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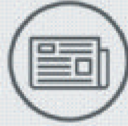

In-depth

News from Reed Smith's Restructuring & Insolvency Group

Note from Peter S. Clark, II (Restructuring & Insolvency Practice Group Leader):

Welcome to the December 2020 issue of the R&I Alert, the newsletter produced by Reed Smith's Restructuring & Insolvency Group.

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Counsel's corner:

- **Jason Angelo** participated on Pennsylvania Bar Institute panel: "Bankruptcy in a Pandemic: What You Need to Know"
- **Katelin Morales** hosted "A Conversation with Chief Judge Magdeline D. Coleman on Diversity and Inclusion"
- **Alexis Leventhal** participated on and moderated a panel on "Careers in Bankruptcy" for law students at Duquesne University School of Law and the University of Pittsburgh School of Law
- **Peter Clark** and **Jared Roach** participated on Business Law Institute 2020 panel: "Bankruptcy Update"

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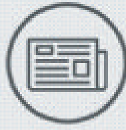

In-depth

Can Midstream Gathering Agreements be Rejected in Bankruptcy?

2020 has seen a significant increase in chapter 11 filings by oil and gas producers. Critical to the operations of these companies, and to the transportation and processing of the producer's gas, are gathering agreements entered into between the producers and midstream companies. A pivotal question posed at the start of these chapter 11 proceedings is whether the gathering agreements are executory contracts subject to rejection or whether they create real property interests that cannot be rejected in chapter 11 proceedings. The answer depends on who you ask. Bankruptcy Judge Sontchi, Chief judge of the Delaware Bankruptcy Court, recently issued three decisions holding that gathering agreements with midstream service providers did not create "covenants running with the land" and could be rejected in a chapter 11 proceeding. Those rulings are in contrast to recent opinions issued by the bankruptcy courts in Texas and Colorado in which the courts found that the midstream agreements at issue created real property interests that could not be rejected. Judge Sontchi determined that in order to run with the land, a covenant must meet the elements required of real property covenants. In the cases at issue, Judge Sontchi ruled that the covenants did not meet all of the necessary elements. In view of these decisions, midstream providers should make sure that gathering agreements have express provisions identifying the particular covenants running with the land and specifically state that such covenants inure to the benefit and burden of the parties and their successors and assigns.

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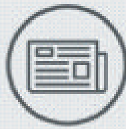

In-depth

Court Raises Potential Bad Faith Issue with “Death Trap” Provisions

In re Affordable Auto Repair, Inc., No. 6:19-bk-18367-MW, 2020 Bankr. LEXIS 2366 (Bankr. C.D. Cal. Sept. 2, 2020).

Case Snapshot

The court in *In re Affordable Auto Repair, Inc.* commented on “death trap” provisions in the context of chapter 11 plans without making an express ruling, though it highlighted some key considerations. In *Affordable Auto Repair*, the proposed plan set forth by Affordable Auto Repair included a class of general unsecured claims placed in “Class 4.” The United States Trustee took issue with the disparate treatment of claims within Class 4 based on whether the creditor voted to accept or reject the plan. The issue the court then raised was whether Class 4 members voting to accept the plan should have their votes designated under 11 U.S.C. § 1126(e) on the grounds that their acceptance was not solicited or procured in good faith. Judge Wallace refrained from ruling, stating that the matter was “currently unripe for decision” since the court had no motion to designate votes pursuant to section 1126(e) before it. Ultimately the court left the responsibility to examine such issues with the Debtor, the U.S. Trustee, and any other interested party.

Factual Background

The Debtor filed for relief under chapter 11 of the Bankruptcy Code on September 23, 2019 and filed a plan, a disclosure statement, and a motion to approve the disclosure statement on June 17, 2020. The Debtor subsequently Amended both the plan and disclosure statement (as amended, the “Plan” and the “Disclosure Statement’) on August 5, 2020, and the motion was heard shortly thereafter.

