

# Stream of Commerce

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## Chairman's Message



### Save the Date – 25<sup>th</sup> Annual Bankruptcy at the Beach Seminar June 8 – 9, 2012

Please mark your calendars and “save the date” as we celebrate the 25<sup>th</sup> Annual Bankruptcy at the Beach Seminar June 8 – 9, 2012 in beautiful Destin, Florida!

We have a wonderful seminar planned with three key note speakers to celebrate our Silver Anniversary Seminar. Our three keynote speakers are: Judge David Houston, Bankruptcy Judge from the Northern District of Mississippi, Judge Frank Santoro, Bankruptcy Judge from the Eastern District of Virginia, and Professor John Czarnetzky of the Ole Miss School of Law in Oxford. We will also have Tony McLain from the State Bar again this year, and we hope to have many of our local Bankruptcy Judges speaking and participating as well. We would like to thank our Judges for their consistent support of this seminar.

Our seminar has been approved for 8 hours of CLE Credit, which includes one hour of Ethics credit. The format of the seminar will be somewhat similar to the format last year, but with a few

adjustments to take into account the suggestions we received from those of you who attended last year's event. The brochure with the keynote speaker bio information and the full seminar agenda and registration information will be mailed out soon, but we were so excited about this year's Silver Anniversary Event that we wanted to get the word out to you all as soon as possible.

Please feel free to make your reservations at the hotel starting now. We will be staying at the SanDestin Beach Hilton Golf and Tennis Resort. You may make your reservations via phone (877-705-6641 or 850-267-9600) or online

([www.sandestinbeachhilton.com](http://www.sandestinbeachhilton.com)). Our block of rooms is already reserved and will fill up fast. Our Group Code is “BOB.”

So, please mark your calendars and plan on joining us Friday June 8<sup>th</sup> and Saturday June 9<sup>th</sup> 2012 in Destin for our 25<sup>th</sup> Annual Bankruptcy at the Beach seminar!

If you have questions at any time you may contact one of your section officers:

Melissa Wetzel, Chairman at [mwetzel@melissawetzel.com](mailto:mwetzel@melissawetzel.com).

## Table of Contents

### Articles Page

Stern v. Marshall: Does it Mean Anything for Non-debtor Releases and “Why the Fuss”? 2

The Court as the Gatekeeper: What is the Courts' Role in Confirming a Chapter 11 Plan 5

Eligibility: Jefferson County Files Chapter 9 7

### Case Notes

*In re Harvel*, 2011 WL 5149070 (Bankr. M.D. AL) 8

*In re Meriweather*, 2011 WL 37644 (Bankr. M.D. AL) 9

*In re John W. McCombs, Jr.*, 2011 WL 4458893 (Bankr. S.D. AL) 9

*In re Elizabeth Katherine Loving*, 2011 WL 3800042 (Bankr. S.D. AL) 9

*In re Smith v. Golatte*, 2011 WL 3862210 (Bankr. M.D. AL) 10

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Looking forward to seeing you at  
the beach!!

Melissa Wetzel

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## Stern v. Marshall: Does it Mean Anything for Non- debtor Releases and "Why the Fuss"?

**By: Eric J. Breithaupt**

On June 23, 2011, the United States Supreme Court released its latest opinion in the continuing saga surrounding the estates of a late Playboy Bunny and her equally deceased, yet quite wealthy husband.<sup>1</sup> Regrettably, the aged husband of the pin-up girl died while they were as yet newlyweds. Proving the adage that fact is often more intriguing than fiction, the Court once again took on the task of sorting through where the heirs of each of the late parties could maintain their respective claims against each other. In the Courts below, Vickie Lynn Pierce (more famously known as Anna Nicole Smith) had filed bankruptcy during the ceaseless battle between herself and Pierce Marshall who was the son of J. Howard Marshall, a man believed to have been one of the richest men in Texas.<sup>2</sup> Like "Vickie" (as the Supreme Court affectionately calls her), Pierce also died during the pendency of the case. Prior to his demise, Pierce filed a non-dischargeability case against Vickie and a Proof of Claim in her bankruptcy asserting defamation in relation to

<sup>1</sup> *Stern v. Marshall*, 131 S.Ct. 2594 (2011).

