1.0 Law & Legal CLE Credit – A/V Approval #1065698

Recording Date – January 9, 2018
Recording Availability – March 6, 2018

Meeting Location	Date	Time	Topic
King County Bar Association 1200 Fifth Avenue - Suite 700 Seattle, WA	**Tuesday, January 9, 2018**	12:00 PM to 1:15 PM	Case Law Update & Local Practice Tips-Term Clerk Discussion of Recent Cases From Around the Ninth Circuit, Including New Case Law From the W.D. of Washington, and a Cheat Sheet for Your Local Procedural Questions

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AGENDA

12:00 PM Introduction

12:10 PM Presentation: 'Case Law Update & Local Practice Tips-Term Clerk Discussion of Recent Cases From Around the Ninth Circuit, Including New Case Law From the W.D. of Washington, and a Cheat Sheet for Your Local Procedural Questions', by Richard Keeton, term law clerk for Judge Christopher Alston, United States Bankruptcy Court; Gabe Reilly-Bates, term law clerk for Chief Judge Brian Lynch, United States Bankruptcy Court; and Samuel Dart, term law clerk for Judge Mary Jo Heston, United States Bankruptcy Court

- Case summaries and comments of recent Ninth Circuit decisions involving bankruptcy issues.
- Topics discussed include: equitable tolling, choice-of-law provisions in contracts, an update on forced vesting in Ch. 13 plans, trustee short sales, and some new decisions involving bankruptcy exemptions.
- Selected local bankruptcy-level decisions from the W.D. Washington, including new decisions on post-confirmation assets in Ch. 13., the date of valuation for post-confirmation lien strips, and trustee short sales.
- Practice tips for local procedures such as requesting telephonic hearings, issue preclusion in non-dischargeability proceedings, and some common mistakes

with 7004 service.

1:15 PM Adjourn

SPEAKER BIOGRAPHY

Richard Keeton, Term Law Clerk for Judge Christopher Alston, United States Bankruptcy Court – Richard Keeton is currently the term law clerk to the Honorable Christopher M. Alston at the U.S. Bankruptcy Court for the Western District of Washington at Seattle. Richard graduated from law school in 2015 from Texas Tech University and subsequently obtained an LL.M. degree from the University of Washington. During law school, Richard served as the editor-in-chief of the Business & Bankruptcy Law Journal and was published in the American Bankruptcy Law Journal. Prior to law school, Richard enjoyed a career in hospitality operations and management at fine hotels in Seattle and Las Vegas.

Gabe Reilly-Bates, Term Law Clerk for Chief Judge Brian Lynch, United States Bankruptcy Court – Gabe Reilly-Bates is a law clerk for the Honorable Brian D. Lynch, Chief Judge of the United States Bankruptcy Court for the Western District of Washington in Tacoma. Gabe Reilly-Bates is a 2003 graduate of Northwestern University School of Law. He practiced in Chicago in the bankruptcy practice group of Jenner & Block LLP and in the commercial litigation group of Shefsky & Froelich Ltd., which merged into Taft Stettinius & Hollister LLP in 2014.

Samuel Dart, Term Law Clerk for Judge Mary Jo Heston, United States Bankruptcy Court – Mr. Dart is a term law clerk for the Honorable Mary Jo Heston, United States Bankruptcy Judge-Tacoma. Prior to clerking for Judge Heston, Mr. Dart worked as a staff attorney for the Chapter 13 Trustee for Tacoma/Vancouver. Mr. Dart is also the author of several articles on bankruptcy issues including "A Brief Guide to Analyzing the Fairness of Student Loan Discrimination" NACTT Academy, January 25, 2015 and "Selected Issues with Reaffirmation Agreements" in the Eastern District of Washington Bar Association's journal, Notes (2014). Mr. Dart graduated from Gonzaga University School of Law in 2014 where he served as an articles editor/executive board member for the Gonzaga Journal of International Law and was on the winning team for the 78th Linden Cup appellate advocacy competition.

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Ninth Circuit Case Law Update &

Local Practice Pointers

Presented By: Gabe Reilly-Bates, Richard Keeton, and Samuel Dart

The Automatic Stay

Post-petition Collection Actions

- *Dingley v. Yellow Logistics, LLC et al (In re Dingley)*, 852 F.3d 1143 (9th Cir. 2017) - Government regulatory exception prevented creditor's continued participation in civil contempt proceedings against the debtor from violating the stay.
- *Porter v. Nabors Drilling USA, L.P.*, 854 F.3d 1057 (9th Cir. 2017) - A Creditor Suing a Debtor as a "Private Attorney General" Does Not Fall Under the Governmental Regulatory Exception under §364(b)(4)).
- *In re Gray*, 567 B.R. 841 (Bankr. W.D. Wash. 2017) (J. Lynch) - Failure to quash bench warrants violated the stay.
- *In re Bayley,* 678 F. App'x 593 (9th Cir. February 27, 2017) - Failure to instruct Sheriff to turnover levied funds is a violation of the stay.

Negative Credit Reports

- *In re Keller*, 568 B.R. 118, 122 (B.A.P. 9th Cir. 2017) - Reporting delinquent payments not an a violation unless the purpose of the reporting was an attempt to coerce the payment of a debt.

Exemptions Post-*Law v. Siegal*

Law v. Siegel, 134 S. Ct. 1188, 1192, 188 L. Ed. 2d 146 (2014). Supreme Court held that a court cannot surcharge a debtor's otherwise legitimate homestead exemption "absent a valid statutory basis for doing so," and further explained that the federal bankruptcy statutes do not provide a statutory basis for denying an exemption due to a debtor's general bad faith. *Id.* at 1196-97.

Impact: Creditors can no longer object to federal exemptions based upon the debtor's bad faith or the fact that creditors were prejudiced "absent a valid statutory basis for doing so."

Objections Still Available

- State law based exemptions are still subject to state law defenses

  -*In re Gray*, 523 B.R. 170, 175 (B.A.P. 9th Cir. 2014) (Case remanded to consider state law equitable defenses).

  -*In re Elliott*, 523 B.R. 188, 194 (B.A.P. 9th Cir. 2014) (same).

  -*In re Aubry*, 558 B.R. 333, 351 (Bankr. C.D. Cal. 2016) (equitable estoppel applied to bar late amendment after Trustee expended resources).

  -*In re Lua*, 692 F. App'x 851, 852 (9th Cir. 2017) (Ninth Circuit considered, and rejected, Trustee's defense of equitable estoppel).

Some Other State Law Defenses to Washington Homestead Exemptions

- (1) Good Faith
  - Although no state-law based exemption has been disallowed by a bankruptcy court in Washington, Washington state courts have disallowed homestead exemptions on the basis of bad faith. *Webster v. Rodrick*, 64 Wn.2d 814, 816, 394 P.2d 689 (1964) (Embezzled funds could not be protected by a homestead exemption).
- (2) Homestead Must Be Located in Washington
  - *In re Wieber*, 182 Wash. 2d 919, 921, 347 P.3d 41, 42 (2015), the Washington Supreme Court held that "Washington's homestead exemption law does not apply to property located in other states." *Id.* at 31.

§ 522(g) - Property Recovered by the Trustee

- Under 11 U.S.C. 522(g), property recovered by the Trustee under §§ 510, 542, 543, 550, 551 or 553 may not be exempted if (1) the transfer was not a voluntary transfer and (2) the debtor did not conceal the transfer.
  - *In re Elliott*, 692 F. App'x 472 (9th Cir. 2017) (Property recovered in a turnover action under §542 may not be exempted).
  - *In re Yan Sui*, 2016 WL 3267352, at *2 (B.A.P. 9th Cir. June 6, 2016), aff'd, 691 F. App'x 372 (9th Cir. 2017) (property transferred pre-petition that was concealed that was recovered by trustee not exemptable)

The “Snapshot” and “Stop Clock” Rules

- “Snapshot Rule”

  -The Debtor’s right to amend is based upon their rights as of the date of their petition. *In re Earl*, No. 16-16428, 2017 WL 5663486, at *1 (9th Cir. Nov. 27, 2017) (Debtor could not claim exemption in home she did not reside in on petition date, after her first residence was foreclosed upon).

- “Stop Clock Rule”

  -*In re Milby*, **875 F.3d 1229** (9th Cir. 2017) (Ninth Circuit combined equitable tolling and “Stop Clock” analysis to give the trustee nearly an additional year to pursue and avoidance action).

§363 Sales and Abandonment

- Sale provisions apply to estate's claims as well as property

  -*Adeli v. Barclay* (*In re Berkeley Del. Ct., LLC*), 834 F.3d 1036 (9th Cir. 2016)

  Disposition of claim held by estate may result in use of § 363 sale provisions.

  -*Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC* (*In re Spanish Peaks Holdings II, LLC*), 872 F.3d 892 (9th Cir. 2017)

  Trustee may sell property free and clear of lease claims notwithstanding § 365(h).

- Creating value with a secured IRS claim

  -*In re Gill*, 574 B.R. 709 (9th Cir. BAP 2017).

  Trustee defeated debtor's abandonment motion through preservation of penalty portion of IRS lien.

Arbitrability and Choice of Law

- Regarding core matters, bankruptcy court has the discretion to weigh competing interests of Bankruptcy Code and Federal Arbitration Act.