The United States Trustee objected to the Disclosure Statement, asserting that it described an unconfirmable Plan that was not proposed in good faith. The crux of the Trustee’s objection was that certain “incentive” provisions in the Plan interfered with creditors’ rights under the Bankruptcy Code. Namely, the treatment of Class 4 claims was ultimately dependent on how the unsecured creditor voted: those who voted to accept would receive more generous terms, those who voted to reject would receive less favorable terms, and those who abstained would receive the same treatment as those who voted to accept—provided that the Plan was accepted by Class 4 as a whole.

Analysis

As the court pointed out, such provisions incentivizing creditors to vote to accept have been referred to as “death trap,” “carrot and stick,” “toggle,” or “fish-or-cut-bait” provisions. However, the court made a distinction between the “death trap” provisions that the Debtor argued were generally upheld by courts and the provisions at issue in the Debtor’s Plan. The court explained that the death trap provisions the Debtor cited to were in the context of plans that rewarded the ***whole class*** with better treatment if it voted to accept the plan then what the entire class would have received if it had voted to reject the plan. In those cases, a single creditor who votes to reject the plan would still receive the better treatment if the class as a whole decides to accept. On the other hand, a creditor voting to accept would receive poorer treatment if the class as a whole voted to reject. The court stated that such treatment was justifiable in that if the class voted to accept, the plan proponent would be spared “the expense and uncertainty of a cramdown fight.”

The court distinguished the Debtor’s Plan, as it provided that individual creditors who voted to accept the plan would still receive better treatment even if the class as a whole voted to reject. Alternatively, the creditor who voted to reject while the class as a whole voted to accept would still receive poorer treatment under the Plan. The court stated that “[s]uch a structure would not appear on its face to have a valid and legitimate business purpose,” because even if the class voted to reject and the plan proponent had to deal with the expense of cramdown, those

creditor who had voted to accept would still "reap rewards."

The court distinguished a case cited by the Debtor, *In re Emerald Oil, Inc.,* in which the court confirmed a chapter 11 plan that provided for a distribution to class members who voted to accept the plan, but not for those who voted to reject. There, the court pointed out, those class members voting to reject the plan received a right to opt out of third party releases, while those who accepted were required to grant the releases.

The court refrained from making a ruling as to whether or not Class 4 members voting to accept the Plan should have their votes designated under 11 U.S.C. 1126(e), noting that there was no motion to designate before it, nor any briefing. The court concluded by discussing the broad language of 11 U.S.C. 1126(e), which it described as sufficiently broad to include bad faith of the plan proponent: " . . . the court may designate any entity whose acceptance or rejection of such plan . . . was not solicited or procured in good faith." The court granted the motion, approved the disclosure statement, and reserved the rights of the United States Trustee and any interested party to "take appropriate action" with respect to the issue of designation under 11 U.S.C. 1126(e).

Conclusion

The *Affordable Auto Repair* court ultimately approved the disclosure statement, tacitly concluding that the death trap provision issue was an issue for plan confirmation or other motion practice. However, in doing so the court raised its reservations and doubts as to whether this type of a carrot and stick approach could be sustained.

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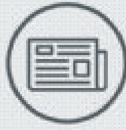

In-depth

Court Dismisses Several Counts of the Debtors' Complaint Against a Bank Upon Determination That the Debtors Had Not Sufficiently Pled the Transfer of Element of its Preference and Fraudulent Transfer Claims

Reagor-Dykes Motors, LP, et al. v. FirstCapital Bank of Texas, N.A., No. 18-50214-RLJ-11, 2020 WL 4939180 (Bankr. N.D. Tex. Aug. 24, 2020).

Case Snapshot

A Court granted a bank's motion to dismiss the preference claims and fraudulent transfer claims in a complaint finding that the Debtors had failed to meet the pleadings standards for these counts. Specifically, the Debtors only generally alluded to the fact that transactions between the Debtors and the bank had occurred over two years pursuant to the alleged kiting scheme, but did not identify which of these transfers were subject to avoidance as preferential and / or fraudulent transfers.