<sup>2</sup> *In re Marshall* 253 B.R. 550 (Bankr. C.D. Cal. 2000), *enforced* 275 B.R. 5 (C.D. Cal. 2000), *vacated* 392 F.3d 1118 (9<sup>th</sup> Cir. 2004), *cert. granted, remanded sub nom. Marshall v. Marshall*, 547 U.S. 293 (2006), *rev'd* 600 F.3d 1037 (9<sup>th</sup> Cir. 2010), *aff'd sub nom. Stern v. Marshall* 131 S.Ct. 2594 (2011).

statements made by Vickie's lawyers suggesting that Pierce was guilty of fraudulent conduct in allegedly manipulating his father's estate – essentially writing Vickie out of the will.<sup>3</sup> In reply, Vickie filed a counterclaim alleging tortious interference by Pierce in the anticipated receipt of a gift from J. Howard Marshall to her.<sup>4</sup>

After summary judgment as to Pierce's defamation claim and a bench trial by the bankruptcy court on her counterclaim, Vickie was awarded a judgment for \$400 million in compensatory damages and \$25 million in punitive damages on her state law claim for tortious interference against Pierce.<sup>5</sup> At issue before the Supreme Court was whether the bankruptcy court had jurisdiction to adjudicate Vickie's state law based counterclaim against Pierce. In a 5-4 decision written by Chief Justice Roberts, the Court answered "no."<sup>6</sup> In so holding the Court recognized that while Vickie's counterclaim was a core-proceeding under the statutory framework of 24 U.S.C. §157(b)(5), the nature of the counterclaim nonetheless exceeded the constitutional boundaries of Article III, §1 of the United States Constitution dealing with the separation of powers between the judiciary and other branches of government.<sup>7</sup>

How then does *Stern v. Marshall* impact other areas of bankruptcy jurisprudence where the bases of jurisdiction are sometimes put to question? In particular, the question arises that if a

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Stern*, 131 S.Ct. 2594.

<sup>7</sup> *Id.*

bankruptcy court cannot entertain a state law counterclaim held by its own debtor, how then may that court grant a non-debtor release as to claims held by parties who hold claims against persons or entities who are not debtors. In the wake of *Stern v. Marshall*, the ability of the bankruptcy court to grant a non-debtor release either through the confirmation of a Chapter 11 Plan or a compromise petition under Rule 9024 may be suspect or at least is now impractical.<sup>8</sup>

The jurisdictional base for granting non-debtor releases is seldom discussed by the Courts in detail. Instead, the focus generally is on the interplay of §524(e)<sup>9</sup> which restricts the grant of a discharge to the debtor and the broader, more permissive grants of authority allowed by §105<sup>10</sup> to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title,” and §1123(b)(6)<sup>11</sup> which provides that “a plan may. . . include any other provision not inconsistent with the applicable provisions of this title.” Those courts which entertain the propriety of non-debtor releases have typically employed the following factors in determine whether to approve the release:

*(1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;*

*(2) The non-debtor has contributed substantial assets to the reorganization;*

*(3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;*

*(4) The impacted class, or classes, has overwhelmingly voted to accept the plan;*

*(5) The plan provides a mechanism to pay [in full] for all, or substantially all, of the class or classes affected by the injunction;*

*(6) The plan provides an opportunity for those claimants who choose not to settle to recovery in full; and*

*(7) The bankruptcy court made a record of specific factual findings that support its conclusions.<sup>12</sup>*

Absent, however, from any of the factors enumerated by the Courts is any discussion of the more fundamental question of whether the bankruptcy court has the power to grant a non-debtor release at all. Those that advocate the efficacy of non-debtor releases typically contend that because the release language is part and parcel of a plan, the bankruptcy court becomes vested with jurisdiction to bind non-debtors as a core proceeding. This view, however, seems obviated by the procedural posture of *Stern v. Marshall* where the argument was made that the determination of

Vickie’s state law counterclaim was compulsory to the adjudication of Pierce’s Proof of Claim in the bankruptcy case. The Supreme Court disagreed with the argument saying, “it is hard to see why Pierce’s decision to file a claim should make any difference with respect to the characterization of Vickie’s counterclaim.”<sup>13</sup> In other words, a traditional non-bankruptcy state law cause of action cannot be re-branded as a core proceeding simply because an adverse party participates in the bankruptcy case. In the context of granting a non-debtor release through the confirmation of a plan, the court’s limitation on jurisdiction seems compelling. The logical result is that the bankruptcy court may not adjudicate the claims of non-debtors who hold claims against others who also are non-debtors.

If the premise is accepted that *Stern v. Marshall* limits the ability of the bankruptcy court to effectively adjudicate state law claims of non-debtors by the judicial fiat of a non-debtor release, the next question becomes whether a non-debtor release may ever be granted. In the context of *Stern v. Marshall* the answer appears to remain in the affirmative. The difference, however, is which court may grant the release. The impact of *Stern v. Marshall* centers on the separation of powers and the relative power of Article III judges to grant plenary relief versus the congressionally created powers of bankruptcy judges which are statutorily limited by the constraints of Titles 11 and 28. As suggested by the Supreme Court, the adjudication of “related” matters under §157(a)(1) is required to be made by the

<sup>8</sup> Fed. R. Bankr. P. 9024.

<sup>9</sup> 11 U.S.C. § 524(e).

<sup>10</sup> 11 U.S.C. § 105.

