2002 Annual Meeting

Bankruptcy Update

(Federal Practice Track)

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BANKRUPTCY UPDATE

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OFF-SHORE TRUSTS

Several "asset-planners" advocate establishment of "off-shore trusts" to shield assets from creditors. Caselaw may, however, be signaling a judicial trend *against* the efficacy and enforceability of such arrangements. *Lawrence v. Goldberg (In re Lawrence)*, No. 00-14481, 2002 WL 86680 (11th Cir. Jan. 23, 2002) and *Federal Trade Comm'n v. Affordable Media*, 179 F.3d 1228 (9th Cir. 1999) are two recent examples. In each case, the issue on appeal was whether the district court erred in finding the trust settlors in contempt for failing to comply with an order to turnover the trust corpus.

***Federal Trade Comm'n v. Affordable Media*, 179 F.3d 1228 (9th Cir. 1999).** In *Affordable Media*, the Andersons created a trust under the law of the Cook Islands in an effort to protect their assets from liabilities. *See id.* at 1232. The trust named the Andersons as co-trustees together with a foreign company licensed to conduct trustee services under Cook Islands law. *See id.* Additionally, the Andersons were named the trust's protectors. *See id. at 1242.* The trust contained so-called duress provisions, which provided that upon the occurrence of an event of duress, the Andersons would be terminated as co-trustees and, accordingly, "control over the trust assets would appear to be exclusively in the hands of the foreign trustee." *Id.* at 1240. An event of duress was defined under the trust to include the issuance of any court order or judgment, which in the opinion of the protector would expropriate, sequester, or in any way restrict the free disposal by the trustee of the trust assets. *Id.*

Subsequently, the Federal Trade Commission brought a claim against the Andersons, and a temporary restraining order and preliminary injunction were entered ordering the Andersons to repatriate any assets held for their benefit outside the United States. *See id.* at 1232. In response to the injunction, the Andersons sent the foreign trustee a letter instructing the trustee to repatriate the trust assets to the United States to be held in the control of the court. *See id.* Upon receipt of the letter, the foreign trustee notified the Andersons that the TRO was an event of duress under the trust, removed the Andersons as co-trustees in accordance with the trust's duress provisions, and refused to repatriate the assets. *See id.* The FTC moved to find the Andersons in civil contempt for failure to comply with the TRO, and the Andersons responded that it was impossible for them to comply with the TRO because they no long had control over the trust. *See id.* The district court rejected the Andersons' impossibility of performance theory and found them in civil contempt. *See id.* at 1241. In finding the Andersons in civil contempt, the district court specifically found that they were still in control of the trust. *See id.* at 1241.

The Ninth Circuit Court of Appeals affirmed and ruled that the district court was not clearly erroneous in finding the Anderson still retained control over the assets. *See id.* at 1243. The court of appeals noted that "[a] party's inability to comply with a judicial order constitutes a defense to a charge of civil contempt." *Id.* at 1239 (citing *United States v. Rylander*, 460 U.S. 752, 757, 103 S.Ct. 1548, 75 L.Ed.2d 521 (1983). The court further noted, however,

> It is readily apparent that the Andersons' inability to comply with the district court's repatriation order is the intended result of their own conduct – their inability to comply and the foreign trustee's refusal to comply appears to be the precise goal of the Andersons' trust.
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> ...
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> Given that these offshore trusts operate by means of frustrating domestic courts' jurisdiction, we are unsure that we would find that the Andersons'

> inability to comply with the district court's order is a defense to a civil contempt charge. We leave for another day the resolution of this more difficult question because we find that the Andersons have not satisfied their burden of proving that compliance with the district court's repatriation order was impossible.
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> ...
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> In the asset protection trust context, moreover, the burden on the party asserting an impossibility defense will be particularly high because of the likelihood that any attempted compliance with the court's orders will be merely a charade rather than a good faith effort to comply. Foreign trusts are often designed to assist the settlor in avoiding being held in contempt of a domestic court while only feigning compliance with the court's orders.

