which was inherited unchanged from the Uniform Fraudulent Transfer Act ("UFTA"), and the adoption by the courts of non-descriptive if not utterly misleading and oxymoronic nicknames for these tests, practitioners often have difficulty in figuring out the elements of these tests, or how exactly they differ from one another.

It is likely better to utterly forget all that one believes they have previously learned about the voidable transaction tests and instead adopt the more logical nomenclature below. There are still five tests, which are organized in the order by which they ought to each be tested:

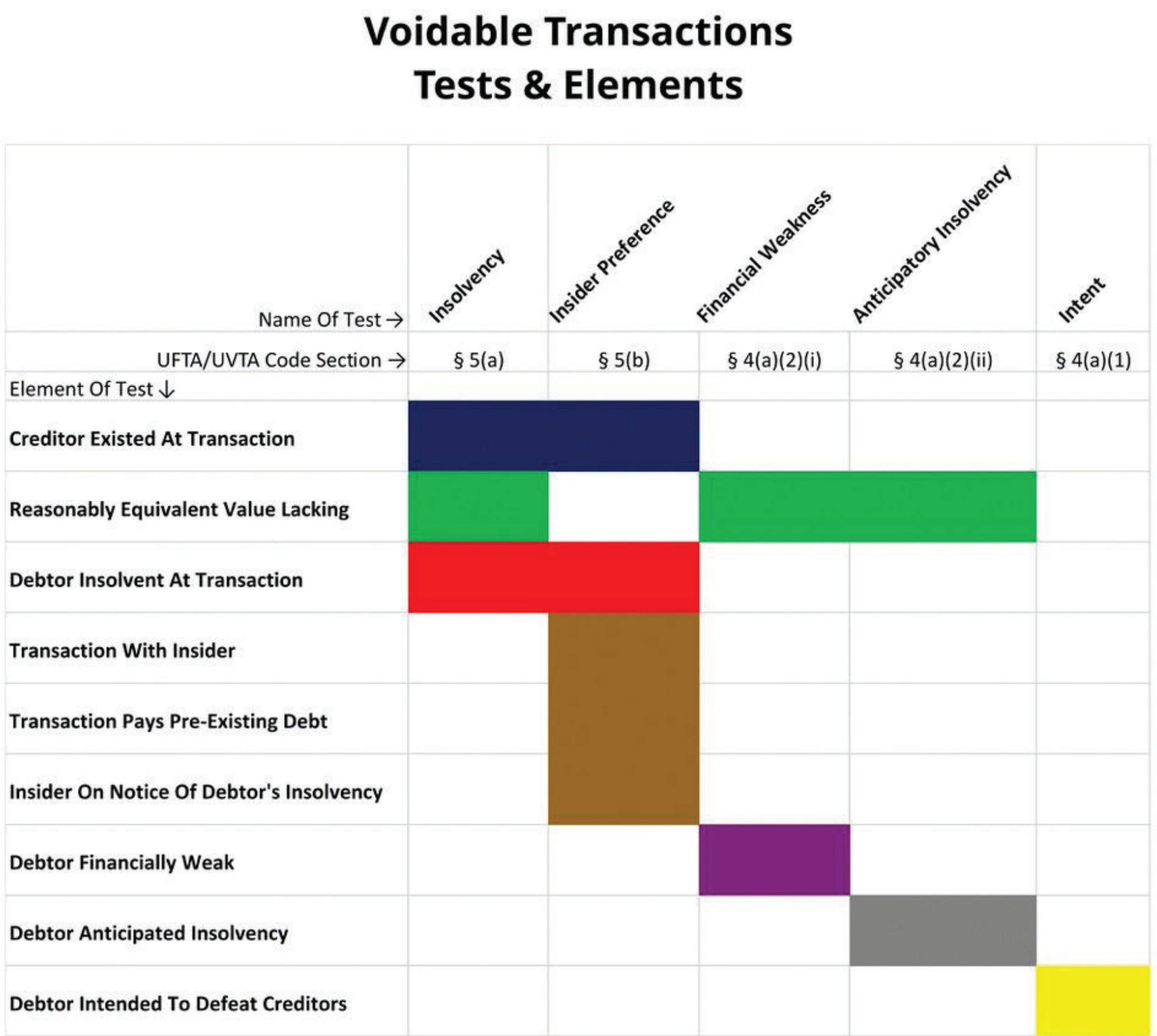
- **Insolvency Test** of § 5(a)
- **Insider Preference Test** of § 5(b)
- **Financial Weakness Test** of § 4(a)(2)(i)
- **Anticipatory Insolvency Test** of § 4(a)(2)(ii)
- **Intent Test** of § 4(a)(1)

These tests and their elements are shown by the Voidable Transactions Tests & Elements Chart (Chart A).

