COLUMBUS BAR ASSOCIATION

Bankruptcy Committee

September 8, 2005

HIGHLIGHTS OF RECENT SIXTH CIRCUIT COURT OF APPEALS DECISIONS[1]

Perfection and Priority

United States of America v. Crestmark Bank (In re Spearing Tool and Manufacturing Co., Inc.), 412 F.3d 653 (6th Cir. 2005)

On June 21, 2005, the Sixth Circuit Court of Appeals issued the above-referenced decision involving a lien priority dispute between the holder (the "Bank") of the first filed security interest in the personal property of a Michigan corporation, "Spearing Tool and Manufacturing Co., Inc." and the Internal Revenue Service (the "IRS"). The IRS asserted a federal tax lien in all personal property of the debtor, and filed two notices of tax liens under an incorrect name, "Spearing Tool & Mfg. Company Inc." The Bank periodically requested lien searches from the Michigan Secretary of State in the exact legal name of the debtor, but the IRS liens did not appear using the Michigan search logic because they were not the exact legal name (though, at one point, the search results from Michigan included a handwritten note that the Bank may wish to search using "Spearing Tool & Mfg. Company Inc.").

The debtor commenced a chapter 11 case, and the Bank learned of the IRS liens and commenced an adversary proceeding to determine the priority of the Bank's lien on the debtor's personal property. The United States Bankruptcy Court for the Eastern District of Michigan (Judge Rhodes) ruled that the IRS lien had priority over the Bank notwithstanding Article 9 of the UCC (which would have required using the correct legal name here). The United States District Court reversed on the basis of the Article 9 rules.

The Sixth Circuit Court of Appeals held that federal law determines the priority of federal tax liens. The Court found that "a 'reasonable and diligent search would have revealed the existence of the notices under these names'" and that the Bank had failed to conduct such a search, particularly in light of the handwritten note from the Michigan Secretary of State. Moreover, the Court determined that requiring the federal government to comply with absolute precision as required under state perfection rules would be unduly burdensome. Finally, the Court rejected the argument that Article 9 applied, because the UCC applies to consensual security interests and not involuntary liens and the IRS, as an involuntary creditor, should be accorded special priority over voluntary creditors.

Although the Sixth Circuit stated that it was not opining as to whether creditors had a general obligation to search name variations (and limited its holding to these facts), this case has resulted in substantial discussion in the UCC commentary. As a result of this case, a first filed security interest in accounts and inventory may be primed by an IRS lien even if the IRS' notices of lien do not comply with Article 9.

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[1] **DISCLAIMER: The review of the cases herein is not a complete legal analysis and does not represent legal advice or conclusions. You are encouraged to read the cases in their entirety and draw your own conclusions.**

Student Loans

Ruehle v. Educational Credit Mgmt Corp. (In re Ruehle), 412 F.3d 679 (6th Cir. 2005)

On June 23, 2005, the Sixth Circuit Court of Appeals affirmed the Sixth Circuit Bankruptcy Appellate Panel's affirmation of the United States Bankruptcy Court for the Northern District of Ohio's ruling by Judge Kendig granting the creditor's Fed. R. Civ. P. 60(b)(4) motion after a entering an order discharging the debtor's student loan debt.

The debtor argued that, pursuant to 11 U.S.C. § 1327(a), the confirmed chapter 13 plan was binding and the creditor's claim for relief was barred by the doctrine of *res judicata.* The bankruptcy court disagreed, holding that the discharge was void because it had been obtained in violation of the creditor's due process rights. It vacated the portion of its discharge order that pertained to the debtor's student loans, finding that she had failed to establish undue hardship as required by 11 U.S.C. § 523(a)(8) and Fed R. Bankr. P. 7001(6). The appellate panel agreed with the bankruptcy court's reasoning and decision and found no error. The Sixth Circuit affirmed the determination that the debtor's proposed chapter 13 plan contained an illegal "discharge by declaration" provision, which purported to discharge her student loan debt without an adversary proceeding. The Sixth Circuit noted that the proposed discharge violated 11 U.S.C. § 523(a)(8) and Fed. R. Bankr. P. 7001(6), which required the debtor to file an adversary hearing in order to establish undue hardship with regard to the loans. The creditor's due process rights had been violated because it was not notified and did not receive the process it was due concerning the loan discharge.