Factual Background

By the Complaint, the Debtors alleged that their "rogue CFO" collaborated with a bank to, in effect, defraud the Debtors and their creditors. According to the Debtors, this was done by the daily movement of funds among the Debtor-entities' bank accounts in amounts that far exceeded the Debtors' ability to honor. The bank was in the middle of this scheme by knowingly allowing the Debtors to maintain large overdrafts in the Debtors' accounts at the bank and by accommodating the Debtors' "perverted" use of sight drafts to create immediate credit and several days' "float" that allowed the scheme to persist. In other words, the Debtors alleged that the bank assisted the CFO in perpetrating a kiting scheme that permitted the Debtors to shield assets from their creditors.

Based upon these facts, pursuant to the Complaint, the Debtors asserted seven ground for recovery as follows:

1. Count One for Preferential Transfers under § 547;
2. Count Two for Actual Fraudulent Transfers under §§ 544, 548(a)(1)(A), 550, and 551;
3. Count Three for Recovery of Avoided Transfers under § 550;
4. Count Four for Equitable Subordination;
5. Count Five for Objection to and Disallowance of Claims;
6. Count Six for Willful Violation of the Automatic Stay; and
7. Count Seven for Attorneys' Fees and Costs

The bank filed a motion for summary judgment seeking dismissal of the preferential and fraudulent transfer Counts on several grounds including: (i) the bank was, at most, a mere conduit on the Debtors' movement of funds in-and-out of their accounts at the bank; and (ii) to the extent the movement of funds constitutes transfers to FirstCapital, the Debtors have failed to plead the transfer-based causes with sufficient particularity.

Court Analysis

Regarding the preferential transfer action, the Court summarily rejected the bank's "mere conduit" argument stating that such argument is an affirmative defense and not properly considered on a motion to dismiss. Despite the failure of this argument, however, the Court agreed with the bank that the Debtors had failed to adequately

identify the specifics of the alleged transfers. The Court addressed the various standards that have been adopted in recent history in determining whether a preference action is properly pleaded: FRCP 8(a) and adopting the heightened pleading standard elucidated in Valley Media, Inc. v. Borders, Inc. (In re Valley Media, Inc.), 288 B.R. 189, 191 (Bankr. D. Del. 2003) or the more relaxed standard under U.S. ex rel. Bledsoe v. Cmty. Health Sys., Inc., 501 F.3d 493, 509–10 (6th Cir. 2007).

As the court explained, under the heighted standard of Valley Media, a plaintiff must plead each transfer by date, amount, transferor, and transferee. By contrast, under the Bledsoe standard, the heightened standard of Valley Media is relaxed "[w]here the allegations in a relator's complaint are 'complex and far-reaching, pleading every instance of fraud would be extremely ungainly, if not impossible.'" In the instant case, the Court decline to adopt either standard, finding that that the Complaint did not provide specificity needed for the alleged preferential transfers under "the most-forgiving view of the standard" and, therefore, fails to give the bank fair notice of the transfers made that are alleged to be preferential.

The Court made a similar finding regarding the actual-fraudulent transfer action: that the complaint failed to meet the pleading standard of FRCP 9(b) in identifying the alleged fraudulent transfers. The Court disagreed with the bank's argument, however, that the Debtors had failed to plead the intent-to-defraud element, finding that, similar to a Ponzi Scheme, a kiting scheme may be afforded the same presumption of fraudulent intent where, as here, the scheme is supported by additional facts supporting the implication of intent.

In sum, the Court concluded that, without curative amendments, Counts One and Two of the Complaint must be dismissed for failure to adequately plead the transfers that support both the preferential and fraudulent transfer claims under §§ 547 and 548, respectively. The Court granted the Debtors fifteen days to amend the Complaint and would consider the amendments upon motion and cause shown.

Practical Considerations

This case serves as a reminder as to the importance of pleading, with the requisite specificity, of the transfers in preferential and fraudulent transfer actions.

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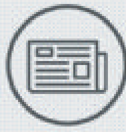

In-depth

Third Circuit Holds that Cramdown May Override Terms of Subordination Agreement

In re Tribune Company, et al. No. 18-2909 (3d Cir. filed Aug. 26, 2020).