Creditor Existed At Transfer

Two of the tests (Insolvency and Insider Preference, collectively known as the *section five tests*) require that the creditor have existed at the time of the challenged transaction, or what is known as an *existing creditor.* The other three tests (Financial Weakness, Anticipatory

CHART A: Note that three of the elements are common to multiple tests, while six elements are unique to particular tests.



Insolvency and Intent, collectively known as the *section four tests*) do not require the creditor to have existed at the time of the transaction, but could also include a creditor that appears after the transaction, or what is called a *future creditor.*

So, why do the section five tests require an existing creditor, but the section four tests do not? There is no good reason for this, and certainly no good public policy reason to support this distinction. Like many other things found in the UVTA, this is simply an anachronism and the carrying on of an old rule simply because it was carried on in the past. A similar anachronism is that the tests have different extinguishment periods (which are very similar to, but not quite the same as, Statutes of Limitation); there is no compelling public policy reason for the disparate extinguishment periods, and at least California has rejected the UVTA periods and simply set all the periods for all the tests at four years, with an additional one-year discovery rule in some circumstances.

Reasonably Equivalent Value Not Present

Three tests (Insolvency Test, Financial Weakness and Anticipatory Insolvency) require that the transaction have lacked *reasonably equivalent value* ("REV"), which means that the debtor did not receive back something of about the same value from the transferee as what the debtor gave up to the transferee. Importantly, REV is always measured through the glasses of creditors, and what the debtor got back must be about as valuable from the viewpoint of creditors as what the debtor gave up. The idea behind REV is to prevent depletion of the debtor's financial estate by the debtor either making gifts or trading valuable assets for assets of dubious value.

Debtor Insolvent At Transaction

The two section five tests (Insolvency and Insider Preference) share the common element of *insolvency,* which employs a balance-sheet analysis to determine if the debtor is at least $0.01 in the red or not. Very simply, if the debtor is in the black, then the debtor is solvent; if the debtor is in the red, then the debtor is insolvent.

But note that one may characterize the UVTA as having effectively three forms of insolvency:

- *Outright insolvency* ("the decks are awash") under the Insolvency Test of § 5(a)
- *Self-inflicted insolvency* ("we're going to take on a big load of cargo and that will sink us") under the Financial Weakness Test of § 4(a)(2)(i).
- *Anticipated insolvency* ("the water is not over the deck yet, but will be shortly barring a miracle") under the Anticipatory Insolvency Test of § 4(a)(2)(ii)

What distinguishes the outright insolvency from self-inflicted and anticipated insolvency is that outright insolvency is simply a pure accounting test with no mental element at all, whereas self-inflicted insolvency and anticipated insolvency look to what the debtor knew or should have known about the likely onset of insolvency at the time of the transaction.

Now let's move on to examine each voidable transaction test in detail.

Insolvency Test of § 5(a)

The Insolvency Test is one of the two ancient (going back to Roman law) tests for a fraudulent transfer, the other is the Intent Test of § 4(a)(1) as modernized into its current form. There are three elements that the creditor must prove:

- The creditor existed as of the time of the transaction;
- Reasonably equivalent value was not present; and
- The debtor was insolvent at the time of the transaction.

Because there is no mental element by anybody involved to be either proven or denied, the Insolvency Test is often the subject of summary judgment rulings by courts in favor of creditors (one of the few places in the law where a plaintiff can win a summary judgment, which requires that no material facts be in serious dispute), and thus is the "creditor's choice" for challenging a voidable transaction.

Insider Preference Test of § 5(b)

The Insider Preference Test gets it name from bankruptcy law, where a debtor paying ("preferring") one creditor over another becomes subject to the preference rules whereby the asset transferred can be brought back into the debtor's estate and shared with all creditors. The test is the most complicated of all the voidable transaction tests since it has five elements:

Like the Insolvency Test, the Insider Preference Test requires:

- The creditor existed as of the time of the transaction; and
- The debtor was insolvent at the time of the transaction.

Unlike the Insolvency Test, however, the Insider Preference Test does not require that the debtor have not received reasonably equivalent value from the transferee. To the contrary, the debtor might have received REV from the transferee. In lieu of that requirement, the Insider Preference Test requires three additional factors:

- The transfer was to an insider;

- The transfer paid a pre-existing (“antecedent”) debt which the debtor owed to the transferee; and
- Facts existed by which the insider transferee knew or reasonably should have known that the debtor was insolvent.