Tirch v. Pennsylvania Higher Education Assistance Agency (In re Tirch), 409 F.3d 677 (6th Cir. 2005)

On June 3, 2005, the Sixth Circuit Court of Appeals reversed a decision of the Sixth Circuit Bankruptcy Appellate Panel upholding the United States Bankruptcy Court for the Southern District of Ohio's ruling by Judge Sellers granting a partial discharge of a chapter 7 debtor's student loans. The Sixth Circuit noted that the Court had very recently adopted the Brunner test in In re Oyler, 397 F.3d 382, 385 (6th Cir. 2005). Accordingly, a debtor seeking a partial discharge on the basis of "undue hardship" must make a three part showing:

> (1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made good faith efforts to repay the loans.

Brunner v. New York State Higher Education Services Corp., 831 F.2d 395, 396 (2d Cir. 1987). The Sixth Circuit determined, under this test, that the debtor failed to carry her burden as to prongs two and three. The Court found that the debtor failed to precisely identify how her condition would impair her future ability to work for a significant portion of the repayment plan.

Moreover, the debtor failed to establish that she had made a good faith effort to repay the loans. The Court noted that, while not a per se indication of a lack of good faith, the debtor's decision not to participate in the William D. Ford Income Contingent Repayment Program (the "ICR") was probative of her intent. The Court went on to explain the calculations for the ICR, and found that the debtor failed to sustain the heavy burden of proving she made a good faith effort to repay the loans.

Damages, Rejection Damages and Application of State Law

In re American HomePatient, Inc., 414 F.3d 614 (6th Cir. 2005)

On July 11, 2005, the Court affirmed the United States District Court for the Middle District of Tennessee's upholding of the bankruptcy court's determination of the amount of damages resulting from the debtors' rejection of an executory contract during a chapter 11 reorganization. The debtors entered into a credit agreement with their senior secured lenders that included a warrant agreement that permitted the lenders to purchase shares of the debtors' common stock at a stated exercise price. Thereafter, the debtors filed for chapter 11 relief, rejected the warrant agreement, and quantified the resulting damages. The Sixth Circuit affirmed the decision of the bankruptcy court setting the rejection date as the day immediately prior to the filing of the bankruptcy petition.

The lenders argued that the bankruptcy court erred in using the prepetition date for calculating rejection damages, suggesting instead that applicable state law required the use of the date of the notice of the breach (*i.e.*, the date of the notice of the rejection motion), and that the Bankruptcy Code only required that the damages be treated as a prepetition claim (not calculated as of the day prior to the petition date). The lenders claimed an additional $6 million in damages by calculating their claim using the price of the shares on the date of the notice of the rejection motion. The Court overruled this argument and determined that, under the clear language of 11 U.S.C. §§ 365(g)(1) and 502(g), damages were properly fixed as of the time of the deemed breach, which was immediately before the date of the filing of the petition.

Bear Stearns Government Securities, Inc. v. Dow Corning Corp. (In re Dow Corning Corp.), ___ F.3d ___, 2005 WL 2000376 (6th Cir. August 22, 2005)

Appellant, assignee of certain settlement payments, appealed the disallowance of "liquidated damages" based on a settlement agreement clause requiring payments of $100 per day if settlement payments were late. The Sixth Circuit Court of Appeals reviewed the applicable choice of law rules in the Sixth Circuit and, applying those rules, concluded that the $100 per day "liquidated damages" provision was not a reasonable estimate of anticipated damages and therefore not enforceable as a penalty provision under Texas law. The Sixth Circuit also concluded that, under Texas law, the debtor could not be estopped from arguing the illegality and unenforceability for public policy reasons of the provision in question.