  -*Kirkland v. Rund* (*In re EPD Inv. Co. LLC*), 821 F.3d 1146 (9th Cir. 2016)

  -*Farmer v. Navient Solutions, LLC* (*In re Farmer*), 567 B.R. 895 (Bankr. W.D. Wash. 2017) (Memorandum Decision) (J. Alston), *aff'd* 2017 WL 4619209 (W.D. Wash. 2017)

- Choice-of-Law in contract must specifically identify the applicable statute of limitations

  -*PNC Bank v. Sterba (In re Sterba)*, 852 F.3d 1175 (9th Cir. 2017)

Chapter 13 Update

- Vesting & Liquidation issues with post-confirmation property

  -*In re Villegas*, 573 B.R. 844 (Bankr. W.D. Wash. 2017)
  Property acquired after confirmation must be added to liquidation value in modified plan but debtor may cover the amount with disposable income already committed.

  -*Bank of New York Mellon v. Watt*, 867 f.3d 1155 (2017)
  Case dismissed but Ninth Circuit provides hope and some lessons for preserving appeals involving plan confirmation.

Chapter 13 update cont’d

- New Claim Filing Rules
  - Old rule- [Chapter 7, 12, and 13], 90 days after the first date set for the meeting of creditors. Fed. R. Bankr. P. 3002 (2017)
  - New rule- 70 days after the order for relief, or after the order of conversion if the case is converted to a Chapter 12 or 13. Fed. R. Bankr. P. 3002(c) (Eff. Dec. 1, 2017).
- For most cases this change will mean <u>months</u> less time to file a claim.
- Rule now expressly applies to <u>secured claims</u>

Local Practice Pointers

- Telephonic Participation
  - -Follow the procedure for each chambers
  - -Last minute requests are disfavored
  - -Know if you are "local counsel"
  - -Use the ECF event to file a letter

- Applications for employment
  - -If you started working before getting employed, the application is *nunc pro tunc* and you will need to address the factors in *Atkins v. Wain, Samuel & Co. (In re Atkins)*, 69 F.3d 970 (9th Cir. 1995).

Local Practice Pointers-Lien Avoidance

- Lien Avoidance Motions

  -Motion must include evidence of:

  1. the value of the subject property;
  2. the amount of the lien movant seeks to avoid;
  3. the amounts of all other liens on the property;
  4. the priority of the liens; and
  5. the recordation of the lien (or whether it was not recorded)

  -A motion to avoid a lien requires service compliant with FRBP 7004

  - For *Individuals*: Service by regular mail, to the individual's home address. BR 7004(b)(1)
  - For *Business Entities*: Service by regular mail, to an officer or managing agent, or to registered agent authorized to receive service. BR 7004(b)(3)
  - For *Insured Depository Institutions*: Service by certified mail, to an officer. BR 7004(h)

  -Motions for Lien Avoidance must provide for at least 28 days' notice. LBR 9013-1(d)(2)(D)

Local Practice Pointers-Traffic Tickets

Section 1328(a) provides a debtor with a "superdischarge" which includes civil fines and traffic tickets, but not criminal traffic tickets or fines.

-RCW 46.63.020 provides that all traffic offenses are not criminal, unless they fall within the 67 enumerated sections. (e.g. DUI, driving without a license, etc.).

-A debtor may separately classify nondischargeable criminal traffic fines and provide different treatment for them if the debtor satisfies the four-part test set forth in *In re Wolff*, 22 B.R. 510 (9th Cir. BAP 1982).

-To satisfy the *Wolff* test, a Ch. 13 plan should pay all unsecured creditors *pari passu* for the first 36 months of a plan, after which a debtor may discriminate against other unsecured creditors by paying criminal fines ahead of others if the debtor has a reasonable basis.

NINTH CIRCUIT BANKRUPTY CASE LAW UPDATE

&

LOCAL PRACTICE POINTERS

Presented by:

Gabe Reilly-Bates, Richard Keeton, and Samuel Dart

*These materials are intended as an informational resource only and do not reflect the opinion of the United States Bankruptcy Court. Readers should perform their own research and consult the chambers procedures of each judge.

RECENT CASES FROM AROUND THE NINTH CIRCUIT

Relief from Stay Violations

1. **Civil Contempt Proceedings May Be Exempt from the Automatic Stay If They Are Not Intended Either to Protect the Government's Pecuniary Interest in the Debtor's Property or to Adjudicate Private Rights**

As the Ninth Circuit recently noted in *Dingley v. Yellow Logistics, LLC et al (In re Dingley)***,** 852 F.3d 1143 (9th Cir. 2017), "once a debtor files for bankruptcy, the Bankruptcy Code imposes an automatic stay prohibiting creditors from attempting to collect pre-petition debts against the debtor. This rule, however, is subject to certain statutorily-enumerated exceptions." *Id.* at 1144. In *Dingley*, the Ninth Circuit considered whether a creditor's post-petition collection efforts fell under the government regulatory exception under §362(b)(4).

After the Debtor, Mark Dingley ("Dingley") failed to appear for a deposition in the Nevada action, the state court imposed discovery sanctions in the approximate amount of $4,000. After the state court set a date for the hearing on a subsequent show cause order, Dingley filed for Chapter 7 bankruptcy. Following notification by Dingley's counsel of the bankruptcy filing, the state court set a briefing schedule for the parties to address the impact of the automatic stay on the pending civil contempt proceedings. The creditor Yellow complied with the Nevada court order and filed supplemental briefing arguing that civil contempt proceedings are not automatically stayed pursuant *David v. Hooker, Ltd.*, 560 F.2d 412 (9th Cir. 1977). Rather than file his own brief, Dingley moved for sanctions in the bankruptcy court pursuant to 11 U.S.C. § 362(k) contending that Yellow violated the stay by filing the supplemental brief in the Nevada action.

The bankruptcy court sided with Dingley but did not address whether the *Hooker* decision, decided one year prior to the enactment of the Bankruptcy Code, controlled the outcome of the case. The Ninth Circuit Bankruptcy appellate panel reversed, reasoning that under *Hooker*, a civil contempt proceeding is only stayed if the substance of the proceeding turns on the collection of an underlying debt or it is merely a ploy to harass the debtor. Dingley timely appealed to the Ninth Circuit and the court affirmed, albeit on a different basis.

Rather than affirm the Bankruptcy Appellate Panel on the basis that *Hooker* was still good law after the enactment of the Bankruptcy Code, the Ninth Circuit

determined it was unnecessary to reach the question in light of the plain language of the government regulatory exception of §362(b)(4). *Dingley*, 2017 WL 1208454, at *3. The Ninth Circuit followed its precedent in court awarded sanctions against the debtor for filing a frivolous appeal. 230 F.3d at 1167

It noted that there are two methods relied upon within the circuit to determine whether a certain action falls within the government regulatory exception: (1) the pecuniary purpose test and (2) the public policy test, the Ninth Circuit found that neither test subjected the Nevada sanctions proceedings to the automatic stay. This was true even though Yellow, a creditor, was the party prosecuting the action and filing briefs. “If the court determines that the government’s action is intended either to protect the government’s pecuniary interest in the debtor’s property or to adjudicate private rights, the government regulatory exemption will not apply.” *Id.* It is not determinative that a private party may initially pursue the resulting sanction or that any sanctions award is payable to a private party. *Id.* at *4. Since Yellow’s pursuit of collection actions in the Nevada state court was to effectuate that court’s public policy interest in deterring certain kinds of litigation misconduct, the Ninth Circuit concluded that sanctions proceedings fit within the government regulatory exemption of the Bankruptcy Code.

Bankruptcy practitioners must remain aware of activities in the underlying state court case. Clients may fail to inform counsel that a state court has imposed deadlines, issued show cause orders, or undertaken other courses of action potentially resulting in sanctions. Without an automatic stay, actions taken by the creditor are not void even if the bankruptcy was filed first. However, the *Dingley* decision does not prevent a debtor from requesting a bankruptcy court stay the action on the basis that the civil contempt proceedings are merely a charade to force payment of a debt dealt with in the bankruptcy. Additionally, bankruptcy courts may be inclined to limit the scope of *Dingley* to its facts to avoid erosion of the automatic stay provision.

2. A Creditor’s Failure to Quash a Bench Warrant Is a Violation of the Stay

In *In re Gray*, 567 B.R. 841 (Bankr. W.D. Wash. 2017) (J. Lynch), the debtors brought an adversary proceeding against a creditor and a collection agency under 11 U.S.C. § 362(k)(1) when they failed to have bench warrants for the arrest of the debtors quashed after they learned of debtors' bankruptcy filing. *Id.* at 843. The creditors’ asserted in their defense that the government regulatory exception to the stay under §362(b)(4) applied in addition to claiming that the violation of the stay was not willful. *Id.*

In *Gray*, the debtors had failed to show up for a supplemental proceedings hearing, so the creditor's debt collection company filed a motion to issue bench warrants. *Id.* The motion was mailed before the debtors filed their Ch. 7 petition, but was granted after the debtors' petition was filed on March 25, 2016. *Id.* A little over a week later, the debt-collection company received notice of the debtors' bankruptcy, but failed to quash the bench warrant, and consequently, the debtors were later arrested pursuant to the bench warrant. The debtors had not received any notice of the motion for the bench warrant or the order allowing it.

