

No. 08-11098

**IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT**

DIANE G. REED,
Real Party in Interest

Plaintiff/Appellee

v.

CITY OF ARLINGTON

DefendantAppellant

**ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS (FORT WORTH
DIVISION)**

**BRIEF OF COMMERCIAL LAW LEAGUE OF AMERICA
AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION
FOR REHEARING *EN BANC***

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CERTIFICATE OF INTERESTED PERSONS

The undersigned counsel of record certifies that the following listed persons and entities as described in the fourth sentence of Rule 28.2.1 have an interest in the outcome of this case. These representations are made in order that the judges of this court may evaluate possible disqualification or recusal.

1. Diane G. Reed, plaintiff-appellee;
2. City of Arlington, Texas, defendant-appellant;
3. Kim W. Lubke, debtor;
4. Commercial Law League of America, amicus curiae;
5. Michael A. McConnell, Marianne M. Auld, Matthew D. Stayton, Kelly, Hart & Hallman, attorneys for defendant-appellant City of Arlington;
6. Denise V. Wilkerson, attorney for defendant-appellant City of Arlington;
7. Todd A. Hoodenpyle, Larry A. Levick, Singer & Levick, P.C., attorneys for plaintiff-appellee;
8. Stephen W. Sather and Barbara M. Barron, Barron, Newburger & Sinsley, PLLC, attorneys for amicus curiae.

/s/Stephen W. Sather

Attorney of record for Amicus Curiae

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BRIEF OF COMMERCIAL LAW LEAGUE OF AMERICA
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THE PETITION FOR REHEARING *EN BANC*

TO THE HONORABLE UNITED STATES COURT OF APPEALS:

COMES NOW the Commercial Law League of America, *Amicus Curiae*, and submits this Brief in Support of the Petition for Rehearing *En Banc* and would show as follows:

STATEMENT OF INTEREST OF AMICUS CURIAE

The Commercial Law League of America (CLLA), founded in 1895, is the

nation's oldest organization of attorneys and other experts in credit and finance actively engaged in the field of commercial law, bankruptcy and reorganization. The League's membership, which numbers nearly 2,000 professionals, includes attorneys from large and small firms and bankruptcy judges representing virtually every state, and consists of representatives of divergent interests in bankruptcy cases. The CLLA has been associated with the representation of creditor interests, while at the same time seeking fair, equitable and efficient administration of bankruptcy cases for all parties in interest.

ARGUMENT AND AUTHORITIES

The seven-year debate that culminated in passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") centered on the desire to "improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensure that the system is fair for both debtors and creditors." H.R. Rep. No. 109-31, 109th Cong., 1st sess., (April 8, 2005), p. 2. The amicus submits this brief out of concern that the panel opinion in this case runs contrary to fundamental policies underlying the Bankruptcy Code as identified by Congress. The holding in *Reed* rewards the dishonest debtor, undermines the ability of trustees to recover assets, and significantly diminishes the opportunity for distributions to unsecured creditors. In doing so, it negatively affects the integrity of the bankruptcy system on multiple levels. While the

opinion addresses the position of a bankruptcy trustee in a single case, the trustee acts on behalf of the creditors and, if the opinion is left standing, it will set a bad precedent in future cases and therefore have an impact far greater than this debtor and his creditors.

This Court's Internal Operating Procedures describe petitions for rehearing en banc as "the most abused prerogative of appellate advocates in the Fifth Circuit." Fifth Circuit, Internal Operating Procedures, Petition for Rehearing En Banc. However, this is exactly the type of extraordinary case which should be considered by the Court on an en banc basis. The panel decision in this case is inconsistent with a prior panel decision on the same subject matter, conflicts with precedent in other circuits, violates the statutory scheme created by Congress and threatens the integrity of the bankruptcy process.

I. The Fifth Circuit Should Grant En Banc Review to Harmonize Its Decisions on Judicial Estoppel

Pursuant to Fed.R.App.P. 35(a) (1), the Court may grant *en banc* review when it is "necessary to secure or maintain uniformity of the Court's decisions." This is a case where *en banc* review is necessary to secure uniformity of the court's decisions. The panel opinion in this case recognized the need to harmonize the court's decisions. While referring to the results in the court's decisions as "to put it kindly, a mosaic," the panel stated that, "(a)bsent en banc harmonization, we must endeavor to reconcile the authorities." *Reed*, slip op. at 4, 5.