<sup>11</sup> 11 U.S.C. § 1123(b)(6).

<sup>12</sup> *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6<sup>th</sup> Cir. 2002); *Cf. In re Zale Corporation.*, 62 F.3d 746 (5<sup>th</sup> Cir. 1995) (the seven (7) factors listed above in *Dow Corning* would satisfy the “unusual circumstances” test adopted by the Fifth Circuit).

<sup>13</sup> *Stern*, S.Ct. at 2616.

district court.<sup>14</sup> In the context of confirmation, this raises the specter of whether a plan containing non-debtor releases may only be confirmed by the district court. If so, the procedural quagmire of whether the case is subject to piece-meal withdrawal of the reference under §157(d) arises.<sup>15</sup> May only the issue of non-debtor release be withdrawn to the district court, or must the entire confirmation process be sent upstairs to an Article III court? Given that the established grounds for granting non-debtor releases require consideration of the plan as a whole, the answer militates toward withdrawal of the reference of the whole case. And as a more practical consideration, the clerks of court are disinclined to withdraw the reference of only a piece of a case; once the reference is withdrawn, the whole case is delivered to the district court. This raises the inherent inefficiencies discussed by the dissent in *Stern v. Marshall*, and puts the district court squarely in the business of dealing with confirmation issues.

There is a mechanism available in the event that the bankruptcy court is without jurisdiction to grant a non-debtor release in a Chapter 11 plan which may prove to be more practical. In the case of *In re Mumford*<sup>16</sup>, the 11<sup>th</sup> Circuit approved non-debtor releases in the context of a Rule 9024 motion. Although no other Circuit Court has approved this mechanism for the consideration of a non-debtor releases, *Mumford* is often cited at the bankruptcy court level for the proposition that the non-debtor release may be obtained

through a compromise petition. From a practice perspective, perhaps the more efficient way to propose a non-debtor release will now be in the context of a Rule 9024 motion so that the discrete issue of granting a non-debtor release can be presented to the district court in isolation rather than forcing confirmation of a plan to be withdrawn to the district court, or worse yet, attempting to obtain a piecemeal confirmation in two courts which would, at best, be chaotic and at worst draw out the confirmation process to the point where the debtor crashes and burns while the confirmation of the case slowly winds its way through the judicial system. To date, the only reported case dealing with *Stern v. Marshall* and a Rule 9024 compromise petition is *In re Ambac Financial Group, Inc.*<sup>17</sup> There, the question was raised as to whether the bankruptcy court had the authority to compromise state law derivative claims. Finding that the claims to be compromised were property of the estate, the bankruptcy court determined that it had jurisdiction, and approved the settlement.<sup>18</sup> *Ambac*, however, is distinguishable from *Mumford* in that *Mumford* dealt with a grant of a non-debtor release as to claims of third parties. In other words, what was released/compromised in *Ambac* was estate property whereas what was released in *Mumford* were claims not owned by the debtor. In the wake of *Stern v. Marshall*, that is a difference which likely makes a difference.

From a procedural standpoint, the mechanism for putting a non-

debtor release before the district court is probably most efficiently accomplished by filing a Rule 9024 motion. Then, upon the receipt of an objection, the Rule 9024 motion becomes a contested matter under Rule 9014.<sup>19</sup> Once that occurs, only the reference as to the contested matter would need to be withdrawn to the district court thereby leaving the main case in tact with the bankruptcy court. Alternatively, a debtor might seek confirmation of a plan in the bankruptcy court, but then request that only proposed findings of fact and recommendations be made by the bankruptcy court to the district court under Rule 9033.<sup>20</sup> Under either process, action by the district court is required in order to obviate the concern that jurisdiction may not be present to sustain the grant of a non-debtor release. Regardless of the procedures, costly delays will obtain. Consequently, it may be that the possibility of granting a non-debtor release survives, but the ability of a party to obtain one is now impractical.

In writing for the majority, Chief Justice Roberts remarked, “why the fuss?” Where non-debtor releases are involved, the stakes are often high. Parties are essentially buying peace through the confirmation process over the objection of others who desire to maintain their state law based litigation claims. More often than not, the non-debtor release is intended to terminate the maintenance of multiple tort claims or large dollar litigation claims. As such, the jurisdiction of a court to grant non-debtor release becomes important. If the

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<sup>14</sup> 11 U.S.C. § 157 (a)(1).

<sup>15</sup> 11 U.S.C. § 157(d).

<sup>16</sup> 97 F.3d 449 (11<sup>th</sup> Cir. 1996).

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<sup>17</sup> 693 F.Supp.2d 241 (S.D.N.Y. 2010).

<sup>18</sup> *Id.*

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<sup>19</sup> Fed. R. Bankr. P. 9014.