Id. at 1239-41. The court of appeals based its ruling on the district court's finding that (1) the Andersons were still protectors of the trust, (2) the trust provided that the duress provisions were subject to the protectors' powers, and the protectors could appoint new trustees, and (3) the Andersons attempted to resign as protectors once the existence of the trust was revealed to the court. *See id.* at 1242-43. "Given that the Andersons' trust is operating precisely as they intended, we are not overly sympathetic to their claims and would be hesitant to overly-restrict the district court's discretion, and thus legitimize what the Andersons have done.

***Lawrence v. Goldberg*, No. 00-14481, 2002 WL 86680 (11th Cir. 2002 Jan. 23, 2002).** *Lawrence* presents a fact pattern similar to *Affordable Media*. Lawrence settled an offshore trust, which granted him the sole power to appoint trustees. *Lawrence*, 2002 WL 86680, *1. Two months later, a judgment was entered against Lawrence. *Id.* Lawrence amended the trust several times; these amendments included (1) adding a spendthrift provision, (2) adding a duress clause that prohibited Lawrence from exercising his powers under duress, and (3) irrevocably proscribing Lawrence from ever being a beneficiary under the trust. *Id.* Subsequently, Lawrence filed a voluntary bankruptcy petition, and the bankruptcy court entered an order directing Lawrence to turnover the trust assets. *Id.* Lawrence argued that it was impossible for him to

comply with the order, but the bankruptcy court rejected the impossibility defense and found that Lawrence had *de facto* control over the trust through his retained powers to remove and appoint trustees and to add and exclude beneficiaries. *Id.* Consequently, the court found Lawrence in contempt. *Lawrence*, 2002 WL 86680, *1. Thereafter, Lawrence executed a document naming the bankruptcy trustee as the trust's trustee and advising the previous trustee of his action; Lawrence asserted that he had no further power to turn the assets over to the bankruptcy trustee. *Id.* The bankruptcy court's order was appealed first to the district court, which affirmed the order.

The Eleventh Circuit Court of Appeals then affirmed the district court. The court of appeals agreed that Lawrence's powers to appoint trustees and name beneficiaries meant that Lawrence retained *de facto* control over the trust. *Id.* at *3. Further, the court of appeals stated,

> [W]e must agree with the trial court that Lawrence's claimed defense is invalid because the asserted impossibility was self-created. We previously have held that, "where the person charged with contempt is responsible for the inability to comply, impossibility is not a defense to the contempt proceedings." ... We agree with the district court that Lawrence created this trust in an obvious attempt to shelter his funds from an expected adverse arbitration award.

Id. at *4 (quoting *Pesaplastic, C.A. v. Cincinnati Milacron Co.*, 799 F.2d 1510, 1521 (11th Cir. 1986)).

SANCTIONS and FEE IMPOSITION

Sanctions in the form of attorney fee imposition were discussed *in Schwartz v. Kujawa,* 270 F.3d 578 (8th Cir. 2001) and *Halverson v. Funaro (In re Frank Funaro, Inc.)*, 263 B.R. 892 (8th Cir. Bankr. App. 2001).

***Schwartz v. Kujawa*, 270 F.3d 578 (8th Cir. 2001).** In *Schwartz*, the Eighth Circuit Court of Appeals considered a district court's order imposing sanctions and directing the payment of attorney fees. Schwartz served as an attorney for Kujawa on various matters until the two terminated their relationship as a result of a personal dispute. *See id.* at 580. Subsequently, Schwartz revealed information regarding Kujawa's finances that Schwartz gained in the course of representing Kujawa, and Schwartz helped creditors file an involuntary bankruptcy petition against Kujawa. *See id.* The Missouri Supreme court formally reprimanded Schwartz upon finding that he violated the Missouri Rules of Professional Conduct by revealing information gained in the course of representing Kujawa. *See id.* at 581. Thereafter, the bankruptcy court dismissed the involuntary petition and noted that the case was primarily a squabble between Schwartz and Kujawa, even though the statutory elements for involuntary bankruptcy had been met. *See id.* Additionally, the bankruptcy court held a hearing on fees, damages, and sanctions, and ordered Schwartz to pay Kujawa $78,409.83 in attorneys' fees and imposed a $100,000 sanction. *See id.* The bankruptcy court based its order on Federal Rule of Bankruptcy Procedure 9011, 11 U.S.C. § 105, and its inherent authority. *See Schwartz*, 270 F.3 at 582.