Judicial estoppel is designed to protect the integrity of the Court system by preventing parties from benefitting from taking inconsistent positions. The elements of judicial estoppel are (1) inconsistent positions, (2) which mislead the court and (3) result in an unfair advantage to the inconsistent party or unfair detriment to the opposing party. *New Hampshire v. Maine*, 532 U.S. 742 (U.S. 2001). In the bankruptcy context, judicial estoppel prevents an abusive debtor from concealing assets and then benefitting from those same assets. However, the court's decisions have split as to whether the trustee and the creditors should be bound by the debtor's omissions.

Between 1999 and 2010, the Fifth Circuit has published four panel opinions on the issue of judicial estoppel in bankruptcy. (i) *Reed v. City of Arlington*, ___ F.3d ___, 2010 U.S. App. LEXIS 19319 (5th Cir. 2010); (ii) *Kane v. National Union Fire Ins. Co.*, 535 F.3d 380 (5th Cir. 2008); (iii) *Superior Crewboats, Inc. v. Primary P & I Underwriters*, 374 F.3d 330 (5th Cir. 2004); and (iv) *Browning Mfg. v. Mims*, 179 F.3d 197 (5th Cir. 1999).

The earliest two decisions, *Browning v. Mims* and *Superior Crewboats*, are consistent in both their logic and their results. However, the Court's decisions in *Reed* and *Kane* cannot be reconciled; which was recognized by the panel in this case when it criticized the *Kane* decision by stating that it "purports" to distinguish *Superior Crewboats*. *Reed*, slip op. at 9. However, a stronger case can be made that

Kane is consistent with the Court’s prior decisions and that *Reed* is the inconsistent decision.

The following chart summarizes the major characteristics of the four decisions:

Case	Wrongdoer	Party Who Sought to Benefit	Role of Trustee	Outcome
<i>Browning Mfg. v. Mims</i> , 179 F.3d 197 (5 th Cir. 1999)	Debtor-in-Possession	Asset purchaser controlled by insiders of Debtor in Possession	Debtor-in-Possession acting in capacity of Trustee was the wrongdoer. See 11 U.S.C. §1107.	Judicial estoppel was applied against the asset purchaser
<i>Superior Crewboats, Inc. v. Primary P & I Underwriters</i> , 374 F.3d 330 (5 th Cir. 2004)	Debtor	Debtor	Trustee abandoned asset based on Debtor’s misrepresentations	Judicial estoppel was applied against the debtor
<i>Kane v. National Union Fire Ins. Co.</i> , 535 F.3d 380 (5 th Cir. 2008)	Debtor	Debtor	Trustee sought to protect claim for benefit of creditors	Judicial estoppel was not applied against the trustee
<i>Reed v. City of Arlington</i> , ___ F.3d ___, 2010 U.S. App. LEXIS 19319 (5 th Cir. 2010)	Debtor	Debtor	Trustee sought to protect claim for benefit of creditors	Judicial estoppel was applied against the trustee

In each of the four decisions, the debtor or debtor-in-possession was the wrongdoer. However, the role of the trustee differed substantially. In *Browning v. Mims*, the wrongdoer was a chapter 11 debtor-in-possession, while the party who

sought to benefit from the omission was a purchaser of the debtor's assets formed by insiders of the debtor. The debtor-in-possession (who had previously exercised the powers of trustee) was not involved in the litigation and would have been properly judicially estopped based on its own conduct. In *Superior Crewboats*, the trustee was misled by the debtor's actions and abandoned the asset pursuant to 11 U.S.C. §554(b). The trustee did not attempt to set aside the abandonment or otherwise pursue the claim. As a result, the court's application of judicial estoppel did not involve a trustee pursuing claims on behalf of creditors.

The most recent cases, *Kane* and *Reed*, each involved a trustee who took affirmative action to pursue the claims on behalf of creditors despite the debtor's misrepresentations. The *Kane* court held that the trustee was not bound by the debtor's post-petition wrongdoing, while *Reed* held that the trustee was bound by the debtor's position, including the potential for judicial estoppel. *Kane* and *Reed* are virtually indistinguishable in that in both cases the trustee sought to recover assets the debtors purposefully sought to retain for themselves by flaunting bankruptcy's core principle that full disclosure is a prerequisite to relief. However, despite this identity of facts, the two panels reached conflicting results. Therefore, the Court should grant *en banc* review.