<sup>20</sup> *Id.* R. 9033.

court granting that relief is subsequently found to have lacked jurisdiction, then the entire premise of a confirmation order that is predicated on non-debtor releases collapses long after parties have moved forward in reliance on the defective release. With that warning in mind, the practitioner is well advised to consider what court should properly be asked to entertain a non-debtor release.

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## The Court as the Gatekeeper: What is the Courts' Role in Confirming a Chapter 11 Plan?

**By: Christopher Conte**

Last February, the Eleventh Circuit issued an opinion in the case *In re Lett*<sup>21</sup> and held that the appellate court could consider an objecting creditor's argument that the confirmed Chapter 11 plan violated the "absolute priority rule" despite the objecting creditor failing to raise that argument before the Bankruptcy Court.<sup>22</sup> In doing so, the Eleventh Circuit imposed upon the bankruptcy courts an independent duty to review a Chapter 11 plan if the plan is what is generally known as a "cramdown" plan under 11 U.S.C. §1129(b). This article will attempt to give a brief overview of the decision in *In re Lett* and discuss the potential ramifications of the decision.

The Debtor in *In re Lett* was an individual physician practicing in

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<sup>21</sup>632 F. 3d 1216 (11<sup>th</sup> Cir. 2011).

<sup>22</sup>*Id.* at 1220.

Selma, Alabama.<sup>23</sup> The primary debts of the Debtor were a judgment lien held by the Alabama Department of Economic and Community Affairs ("ADECA") which was in excess of \$3 Million, and a leasehold interest held by Ball Healthcare Dallas, LLC ("Ball") against a nursing home located in Selma.<sup>24</sup> The Debtor filed several amended plans of reorganization, with the Debtor's third amended plan of reorganization being the one ultimately confirmed by the Bankruptcy Court.<sup>25</sup> The Debtor's plan bifurcated ADECA's claim into secured and unsecured claims. The Plan proposed to pay to ADECA on account of its secured claim \$235,615 in equal installments beginning five years after confirmation. With respect to ADECA's unsecured claim of over \$2 Million, the Debtor proposed to pay roughly one percent in two annual installments.<sup>26</sup> The Plan further provided that "all property of the Estate shall revert in the Reorganized Debtor, all free and clear of all claims, liens, encumbrances and other interests of creditors."<sup>27</sup> ADECA voted to reject this plan and filed a written objection.

At the confirmation hearing, counsel for the Debtor offered a lengthy proffer that the proposed plan conformed with all of the requirements of 11 U.S.C. §1129, that the proposed plan was proposed in good faith and that the proposed plan did not unfairly discriminate against any creditors and was fair and equitable as to all

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<sup>23</sup>*Id.* at 1221.

<sup>24</sup>*Id.*

<sup>25</sup>*Id.* at 1222.

<sup>26</sup>*Id.*

<sup>27</sup>*Id.*

classes of creditors.<sup>28</sup> ADECA did not object to any portion of the proffer, but did raise a number of independent objections none of which were brought before the appellate courts.<sup>29</sup> Notably, ADECA did not raise any objection to the plan on the basis that it violated the absolute priority rule.<sup>30</sup> At the conclusion of the confirmation hearing, the Bankruptcy Court issued an order that "the objections of ADECA are due to be overruled and the plan meets th[e] necessary requirements of §1129."<sup>31</sup>

On appeal, ADECA, for the first time raised the objection that the plan violated the absolute priority rule as set forth in 11 U.S.C. §1129(b)(2).<sup>32</sup> The district court declined to reach the merits of ADECA's argument, instead holding that ADECA "did not preserve the issue for review because it did not raise the issue in the bankruptcy court."<sup>33</sup> Following the district court's ruling, ADECA appealed to the Eleventh Circuit.

The Eleventh Circuit started its discussion of the absolute priority rule by stating the rule that makes up the backbone of appellate practice: "[o]rordinarily an appellate court does not give consideration to issues not raised below."<sup>34</sup> However, the Eleventh Circuit went on to explain that, despite the above general rule, it would

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<sup>28</sup>*Id.* at 1223.

<sup>29</sup>*Id.* at 1224.

<sup>30</sup>*Id.*

<sup>31</sup>*Id.*

<sup>32</sup>*Id.*

<sup>33</sup>*Id.*

<sup>34</sup>*Id.* at 1226, quoting *Hormel v. Helvering*, 312 U.S. 552, 556, 61 S.Ct. 719, 721, 85 L.Ed.1037 (1941).

consider an issue raised for the first time on appeal if the issue involved only a pure question of law and if the failure to hear the issue would result in a “miscarriage of justice.”<sup>35</sup>This is known as the civil version of the “plain error rule.”