Case Snapshot

A Chapter 11 Debtor's proposed plan included the making of payments to one class of creditors from indebtedness that had previously been subordinated to that of another class of creditors outside of bankruptcy. The senior creditors objected to the plan on the grounds that (i) it violated 11 U.S.C. § 510(a) by not giving effect to their existing subordination agreement, and (ii) it violated 11 U.S.C. § 1129(b)(1) by unfairly discriminating against them. The United States Bankruptcy Court for the District of Delaware confirmed the plan, and the District Court affirmed. The United States Court of Appeals for the Third Circuit affirmed the Bankruptcy Court's approval of the plan, holding that a cramdown under § 1129(b)(1) may modify or overrule the terms of a pre-existing subordination agreement, so long as the plan does not unfairly discriminate between classes of creditors.

Factual Background

The facts of the case are somewhat technical and complex, but basically are as follows. The Tribune Company ("Debtor") filed its chapter 11 petition in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") in 2008. At the time of filing, a group of creditors (the "Senior Creditors") held approximately $1.283 billion in debt owed by Tribune (the "Senior Debt"). The Senior Debt included indentures explicitly giving it priority of payment over certain other indebtedness of Debtor to other creditors in the aggregate amount of approximately $984 million (the "Subordinated Debt"). The indentures in the Subordinated Debt provided that none of the Subordinated Debt was to be repaid until all "Senior Obligations" were first repaid in full, which included, but was not necessarily limited to, the Senior Debt. Debtor also had the following relevant indebtedness: (i) approximately $150.9 million of unsecured "Swap" debt in connection with a failed leveraged buyout (the "Swap Debt"); (ii) approximately $105 million of unsecured claims held by Tribune Media Retirees (the "Retiree Debt"); and (iii) approximately $8.8 million of unsecured claims held by trade and other miscellaneous creditors (the "Trade Debt", and together with the Swap Debt and the Retiree Debt, the "Other Unsecured Debt").

In time, Debtor proposed a plan of reorganization (the "Plan"), which classified the Senior Creditors separately from the Other Unsecured Debt. The Plan proposed to pay both the Senior Creditors and the Other Unsecured Debt partially from monies under the Subordinated Debt. The effect of this would essentially be to give the Other Unsecured Debt equal payment rights to the Subordinated Debt with the Senior Debt, despite the fact that the Other Unsecured Debt did not constitute "Senior Obligations" as required by the subordination indentures. The Senior Creditors objected to the Plan on two fronts: (i) firstly, they claimed that it violated § 510(a), which provides that a subordination agreement is enforceable in a bankruptcy case to the same extent that it would be under applicable nonbankruptcy law; and (ii) the Plan unfairly discriminated against the Senior Creditors in favor of the Other Unsecured Debt by increasing the recovery of the Other Unsecured Debt at the cost of the recovery on the Senior Debt, in violation of § 1129(b)(1). The Bankruptcy Court confirmed the Plan anyway, and the United States District Court for the District of Delaware affirmed. The Senior Creditors then appealed again to the United States Court of Appeals for the Third Circuit (the "Court").

Court Analysis

The Court first addressed the Senior Creditors' argument that the Plan violated § 510(a) by not strictly enforcing the terms of their subordination indentures. Looking to the plain text of the Bankruptcy Code, the Court noted that § 1129(b)(1) specifically begins with the words "Notwithstanding section 510(a)." The Court thus determined that the cramdown provisions of § 1129(b)(1) may override the protections given to subordination agreements through § 510(a), so long as the other requirements of § 1129(b)(1) are met. While the Court had little difficulty in reaching this conclusion, it noted that it was only aware of one other case (*In re TCI 2 Holdings*, 428 B.R. 117, 141 (Bankr.

D.N.J. 2010)) that addressed a similar issue. Despite this lack of guidance, the Court determined that both § 1129 (b)(1) and § 510(a) operate to determine the priority of distributions to creditors, and given this alignment of purposes, the “notwithstanding” language of § 1129(b)(1) clearly gives that section priority in the event of any conflict between a plan and a subordination agreement. Therefore, the Senior Creditors could not rely on § 510(a) for their objection to the Plan.