In other words, the insider transferee should have been aware that the debtor was underwater, but did a deal with the debtor anyway so that the transferee could get paid off even if other creditors got stiffed. That’s what the Insider Preference Test is about.

There is a significant question about whether the Insider Preference Test belongs in the UVTA, with probably the better view being that states should simply adopt their own preferential transfer regimes as separate law, and then excise this test from the UVTA. This is exactly what, for example, California has done–the Golden State does not include the Insider Preference Test at all but that issue is considered by other law.

Financial Weakness Test of § 4(a)(2)(i)

The Financial Weakness Test examines whether the debtor was too financially weak to do some deal, and that deal ultimately cast the debtor into insolvency. There are two elements to this test:

- Reasonably equivalent value was not present; and
- The assets of the debtor were inadequate to engage in some deal which the debtor engaged in.

This test, which is sometimes called the equity-sense insolvency test, seems to come up most often in the mergers and acquisitions or corporate restructuring context, where a financially-distressed company engages in some deal that has the effect of transferring its assets to a White Knight while leaving the creditors of the company holding the bag.

The test, however, is certainly not limited to that context. It may come into play, for instance, in the asset protection planning context where a debtor who is not in financial distress but transfers away the bulk of her assets into a trust, and then some foreseeable liability soon thereafter materializes which casts the debtor into insolvency. The lesson here for asset protection planners is that merely testing for strict insolvency is not enough, but one must look out on the horizon for possible liabilities as well.

Anticipatory Insolvency Test of § 4(a)(2)(ii)

The Anticipatory Insolvency Test involves the case where the debtor knows the ship will soon be underwater, and tries to offload some assets to the transferee before the water finally washes over the deck. There are two elements:

- Reasonably equivalent value was not present; and
- The debtor knew or should have known that it would very soon not be able to pay its debts as they came due.

While the latter element is technically different from insolvency as defined in the UVTA, the practical effect is about the same since a debtor that cannot pay its debts as they come due is presumed to be insolvent. This is similarly a test that most often appears in the mergers and acquisitions or restructuring context.

It should be noted that one could quite aptly characterize the Insolvency Test, the Financial Weakness Test and the Anticipatory Insolvency Test as the *financial distress tests*, since that is the essence of what they test albeit through different methods. If a debtor is in financial distress and makes a transfer without receiving reasonably equivalent value in return, then it is likely that at least one of these three tests will be met.

Intent Test of § 4(a)(1)

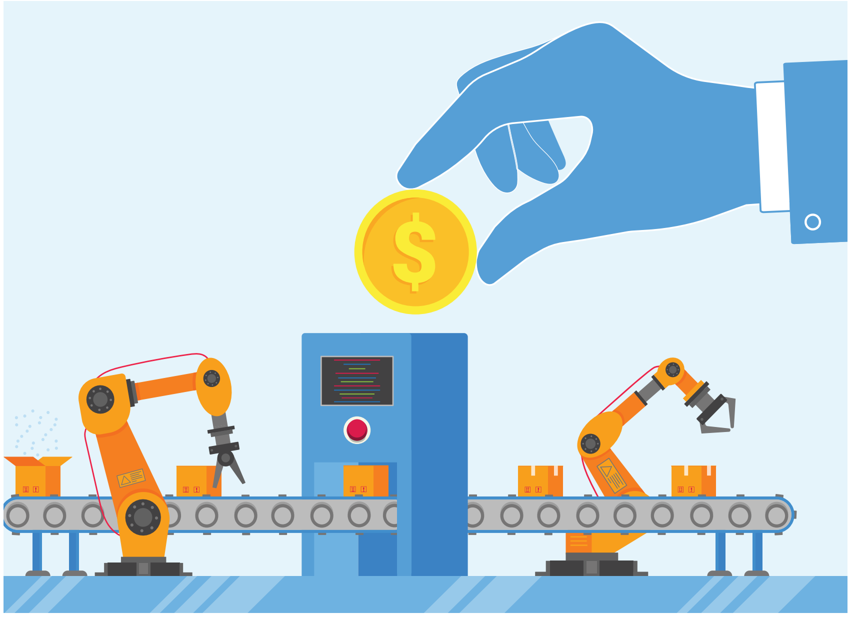
The test that most practitioners associate with a voidable transaction is the Intent Test of § 4(a)(1). The Intent Test has but a single element:

- The debtor engaged in the transaction with the intent to diminish the rights of any creditor, past, present or future.