Oddly, after discussing the “plain error rule” the Eleventh Circuit ultimately held that it was not applicable to the case before it. Instead, the Eleventh Circuit held that the fact that a creditor had objected to the Plan, thus triggering the provisions of 1129(b), was enough in and of itself to place the absolute priority rule before the bankruptcy court, regardless of whether a creditor specifically objected on that basis or not.<sup>36</sup>The Eleventh Circuit then held that the “Bankruptcy Code envisions a bankruptcy court exercising an independent duty to ensure that the strictures of §1129(b) are met with regard to impaired dissenting classes of creditors in a Chapter 11 cramdown.”<sup>37</sup>The Eleventh Circuit even went so far as to state that dissenting creditors who do not attend the confirmation hearing “should presume that the bankruptcy court will complete its statutorily mandated duties-and, relatedly, for the appellate courts to hear challenges when the court

errs as a matter of law concerning the absolute priority rule.”<sup>38</sup> Perhaps as surprising as the decision it reached is the fact that the Eleventh Circuit viewed itself as acting to restore order to the bankruptcy courts. At the conclusion of its opinion the Eleventh Circuit baldly stated that its holding “should rededicate bankruptcy courts to the faithful execution of their statutory duties and ensure that contentious cram down proceedings occur as envisioned by Congress.”<sup>39</sup>

### **Decisions in the Wake of *In Re Lett***

Assessing the impact of *In re Lett* is difficult at this stage as there are few reported decisions on the subject. However, even with the dearth of case law, it is clear that the bankruptcy courts are already taking the “independent review” requirement to heart and making specific findings regarding whether the plan complies with the “absolute priority rule” regardless of whether a dissenting class of creditors raises that specific objection.<sup>40</sup> There is also one case already citing *In re Lett*, in the context of a Chapter 13 Plan and holding that the same independent review is required with respect to the provisions of a Chapter 13 Plan.<sup>41</sup>

Perhaps the most interesting case to come out of the wake of *In re Lett* is the recent decision of the Bankruptcy Court for the Southern District of Alabama in *In re Calhoun*, 2011 WL 3664418 (Bankr.S.D.Ala. Aug 19, 2011). In *Calhoun*, Judge Margaret Mahoney considered a Chapter 11 plan in which two creditors objected, GE Capital Solutions (“GE”) and Zion First National Bank (“Zion”).<sup>42</sup> Because there were two objecting creditors, the bankruptcy court turned to a review of 11 U.S.C. §1129(b) with respect to the objecting creditors. First, in reviewing GE the bankruptcy court concluded that the Debtor’s plan complied with the absolute priority rule because the plan proposed to pay GE in full.<sup>43</sup>

The bankruptcy court then turned its attention to Zion, whose claim had been bifurcated into a secured portion (Class 3) and an unsecured portion (Class 9). The bankruptcy court concluded that the plan complied with the absolute priority rule as to the secured portion of Zion’s was retaining its lien and the secured portion of its claim was being paid in full.<sup>44</sup> However, with respect to the unsecured portion of Zion’s claim, the bankruptcy court concluded that there was a possible violation of the absolute priority rule but that Zion had only filed a ballot with respect to its class 3 claim and not its class 9 claim.<sup>45</sup> As a result, there was no “dissenting” class with respect to the class 9 claim and 11 U.S.C.

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<sup>35</sup>*In re Lett*, 632 F.3d at 1227.

<sup>36</sup>*In re Lett*, 632 F.3d at 1229-30 (“To reiterate we do not hold that a failure to hear ADECA’s argument grounded in the absolute priority rule would lead to a miscarriage of justice; rather, we hold that the requirements of §1129(b) in a cramdown proceeding sufficiently present the absolute priority rule in the bankruptcy court as to preserve the issue for review and obviate the civil plain error rule in this narrow context.”)

<sup>37</sup>*In re Lett*, 632 F.3d at 1229.

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<sup>38</sup>*Id.* at 1230.

<sup>39</sup>*In re Lett*, 632 F.3d 1230.

<sup>40</sup>*See, e.g. In re Calhoun*, 2011 WL 3664418 (Bankr.S.D.Ala. Aug 19, 2011); *In re Rosewood at Providence, LLC*, 2011 WL 6780890 (Bankr.M.D.Ga. Dec. 27, 2011); and *In re Trenton Ridge Investors, LLC*, 2011 WL 4442270 (Bankr.S.D.Ohio June 23, 2011).

<sup>41</sup>*In re Beasley*, 2011 WL 4498942 at \*2 (Bankr.N.D.Ala. Sept. 27, 2011).

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<sup>42</sup>*In re Calhoun*, 2011 WL at \*3.

<sup>43</sup>*Id.*

<sup>44</sup>*Id.*

<sup>45</sup>*Id.*

§1129(b) was not applicable.<sup>46</sup> It does not appear that any creditors appealed this decision.