Protection of Good Faith Purchasers

Made in Detroit, Inc. v. Official Committee of Unsecured Creditors (In re Made in Detroit, Inc.), 414 F.3d 576 (6th Cir. 2005)

On July 1, 2005, the Court upheld the dismissal of the debtors' appeal by the United States District Court for the Eastern District of Michigan of an order confirming a chapter 11 plan of liquidation as well as approving a sale of assets of the debtors under section 363 of the Bankruptcy Code. The appeal was dismissed pursuant to 11 U.S.C. § 363(m) because the property at issue was sold to a good-faith purchaser, so the appeal of the bankruptcy court's order confirming the plan of liquidation was statutorily moot.

The debtor appellants argued that the courts below erred in finding that the defendant trust was a good-faith purchaser for statutory mootness purposes. The Sixth Circuit concluded the trust was a good-faith purchaser and the sale of the property to the trust rendered the debtors' claims moot. The trust purchased the property in good faith, and the bankruptcy court specifically found that terms of the sale of the property were fair and reasonable, were negotiated at arms length, in good faith, and were in the best interests of the estate. Appellants failed to cite any evidence in the record to establish that the process of selling the property was tainted by fraud or collusion. The bankruptcy court's finding that the $4,800,000 price offered by the trust for the property was fair and reasonable was not clearly erroneous in light of several appraisals of the property ranging in value from $3,400,000 to $18,000,000.

Cramdown

Bank of Montreal v. Official Committee of Unsecured Creditors (In re American HomePatient, Inc.), ___ F.3d ___, 2005 WL 1949548 (6th Cir. August 16, 2005)

The United States Bankruptcy Court for the Middle District of Tennessee confirmed the chapter 11 debtor's proposed plan of reorganization pursuant to the "cramdown" provisions of 11 U.S.C. § 1129(b). The secured lenders appealed the confirmation order. The United States District Court for the Middle District of Tennessee denied the debtor's motion to dismiss on the basis of equitable mootness but affirmed the confirmation order. Both parties appealed.

The bankruptcy court determined that the appropriate cramdown interest rate for the secured lenders was 6.785 percent and fixed their collateral value at an amount less than what they were owed. The debtor moved to dismiss the lenders' appeal on the grounds of equitable mootness. The Sixth Circuit held that this motion was properly denied because the Fifth Circuit's test for equitable mootness, which it has adopted, was not met. See Bank of Montreal at *2-3, citing Manges v. Seattle-First Nat'l Bank (In re Manges), 29 F.3d 1034, 1039 (5th Cir. 1994). Though the plan was substantially consummated and the lenders had not obtained a stay, they plausibly argued that the debtor could pay the amount they sought without affecting the plan's success. The Sixth Circuit concluded that the bankruptcy court properly used the "coerced loan theory" in setting the interest rate at 3.5 percent over the rate for a six-year Treasury bill. The "eyepopping" 12.16 percent interest rate sought by the lenders - nearly eight percentage points higher than the prime rate - would have resulted in a windfall for them. The Sixth Circuit also found that the bankruptcy court properly valued the lenders' collateral by accepting the opinion of the debtor's

expert, who took current liabilities and excess cash into account when calculating the debtor's enterprise value.

PREVIEW FOR OUR NEXT MEETING

Successor Liability and Discharge of Debt; Veil Piercing; Fraudulent Transfers

Mickowski v. VisiTrak Worldwide, LLC, 415 F.3d 501 (6th Cir. 2005)

Taylor Steel, Inc. v. Keeton, 417 F.3d 598 (6th Cir. 2005)

Schilling v. Heavrin (In re Triple S Restaurants, Inc.), ___ F.3d ___; 2005 WL 2076636 (6th Cir. August 30, 2005)

Recent Sixth Circuit Bankruptcy Appellate Panel Decisions

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Recent Bankruptcy Court Decisions

TBA