The bankruptcy court held that the creditors' actions did not fall within the governmental regulation exception specified in §364(b)(4). It distinguished *Dingley*, and held that there was no litigation misconduct by the debtors; rather, the creditors were merely attempting to collect a debt which would ultimately be dischargeable in the debtors' bankruptcy.

The court also held that the creditors willfully violated the stay after it concluded that Defendants "had an affirmative duty, upon learning of Plaintiffs' bankruptcy filing, to contact the Cowlitz County Superior Court and inform them of the bankruptcy filing and ensure the orders issuing bench warrants and the bench warrants themselves were quashed." *Id.* at 846.

A non-debtor party has an affirmative duty to ensure it is in compliance with the automatic stay. *See Sternberg v. Johnston*, 595 F.3d 937, 943–44 (9th Cir. 2010). The court noted that fifty days passed from when Defendants became aware of the bankruptcy filing, and the arrest of the Plaintiffs at their home on the bench warrants. *Gray*, 567 B.R. at 846.

3. A Creditor Suing a Debtor as a "Private Attorney General" Does Not Fall Under the Governmental Regulatory Exception under §364(b)(4)

In *Porter v. Nabors Drilling USA, L.P.*, 854 F.3d 1057 (9th Cir. 2017), the Ninth Circuit considered whether the government regulatory exception to the automatic stay applies to claims brought by individuals pursuant to California's Private Attorney General Act of 2004 ("PAGA"), which allows individuals to pursue labor violations on behalf of the state.

The Ninth Circuit held that there was insufficient governmental involvement to qualify for the governmental regulatory exception as §364(b)(4) requires involvement ""by a governmental unit . . . to enforce such governmental unit's . . . police and regulatory power." Id. at 1062 (9th Cir. 2017). The Ninth Circuit noted the definition of a "governmental unit" found in 11 U.S.C. § 101(27) is not broad enough to cover a private citizen suit and the creditor conceded he did not fall

within that definition. Likening PAGA actions to qui tam claims, the Court resolved that absent intervention by the actual governmental unit, a private citizen suit simply was not an act by a "governmental unit" to enforce its police and regulatory power.

The creditor argued that under *Dingley*, its actions fell were covered under the §364(b)(4) governmental regulatory exception. The Ninth Circuit distinguished the analysis in *Dingley* because the sanctioning court conducted the additional proceedings to advance its own interests, even where first requested by a party in the litigation. By contrast, at no time did any governmental agency participate in the creditor's lawsuit or in any way control the litigation. The Ninth Circuit noted that while an ultimate sanction might be issued by the court, the initial bringing of the lawsuit was not undertake on behalf of the court, but on behalf of the state labor agency. Therefore, unlike in *Dingley*, the PAGA claim was subject to the automatic stay.

4. Post-petition Negative Credit Reporting is Not a Per Se Violation of the Automatic Stay under §362(a)(6)

In *In re Keller*, 568 B.R. 118, 122 (B.A.P. 9th Cir. 2017), the Ninth Circuit Bankruptcy Appellate Panel held that postpetition credit reporting of overdue or delinquent payments, without more, does not violate the automatic stay as a matter of law. However, the BAP cited authority from other jurisdictions holding that the reporting could potentially be a violation of the automatic stay if the specific purpose of the reporting was to attempt to coerce the payment of the debt. Notwithstanding *Keller*, it is still probably best to advise your clients to avoid reporting delinquent debts post-petition.

5. Creditor Had Affirmative Duty to Instruct Sheriff to Turnover Levied Funds to Estate

The Ninth Circuit affirmed a bankruptcy and district court's decisions that a creditor had violated the automatic stay when it failed to direct the Sheriff to release levied funds back to the debtor's estate. *In re Bayley*, 678 F. App'x 593 (9th Cir. February 27, 2017). In *Bayley*, the Ninth Circuit noted that under 11 U.S.C. § 362(k)(1), a violation of the automatic stay is willful "if [the] party knew of the automatic stay, and its actions in violation of the stay were intentional." *Id.* at 593. It noted that the debtor immediately informed the creditor of the automatic stay and found that the creditor was aware of the effects of the automatic stay. *Id.* at 594. Despite

that knowledge, the creditor instructed the Sheriff to hold the levied funds rather than return them to the estate. *Id.* The Ninth Circuit awarded the debtor attorney's fees for bringing its action to enforce the stay, including for all appeals. *Id.*

The Ninth Circuit has recently clarified that a debtor is entitled to all attorney's fees incurred in prosecuting an action for damages under § 362(k). *In re Schwartz-Tallard*, 803 F.3d 1095, 1101 (9th Cir. 2015). In *Schwartz-Tallard*, the Ninth Circuit reversed its previous ruling under *Sternberg v. Johnston*, 595 F.3d 937, 948 (9th Cir. 2010), that had not allowed the recovery of attorney's fees for stay violations. In *Sternberg*, the Ninth Circuit had held that held that attorneys' fees under § 362(k) are limited to "those attorney fees related to enforcing the automatic stay and remedying the stay violation, not the fees incurred in prosecuting the bankruptcy adversary proceeding in which he pursued his claim for those damages." *Id.* at 940.

An award of punitive damages in an action for damages under § 362(k) requires "some showing of reckless or callous disregard for the law or rights of others." *In re Snowden*, 769 F.3d 651, 657 (9th Cir. 2014); (citing *In re Bloom*, 875 F.2d 224, 228 (9th Cir.1989)).

<u>Exemption Cases in the Wake of *Law v. Siegel*</u>

1. *Law v. Siegel*

In *Law v. Siegel*, 134 S. Ct. 1188, 1192, 188 L. Ed. 2d 146 (2014), the Supreme Court held that a court cannot surcharge a debtor's otherwise legitimate homestead exemption "absent a valid statutory basis for doing so," and further explained that the federal bankruptcy statutes do not provide a statutory basis for denying an exemption due to a debtor's general bad faith. *Id.* at 1196-97. In *Law v. Siegel*, the Supreme Court struck down a lower court's $75,000 surcharge of a debtor's exemption after the Trustee had successfully challenged a sham lien that the debtor had placed on his property in an effort to preserve his equity in the property. *Id.* at 1195.

Prior to *Law v. Siegel*, bankruptcy courts throughout the country, including courts in the Ninth Circuit, denied leave to amend or disallowed a claimed exemption if the trustee or other party in interest timely objected and showed that either: (1) the debtor acted in bad faith; or (2) creditors were prejudiced. *See Martinson v. Michael (In re Michael)*, 163 F.3d 526, 529 (9th Cir. 1998).

However, dicta in *Law v. Siegel* suggests that if a debtor asserts a state law based exemption, then all of the state law defenses to an exemption come into play.

(including, without limitation, equitable estoppel, bad faith, etc.) The dicta stated that it is "true that when a debtor claims a state-created exemption, the exemption's scope is determined by state law, which may provide that certain types of debtor misconduct warrant denial of the exemption." *Id.* at 1196-97. Below are some examples of cases from Ninth Circuit Courts as well as other possible grounds for challenging exemptions.

2. State Court Exemptions Are Subject to "State Law" Defenses

a. In *In re Gray*, 523 B.R. 170, 175 (B.A.P. 9th Cir. 2014), the Ninth Circuit BAP remanded a case to the bankruptcy court after the bankruptcy court had held that the Trustee was not entitled to rely on equitable defenses to object to the exemption. In *Gray*, the debtors attempted to claim an exemption over previously undisclosed rent after the Ch. 7 Trustee questioned a payment of $2,707.00 made to their landlord. *Id.* at 171. The bankruptcy court denied the debtors' request to amend the exemption, finding that the debtors acted in bad faith and concealed their prepaid rent. The debtor's exemption was based upon Arizona state law under Ariz. Rev. Stat. Ann. § 33–1126(C), as Arizona has opted out of the federal exemption scheme. *Id.* at 175.

   On review, the Ninth Circuit BAP determined that but for the allegation of bad faith, the debtor's exemption was presumptively valid, and that it did not appear that the bankruptcy court considered whether Arizona's exemption laws might allow an equitable defense. *Id.* The BAP remanded the matter to give the bankruptcy court the opportunity to determine whether under Arizona law, equitable considerations may be used to disallow exemptions. *Id.*

b. In *In re Elliott*, 523 B.R. 188, 194 (B.A.P. 9th Cir. 2014), the Ninth Circuit BAP rejected a Trustee's objection to a debtor's exemption under *Law v. Siegel*, but remanded the case noting that "state law governing California's homestead exemption criteria and the Code's limitations on exemptions may provide another basis to deny [the debtor's] claimed homestead exemption in the [property]."

c. In *Kornhauser v. Block*, the Ninth Circuit BAP considered whether there was a state basis under Nevada law that would permit the bankruptcy court to deny an exemption on a bad-faith ground, but determined that there was no statutory authority under Nevada law. *In re Block*, 2016 WL 3251406, at *6

(B.A.P. 9th Cir. June 3, 2016). It therefore permitted the Debtor to amend his exemption claimed under state law. *Id.*

d. *In re Aubry*, 558 B.R. 333, 351 (Bankr. C.D. Cal. 2016), a bankruptcy court denied a debtor's late amendment to her exemptions to claim an annuity exempt after the Trustee had expended considerable resources to liquidate the annuity, finding that "Debtor's amended exemption in the [a]nnuity should be disallowed based on application of California's doctrine of equitable estoppel." *Id.* at 350.

e. In *In re Lua*, a debtor's initial schedules did not list a homestead exemption, but after three years of litigation with the Ch. Trustee, the debtor amended her schedules and claimed a state-law exemption over her property. *In re Lua*, 692 F. App'x 851, 852 (9th Cir. 2017). The Ch. 7 Trustee objected, claiming the debtor should be equitably estopped from amending her schedules after he had expended resources in the litigation. The bankruptcy and district courts both sustained the trustee's objections. The Ninth Circuit, reversing the lower courts, held that the debtor's initial schedules could not form the basis of equitable estoppel, because the Trustee could not rely upon the representations in the schedules. *Id.* at 852. It held that the Trustee knew or should have known, that in the event circumstances changed, that Lua could amend her exemptions "as a matter of course. . . ." *Id.* In part, the Ninth Circuit relied upon the fact that the Debtor's circumstances had changed after the bankruptcy court entered an order finding that the debtor's residential property was 100% community property, which provided the debtor with a new factual basis to claim a homestead exemption.