Beyond these reported decisions, *In re Lettis* likely to change the dynamic between dissenting creditors and the debtor in a Chapter 11 case. Dissenting creditors now may have more leverage in negotiating a withdrawal of their objections because they can now dissent and then lay in the weeds until after confirmation and appeal if the case is confirmed. Prior to *In re Lett*, dissenting creditors had to object to the Chapter 11 plan and then prosecute their objections at the confirmation hearing, a potentially expensive proposition. Depending on the value of the dissenting creditor's claim, the Debtor potentially had some leverage in negotiating with the dissenting creditor because of the potential cost involved in a contentious confirmation hearing. Now, the dissenting creditor no longer has to engage in the confirmation hearing and can rely on the bankruptcy court to potentially do its dirty work for it. Ironically, in attempting to "ensure that contentious cram down proceedings occur as envisioned by Congress" the Eleventh Circuit may have made the confirmation hearings less contentious by requiring the bankruptcy court to take over the role of the dissenting creditors.

An additional impact of *In re Lett* may be to cause debtors to affirmatively proffer evidence of new value in an attempt to circumvent the absolute priority rule, even in the absence of challenges to the proposed plan

on that basis. By doing so, the debtor allows the bankruptcy court to reach a holding that the absolute priority rule has been satisfied as a result of the new value being offered by the junior class of creditors (typically the equity interest holders in the Debtor). Such a holding by the bankruptcy court would likely fall outside the realm of being a pure holding of law, as the sufficiency of the new value given by the junior class of creditors is likely a question of fact, and not one of law.

In any event, it is clear that the holding of the Eleventh Circuit in *Lett* has increased the burden upon the bankruptcy courts to affirmatively review the Chapter 11 (and possibly Chapter 13) plans that are presented to them if there are any dissenting classes of creditors. The bankruptcy court can no longer rely solely upon the creditors and their attorneys to raise the appropriate objections and present evidence at the confirmation hearing. Now, it is up to the bankruptcy court to take on the role of the creditors' counsel when reviewing a Chapter 11 plan for potential violations of 11 U.S.C. §1129(b). To answer the question posed at the beginning of this article: It appears that the bankruptcy court is now to take an active role in the confirmation hearing by potentially becoming an advocate for the dissenting creditors.

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**Eligibility: Jefferson  
County Files  
Chapter 9  
By: William L. Thuston,  
Jr.**

On November 9, 2011, Jefferson County, Alabama, filed a voluntary petition for relief under Chapter 9. According to the County, the confluence of two (2) principal factors led to its bankruptcy filing:<sup>47</sup> First, the County was overwhelmed by debt service obligations related to its sewer system, which in turn led to credit rating downgrades and accelerated repayment schedules not only with respect to the sewer system's outstanding debt of over \$3.1 billion in principal alone, but also with respect to millions of dollars of the County's long-term general obligations. Second, while the sewer system calamity was unfolding, a combination of litigation and lack of legislative action left the County without the ability to collect an occupational tax, one of the County's principal sources of revenue and the only significant source of revenue without earmarks.

To be eligible for Chapter 9 protection, the municipality must meet the following five (5) eligibility requirements:

1. qualification as a municipality;
2. specific state authorization to file bankruptcy;
3. insolvency;
4. desire to effect a plan to adjust its debts; and,
5. either reach an agreement with a majority of its creditors concerning its debts, negotiate in good faith and fail to reach such an agreement, be unable to negotiate with the creditors

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<sup>47</sup> This information is taken directly, and often verbatim, from the pleadings filed by the County in its bankruptcy case. Neither Christian & Small LLP nor its attorneys take any position regarding whether these statements are true and correct.

<sup>46</sup> Id.

because such a negotiation is impracticable, or believe a creditor is attempting to obtain a preferential transfer subject to avoidance under the Bankruptcy Code. Certain creditors have conceded that the County meets four (4) of these requirements, but they are vigorously challenging whether the County has authorization to file bankruptcy under Alabama state law.

Unlike the other chapters of the Bankruptcy Code, Chapter 9 provides that a debtor is only eligible to file bankruptcy if the State in which the debtor is located has specifically authorized the debtor to file bankruptcy. Only about half the States authorize municipalities to file bankruptcy. Alabama has a state statute that allows municipalities to file Chapter 9 bankruptcy, but there is disagreement regarding whether Jefferson County qualifies under the statute ( *Ala. Code* § 11-81-3). The statute is found in the section of the Code of Alabama regarding municipal and county bonds. It contains a broad authorization for municipalities with bond debt to file bankruptcy. Jefferson County, however, does not have any bond debt; it only has warrant debt.

Warrants, like bonds, are debt instruments typically issued by municipalities to raise money to fund certain improvements. Jefferson County, for example, issued warrants to pay for the costs of upgrading its sewer system. The main difference between warrants and bonds is that bonds may not be issued unless they are first approved by a majority vote of qualified voters; warrants, by contrast, may be issued without any such vote. This difference in the approval process may have made it more attractive for Jefferson County, and many

other municipalities across the country, to issue warrants rather than bonds when seeking to raise money to fund improvements.