II. The Court Should Grant En Banc Review To Consider Whether the Reed Decision Undermines the Statutory Scheme Created by Congress

The panel opinion in *Reed* refused to distinguish between the bad acts of the debtor and the independent position of the trustee. The panel stated:

(I)t is not sufficient to distinguish the debtor's conduct from that of the trustee in applying judicial estoppel. Even though Reed herself takes no inconsistent legal positions, she succeeds to the debtor's claim with all its attributes, including the potential for judicial estoppel.

Reed, slip op. at 7. The panel did not cite any authority for this proposition.

The panel is only partially correct. The trustee does succeed to the debtor's rights *as of the petition date*. If the debtor engages in *pre-petition* conduct that warrants application of judicial estoppel, that charge may be made against the trustee after the bankruptcy case has been commenced.

However, judicial estoppel based upon an omission from the bankruptcy schedules is a unique situation that, by definition, cannot be attributed to the trustee. The debtor's inconsistent positions are comprised of 1) a representation to the bankruptcy court that the debtor does own a certain asset (here, the FMLA claim) and 2) an inconsistent representation to another court that the debtor does, in fact, own the undisclosed asset after the bankruptcy case has been commenced (here, the post-petition prosecution of the FMLA claim).

As the facts of this case and, more importantly, the chapter 7 statutory scheme make clear, the debtor can only accomplish the second representation by deceiving

the trustee and violating bankruptcy statutes that require full disclosure of all assets and surrender of non-exempt assets. Thus, it is not only statutorily impermissible to attribute the debtor's post-petition misrepresentation and other misconduct to the trustee, it turns all notions of equity on their head to hold a trustee--and, by extension, the debtor's creditors--accountable for a debtor's violations of the Bankruptcy Code

Upon the filing of the bankruptcy petition, an estate is created of essentially all of a debtor's assets. 11 U.S.C. §541. Although property is abandoned upon the conclusion of a case under 11 U.S.C. §554(c), this does not apply to assets that are *unscheduled*. Such property remains the property of the estate. 11 U.S.C. §554(d). During these periods, the trustee is the sole representative of the bankruptcy estate and the sole party with authority to deal with the assets of the bankruptcy estate. By relying on an equitable doctrine to override statutory commands, the court undermines Congress's directives.

A. Judicial Estoppel Based on a Debtor's Omission Cannot be Attributed to the Trustee

In a bankruptcy case, judicial estoppel based on omissions from the debtor's schedules can only arise after the bankruptcy case is filed. This is because judicial estoppel requires both an inconsistent position and an attempt to benefit from that inconsistent position. The first element of judicial estoppel arises when a debtor fails to make full disclosure in the schedules of assets and liabilities and the second comes from the debtor's subsequent claim of ownership of that omitted asset. Schedules of

assets and liabilities are to be filed with the bankruptcy petition or within fourteen days thereafter. 11 U.S.C. §521(a)(1)(B)(i); Fed.R.Bankr.P. 1007(b) and (c). While the initial statement, as contained in the schedules of assets and liabilities, may take place shortly after the moment of filing the bankruptcy, the subsequent attempt to benefit from the concealed asset can only take place subsequent to the petition; moreover, the subsequent attempt to benefit can take place only by deceiving the trustee and violating bankruptcy law.

B. Congress Gave the Trustee Sole Authority Over Property of the Estate

Congress has placed the trustee at the vanguard of chapter 7 cases. The trustee is the representative of the bankruptcy estate, 11 U.S.C. §323(a), and is responsible for marshalling assets for the benefit of creditors, 11 U.S.C. §704(a)(1).

When a debtor files bankruptcy, he surrenders control of his assets to a bankruptcy estate. The bankruptcy estate consists of, among other things, “all legal or equitable rights of the debtor in property as of the commencement of the case.” 11 U.S.C. §541(a)(1).

The Bankruptcy Code is designed to protect assets of the estate for the benefit of creditors. If a claim is not barred by the statute of limitations on the date of filing the bankruptcy petition, the trustee may commence such action before the later of the date limitations would have expired or two years after the petition date. 11 U.S.C. §108(a). This allows the trustee a reasonable period of time in which to evaluate the

claim and determine whether to pursue it. *Matter of Grosso Investment, Inc*, 457 F.2d 168 (9th Cir. 1972)(construing similar provision under Bankruptcy Act).