These are examples of courts applying common law "state law" defenses to state-law based exemptions. It offers two lessons: (1) as a creditor, you may assert state law equitable defenses to a claim of an exemption, and not only those that are statutorily based and (2) from a debtor's perspective, it is always advisable to inform the Trustee of your intention to amend your schedules in the future to defeat a potential equitable estoppel defense to a new exemption.

Note: Washington bankruptcy courts have not invalidated a state-law based exemption based on the Debtors' bad faith post-*Law v. Siegel*, but the Washington Supreme Court has invalidated a homestead exemption based upon the Debtor's bad faith. *Webster v. Rodrick*, 64 Wn.2d 814, 816, 394 P.2d 689 (1964) ("A constant running "thread"

throughoutWashington's homestead exemption jurisprudence is a requirement that a homestead exemption be filed in 'good faith.' ") (citing *Barouh v. Israel*, 46 Wn.2d 327, 332, 281 P.2d 238 (1955)). In *Webster*, an employee embezzled funds from her employer to benefit the marital community. The employer sued to recover the embezzled funds and obtained a money judgment against the employee both individually and against her marital community. Prior to judgment, the defendant employee filed a declaration of homestead upon the property occupied by them as a residence. Shortly thereafter, the trial court concluded that "the funds were misappropriated for the purpose of benefiting the community," and that the "community was unjustly enriched at the expense of the plaintiff." *Id.* at 815. The trial court then entered judgment for the employer and against the employee and the marital community. *Id.*

The plaintiff employer attempted to have the employee's home sold to satisfy the judgment. The defendant employee sought to quash the writ of execution, relying on the declared homestead exemption. The employer then attacked the validity of the exemption and asked the court to declare the homestead invalid. The trial court denied the employer's request, which decision was reviewed on appeal. *Id.* at 816. The Washington Supreme Court reversed and remanded with directions to grant the motion to declare the homestead invalid. The Washington Supreme Court identified the ways in which the employee's illicit activity went to benefit the community and were traceable to the property claimed as the homestead. *Id.* at 818.

3. Other Statutory Bases for Objecting to Exemptions in the Code

a. In *In re Elliott*, 692 F. App'x 472 (9th Cir. 2017), the Ninth Circuit held that §522(g) provided a valid statutory basis for the bankruptcy court's disallowance of the debtor's claimed exemption after the Trustee recovered the debtor's property in a turnover action under §542. Section 522(g) allows a debtor to exempt property that is recovered by the trustee only if the transfer was not a voluntary transfer and the debtor did not conceal the transfer.

   Note that for this exception to apply, the Trustee actually has to "recover" the property under §§ 510, 542, 543, 550, 551 or 553. Previously undisclosed property in the debtor's possession would not qualify. *In re Fuentes*, 687 F. App'x 542, 544–45 (9th Cir. 2017) (where the parties agreed that the debtors neither transferred the Property nor concealed the Property. (citing *Glass v. Hitt (In re Glass)*, 60 F.3d 565, 568–69 (9th Cir. 1995) (explaining what is required for 11 U.S.C. § 522(g)(1) to apply). *Glass*

held that a full adversary proceeding or a judicial determination was not required to constitute a “recovery” – it could be less.

b. In *In re Yan Sui*, 2016 WL 3267352, at *2 (B.A.P. 9th Cir. June 6, 2016), aff'd, 691 F. App'x 372 (9th Cir. 2017), the Ninth Circuit Bankruptcy Appellate Panel affirmed a bankruptcy court’s decision that a Debtor was not entitled to claim a homestead exemption after the Trustee recovered the Property because he voluntarily transferred it prepetition and then concealed the Property once he filed his bankruptcy case. *Id.* at *2.

4. The “Snapshot Rule” – Exemption Rights Are Determined as of the Petition Date

In *In re Earl*, No. 16-16428, 2017 WL 5663486, at *1 (9th Cir. Nov. 27, 2017) the Ninth Circuit reaffirmed the “snapshot rule” which provides that “bankruptcy exemptions are fixed at the time of the bankruptcy petition.” *In re Jacobson*, 676 F.3d 1193, 1199 (9th Cir. 2012); *White v. Stump*, 266 U.S. 310, 313, 45 S.Ct. 103, 69 L.Ed. 301 (1924). In *Earl*, the debtor filed a Ch. 13 case in October 2013, and she scheduled two residential properties. She claimed a homestead exemption on one of the properties, but after the debtor was unsuccessful in challenging a foreclosure on the property, the Debtor amended her schedules to claim an exemption on the other residential property.

The Ninth Circuit noted that while a debtor may amend his or her exemptions “as a matter of course any time before the case is closed, the debtor’s right to an exemption is “determined based on the debtor’s rights on the petition date. *Id.* at 1. Because the Debtor did not reside in the Sunnyvale property at the time she filed for bankruptcy, and because Arizona law “requires at least the physical presence of the individual claiming a homestead exemption,” the Ninth Circuit held that the debtor waived any right to claim she was entitled to an exemption for the residential property in which she did not reside as of the date of the filing of her petition.

5. Washington’s Homestead Exemption Only Applies to Residences Located in Washington State

In *In re Wieber*, 182 Wash. 2d 919, 921, 347 P.3d 41, 42 (2015), the Washington Supreme Court considered the question of whether “the Washington homestead exemption law, RCW 6.13.010–.240, apply extra-territorially to real property located in other states?” *Id.* at 921. A bankruptcy court from the Western District of Washington had certified the question after a Ch. 13 debtor claimed an exemption over property located in Ketchikan, Alaska. *Id.* The Washington

Supreme Court answered the question in the negative, holding that "Washington's homestead exemption law does not apply to property located in other states." *Id.* at 31.

Equitable Tolling, Abandonment & Valuation

1. **Equitable tolling allows a trustee to file an avoidance action nearly a year after the normal statutory period even though the trustee became aware of the cause of action before the limitations period ran.**

   ***In re Milby*, 875 F.3d 1229 (9th Cir. 2017).** Mere days before expiration of the two-year limitation period for avoidance claims on September 22, 2013, a group of creditors alerted the Chapter 7 trustee to potential causes of action based on allegedly fraudulent transfer. The trustee declined to pursue the claims and instead chose to file an unrelated avoidance action on September 19, 2013. The trustee eventually settled the unrelated claims in August 2014. Before the bankruptcy court could approve the claims, the same creditors that alerted the trustee to additional fraudulent activity again approached the trustee to see if the creditors could pursue the claims either on behalf of the estate or derivately on behalf of one of the debtor's companies. The trustee agreed and the court appointed the creditors to pursue an avoidance action on September 16, 2014. The creditors filed a complaint the next day.

   The debtor moved for summary judgment, alleging that the complaint was barred by the two year statute of limitation. The creditors countered that equitable tolling applied because the debtor had failed to disclose the transfers to the trustee and had failed to cooperate with the trustee's discovery requests.[1] The bankruptcy court sided with the debtor and dismissed the complaint as untimely based on the trustee's delay in filing the action after discovering the claims. On appeal, the Ninth Circuit BAP reversed, holding that post-discovery delay was not relevant to the determination of whether equitable tolling applied. Debtor appealed and the Ninth Circuit affirmed after clarifying the law on equitable tolling.

   In its decision, the Ninth Circuit determined that neither the bankruptcy court nor the BAP had correctly applied the law regarding equitable tolling. The doctrine of equitable tolling is an exception to the ordinary claim processing rules where the party seeking to establish equitable tolling establishes: (1) that the party has been pursuing its rights diligently, and (2) some extraordinary circumstance stood in the way of timely filing. *Gibbs v. Legrand*, 767 F.3d 879, 884-85 (9th Cir. 2014). The

[1] The debtor's discovery abuses were substantial enough to cause the bankruptcy court to deny the debtor's discharge as a discovery sanction.

bankruptcy court found that the debtor's egregious conduct qualified as an extraordinary circumstance in order to apply equitable tolling, but that the trustee's delay in filing the complaint (or handing the task off to the creditors) did not establish diligence in pursuing the claim.