The Intent Test is effectively a catch-all test of last resort which posits that if a creditor cannot prove a voidable transaction through any other test, then the creditor can still do so by showing that the debtor intended to diminish the rights of creditors. That the Intent Test is the catch-all test is confused by the fact that it is unfortunately the first test listed in the UVTA,

– Continued on page 40

Purchase Order Financing to the Debtor in Possession



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The lender's dilemma: After months of sputtering along, your borrower has finally exhausted its existing facility and is contemplating filing for bankruptcy to conduct an orderly wind down. Suddenly it receives a reprieve; a long sought-after purchase order for its most profitable product, from its best and most stable customer. Like manna from Heaven, filling this order could be a reflection that your borrower has hit bottom and can begin its turnaround, or it's a last gasp effort enabling the borrower to survive long enough to maintain a going concern value and a good customer relationship. But when the existing lender's line is completely tapped out and an immediate need for funds is required to fill the order, what's the solution? Purchase Order Financing (PO Financing).

In PO Financing, the borrower assigns its right and obligations to its customer's purchase order to a PO Lender. The PO Lender purchases the product (for which the customer has issued a PO) from the manufacturer on behalf of the borrower. After the product has been finished (following inspection, shipment, delivery to a U.S. port, delivery to the customer, then acceptance of the product by the customer), the manufacturer is paid by the PO Lender. The product is "sold" to the borrower by the PO Lender and concurrently sold by the borrower to its customer, who issued the PO. Depending on terms of sale between the borrower and its customer, the customer may pay for the product when it is delivered or at some point of time thereafter. If the terms of sale are "payment upon delivery," then upon delivery, the borrower issues an invoice to the customer; the customer pays the borrower and the borrower repays the PO Lender for the cost of the product plus interest and the PO Lender's fees. If the terms of sale between the borrower and the customer are for payment for the product sometime after the customer's receipt of the product, the borrower issues an invoice to its customer and an account receivable will have been created. The PO Lender may retain possession of the invoice or assign the invoice to the borrower's working capital lender. If the invoice is assigned to a working capital lender, the PO Lender will be repaid its advances plus interest and fees by the working capital lender. The customer then will pay the invoiced amount to the working capital lender. Alternatively, the borrower will have assigned the invoice to the PO Lender and the customer will pay the invoice according to the terms of sale to the PO Lender. Upon receiving payment from the borrower's customer, the PO Lender deducts its advances, interest and fees and remits the balance of the payment to the borrower.

Since PO Financing can be used for short-term relief within a bankruptcy or a "first date," that can mature into a longer-term relationship after the bankruptcy (if all goes well in Chapter 11), PO Financing should be high on the list of financing solutions in a Chapter 11. PO Financing can provide a much-needed lifeline in Chapter 11 and benefit both the borrower who has exhausted its availability from its existing lender; and the lender, who desperately needs the borrower to preserve its going concern value in order to maximize the value of its collateral. All the while the PO Lender has comfort knowing that its risk is being mitigated by utilizing all of the protections that a bankruptcy proceeding provides: transparency, the ability to enhance its collateral through a Bankruptcy Court Order and assurances that both the risks of dealing with a borrower in financial hardship and cost of enforcement is limited since the borrower is already in a court where the PO Lender can enforce its rights if the need exists.

The Process, Obstacles and Benefits of Providing PO Financing to the Debtor in Possession

The challenge for many PO Lenders is navigating the several legal hoops that one must go through to make PO Financing to a Chapter 11 Debtor in Possession mutually beneficial. The hoops are described below:

THE BORROWER

The first step is convincing the PO Lender and its existing lender that the profit margins built into selling the product will support PO Financing. Does the manufacturer have access to all raw materials? Are there any risks that the product will not be produced on schedule and on time? Is there a risk of non-payment of the finished product? If the product is being manufactured abroad, does the PO Financing need independent support, by, for example, letters of credit? All these issues go into pricing of the PO Financing.

Since the borrower's customer may be "spooked" by the sudden appearance of the PO Lender especially in this day of credit schemes and the borrower's bankruptcy, the borrower should be prepared to facilitate complete communication between its customer and the PO Lender.

Similarly the borrower may look at the PO Lender as a potential source for exit financing after it emerges from its Chapter 11. The borrower should carefully examine whether the PO Lender has the ability to provide more full service. Can it provide additional lending facilities, such as exit financing, or is it just a one trick pony?