On appeal from the Eighth Circuit Bankruptcy Appellate Panel, which affirmed the bankruptcy court, the Eighth Circuit Court of Appeals reduced the attorneys' fees to $66,656.33, and reversed the $100,000 sanction levied against Schwartz. With respect to the attorneys' fees, the court of appeals agreed with the lower courts "that most of the fees were properly allowed as being the direct result of Mr. Schwartz's unethical behavior." *Id.* However, the court of appeals found three instances of work in which it was not reasonable to hold Schwartz responsible for the fees. *See id.* First, the court of appeals found that Schwartz should not have to pay for fees

pertaining to time spent by Kujawa's attorney conversing with members of the press because such conversations were not necessary to a sound legal defense of the involuntary bankruptcy petition. *Id.* Second, the court of appeals determined that Schwartz's misconduct was not related to fees for Kujawa's resistance to a motion of a creditor to lift the automatic stay. *See id.* "If Mr. Kujawa's harm results from being put in bankruptcy, it is incongruous to make Mr. Schwartz pay for Mr. Kujawa's efforts to use the bankruptcy to benefit and protect himself." *Schwartz*, 270 F.3d at 582. Finally, the court of appeals found that Schwartz should not be responsible for attorneys fees pertaining to the appeal from the bankruptcy court's decision to dismiss the involuntary petition. *Id.* This final determination was based in part on the fact that the appeal occurred almost a decade after the initial filing of the petition, and "Rule 11 is more sensibly understood as permitting an award only of those expenses directly caused by the filing, logically, those at the trial level." *Id.* at 583.

In discussing the $100,000 monetary sanction, the court of appeals noted,

> The cornerstone of imposing a monetary sanction ... should be the selection of an amount no greater than sufficient to deter future misconduct by the party. ... While awarding an amount of sufficient size to capture the attention of the misbehaving party may be part of effective deterrence, we believe the $100,000 sanction was an abuse of discretion. The amount is not related concretely to redressing the harm of Mr. Schwartz's misconduct and is not supported by the facts as being necessary to deter Mr. Schwartz in the future.

Id. at 583-84. The court of appeals specifically noted that eleven years had passed since Schwartz committed any ethical breach of his duties as an attorney, and Schwartz's reprimand likely acted as a strong deterrence against Schwartz committing any future breaches. *See id. a*t 584. Further, the court found the awarded attorneys' fees were substantial and redressed

Schwartz's actions toward Kujawa. *See id.* The court therefore reversed the levy of sanctions against Schwartz.

***Halverson v. Funaro*, 263 B.R. 892 (8th Cir. B.A.P. 2001).** In *Halverson*, the bankruptcy trustee filed an avoidance action to recover allegedly fraudulent or preferential transfers. *See Halverson*, 263 B.R. at 897. The trustee and Funaro brought cross-motions for summary judgment on the action, which the bankruptcy court denied. *See id.* After a trial on the action, the bankruptcy court found against the trustee and announced its intentions to award attorney's fees to Funaro. *See id.* Subsequently, the court awarded attorney's fees based on Federal Rule of Bankruptcy Procedure 9011, and the trustee appealed the award. *See id.*

The Eighth Circuit Bankruptcy Appellate Panel reversed the court's award on procedural and substantive grounds. On procedural grounds, the BAP found that the fees were awarded in contravention to Rule 9011 because Funaro did not file a formal motion for sanctions and the court did not enter an order to show cause. *See id.* at 902-02. On substantive grounds, the BAP observed that "in order to impose a Rule 9011 sanction the court must find that an attorney submitted a claim that has no chance of success under existing precedents and that fails to advance a reasonable argument to extend, modify, or reverse the law as it stands." *Halverson*, 263 B.R. at 900. "Rule 9011 requires only that an attorney make a reasonable inquiry prior to filing a complaint. ... In making its objective determination, the court should also consider whether anything in the record reflects a tenable basis for the allegations contained in the complaint." *Id.* at 903. The BAP found that bankruptcy court's denial of Furaro's motion for summary judgment demonstrated that there may have been some basis for the litigation. Consequently, the BAP ruled there was no basis for the bankruptcy court's finding that the

complaint was filed for improper purposes or that the complaint's contentions were not warranted by existing law. *See id.*