Starting with the bankruptcy court, the Ninth Circuit determined that the bankruptcy court erred when it concluded that the trustee failed to act diligently after discovering the transfers. Instead, "it is 'diligence *during* the existence of an extraordinary circumstance [that] is the key consideration.'" *Milby*, 875 F.3d at 1233 (internal quotations omitted) (emphasis in original). Although the bankruptcy court incorrectly assumed that diligence after discovery precluded equitable tolling, the BAP made the mistake of assuming that this fact was never relevant.

The Ninth Circuit reaffirmed that a litigant's diligence after discovering the claim is not given the same weight as diligence during the time prior to discovery. Instead, the Ninth Circuit confirmed that the "stop-clock" rule applies to tolling of the two-year period in §546(a)(1). This means that the event tolling the statute effectively "stops the clock" until a later event (discovery) permits the statute to resume running. *Milby*, 875 F.3d at 1234. In *Milby*, the trustee's diligence during the first nearly two-year period did not require the filing of a complaint in the few days remaining before the two year deadline. Instead, filing the fraudulent transfer complaint nearly a year after discovery was timely under the circumstances because the trustee exercised diligence and was therefore entitled to an extended time for filing a complaint.

2. **The trustee may avoid and preserve the penalty portion of an IRS lien against a debtor's residence to create a benefit to the estate and prevent abandonment.**

In re Gill, **574 B.R. 709 (9th Cir. BAP 2017).** In 2009, Debtor purchased a residence in Beaverton, Oregon for $310,000. Creditor Kirresh held the promissory note secured by the residence. After defaulting on the Kirresh note in 2015, the Debtor filed a Chapter 13 bankruptcy case, which he subsequently converted to a Chapter 7. Prior to the Debtor's conversion of the case, Kirresh filed a secured proof of claim in the amount of $368,558.57. The IRS also filed a secured claim for $211,586.87, with $161,530 secured and $48,276.33 attributable to tax penalties.

Kirresh subsequently moved for relief from stay. The Debtor claimed the residence had a value of $500,000 in his schedules and disclosed about $48,000 of dischargeable unsecured debt, with the remainder nondischargeable student loans. The creditor claimed that relief from stay was appropriate because

between the Kirresh lien, now $371,000, and the IRS lien, the Debtor had no equity in the property. The Debtor opposed the motion, arguing that the value was increasing and there was equity above the liens.

After Kirresh and the Chapter 7 trustee entered into a stipulation to allow the estate time to sell the residence, the Debtor filed a motion to compel abandonment of the property. The Trustee defended against abandonment by pointing out that he could avoid, subordinate, and preserve the penalty portion of the IRS lien for the benefit of the unsecured creditors pursuant to §§ 724(a), 726(a)(4) and 551. Furthermore, the Debtor's homestead exemption was subject to the IRS lien, so unless the lien was satisfied, there were no proceeds for the exemption. The Debtor countered by arguing that his $500k value was based on completing deferred maintenance.

At the evidentiary hearing on the value of the residence, the Debtor presented a report from a realty group supporting a value of $516,720 for the residence and a lower "comp analysis value" of $434,039, along with estimated repairs of $74,991. The Trustee presented a comparable list prepared by a realtor who also provided a supporting valuation of $539,000, though the realtor had not sold any homes in the area in the past 12 months. Ruling from the bench the Court determined that the value of the residence was $500k, as scheduled by the Debtor and therefore denied the motion to abandon because of the trustee's ability to realize a sale that would benefit the estate.

Despite Debtor's contention that the court should have discounted the property for the cost of repairs he testified that the property required, the bankruptcy court was entitled to reject this testimony and rely on the value in the schedules. Furthermore, the Debtor attempted to use a higher value when it suited him in the relief from stay proceedings.

The bankruptcy court was also correct that the trustee could avoid the penalty portion of the IRS lien and preserve it for the estate. Although the Kirresh and IRS liens exceeded the value of the residence, the trustee's ability to subordinate the penalty portion of the IRS claim for the benefit of other creditors was sufficient to show that the residence held value for the estate. "The purpose of § 724(a) is to protect unsecured creditors from the debtor's wrongdoing… Enforcement of penalties against a debtor's estate serves not to punish delinquent taxpayers, but rather their entirely innocent creditors." Gill, 574 B.R. at 716. Since the avoided penalty portion is automatically subordinated after other unsecured creditors, the residence was not burdensome or of inconsequential value to the estate as required by § 554(b).

Comments: This case serves as a reminder of how important it is to have a basis for the valuation claims in the schedules. The bankruptcy court was not amused with the debtor's self-serving representations about the value of the

residence. With discretion to weigh the evidence, the court chose to hold the debtor to the fair market value in the schedules rather than adopt later testimony.

Section 363 Sales

1. **A settlement approved under Rule 9019 selling the estate's state court legal claims constituted an appropriate exercise of § 363(m).**

***Adeli v. Barclay* (*In re Berkeley Del. Ct., LLC*), 834 F.3d 1036 (9th Cir. 2016).** Prepetition, debtor LLC ("Debtor") bought a parcel of land for the purpose of constructing a mixed-used building. Debtor obtained a construction loan, later sold to First-Citizens Bank & Trust ("Creditor"). Creditor attempted to foreclose on the project, and Debtor filed a Chapter 11 petition along with a lawsuit against Creditor in state court. Creditor removed the state court action to the bankruptcy court, and the parties eventually reached a settlement. The settlement fell apart, and Debtor then filed a second Chapter 11 case and another action in state court against Creditor. Creditor again removed the action to the bankruptcy court, and obtained relief from the automatic stay. Creditor took possession of the project and sold it to a third-party purchaser, leaving Creditor with a deficiency claim. Creditor also filed a crossclaim in the adversary, alleging breach of settlement. The bankruptcy case was eventually converted to a Chapter 7, and the appointed trustee met with Creditor and Debtor to explore settlement options. The parties reached a settlement that allowed Creditor, subject to overbid procedures, to purchase the estate's legal claims arising out of the state court case in exchange for cash and a waiver of Creditor's claims against the estate. The bankruptcy court granted approval of the settlement under FRBP 9019 and granted the sale of the estate's claims under § 363(b). Debtor appealed the bankruptcy court's approval of the settlement. Notably, Debtor failed to seek a stay of the sale order.

Debtor argued, among other things, that § 363 only applies when a trustee sells estate property, not the estate's potential legal claims. The Ninth Circuit held that a bankruptcy court has the discretion to apply § 363 procedures to a sale of claims pursuant to a settlement approved under Rule 9019. The court reasoned that disposition of a legal claim through a compromise is tantamount to the sale of intangible property of the estate. The court also rejected an argument by the Debtor that he was not required to seek a stay pending appeal, as required by § 363(m), because the trustee's overbid procedures did not attract outside bidders. Because the compromise was the product of an arms-length negotiation, Debtor's principal was required to obtain a stay.

2. **Section 365, which governs the formal rejection of a lease, does not preclude a sale free and clear under section 363(f). Where there is a sale but no rejection, there is no conflict.**

   Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC **(*In re Spanish Peaks Holdings II, LLC*), 872 F.3d 892 (9th Cir. 2017).** Montana resort Spanish Peaks leased restaurant space and other commercial real estate to two separate related LLCs ("Lessees"). Facing operational losses, the resort filed for Chapter 7. The chapter 7 trustee, along with the mortgagor of the resort property, agreed to an auction liquidating the real and personal property of the debtor. The stipulation stated the sale would be free and clear of all liens, and the trustee moved for an order authorizing the sale. Lessees were not mentioned as encumbrances that would survive the sale, and notably, the trustee did not reject the leases. Noting the omission, Lessees objected to the sale, arguing that the Code gave them the right to retain possession of the property notwithstanding the sale. The bankruptcy court authorized the auction and subsequently approved the sale over the objections of the Lessees. However, the court's order approving the sale did not clarify whether the sale was free and clear of the leases. After an evidentiary hearing, the bankruptcy court held that the sale was free and clear. Lessees appealed, and the district court affirmed, reasoning the sale extinguished the leases because the foreclosure of a mortgage would terminate any leasehold interests junior to the mortgage.

   In its holding, the Ninth Circuit adopted the Seventh Circuit's conclusion that § 363(f) does not conflict with § 365(h), which protects a lessee's right to continued possession despite a trustee's rejection of a lease. The Ninth Circuit applied the "universally understood" definition of rejection in the bankruptcy context as a declaration by the trustee that the estate will not take on the obligations of a lease or contract. The court concluded that when the trustee sold the estate assets pursuant to § 363(f) without otherwise rejecting the leases as contemplated by § 365, there was no conflict between the two statutes. When the trustee sold the debtor's assets free and clear of interests in accordance with § 363(f), but did not reject the leases, § 365 was not triggered, and the assets were sold free and clear of the leases.

§ 1111(b) elections

Postpetition foreclosure by senior lien creditor eliminates a nonrecourse junior lien creditor's right to a deficiency pursuant to 11 U.S.C. § 1111(b) notwithstanding that the lien existed on the date of the bankruptcy petition

***Mastan v. Salamon (In re Salamon)*, 854 F.3d 632 (9th Cir. 2017).** In April of 2009, Debtors James and Jeanne Salamon purchased a parcel of real property located in Los Angeles, California. The seller entered into a wrap-around mortgage with debtor for $1,030,000 to partially fund the purchase of the property and secured the mortgage with a note and deed of trust designated as the "All Inclusive Note." Separately, Debtors also executed a note and deed of trust in the amount of $325,000 in favor of seller to fund the balance of the purchase price. The property was at that time encumbered by two prior deeds of trust secured by the property. Under the terms of the agreement, Debtors were to make payments to an entity designated by the seller and that entity would then make payments on the two underlying obligations.