The Court then turned to the Senior Creditors’ remaining argument: that the treatment of the Senior Creditors vis-à-vis the Other Unsecured Debt unfairly discriminated against the former in favor of the latter, in violation of § 1129 (b)(1). Following from its holding with respect to § 510(a), the Court began with the premise that the essential element for approval of a § 1129(b)(1) cramdown is that it does not “unfairly discriminate,” regardless of what other provisions it may override (in this case, § 510(a)). The Court went through a discussion of the four types of tests usually employed in unfair discrimination cases, noting that the Bankruptcy Court employed the “rebuttable presumption” test derived by Professor Markell.

The Senior Creditors alleged that the Bankruptcy Court erred by testing for unfair discrimination by comparing the Senior Creditors’ treatment under the Plan (where the subordinated payments were partially made to the Other Unsecured Debt) versus what the Senior Creditors would have recovered if the subordination provisions had been given full force and effect. The result of this analysis was a negligible change, which the Bankruptcy Court held did not constitute unfair discrimination. The Senior Creditors instead alleged that the Bankruptcy Court should have compared the recovery of the Senior Creditors’ class if they did not receive the benefit of subordination versus the recovery of the class containing the Other Unsecured Debt under the Plan. The Court applied went through an eight-step walkthrough of applying the unfair discrimination test in the case of a subordination agreement, determining that a presumption of “unfair discrimination” results when a dissenting creditor is afforded a “materially lower” percentage recovery under a plan than under a pro-rata distribution among equally-situated creditors of the same priority. Finding that the Bankruptcy Court correctly determined that no “materially lower” recovery was afforded to the Senior Creditors, the Court affirmed the Bankruptcy Court’s approval of the Plan and held that it did not unfairly discriminate against the Senior Creditors by failing to give full effect to the subordination indentures.

Practical Implications

Tribune serves as something of a cautionary tale for unsecured creditors who hope to protect their interests through subordination. At least within the Third Circuit, precedent has now been established that the protections of those subordination agreements do not withstand the force of a cramdown under § 1129(b)(1). An obvious—although perhaps impracticable—solution to this development would be for creditors to demand security from their borrowers, so as to avoid the cramdown problem in the first place. Conversely, from a debtor’s perspective, *Tribune* serves to make the Chapter 11 plan process even more flexible in the relief it can afford. By holding that § 1129(b)(1) overrides § 510(a), debtors have one less obstacle to navigate in the plan confirmation process, provided that the plan ultimately does not unfairly discriminate in its treatment of the subordination agreement.

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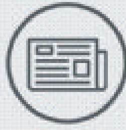

In-depth

Court Permits Election Of Sub Chapter V Small Business Case; Construes §1111(b) Election

Summary of decisions *In re Body Transit, Inc.*, No. BR 20-10014 ELF, 2020 WL 1486784 (Bankr. E.D. Pa. Mar. 24, 2020).

In this summary, we highlight two decisions issued by the United States Bankruptcy Court for the Eastern District of Pennsylvania in the In re Body Transit, Inc. bankruptcy case. In the first decision from March 24, 2020, the bankruptcy court held that the debtor had the right to elect to have its case proceed under subchapter V of chapter 11 pursuant to the Small Business Reorganization Act of 2019 ("SBRA"). Even though the case was originally commenced prior to the effective date of the SBRA, the court held that the election was proper and the case could proceed under subchapter V. See 613 B.R. 400 (Bankr. E.D. Pa. 2020).

The court's more recent decision on August 7, 2020 addressed an objection to the secured creditor's §1111(b) election and a motion to determine secured status. Because the issues had overlapping factual and legal issues, the court consolidated the matters for an evidentiary hearing. After hearing from at least four witnesses, the court evaluated the lender's secured position and its relative rights under the bankruptcy code.

The debtor operated three (3) gyms. Two of the locations were closed and the assets therefrom sold. The secured lender held liens on substantially all of the debtor's personal property - consisting mostly of fitness equipment. The debtor intended to reorganize around the remaining location and presented a plan for confirmation. In its plan, the debtor sought to bifurcate the secured lender's claim. The secured creditor objected and attempted to exercise its rights under §1111(b) of the Bankruptcy Code. The debtor, in turn, objected to the lender's election.