If the trustee closes a case without administering properly listed assets, they are abandoned back to the debtor by operation of law. 11 U.S.C. §554(c). However, this does not apply to undisclosed assets. Under section 554(c), only “property scheduled under section 521(1)” may be abandoned to the debtor. If property is not scheduled and therefore not abandoned, the property “remains property of the estate.” 11 U.S.C. §554(d). Thus, Congress has dictated that debtors not receive the benefit of undisclosed assets. *Chartschlaa v. Nationwide Mutual Insurance Co.*, 538 F.3d 116 (2nd Cir. 2008).

The Bankruptcy Code gives the trustee sole control over property of the estate. The trustee is given the power to use, sell or lease property of the estate, 11 U.S.C. §363, the power to obtain credit on behalf of the estate, 11 U.S.C. §364, and the right to assume or reject executory contracts or unexpired leases on behalf of the estate, 11 U.S.C. §365. The trustee is also given the power to seek approval of a compromise and settlement. Fed.R.Bankr.P. 9019.

When the estate owns causes of action, the trustee is the party who is authorized to use, sell or compromise those claims. *Cadle Co. v. Mims*, 608 F.3d 253 (5th Cir. 2010).

The panel opinion disregards the statutory scheme. The panel opinion holds

that failure to disclose an asset will give rise to judicial estoppel and prevent the asset from being claimed by the estate. However, Congress has dictated that undisclosed assets remain property of the estate under section 554(d). The result of the panel opinion is that the debtor's pursuit of an undisclosed asset will prejudice the rights of the bankruptcy estate as occurred in this case. Congress has dictated that *only* the trustee, not the debtor, may administer property of the estate post-petition. The panel opinion effectively permits the debtor's unauthorized use of property of the estate to prejudice the estate and therefore its creditors. This conflicts with the express mandate by Congress to preserve property of the estate.

III. The Court Should Grant En Banc Review To Consider the Impact of the Reed Decision on the Integrity of the Bankruptcy System

As stated by the panel, “judicial estoppel is a doctrine that protects the integrity of court proceedings.” Slip op. at 5. However, the panel opinion poses a serious threat to the integrity of the bankruptcy system.

Bankruptcy is intended to protect the “honest but unfortunate” debtor. *Marrama v. Citizens Bank*, 549 U.S. 365, 367 (2007). However, a parallel purpose is to create an estate for the benefit of creditors. *Toibb v. Radloff*, 501 U.S. 157 (1991). While the dishonest debtor should not benefit from his wrongdoing, his creditors are independent of these offenses and should not bear the debtor's punishment.

The debtor in this case is a prime example of one that fails to meet the honest but unfortunate standard. At the time he filed bankruptcy, he held a judgment against the City of Arlington for over \$1 million, yet nowhere in his bankruptcy schedules did he disclose the existence of the judgment or even reveal the existence of the lawsuit. His schedules indicated that he had no non-exempt assets.

The integrity of the bankruptcy system is policed by multiple parties and foremost among them is the trustee. The bankruptcy system depends upon the integrity of the debtor and the professionalism and ethics of the debtor's counsel. It also depends upon the trustee, the creditors and the United States Trustee to expose wrongdoing.

Under *Reed*, the debtor is given a perverse incentive for dishonesty. If the debtor commits fraud and is not caught, he retains and reaps the benefits of his wrongdoing. On the other hand, a debtor who starts down the path of wrongdoing and repents has little opportunity to make things right for his creditors and mitigate the damage. If a debtor omits assets from his schedules and is found out, he will be subject to revocation of his discharge (as happened here) and criminal prosecution; but this "punishment" does not improve the position of his creditors. While there is no excuse for dishonesty, the *Kane* opinion allows the ethically wavering debtor the opportunity to make belated disclosure and allow his creditors

to receive what they were entitled to. Under *Reed*, once a debtor is dishonest, he is deprived of the means to make restitution to his creditors by turning over the asset to the trustee. This means that the practical incentive under *Reed* is for the debtor who starts dishonestly to follow the scheme to the end.

The *Reed* opinion also removes the incentive for the debtor's counsel to bring fraud to light. The true hero in this case was Roger Hurlbut, the debtor's non-bankruptcy attorney. When attorney Hurlbut learned of his client's deception, he promptly notified the trustee. His reward for doing the right thing was being deprived of his fee when the court reversed the judgment he had devoted so much time and hard work to obtaining. It seems unfair that he was punished for being honest. The result certainly does not create any positive incentive for the debtor's attorney to police his client.