The County has taken the position that the statute applies equally to municipalities who have either bond debt or warrant debt. Certain creditors, however, contend that there is a clear difference between bond debt and warrant debt and, that because the County has no bond debt, the County is not authorized to file bankruptcy.

If Jefferson County is authorized to file bankruptcy under the state statute even though the County does not have any bond debt, the County's bankruptcy case will continue to proceed and it will be allowed to propose a plan for the adjustment of its debts; otherwise, the case may be dismissed.

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## Case Notes

### ***In re: Harvel*, 2011 WL 5149070 (Bankr. M.D. AL)**

The Debtors filed a Chapter 13 petition, along with a proposed Plan, on November 5, 2007. The Debtors' original Plan proposed to pay Fort McClellan Credit Union ("Credit Union") directly without modifying the lien. On December 4, 2007, the Debtors amended their Plan without changing the Credit Union's treatment, but the Court did not have proof of service. On January 4, 2008, the Debtors again amended their Plan and valued the Credit Union's collateral (a vehicle) at \$25,500.00. Again, the Court's record did not contain proof of service.

On February 26, 2008 the Court confirmed the Debtors' January 4,

2008 Plan and no creditors filed objections. On March 4, 2008, Credit Union timely filed a proof of claim for \$34,622.55 and claimed that it was fully secured. The Credit Union did not object to confirmation and the Debtors did not object to the Credit Union's claim. Neither party requested a hearing. The Debtors performed under the Plan for over three years before their automobile was stolen.

The Debtors received \$15,000.00 from the insurance company and proposed to pay the Credit Union the balance of the secured claim, \$9,337.85, and keep the remaining funds to purchase another vehicle. The Credit Union objected and claimed to be fully secured.

"Creditors who are not given adequate notice of a Plan are not bound by it." See, *City of New York v. New York, H.H. & H.R. Co.*, 344 U.S. 293, 2966-97 (1953); *In re Calvert*, 907 F.2d 1069, 1070 (11<sup>th</sup> Cir. 1990). The Credit Union "concedes that it had actual knowledge of the Amended Plan, notwithstanding the fact that the Debtor failed to file proof of service of the amended Plan." Thus, the Debtors' failure to file proof of service was not fatal to the Debtors' Motion to Approve Compromise.

The question at issue before the Court was "whether a proof of claim, which is 'deemed allowed' as no objection had been filed, overrides a confirmed Chapter 13 Plan." While the Credit Union's proof of claim was timely filed, albeit after confirmation, it was incumbent on the Credit Union to promptly bring the matter to the bankruptcy court's attention. The Credit Union slept on its rights for three years and then asked the

Court to value the collateral after it had been stolen and was not available for inspection. The Court denied the Credit Union's request for a valuation hearing pursuant to the doctrine of laches and the Debtors' Motion to Approve Compromise was granted.

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***In re: Meriweather*, 2011 WL 37644 (Bankr. M.D. AL)**

Ronald Meriweather ("Meriweather") filed a Chapter 13 petition on March 25, 2011. Gil's Auto's ("Gil's") was listed in the schedules and mailing matrix and did not object to confirmation. "Under the Plan, Gil's secured claim is also a 910 claim, to be paid in full, with interest, over the life of the Plan." Four months after confirmation of the Plan, Gil's filed a motion for relief from the automatic stay and argued that the vehicle was not part of the bankruptcy estate because (1) Gil's owned the vehicle and (2) Meriweather only held a leasehold interest in the vehicle. While Gil's did not allege a lack of adequate protection or that Meriweather breached the lease agreement, it's position was "simply that the Bankruptcy Court does not have any business telling Gil's what it can do with the Tahoe, because it is Gil's Tahoe."

Similarly, Shaquale Nolan filed a Chapter 13 petition which provided for a secured claim for Gil's on a 2002 automobile. As in Meriweather's case, Gil's was listed in the schedules and the mailing matrix. Gil's did not object to confirmation. Three months after confirmation, Gil's filed a motion for relief from the automatic stay that was identical to the motion filed in Meriweather's case.

The Court held that Gil's assertion that leases are not part of the bankruptcy process is without merit and wholly incorrect. Moreover "[o]nce confirmed, a chapter 13 plan binds the debtor and his creditors to the terms of the plan on any issue 'actually litigated by the parties and any issue necessarily determined by the confirmation order.'" 8 Collier on Bankruptcy ¶ 1327.02 (16<sup>th</sup> Ed. 2011). Gil's motions for relief from the automatic stay were denied by the Court.