THE EXISTING LENDER

The need for PO Financing is premised on the assumption that the borrower and its existing lender have deal fatigue; that the PO Lender is not just providing a financing alternative, but it adding intrinsic value to the borrower by enhancing its going concern value, and thus the existing lender's collateral. The existing lender should be prepared to carve out the proceeds from the PO Financing from the existing lender's collateral package. That carve-out extends to all rights relating to the purchase order for which the PO Lender is providing financing, the finished product, accounts receivable created by the sale of the finished product and proceeds therefrom. Likewise the existing lender should fully subordinate their claim to the extent of any advances made by the PO Lender, and its costs.

THE PO LENDER

The PO Lender needs to ensure that its documents go beyond the protections expected in a traditional relationship; that they protect it as a lender to a Debtor in Possession with a super-priority, and the ability to seek reimbursement of its advances and fees as a super-priority expense if for some unanticipated reason the whole transaction turns upside-down. This is where knowledge of the bankruptcy process and knowing the line between what's obtainable and what's egregious in the eyes of the Bankruptcy Judge, the Creditors Committee (if one exists) and the United States Trustee comes into play. Since none of those parties are as familiar with PO Financing as the PO Lender and its counsel, it's important to strike a balance between what's fair when providing PO financing to a challenged borrower, and what's unnecessary.

The PO Lender typically needs to anticipate how it would dispose of its collateral if the Borrower were to default. Where the PO Lender is facilitating a transaction with a Debtor in Possession, the PO Lender needs to craft its documents to enable it to rely on the Bankruptcy Court, if necessary, to liquidate its collateral, even if for instance the collateral includes licensed goods. And consider whether the appointment of a Trustee under Chapter 11 or Chapter 7, or the automatic stay might affect any of the PO Lender's ability to liquidate its collateral. For instance, if the deal goes sour, the PO Lender may prefer one liquidator over another. The time to negotiate that preference is during the Bankruptcy Court loan approval process, not later.

The PO Lender's documents may provide for all of its fees and costs be paid without further court approval. Whether or not those fees and costs include its attorney's fees, or whether there is a cap on those fees after which court approval is necessary is another topic for negotiation among the parties.

Typical lending agreements provide for a minimum term, or a minimum volume, lest the borrower become liable to pay a fee to the lender. Where those terms are breached as a result of the Debtor converting its case to one under Chapter 7, or simply liquidating, that unpaid fee may become an administrative expense against the Debtor's Chapter 11 estate.

Lastly, the PO Lender needs to ensure that it's receiving and reviewing all pleadings and reports filed in the bankruptcy case, including Monthly Operating Reports. The pleadings and report are telling when something is amiss, or about to become amiss in the underlying bankruptcy case.

PO Financing to the debtor in possession can be lucrative, beneficial and provide entry to a longer-term relationship with the borrower following its bankruptcy. Navigating the Debtor in Possession Financing Orders requires familiarity with the nuances of the Bankruptcy Code and ensuring that you've anticipated the unexpected. ■

The Ongoing Battle for Recognition and Payment of 503(b)(9) Claims

– Continued from page 25

Can a vendor assert a 20-day administrative priority claim in any bankruptcy case? The answer is yes – administrative priority claims under §503(b)(9) can be asserted in regards to claims under any Chapter of the Bankruptcy Code, though, effectively, they are of significant value to vendors only in Chapter 11 cases. The reason is that the highest level of priority in cases in other Chapters of the Bankruptcy Code (such as Chapter 7 cases) are the expenses of the costs of administration including the costs and expenses of preserving the bankruptcy estate such as the Trustee's fee, the attorneys for the Trustee's fees and costs and so forth. Administrative priority claims under §503(b)(9), though they retain a priority status in these cases filed in other Chapters, are a lower-level of priority and are not paid unless the costs of administration are first paid in full.[6]

What is the process for a vendor to assert an administrative priority claim under §503(b)(9)? The short answer is that it is dependent on the process used in the Court where the case is pending, the process that may have been ordered by the Court in a particular case or the terms of a Chapter 11 Debtor's Plan of Reorganization. The Bankruptcy Code itself does not specify the process. There is a significant variability between the Bankruptcy Courts as to how and when a vendor must make its claim, so it is easy for a vendor to get tripped up and inadvertently fail to timely make such a claim or make the claim in the "wrong" way. Therefore, it is vitally important for a vendor to understand the process in place in the applicable Bankruptcy Court in order to devise a strategy for making a claim timely and in the correct way. ■

6 Section 503 of the Bankruptcy Code–Allowance of Administrative Expenses–sets forth the priority in payments for administrative expense claims. Section 503(b)(9) claims are the lowest level of priority for such administrative claims though, as an administrative claim, it has a higher priority level in regards to payment than general unsecured claims.