On March 25, 2010, the seller filed his own Chapter 11 bankruptcy. Peter Mastan was appointed as a trustee in the Chapter 11 and then remained the trustee for the estate when the case was later converted to a Chapter 7. Following seller's bankruptcy, Debtors filed their own Chapter 11 bankruptcy petition and Mastan filed two timely proof of claim on behalf of seller's estate for the two liens secured by the subject property. Shortly after the proof of claim were filed, the bankruptcy court approved a stipulation granting relief from stay as to the senior lienholder so it could foreclose on the property.

The property was sold at a foreclosure sale on March 13, 2013 for $1.275 million. The foreclosing trustee sent Mastan, as trustee for seller's estate, a check for $150k, representing the balance of the sale proceeds thereby satisfying the entire All Inclusive Note but only part of the separate financing between Debtors and Seller. Mastan then filed an amended proof of claim in the Debtors' bankruptcy for $303,304.75.

Debtors proceeded to file a motion to disallow the amended claim on the basis that there was no longer any property in the estate on which there could be a recourse lien. The bankruptcy court sustained the objection and both the Bankruptcy Appellate Panel and the Ninth Circuit affirmed.

In its decision affirming the courts below, the Ninth Circuit parsed the language of 11 U.S.C. § 1111(b) to determine whether a non-recourse lien was entitled to

treatment as a recourse obligation after the property in which the estate held an interest had been sold. Mastan had argued that the relevant date for determining whether § 1111(b) applies is the petition date. The Ninth Circuit rejected this reading, reasoning that neither the terms of § 1111(b) nor the language of § 502 supported fixing the date for determination of the claim's status as the petition date. The Ninth Circuit found that the purposes of § 1111(b) were served by examining that sections applicability on the date of the claim objection rather than the petition date.

The Court determined that the election to treat a nonrecourse claim as recourse prevented a debtor from improving his or her position by filing a bankruptcy and retaining the property. However, the Salamons were not attempting to retain the collateral securing the seller's note, leaving the seller (in this case Mastan as the trustee) with "exactly what he bargained for in a non-bankruptcy context: a senior creditor foreclosed on the property, extinguishing Mastan's junior liens and leaving Mastan without recourse to pursue deficiency judgments against the Salamons." Since the liens were extinguished by operation of the senior creditor's foreclosure, Mastan did not hold a lien on property in which the estate held and interest at the critical time, the objection to claim, as is necessary for § 1111(b) to apply.

The Ninth Circuit pointed out that Mastan could have protected the interest in the property through an objection to the motion for relief from stay although it is unclear what Mastan could have argued to prevent the bankruptcy court from granting relief. Having failed to do so, the foreclosure terminated the lien securing the obligation and thereby prevented application of the § 1111(b) election.

Comments: The petition date does not control all aspects of a bankruptcy case. For those few creditors seeking to use an § 1111(b) election it may become necessary to strategize how to hold on to that status as long as necessary.

Arbitration Clauses & Choice of Law

1. **When an adversary proceeding involves core matters under 28 U.S.C. § 157(b), the bankruptcy court has discretion to weigh the competing interest in favor of proceeding in court rather than by private arbitration.**

***Kirkland v. Rund* (*In re EPD Inv. Co. LLC*), 821 F.3d 1146 (9th Cir. 2016).** Chapter 7 trustee filed an adversary proceeding against debtors' attorney and attorney's wife, asserting fraudulent conveyance, subordination, and

disallowance causes of action. Attorney moved the bankruptcy court to compel arbitration, arguing that the agreements with the debtors at issue included broad arbitration clauses requiring binding private arbitration. The bankruptcy court denied the attorney's motion to compel arbitration, and defendants appealed.

The Ninth Circuit held that the bankruptcy court had discretion to decide the motion and that it did not abuse its discretion in denying it. The arbitration provisions at issue conflicted with Bankruptcy Code purposes of having bankruptcy law issues decided by bankruptcy courts, of centralizing resolution of bankruptcy disputes, and of protecting parties from piecemeal litigation. There was no abuse of discretion because the debtors' case had been pending in the bankruptcy court for nearly three years. As the causes of action were core proceedings, the bankruptcy court had discretion to weight the competing bankruptcy and arbitration interests at stake.

2. **Dischargeability of student loans under § 523(a)(8) is a core matter in which the bankruptcy court may deny a motion to compel arbitration due to inherent conflict.**

***Farmer v. Navient Solutions, LLC* (*In re Farmer*), 567 B.R. 895 (Bankr. W.D. Wash. 2017) (Memorandum Decision) (J. Alston), *aff'd* 2017 WL 4619209 (W.D. Wash. 2017).** Debtor executed a promissory note for a loan to finance expenses incurred studying for a post-graduate bar exam. Defendant Navient is the servicer of this loan. The note contains an arbitration clause, providing that any disputes will be resolved by binding arbitration. Debtor defaulted on the loan, and filed for Chapter 7 protection, scheduling the loan as an unsecured claim. Debtor did not dispute the applicability or enforceability of the arbitration provision, but she argued that because the arbitration would address a core bankruptcy matter—whether the loan is a non-dischargeable debt—the bankruptcy court has discretion to retain jurisdiction to resolve the matter.

The bankruptcy court agreed with the Debtor, concluding that arbitration of the matter would jeopardize a core bankruptcy proceeding. In its analysis, the court used the Supreme Court's *McMahon* three-factor test to determine whether another statute reflects Congress' desire to override the Federal Arbitration Act. *See Shearson/Am. Exp., Inc. v. McMahon*, 482 U.S. 220, 224 (1987). Under that framework, courts are to examine: (1) the text of the statute, (2) the statute's legislative history, and (3) absent such express conflict, whether an inherent conflict exists between arbitration and the underlying purposes of the statute. *Id.* Debtor conceded that there is nothing in the text or legislative history of the Bankruptcy Code evincing Congressional intent to override the FAA. Thus, the

court was left to determine whether an inherent conflict existed between the underlying purpose of the Bankruptcy Code and the FAA.

Navient argued that Supreme Court jurisprudence has evolved since *McMahon* and no longer includes the inherent conflict factor. *See CompuCredit Corp. v. Greenwood*, 565 U.S. 95 (2012), and *Am. Exp. Co. v. Italian Colors Rest.*, 133 S. Ct. 2304 (2013) (in both cases, considering only the text and legislative history of potentially conflicting statutes to address whether a congressional command existed). Farmer argued that as recently as 2016, the Ninth Circuit applied the inherent conflict analysis. *See In re EPD Inv. Co.*, 821 F.3d at 1150. The bankruptcy court found and the district court affirmed that *EPD* does not conflict with Supreme Court precedent, reasoning that if the Supreme Court wanted to abandon inherent conflict as a consideration, it would have done so explicitly in *CompuCredit* and *Italian Colors*. Accordingly, it was appropriate for the bankruptcy court to consider the inherent conflict factor. And as Navient readily admitted dischargeability of a debt is a core bankruptcy matter, it was appropriate for the court to find an inherent conflict between the Bankruptcy Code and arbitration of the dischargeability of Farmer's loan.

In November, Navient appealed to the Ninth Circuit. The appeal is currently pending.

3. A general choice-of-law provision in a contract does not include the statute of limitations of the chosen forum unless expressed in the contract.

***PNC Bank v. Sterba (In re Sterba)*, 852 F.3d 1175 (9th Cir. 2017).** Debtors purchased a condo in California with junior financing from National City Bank. The Note included a provision requiring the application of Ohio law "without regard to conflict of law principles." The debtors subsequently filed a bankruptcy in the Northern District of California and objected to the claim of PNC Bank (National City Bank's successor in interest) contending the claim was barred by California's four-year statute of limitations. PNC defended arguing that the promissory note's choice of Ohio law controlled and therefore the claim was timely because it was within Ohio's longer six year statute of limitations period.

The bankruptcy court agreed with PNC and determined that the choice-of-law provision selecting Ohio law also included that state's statute of limitations period. The Ninth Circuit BAP reversed and PNC appealed. The Ninth Circuit reversed the BAP after determining that the parties were required to expressly

state that the choice of Ohio law also included a choice of Ohio's statute of limitations but that exceptional circumstances existed to prevent application of California's shorter limitations period.

The Ninth Circuit began its analysis with a recognition that "[w]hen it comes to conflicts of law, bankruptcy is a bit of an odd duck." Unlike in the ordinary federal diversity case, a federal bankruptcy court will apply federal choice-of-law rules rather than the choice-of-law rules for the state in which it sits. *Lindsay v. Beneficial Reinsurance Co. (In re Lindsay)*, 59 F.3d 942, 948 (9th Cir. 1995). This has a tendency to create unusual choice-of law issues in bankruptcy cases.