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***In re: John W. McCombs, Jr.*, 2011 WL 4458893 (Bankr. S.D. AL)**

John W. McCombs Jr. ("McCombs" or "Debtor") executed a mortgage and promissory note to borrow \$1,233,000.00 from Heritage First Bank ("Heritage") on February 16, 2007. Heritage received a security interest, along with an assignment of rents, in six rental properties in Baldwin County, Alabama. In March 2011, the Debtor defaulted and Heritage mailed severance of rents notices to the respective tenants. The Debtor subsequently filed a chapter 11 petition and Heritage sent a second set of severance of rents notices. Heritage only received \$700.00 from the tenants. The Debtor collected approximately \$14,000.00 in rent from March 31, 2011 (the Petition Date) through July 2011. Heritage filed a motion to prohibit the use of cash collateral and asserted therein that the Debtor was using it without permission.

The Debtor argued that the assignment of rents was merely a collateral assignment and not an absolute assignment. "This distinction was critical because a prepetition, absolute assignment of rents strips the Debtor and the bankruptcy estate of any

proprietary interest in those rents. Under Alabama state law, the proper effect of an assignment of rents clause must be gleaned from the intent of the parties as exhibit in the language of the clause itself." See *In re Turtle Creek, Ltd.*, 194 B.R. 267, 278 (Bankr. N.D. Ala. 1996). Courts must interpret the actual assignment language in order to determine a party's intent. In the instant case, the phrase "[t]his assignment of Rents constitutes an absolute assignment and not an assignment for additional security only," proved that the assignment in question was indeed an absolute assignment. Thus, the Debtor retained no "proprietary interest in the rents that would have passed to the bankruptcy estate, pursuant to 11 U.S.C. § 541," and Heritage was entitled to receive the rents from the day the severance of rents notices were received by the tenants. The Court denied Heritage's motion because there was no cash collateral.

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***In re: Elizabeth Katherine Loving*, 2011 WL 3800042 (Bankr. S.D. AL)**

Elizabeth Katherine Loving filed a chapter 7 bankruptcy petition on April 8, 2011. The Debtor filed an adversary proceeding "asking the Court to determine the dischargeability of her 2007 Federal Income tax obligation." The United States filed a motion for summary judgment and asserted that the Debtor's 2007 tax debt was excepted from discharge because it was due on April 15, 2008, a period of less than three years from the petition date. The Debtor argued that 11 U.S.C. § 523(a)(1) does not bar the dischargeability of her 2007 Federal Income tax obligation.

"Section 523(a)(1)(A) of the Bankruptcy Code deems priority

taxes, as defined in 11 U.C.C. § 507(a)(8)(A)(i) and (ii), nondischargeable. Under 507(a)(8)(A)(i), a tax is a priority tax where it is a “tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition” and (1) “a return if required, is last due, including extensions, after three years before the date of the filing of the petition,” or (2) is “assessed within 240 days before the date of the petition. The Court found that (1) the Debtor’s 2007 tax debt was an “income tax debt for a taxable year that ended before the Debtor filed her petition on April 8, 2011”; and (2) that the Debtor’s 2007 tax return was due on April 15, 2008, a date within three years of Debtor’s April 8, 2011 petition date. The United States’ motion for summary judgment was granted and the Debtor’s 2007 Federal income tax debt was deemed nondischargeable.

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***In re: Smith v. Golatte, 2011 WL 3862210 (Bankr. M.D. AL)***

Creditor Smith (“Smith”) filed an adversary complaint under 11 U.S.C. § 523(a)(6) to determine the dischargeability of a debt owed to him by the Debtor Golatte (“Golatte”). Under 11 U.S.C. § 523(a)(6), the injury must be both “willful” and “malicious.”

Smith filed a complaint against Golatte in state court in December 2006 wherein he alleged gross negligence and wantonness on the part of Golatte as a result of a traffic accident. The facts at issue before the state court were, in relevant part, that Golatte was traveling on I-85 in the left-hand lane and attempted to turn into the median to perform a u-turn. Unfortunately, an individual was killed and Smith was injured after colliding with Golatte’s automobile. Smith received a monetary judgment in March 2010 in the amount of \$534,056.00, including an award

for punitive damages on the wantonness count, and Golatte did not appeal.

Golatte filed a voluntary chapter 7 bankruptcy petition and Smith subsequently filed an adversary proceeding. Golatte filed a motion for summary judgment. The court held that Smith failed to show that the injury was willful and granted Golatte’s motion. At issue before the Court was whether the injury was “willful and malicious.” Smith argued and the Court agreed that the injury was “malicious and that the doctrine of collateral estoppel preclude[d] this court from relitigating the issue.” With respect to the willful component, the Court held that “an award of punitive damages does not necessarily reflect a determination that a defendant acted intentionally” and therefore, the doctrine of collateral estoppel did not bar litigation on the issue of whether the debtor intended the injury.

## Submissions

### Wanted

*Stream of Commerce* is continually looking for articles on current topics in the areas of creditors’ rights and bankruptcy law. If you have any article we can review and possibly publish, please contact:

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