OTHER RECENT EIGHTH CIRCUIT and LOCAL CASE LAW

Landmark Community Bank, N.A. v. Perkins (In re Perkins), 271 B.R. 607 (8th Cir. Bankr. App. 2002), perhaps provides a glimpse of how e-filing may impact our practice. In *Landmark Community Bank*, after the bankruptcy court entered an order *deferring* the debtor's discharge, confusion arose as to when was the deadline for *filing* a complaint objecting to the discharge. Landmark, a credit of the debtor, was informed by the trustee that the court's order extended the time for filing such a complaint from November 27, 2000, to January 8, 2001. *See id.* at 608. Additionally, the electronic case file on the court's website showed both dates as deadlines for filing an objection to discharge. *See id.* at 608-09. Then Landmark inquired of the clerk of court and was told orally by the clerk that the deadline was extended to January 8. *See id.* at 609.

Prior to the January 8, 2001, deadline, Landmark filed an 11 U.S.C. § 727 complaint. *See id.* The BAP found that as of January 8, all the parties, including the debtor's counsel, the trustee, and the clerk's office employees who entered the new date into the electronic case file and orally represented that the deadline was extend, were all operating under the presumption that the deadline was extended to January 8, 2001. *See Landmark Community Bank*, 271 B.R. at 611. On the date of the trial on the complaint, after the parties had engaged in discovery and the court had denied Landmark's motion for summary judgment, the court raised the issue of whether the complaint had been timely filed. *See id.* at 609. The debtor then filed a motion to

dismiss based on failure to time file the objection to discharge under Federal Rule of Bankruptcy Procedure 4004. *See id.* The bankruptcy court found the true deadline was November 27, 2000, and granted dismissed Landmark's action. *See id.* Landmark appealed on the basis that equitable grounds existed to extend the deadline to January 8, 2001; Landmark conceded that the order *deferring* discharge did not operate to *extend* the deadline. *See id.*

On appeal, the BAP noted that it had previously ruled that a bankruptcy court may apply equitable principles to extend the discharge objection bar date. *See Landmark Community Bank*, 271 B.R. at 611 (citing *In re Bozeman*, 226 B.R. 627, 630 (8th Cir. BAP 1998). Relying on decisions by other circuit courts of appeals, the BAP reversed that bankruptcy court's decision and found that because the clerk of court erroneously posted a second bar date, and equity favored permitting Landmark's complaint.

> The bankruptcy court published the new bar date in the electronic case file on its website, and orally confirmed that January 8, 2001, was the section 727 deadline upon inquiry by one of Landmark's attorneys. The bankruptcy court clerk was wrong to establish a new bar date, but after careful consideration, we determine that Landmark reasonably relied on the January 8, 2001 deadline, and that under the fact of this case, the bankruptcy court abused its discretion by failing to exercise its equitable powers and permitting Landmark's section 727 adversary complaint to proceed. *Influencing our decision is the fact that the federal court system is rapidly converting to electronic case filing, that eventually all of the bankruptcy courts will be conducting business predominately electronically and that parties need to be able to rely on information contained in a bankruptcy court's electronic case file, including bar dates published by a bankruptcy court clerk. The parties to a bankruptcy case must be able to have confidence in the electronic case filing system.* Further, ... parties need to be able to rely on communications made by employees in the bankruptcy court clerk's office. When, as in this case, the information contained in the electronic case file on the bankruptcy court's website is confusing, the parties should be able to rely on the information given by a bankruptcy court clerk to resolve the confusion.

Id. at 614.

Judge Schermer dissented from the decision and contended that Landmark's reliance on the electronic case file and oral representation of the court clerk was not reasonable. *See Id.* at 616. Concerned with the possible encouragement of "future quests for ambiguity where none exists," the dissent noted, "[t]he majority would have a deputy clerk 's entry on a web page or an unreasonable misinterpretation have the force of law, superceding the clear Federal Rules of Bankruptcy Procedure promulgated by Congress." *Id.*

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