Starting with the threshold question of whether a contractual choice-of-law provision also includes the statute of limitations of the chosen forum, the Court concluded that the contract in this case did not. Citing existing circuit precedent, Judge Korman noted that where the choice-of-law provision fails to expressly include the statute of limitations, courts should determine the contract is silent on the issue. *Des Brisay v. Goldfield Corp.*, 637 F.2d 680 (9th Cir. 1981). The choice-of-law provision at issue in *Des Brisay* was materially identical to the provision in the Sterba contract. Since statute of limitations are usually considered matters of local procedure, the failure to expressly elect the statute of limitations prevented including a choice by implication.

Since the Sterba contract was silent on the issue of whether the choice-of-law provision also adopted Ohio's statute of limitations, the Ninth Circuit determined that the Restatement (Second) of Conflict of Laws addressing conflicts between statutes of limitation applied. Normally, the Restatement would apply the statute of limitations of the forum state in this situation on the basis that the forum state has a substantial interest in preventing prosecution of claims it determines are stale. However, the Ninth Circuit did not apply California's shorter limitations period because the "exceptional circumstances" provision of § 142 applied instead.

The majority opinion reasoned that deviation from California's shorter limitation period was appropriate because PNC did not have an alternative forum to bring its claim other than the Northern District of California bankruptcy court. Unlike a typical lawsuit where the plaintiff elects where to bring the claim and starts the action, PNC bank was obligated to bring all of its claims in the district where the Sterbas filed bankruptcy. PNC's predecessor, National City Bank was located in Ohio and under these circumstances, the majority determined Ohio had the more substantial interest in resolution of the claim.

Judge Tashima concurred in the judgment but wrote separately to note that the majority could have found a shorter route to the same answer. Since the contract included a provision requiring application of Ohio law "without regard to conflict of law principles." Judge Tashima would have construed that phrase as an express adoption of the Ohio statute of limitations without any of the analysis called for under § 142 of the Restatement.

Comments: The majority's application of the "exceptional circumstances" provision of § 142 of Restatement (Second) of Conflict of Laws could apply in a significant number of bankruptcy cases given the national reach of a bankruptcy proceeding. Creditor counsel may wish to review standard contracts with their clients to make certain that if a specific limitations period is intended, such election is expressly made in the contract.

Vesting and Liquidation Value in Chapter 13 Plans

Proceeds from a post-petition, post-confirmation auto accident become part of the liquidation calculation in a modified Chapter 13 plan.

***In re Villegas*, 573 B.R. 844 (Bankr. W.D. Wash. 2017)**.The debtors filed for Chapter 13 bankruptcy on September 30, 2013. The original confirmed plan provided that the liquidation value of the estate was $0.00 but the plan proposed to pay $27,931.44 to unsecured creditors due to the projected disposable income of the debtors. The plan was confirmed on February 27, 2014. The debtors were involved in an automobile accident on April 25, 2014, but did not disclose the accident (or the pending settlement) until they amended their schedules in November 2016.

The amended schedules disclosed a settlement in the amount of $24,500, and claimed an exemption in the entire net amount of the settlement pursuant to the federal personal injury exemption.[2] The Chapter 13 trustee objected to the debtor's exemption and, when the debtor's failed to respond, the court entered an order sustaining the objection. On March 2, 2017, the trustee filed a motion to modify the plan in order to have the remainder of the settlement proceeds paid to unsecured creditors. Since the debtors were without a valid exemption, the

[2] The debtors also sought *nunc pro tunc* approval of the employment and compensation of the personal injury attorney but that application was withdrawn after an objection from the Chapter 13 trustee.

trustee argued that good faith demanded the debtors commit the proceeds to the plan because the funds were a windfall to the debtors.[3]

The debtors responded to the modification motion with a request to keep a portion of the funds in order to pay for expenses, including two post-petition loans from a relative, home repairs, furniture, and dental work. At the hearing the bankruptcy court expressed concerns regarding how to account for a post-confirmation asset that did not arise from employment. After inviting additional briefing, the trustee argued that the best interests of creditors test did not apply post-confirmation, while the debtors countered that whatever the figure was, the plan payments plus $5,702.13 of the proceeds would cover the amount.

Judge Lynch framed the trustee's modification as presenting three issues: (1) whether the debtors are required to pay non-exempt post-confirmation settlement proceeds to comply with the "best interests" test, (2) jf the settlement proceeds are part of the liquidation test, are the debtors entitled to a credit for the payments unsecured creditors will already receive under the plan, and (3) are the debtors required to pay some or all of the proceeds to the plan in order to satisfy the good faith requirement.

The court started by noting that Ninth Circuit supports the idea that confirmation prevents re-valuing of property once the liquidation value is set. *In re Hoopai*, 581 B.R. F.3d 1090, 1101 (9th Cir. 2009). However, there is a distinction between property in existence on the date the plan is confirmed, and property a debtor may acquire after the time of confirmation. *In re Roberts*, 514 B.R. 358, 365 (Bankr. E.D.N.Y. 2014). This newly acquired property "must be valued as of the date of any modification motion for purposes of § 1325(a)(4) and the nonexempt value of that post-confirmation asset should be added to the previously calculated best interests of creditors number." *Villegas*, 573 B.R. at 850.

Although a debtor may have to account for a post-confirmation windfall in a modified plan the debtor may not have to turn over the funds to meet the modification standards. Instead, the debtors are entitled to count the payments made or to be made under the confirmed plan towards the increased liquidation figure resulting from the post-confirmation asset. As with confirmation of the original plan, the "best interests" and "best efforts" tests do not require double-counting the same funds. A debtor paying more than required by § 1325(a)(4) on account of disposable income need not increase the distribution to unsecured

[3] The debtors amended Schedule C a second time but after again failing to respond to the trustee's objection this exemption was only allowed in the un-objected amount of $3,738.84.

creditors solely on account of a post-confirmation asset. The court did not reach the good faith issue on the record before it.

Comments: The *Villegas* opinion represents a significant change from current bankruptcy practice in Western Washington. One advantage for the high-income, low asset debtor is that a post-confirmation windfall may not have to go to the trustee at all. On the other hand, with liquidation value tied to discharge, a debtor obtaining assets post-confirmation may face a forced liquidation of assets in order to pay pre-petition creditors the amount demanded by a re-calculated § 1325(a)(4) figure.

Whatever Happened to Watt?

***Bank of New York Mellon v. Watt,* 867 f.3d 1155 (2017)**.

Background: The debtor in *Watt* confirmed a plan vesting property subject to non-dischargeable home owner's association dues back with the lender in an attempt to avoid liability for the post-confirmation dues. The district court reversed and vacated the order confirming the plan. The debtor appealed and it was hoped that the Ninth Circuit might uphold mandatory vesting as a solution to the often intractable problem of accruing HOA dues post-petition or other issues that may cause a debtor to want title to real property transferred to a lender.

What happened: The Ninth Circuit dismissed the *Watt* appeal as moot. While the appeal was pending, the debtor successfully confirmed a plan providing for a §363 sale back to the lender. Since the district court's order vacated confirmation, and the debtor never appealed the order confirming the second plan, the Ninth Circuit was left without a final and appealable order to consider. *Bullard v. Blue Hills Bank*, 135 S.Ct. 1686 (2015).

Although the Ninth Circuit never reached the question of mandatory vesting in a Chapter 13 plan it may have signaled receptiveness to the issue. After noting that that the validity of a mandatory vesting provision is "an important and recurring legal question." *Watt*, 867 F.3d at 1158 (collecting cases and commentary in a footnote). The Ninth Circuit went on to discuss at least three different avenues for the debtor to challenge the provisions, including a timely appeal of the second plan the debtor proposed and confirmed. Since the debtor declined to take any additional action to appeal, the Ninth Circuit left the main legal question of whether a debtor may force a creditor to take title to property through a plan provision for another day.

PRACTICE POINTERS

Telephonic Participation-

- Each judge is different. Review the procedures for each chambers.
- Judge Lynch usually requires local counsel (i.e., counsel in the W.D. Wash.) to participate in person. Judge Heston will often allow telephonic participation if the issue is minor, there is little expected argument, or the court lodged an order with questions). However, all judges reserve the right to not allow you to participate by telephone.
- **Do no wait**. Likely to have the request denied if unwilling to follow that judge's procedures. For Judge Heston, 48-hour advanced request made by filing a letter on the docket. There is an ECF event for this!

Employment applications-

- Necessary if you want to get paid.
- If you started working before getting employed, the application is *nunc pro tunc* and you will need to address the factors in *Atkins v. Wain, Samuel & Co. (In re Atkins)*, 69 F.3d 970 (9th Cir. 1995).
- Employment **prior to working** is preferable because the standard for after-the-fact employment is much higher.
- Even if you think a claim is not viable, a Chapter 13 plan has been confirmed, or the debtor tells you they are free to sell the property, check with the attorney and get employed. This includes realtors who receive a commission from the sale.

New rules for filing proof of claim

- Timely filing of a proof of claim is critical in most consumer cases, especially in Chapter 13 (if you want money).
- Old rule- [Chapter 7, 12, and 13], 90 days after the first date set for the meeting of creditors. Fed. R. Bankr. P. 3002 (2017)
- New rule- 70 days after the order for relief, or after the order of conversion if the case is converted to a Chapter 12 or 13. Fed. R. Bankr. P. 3002(c) (Eff. Dec. 1, 2017).
- For most cases this change will mean months less time to file a claim.
- New rule expressly applies to secured claims

Lien Avoidance
A debtor may avoid the fixing of a judicial lien on the debtor's interest in property to the extent such lien impairs an exemption to which the debtor is entitled. 11 U.S.C. § 522(f)(1).