WHY MCA? Adding Havoc to Chaos
— Continued from page13

APPENDIX

PURCHASE AND SALE OF FUTURE RECEIVABLES

Merchant hereby sells, assigns and transfers to MCA (making MCA the absolute owner) in consideration of the funds provided ("Purchase Price") specified below, the Specified Percentage (defined below) of Merchant's future accounts, contract rights and other obligations arising from or relating to the payment of monies from Merchant's customers' and/or other third party payors (the "Receipts") defined as all payments made by cash, check, credit or debit card, electronic transfer or other form of monetary payment in the ordinary course of the merchant's business), for the payment of Merchant's sale of goods or services until the amount specified below (the "Purchased Amount") has been delivered by Merchant to MCA (the "Agreement" or "Merchant Agreement").

The Purchased Amount shall be paid to MCA by Merchant's irrevocably authorizing only ONE depositing account acceptable to MCA (the "Account") to remit the percentage specified below (the "Specified Percentage") of the Merchant's settlement amounts due from each transaction, until such time as MCA receives payment in full of the Purchased Amount. Merchant hereby authorizes MCA to ACH Debit the specified remittances from the Merchant's bank account on a daily basis and will provide MCA with all required access codes, and monthly bank statements. Merchant understands that it is responsible for ensuring that the specified percentage to be debited by MCA remains in the account and will be held responsible for any fees incurred by MCA resulting from a rejected ACH attempt or an event of default. (See Appendix A). MCA is not responsible for any overdrafts or rejected transactions that may result from MCA's ACH debiting the specified amounts under the terms of this agreement. MCA may, upon Merchant's request, adjust the amount of any payment due under this Agreement at MCA's sole discretion and as it deems appropriate. Notwithstanding anything to the contrary in this Agreement or any other agreement between MCA and Merchant, upon the violation of any provision contained the MERCHANT AGREEMENT TERMS AND CONDITIONS or the occurrence of an Event of Default under the MERCHANT AGREEMENT TERMS AND CONDITIONS, the Specified Percentage shall equal 100%. A list of all fees applicable under this agreement is annexed hereto in Appendix A.

PURCHASE PRICE:	SPECIFIED PERCENTAGE:	PURCHASED AMOUNT:
$200,000.00	**15%**	**$291,800.00**

SCOTUS Rejects Strict Liability Standard for Violations of Discharge Injunction

– Continued from page 23

Circuit BAP spends six pages reciting the facts which led to the Bankruptcy Court’s decision to sanction the creditor. Included in that lengthy tale is the fact that both an Oregon state trial court and the Bankruptcy Court itself had previously determined that the creditor’s action was not a violation of the discharge injunction. After the U.S. District Court in Oregon overruled the Bankruptcy Court’s finding, the case went back to the Bankruptcy Court, which was placed in the odd position of determining the sanction for contempt resulting from action the Court had previously ruled did not violate the discharge injunction. Having no room for discretion, the Court hit the creditor with a $100+k sanction, which was understandably appealed to the Ninth Circuit BAP.

The BAP reversed the Bankruptcy Court. After reviewing the usual strict liability standard, the BAP focused on the first prong of the test, whether the creditor had “actual knowledge” that the discharge order applied to its actions. Since the facts of the case show that, in large part, the post-discharge litigation revolved primarily around <u>whether</u> the claims were discharged at all, the BAP found that <u>until</u> that issue had been decided adversely to the creditor, the creditor “could not possibly have been aware that the discharge injunction was applicable.” *Emmert v Taggart,* 548 B.R. 275, 291 (9th Cir BAP 2016). As the BAP noted, the decision by the US District Court that the injunction did apply actually ended the creditor’s actions – and the BAP was unwilling to sanction a party for simply proceeding with litigation to determine a disputed issue.

The Debtor then appealed to the Ninth Circuit, which affirmed the BAP but changed the analysis used to determine that the creditor had not been in contempt. Where the BAP focused on the creditor’s knowledge of the applicability of the discharge injunction, the Ninth Circuit ruled that – as to this first prong – “the creditor’s good faith belief that the discharge injunction does not apply to the creditor’s claim precludes a finding of contempt, even if the creditor’s belief is unreasonable.” *Lorenzen v Taggart,* 888 F.3d 438, 444 (9th Cir. 2018). As the creditor here clearly had a good faith belief, the contempt finding was held to be erroneous.