The majority of the opinion highlights the valuation information which the court received at the evidentiary hearing. However, the case is interesting because it explores the little used (and often confused) §1111(b) election. In addition to highlighting the significance of the election – why it could be used and when it is beneficial - the court also explored when the election may be refused.

The court first highlighted the significance of the §1111(b) election and its implications for confirmation of a plan over the objection of a secured creditor. The §1111(b) election allows a secured creditor to retain the entirety of its principal claim through a plan. In the plan, the debtor is only required to make payments equal to the secured portion of its claim plus interest, but the lender reserves the right to receive its full principal balance from any disposition of collateral. The election lies exclusively with the secured creditor, unless the court finds that the collateral to be retained as "inconsequential value". The court also reviewed the policies §1111(b) was meant to protect. Section 1111(b) protects a secured creditor from having its claim striped down in a depressed collateral market, when the collateral has foreseeable appreciation.

The code does not define "inconsequential value," so the court explored how that assessment should be made. While reviewing other possible explanations, the court concluded that determining "inconsequential value" requires a comparison of the value of the secured creditor's interest (i.e., the value of its collateral) to its overall claim position. Based on the evidentiary hearing, the court found that that secured creditor's collateral value was $80,000, which was roughly 8% of its overall claim. The court also noted testimony about the substantial changes to fitness center businesses and the short and long-term headwinds stemming from the COVID-19 pandemic. Because fitness centers may have a fundamental shift in its overall business plan and asset valuation, the court concluded that the current environment did not anticipate foreseeable appreciation. In fact, the §1111(b) election here was solely as a means to block confirmation (resulting in a liquidation value for assets – which was even less than what the court assessed). For that reason, the court concluded that the secured creditor's valuation was of "inconsequential value;" therefore, the court could statutorily refuse the secured creditor's §1111(b) election. The court sustained the debtor's objection to the creditor's §1111(b) election and bifurcated the creditor's claim into an $80,000 secured portion and an $890,000 unsecured portion.

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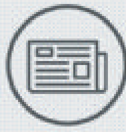

In-depth

Strong Arm Powers Used to Avoid Judgment Lien: A Lesson in Compliance with State Law Execution Rules

Straffi v Aeris Bank (In re Hillesland), No. 19-25278(CMG), 2020 Bankr. LEXIS 2235 (Bankr. D.N.J. Aug. 17, 2020).

Case Snapshot

The Bankruptcy Court held that a chapter 7 trustee could avoid judgment creditor's lien pursuant to his "strong-arm" powers under section 544(a) of the bankruptcy code because the judgment creditor did not make a good faith effort to locate debtor's personal property before it levied against real property, as required under applicable New Jersey law.

Factual Background

Bank obtained a pre-petition judgment in the amount of about $65,000, which was docketed as a state-wide lien. Bank took some steps to engage in post-judgment discovery, including issuing an information subpoena. Judgement Debtor responded to the subpoena indicating that he owned some real property, refused to answer certain questions regarding personal property, and indicated that he owned bank accounts and a vehicle jointly with his wife. Bank did its own investigation to reveal certain bank accounts owned solely in Debtor's name, and took steps to levy against those accounts though a writ of execution seeking to levy against the Debtor's personal property and "if sufficient personal property cannot be found then … out of real property." Thereafter, the Bank re-submitted the writ of execution instructing the Sheriff to levy upon the debtor's "good and chattels and real estate" without an itemization of any personal property to seek out. The Debtor refused the sheriff access to his property, and the Sheriff was unable to determine whether the Debtor had any personal property to levy. Bank took steps to obtain a court order for entry to the property. That motion had not been granted as of the debtor's bankruptcy filing.

Case Analysis

The Chapter 7 Trustee's lien powers under section 544(a) of the Bankruptcy Code grant him the status of a hypothetical judicial creditor who has levied upon the debtor's property. This status is senior to an actual judicial lien holder who has to levied, but junior to a valid lien holder who has properly levied on the property pre-petition. Thus, the Court here was tasked with determining whether the Bank had properly levied on the Debtor's property pre-petition.