There are four basic elements of an avoidable lien:

1. There must be an exemption to which the debtor would have been entitled;
2. The property must be listed on the debtor's schedules and claimed exempt;
3. The lien must impair that exemption; and
4. The lien must be a judicial lien.

In re Goswami, 304 B.R. 386, 390-91 (B.A.P. 9th Cir. 2003) (quoting *In re Mohring*, 142 B.R. 389, 392 (Bankr. E.D. Cal. 1992, *aff'd* 24 F.3d 247 (9th Cir. 1994).

Common Deficiencies with Lien Avoidance Motions

- The motion must include evidence of:
    - the value of the subject property
    - the amount of the lien movant is seeking to avoid
    - the amounts of all other liens on the property
    - the priority of the liens
    - the recordation of the lien (or whether it was not recorded)

Motion must be supported by evidence (e.g., a declaration) supporting the debtor's factual assertions regarding these concepts.

- A declaration from counsel is insufficient.

The debtor carries the burden to demonstrate that the lien actually impairs his or her exemption. *In re Hanger*, 217 B.R. 592, 594-95 (B.A.P. 9th Cir. 1997).

As such, the debtor must have taken an exemption in the property.

If no exemption taken upon filing, the debtor may amend Schedule C to claim an exemption in the property at issue before seeking to avoid the lien. *See, e.g.*, *In re Schneider*, 2013 WL 5979756 (Bankr. E.D.N.Y. 2013).

Lien Avoidance through a Chapter 13 Plan
If the debtor seeks to modify a judicial lien or security interest using § 522(f) in a chapter 13 plan, the debtor must:

1. Complete Section IV.C. of the plan to include both "See X" in the line titled "Collateral" before describing the collateral and the proposed monthly payment. If the plan completely avoids the lien, the monthly payment amount will be $0.

2. Include the following language in Section X of the plan:

   [creditor] holds a judicial lien or security interest avoidable under 11 U.S.C. § 522(f) against [collateral]. The value of the collateral is [$]. The claims of other creditors holding higher priority security interests or liens against the collateral total [$]. The Debtor is entitled to an exemption under 11 U.S.C. § 522(b) of [$] (collateral value minus total amount of higher priority secured claims minus the debtor's exemption). The balance of [creditor's] claim is an unsecured claim. The monthly payment on the secured claim under the plan is [$].

3. File, with the plan, evidence (e.g., a declaration) supporting the debtor's factual assertions regarding the value of the collateral, the amount of the debtor's exemption, and the amount of the relevant liens.

4. Serve the plan on the holder of the claim in accordance with FRBP 7004.

5. File a proof of service.

LBR 3015-1(g), effective 12/01/2017.

Service Issues with Lien Avoidance

A motion to avoid a lien is a contested matter within the meaning of FRBP 9014, which requires service compliant with FRBP 7004.

- For *Individuals*: Service by regular mail, to the individual's home address. BR 7004(b)(1).
- For *Business Entities*: Service by regular mail, to an officer or managing agent, or to registered agent authorized to receive service (i.e., CT Corporation System). BR 7004(b)(3).
- For *Insured Depository Institutions*: Service by certified mail, to an officer. BR 7004(h).

Motions for Lien Avoidance must provide for at least 28 days' notice. LBR 9013-1(d)(2)(D).

7004 service also applies to lien stripping under §§ 506 and 1322(b)(2).

<u>Some Tips on Traffic Ticket Plans in Ch. 13 Cases in Washington State</u>

Upon completion of a Ch. 13 plan, 11 U.S.C. §1328(a) offers a Debtor a "discharge of all debts provided for by the plan" with a few enumerated exceptions. One such exception is stated in §1328(a)(3), which provides an exception for "restitution, or a criminal fine." It states, in pertinent part:

> "[A]s soon as practicable after the completion by the debtor of all payments under the plan, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title except any debt . . .
>
> (3) for restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime . . . ."

Thus, whether a traffic ticket is dischargeable under 11 U.S.C. §1328(a) depends upon whether the infraction is classified as a civil or criminal offense.

Washington State has divided the penalties arising from traffic offenses into two categories: civil infractions and criminal offenses. RCW 46.63.020. *In re Games*, 213 B.R. 773, 776 (Bankr. E.D. Wash. 1997). RCW 46.63.020 provides that <u>all</u> traffic offenses are not criminal, <u>unless</u> they fall within the 67 enumerated sections. RCW 46.63.020 states that:

> "**Failure to perform any act** required or the performance of any act prohibited by this title or an equivalent administrative regulation or local law, ordinance, regulation, or resolution relating to traffic including parking, standing, stopping, and pedestrian offenses, **is designated as a traffic infraction <u>and may not be classified as a criminal offense</u>**, except for an offense contained in the following provisions of this title or a violation of an equivalent administrative regulation or local law, ordinance, regulation, or resolution: (1) RCW 46.09.457(1)(b)(i) relating to a false statement regarding the inspection of and installation of equipment on wheeled all-terrain vehicles; . . . ."

RCW 46.63.020. Examples of a few traffic violations that are classified as criminal offenses are: ". . . (13) RCW 46.20.005 driving without a valid driver's license; . . . (16) RCW 46.20.342 relating to driving with a suspended or revoked license or status; . . . (33) RCW 46.52.02 relating to duty in case of injury to or death of a person or damage to an attended vehicle; . . . (44) RCW 46.61.500 relating to reckless driving; and (45) RCW 46.611.502 and 46.61.504 relating to persons under the influence of intoxicating liquor or drugs. . . ."

While fines for criminal offenses may be nondischargeable, costs of prosecution of criminal offenses are dischargeable under §1328(a). In *In re Ryan*, 389 B.R. 710 (B.A.P. 9th Cir. 2008), the BAP for the Ninth Circuit concluded that the exception to discharge included in § 1328(a)(3) for "restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime" does not cover costs of prosecution included in such a sentence. *Id.* at 720. The Ninth Circuit BAP stated that the term "criminal fine" was not defined in the Code, and relied the principle that exceptions to discharge are to be construed narrowly in favor of debtors, particularly in chapter 13, where a broad discharge was provided by Congress as an incentive for debtors to opt for relief under that chapter rather than under chapter 7. The Ninth Circuit BAP reasoned that:

> "Congress could have adopted an exception to discharge in chapter 13 that mirrored § 523(a)(7). It did not do so. In contrast, under BAPCPA, when Congress wanted to limit the chapter 13 "superdischarge," it incorporated exceptions to discharge from § 523 wholesale. *See* current § 1328(a)(2), excepting from the chapter 13 discharge any debts of the kinds specified in subsections (1)(B) and (C), (2), (3), (4), (5), (8) and (9) of § 523(a)."

Id. at 719. Thus, costs of prosecution that are added to the debts should be separated from the underlying criminal fines.

A debtor may separately classify nondischargeable criminal traffic fines and provide different treatment for them if the debtor satisfies the four-part test set forth in *In re Wolff*, 22 B.R. 510 (9th Cir. BAP 1982), which determines when a debtor may discriminate against a class of unsecured creditors under 11 U.S.C. 1322(b)(1). The four part test under *Wolff* is: (1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination. *Id.* at 512.

Drafting a Ch. 13 Plan that Specially Classifies Non-dischargeable Criminal Fines

One of the goals of a successful Ch. 13 plan is to give the debtor a fresh start. The discharge helps remove unsecured debt, but the debtor must specially classify non-

dischargeable debts such as criminal fines in order to leave bankruptcy with a clean slate. In three opinions from 1997, 1998, and 2002, Chief Judge John A. Rossmeissl of the Eastern District of Washington analyzed the issue of a Ch. 13 debtor's discriminatory treatment of criminal traffic fines: *In re Games*, 213 B.R. 773 (Bankr. E.D. Wash. 1997), *In re Ponce*, 218 B.R. 571 (Bankr. E.D. Wash. 1998), and *In re Gallipo*, 282 B.R. 917 (Bankr. E.D. Wash. 2002). In these opinions, Chief Judge Rossmeissl set forth the parameters which he found satisfied the *In re Wolff* test. He denied the debtor(s)'s confirmation in each of these cases, but indicated how the debtor(s) could amend their respective plans to satisfy the four part *Wolff* test. While these opinions are not binding, they may provide practitioners with helpful analysis.

Based on Judge Rossmeissl's rulings in *Games*, *Ponce* and *Gallipo*, a Ch. 13 plan should pay <u>all</u> unsecured creditors *pari passu* for the first 36 months of a plan, after which a debtor may discriminate against other unsecured creditors by paying criminal fines ahead of others if the debtor has a reasonable basis. In addition, the unsecured creditors should receive something in exchange for the discriminatory treatment. Obtaining the reinstatement of a driver's license is a reasonable basis for discrimination (if the debtor needs to drive to work), but the mere fact that the debt is non-dischargeable is not a reasonable basis for discrimination (for example, in *Gallipo*, the specially classed criminal fines were for shoplifting).