The Debtor applied for certiorari to the Supreme Court, to challenge the Ninth Circuit’s “good faith belief” standard. The Court agreed with the Debtor that the Ninth Circuit was wrong, but also rejected the “strict liability” approach applied in the Bankruptcy Court and urged by the Debtor and evidently did not care for the BAP’s analysis that until the issue of whether the injunction applied was resolved a creditor cannot knowingly violate it.

Instead, the Supreme Court found that the test to be applied is whether there is “no objectively reasonable basis” for the creditor’s conduct. (The Court did not directly declare that the two-prong analysis is overruled, but the discussion makes clear that the Court did not believe that the “strict liability” analysis is appropriate at all.) This entirely different approach resulted from the Supreme Court’s view that the case should be considered in light of the traditional principles of civil contempt when applied to other injunction violation – unrelated to bankruptcy. The Court emphasized that, outside the bankruptcy context, contempt is not appropriate “where there is a fair ground of doubt as to the wrongfulness of the Defendant’s conduct.” [Page 6, cit. omitted] The Court made plain that while the creditor’s subjective belief is not decisive (rejecting the Ninth Circuit’s approach), that belief might assist the court in deciding what sanction – if any – would be appropriate.

Since the courts below had not applied this “objectively reasonable basis” standard, the case was remanded. Given the Bankruptcy Court’s prior conclusion that the creditor was correct in claiming that the injunction did not apply, it seems likely that that Court will conclude the creditor had the requisite “fair ground of doubt” necessary to avoid sanction for contempt.

While not as creditor-friendly as the Ninth Circuit’s “good faith basis” standard would have been, the *Taggart* opinion does give a glimmer of hope to creditors in discharge injunction litigation. It may not be often that the “fair ground of doubt” can be established, but compared to the strict liability test utilized up to this point, a creditor with a credible argument may proceed with the thought that it may avoid a sanction simply for trying.

More encouraging for creditors is the fact that the Supreme Court rejected the idea that bankruptcy contempt is treated differently than any other civil contempt. In particular, the final paragraph of the *Taggart* opinion provides a solid argument against using the “strict liability” standard even in the far more common cases of stay violation. The Debtor contended that the Court should adopt the strict liability standard because it would be consistent with the standard used to remedy stay violations. Because there is no specific provision in the Bankruptcy Code to address violations of the discharge injunction, the Court rejected that argument and distinguished the specific language in §362 (“willful violations”) from the general authority of the Court to enforce its orders under §105 that provides the sanction remedy in the event of a stay violation. The Court then supplemented this thought with a parenthetical comment that “willful” is also <u>not typically associated</u> with strict liability. The Court noted that it was not deciding whether “willful” in §362 would support a strict liability standard, but clearly they felt the implication needed to be raised — that the Court will consider the “willfulness” of a stay violation in the same way that willfulness is applied in other civil contexts. A creditor whose action is objectively reasonable but ultimately found to violate the automatic stay should certainly argue that *Taggart* shows the strict liability standard is no longer appropriate. ■

Bankruptcy Protections For The Non-Debtor Former Spouse And The Gap Between A5 and A15

– Continued from page 27

Conversion

At first blush it appears that concern will only arise for the creditor spouse if the debtor spouse has declared Chapter 13 bankruptcy. But it is important to recall that debtor can covert between chapters of the Bankruptcy Code. A Chapter 7 case can be coverted to a Chapter 11 or 13 case if it has not previously been converted. 11 U.S.C. §§ 706 and 707. And Chapter 11 and 13 cases can be converted to Chapters 7, 11, or 13. 11 U.S.C. §§ 1112 and 1307. Just because a case is not filed under Chapter 13 does not mean that it will not end up in Chapter 13.

CONCLUSION

When representing a creditor spouse, a full understanding of the nature of the divorce-related debts is necessary. If the creditor spouse’s understanding of the obligations matches the treatment proposed by the debtor’s petition, there is little cause for concern. But, if a risk of discharge or non-priority treatment of DSO or (a)(15) debt obligations appears, an adversary action may become necessary. Determining is a particular provision of a divorce or separation agreement is in the nature of (a)(5) alimony, maintenance, or support, or whether it is properly classified as an (a)(15) debt obligation arising from property division or settlement is not always easy. One cannot assume that the judge or debtor’s attorney will properly classify or reclassify a debt. Depending on the goals of the client, a proactive adversary approach may be required. ■

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– *Continued from page 31*

and so practitioners tend to focus on it first when their case might be much easier made through another test.

Of course, debtors will almost always deny that such was their intention, so the test is effectively an objective test that looks at the totality of the facts and circumstance which surround the transaction to determine the debtor's intent with little regard for the debtor's self-serving denials.