Perhaps most importantly of all, the trustee is deprived of both the incentive and the ability to pursue undisclosed assets. If the trustee learns of an undisclosed asset which is being stealthily misappropriated by the debtor, the trustee's ability to pursue it under the *Reed* opinion is significantly diminished, if not eradicated. Under 11 U.S.C. §326, the trustee is paid a commission on funds distributed to creditors. However, in this case, the diligent trustee will receive nothing for her efforts which, ultimately, means the creditors of the debtor will be deprived of what could have been a substantial distribution from a significant non-exempt

asset. Ironically, the fact that the trustee is a lawyer and would benefit from any recovery was cited as a reason why it would be inequitable to allow the case to continue. *Reed*, slip op. at p. 8. (“Here, equity does not favor ignoring Lubke’s misuse of the court system for the primary benefit of attorneys”).

Finally, in the context of the actions of the City of Arlington, a wrongdoer is given the opportunity to escape responsibility. Congress adopted the Family Medical Leave Act because it believed that it would provide a net benefit to society. It included penalties for violating the Act in order to deter bad behavior. Here, the City of Arlington was ready to settle until it learned of the bankruptcy. With this new information, it sought to evade responsibility on issues outside of, and irrelevant to, its conduct.

In the case of an undisclosed asset in bankruptcy, the debtor, debtor’s counsel, creditors and even the defendant should have an incentive to bring the asset to the attention of the trustee so that the action may be pursued or compromised for the benefit of the bankruptcy estate and its creditors. This case makes it much less likely that this will occur.

IV. Conclusion

The panel opinion punishes creditors for the wrongdoing of the debtor and thus undermines the integrity of the system. Judge Easterbrook of the Seventh Circuit recognized the injustice of applying judicial estoppel in this situation when

he stated:

Judges understandably favor rules that encourage full disclosure in bankruptcy. Yet pursuing that end by applying judicial estoppel to debtors' self-contradiction would have adverse effects on third parties: the creditors. Biesek's nondisclosure in bankruptcy harmed his creditors by hiding assets from them. Using this same nondisclosure to wipe out his FELA claim would complete the job by denying creditors even the right to seek some share of the recovery. Yet the creditors have not contradicted themselves in court. They were not aware of what Biesek has been doing behind their backs. Creditors gyped by Biesek's maneuver are hurt a second time by the district judge's decision. *Judicial estoppel is an equitable doctrine, and using it to land another blow on the victims of bankruptcy fraud is not an equitable application.* Instead of vaporizing assets that could be used for the creditors' benefit, district judges should discourage bankruptcy fraud by revoking the debtors' discharges and referring them to the United States Attorney for potential criminal prosecution.

Biesek v. Soo Line RR Co., 440 F.3d 410, 413 (7th Cir. 2006) (emphasis added).

The Court should grant rehearing *en banc* to protect the interest of creditors in this and future bankruptcy cases. As the Seventh Circuit so eloquently stated, using judicial estoppel to “land another blow on the victims of bankruptcy fraud is not an equitable application.” However, the panel opinion would allow exactly such a result in this case and others.

Under the *Reed* opinion as it now stands, the interest of unsecured creditors in receiving a fair distribution from bankruptcy estates is dismissed by an arbitrary and capricious application of an equitable doctrine. On the date of the bankruptcy petition, creditors had the right to share in a valuable asset which became property of the estate. The creditors were victimized once when the debtor concealed this

valuable asset. They will be victimized a second time if the panel opinion is allowed to stand. As a professional organization with a long-standing interest in the rights of unsecured creditors, the Commercial Law League urges the court to grant *en banc* review.

WHEREFORE, PREMISES CONSIDERED, Amicus Curiae prays that the Court grant *en banc* review and for such other relief at law and in equity to which he may be entitled.

Respectfully submitted,

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By my signature above, I hereby certify that a true and correct copy of the foregoing was sent via first class mail, postage prepaid, this 6th day of October, 2010, to the following:

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CERTIFICATE OF COMPLIANCE WITH RULE 32(A)

1. This brief complies with the type-volume limitations of Fed.R.App.P. 32(a)(7)(B) because this brief contains 3,686 words, excluding the parts of the brief exempted by Fed.R.App.P. 32(a)(7)(B)(iii).

2. This brief complies with the typeface requirements of Fed.R.App.P. 32(a)(5) and the type style requirements of Fed.R.App.P. 32(a)(6) because this brief has been prepared in a proportionately spaced typeface using Microsoft Word 97-2003 in 14-point Times New Roman font.

/s/Stephen W. Sather