In New Jersey, a sheriff is required to first attempt to levy upon personal property of a judgment debtor before levying upon real estate. The judgment creditor must make a good faith attempt to ascertain the location of the judgment debtor's personalty within the county and supply that information to the sheriff along with the writ of execution prior to levying against real property. Under New Jersey law, it is impermissible to simultaneously levy upon real and personal property, although the writ can seek to satisfy the judgment first from personal property and if sufficient personal property cannot be found, then out of real property.

Courts in New Jersey have held that a judgment creditor made a good faith attempt to locate personal property where the judgment debtor evaded questioning during a deposition in aid of execution or when answering an information subpoena. However, courts have found an absence of good faith effort where a judgment creditor fails to participate in the discovery process. Judgement creditors may rely upon judgment debtor's discovery responses in establishing to the sheriff that the judgment debtor does not have sufficient personal property assets to levy. However, the judgment creditor cannot rely upon a judgment debtor's refusal to allow entry into a premises as evidence of a lack of personalty; in that case, the judgment creditor should obtain an order to enter from the court which would enable the judgment creditor to inventory personal property. Courts have held that without taking steps to inventory personal property, the judgment creditor had not made good faith effort to locate ad levy upon personal property and, therefore, were not justified in executing upon real property.

In this case, the Bank engaged in post-judgment discovery by issuing an information subpoena, and the debtor left many questions regarding personal property ownership blank. The Bank argued that it made a good faith effort to locate personal property, and that the writ contained language requesting that the sheriff first attempt to levy against personal property before levying upon real property. The Court struck down this position for several reasons. First, the Court held that the Bank did not have additional information to know whether the Debtor's blank answers were an indication that the Debtor did not own such property or whether his failure to answer wan an oversight or intentionally evasive; in fact, the Court concluded that it was unreasonable under the circumstances for the Bank to conclude that the Debtor had no personal property, given that the information subpoena responses did disclose an ownership interest in a vehicle and that the Bank's own investigation revealed a few bank accounts. Under the circumstances, the Bank had a duty to probe further to identify and sell personal property before it could validly levy against real property.

Second, the Court observed numerous ways in which the Bank's execution strategy belied its arguments before the bankruptcy court. For example, the Court observed that the Bank filed a motion to enter the property, seemingly in recognition of the fact that a judgment creditor cannot rely upon the debtor's refusal to allow entry to property as proof of a lack of personal property to levy upon, which is inconsistent with the position taken before the Bankruptcy Court, where it argued that it had no duty under the circumstances to attempt to levy against personal property first. Additionally, the writ delivered to the sheriff instructed the sheriff to execute upon "goods and chattels and real estate", without itemizing the "goods and chattels" to be levied upon; the Court reasoned that had the Bank intended to rely upon the information subpoena reply as indication of a lack of personal property assets, that Bank would have structured the writ differently. Finally, the Court observed that the Bank picked and chose when to rely upon the Debtor's information subpoena responses, conducting additional investigation on some aspects (i.e. bank accounts) and not on others (i.e. ownership of a vehicle). To this point, the Court held that the Bank "cannot pick and choose to rely on the Reply to avoid inventorying household assets, but not rely on the Reply when seeking out more liquid assets such as cash from bank accounts."

Ultimately, the Court concluded that the Bank's levy was not properly executed, that the Bank did not make a good faith effort to locate personal property before levying upon real property, that the Debtor's blank answer to the question about personal property in the Reply and refusal to allow entry did not relieve the Bank of the requirement to first levy upon personal property, and that the Bank was required to do further investigation to access and inventory the personal property. For that reason, the Court held that the Trustee's strong-arm powers allowed him to avoid the Bank's judgment lien and granted summary judgment in the Trustee's favor.

Practical Considerations

It is important for judgment creditors to be aware state law execution processes vary greatly from state to state, and great care must be taken to comply with execution procedures so as to minimize the risk that a judgment lien can be avoided during a post-judgment bankruptcy through the trustee's strong arm powers under section 544(a).

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