To assist the court in making this determination, the UVTA includes in § 4(b) the so-called "Badges of Fraud", being a non-exclusive list of factors that the courts should look at in determining the debtor's intent. Whether the Badges are more helpful than harmful is dubious since courts frequently miss their entire purpose which is to highlight particularly telling facts and circumstances, and instead engage in an improper counting of the Badges to see who has the most. Indeed, the Uniform Fraudulent Conveyance Act ("UFCA"), as the predecessor to the UFTA/UVTA did not list any Badges, and § 548 of the U.S. Bankruptcy Code likewise eschewed the Badges. Probably the better position is to punt the Badges as a bad idea that has lingered too long.

The downside to any intent-based test is that it is very difficult for a creditor to win on summary judgment, and the debtor has an equal chance to convince a lay jury that no matter how egregious a particular transaction otherwise looks, there simply was no intent present to cheat creditors. The smart creditor will therefore look to satisfy any other test before resorting to the Intent Test, while novices will jump right into the Badges of Fraud and start floundering around there first.

A Final Word

The fundamental problem with the UVTA is its poor structure, which makes these tests much more difficult to discern and apply than the situation needs to be. To say that a complete redrafting of the UVTA is long overdue would be a substantial understatement. Hopefully, there will be a revised UVTA (RUVTA) in the not too distant future. ■

Tales from the Front

by Emory Potter, Esq.

Hays Potter & Martin, LLP

I have been asked to fill in for Tim Wan on his column while he has taken the cushy position of President of the Commercial Law League of America for the next year. I will do my best to fill his shoes, but, as I do not practice in Gotham City, the characters you have come to know and love will not be included in this column until his return.

Emory Potter is a construction, commercial and civil litigation attorney with extensive trial experience. His specialties include material man's lien practice, bond work related to construction, creditors' rights, and commercial collections, handling a large volume of litigation from initiation of suit through post-judgment collection.

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When I graduated from law school in 1991, I was married and unemployed in a job market that was far from stellar. In order to make ends meet, I had a job delivering pizza by night and was taking appointed misdemeanor criminal cases in the State Court of Fulton County by day. It was arranged like a cattle call. All defendants in cases where the public defender's office either had a conflict, or for some other reason could not handle, were sent to a large holding cell outside of the courtroom. The attorneys taking appointed cases signed in on a list near the bench. A name of an accused was called, along with the next attorney on the list. The newly appointed attorney then went to the holding cell, sounded for the accused's name and spoke with his/her client for the first time across the cell's steel bars. Once appointed, the fee was $50.00, flat. Plead them out that day: $50.00. Try the case to a jury: $50.00. I had a law degree and often made more money delivering pizzas later that evening than I did taking the appointed cases.

One day, I was waiting my turn and was appointed to represent Ernest T. Bass. I was informed he had been charged with criminal trespass for breaking into an abandoned building in downtown Mayberry. I went back to the holding cell and sounded for Mr. Bass. He worked his way through the crowd of other accused awaiting their new attorney and introduced himself.

I told him that this should be pretty easy to deal with, but I needed to ask him a few questions. He told me he had illegally entered the premises to get out of the rain. He reported no disputes with the arresting officer and no outstanding warrants.

"Do you have any prior convictions?" I asked.

"Yes sir, quite a few," he said, lowering his head, seemingly in shame.

"Any felonies?" I asked.

His head jerked back up, he looked me in the eye and adamantly said, "No Sir! I specialize in misdemeanors!"

"You are sure there are no felonies?"

"Completely"

I went back to meet with the solicitor on the case, Mr. Fife. I gave him the name of my client and his assistant, Juanita, handed him the file. At that time, criminal histories were printed out on alternatively green and white paper with holes down the side for the printer driver. The file was thick from the very large amount of computer printout paper rolled up inside. Mr. Fife looked at the file without opening it and said "Looks like Mr. Bass is not going anywhere any time soon!"

I offered to make a bet with Mr. Fife. I was willing to wager time served versus a one year sentence that there were no felonies anywhere on the criminal report. Both Fife and I knew that the County jail was so overfilled that he would get 3 for one on days served and had been in for a couple of months already, me losing would likely only account for a couple of weeks. Mr. Fife looked at the roll and informed me that he would have to speak with his boss, Mr. Griffith. He came over, looked at the big roll, and said "Sure, why not?"

The file was placed on the conference table and the criminal history report was unfurled across its full length and on the floor for another few feet or so. We all reviewed it together and there was not a felony to be seen. Time served.■

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