



1 of 197 DOCUMENTS

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Braucher on Hertz Corp. v. Friend

2010 Emerging Issues 5316

Anne Braucher on the Effect of the Supreme Court's Adoption of the Nerve Center Test on Bankruptcy Venue -- *Hertz Corp. v. Friend*, 2010 U.S. LEXIS 1897, 130 S. Ct. 1181 (Feb. 23, 2010)

By Anne Braucher

September 22, 2010

SUMMARY: According to *Hertz v. Friend*, the nerve center test is the only appropriate test for determining the location of a principal place of business. The Court stated that a corporation's principal place of business is the place where its officers direct, control, and coordinate its activities, most often its headquarters. Under bankruptcy law, however, the principal place of business is only one of several venues that a debtor can consider.

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ARTICLE: A Corporation's Principal Place of Business is its Nerve Center, the Location where its Officers Direct, Control, and Coordinate its Activities.

The United States Supreme Court has ruled that, for purposes of establishing diversity jurisdiction, a corporation's principal place of business is the place where the corporation's officers direct, control, and coordinate the corporation's activities, normally its headquarters. The decision, *Hertz Corp. v. Friend*, 559 U.S. ___, 2010 U.S. LEXIS 1897, 130 S. Ct. 1181 (Feb. 23, 2010), resolves a split among circuit courts regarding whether a corporation's principal place of business is where it does the most business, where it is headquartered, or some other place where it has a large amount of business assets. The Court stated that identifying a corporation's principal place of business as its headquarters serves the purposes of the diversity jurisdiction statute. A headquarters is a single location that lends predictability and simplicity to a jurisdictional determination.

Background.

Federal courts have jurisdiction in diversity cases pursuant to 28 U.S.C. § 1332(a). According to this statute, a federal court may decide a case in which the defendants are citizens of different states than the plaintiffs. Section 1332(c) further provides that, for purposes of determining diversity, a corporation is a citizen of the states in which it is incorporated and where it has its principal place of business. Over time, courts have developed a great number of tests for determining in which state a corporation has its principal place of business. Depending on the court in which the case is pending, the principal place of business may be the location of a corporation's "center of gravity," "nerve center,"

principal office, principal business assets, or where it does the most business. *Hertz*, 2010 U.S. LEXIS 1897, at *26-29, 130 S. Ct. at 1192-3.

Under bankruptcy law, a debtor has several options when deciding where to file its petition. A debtor may file its petition in the district "in which the domicile, residence, principal place of business in the United States, or principal assets in the United States ... have been located for the [180] days immediately preceding such commencement." 28 U.S. § 1408(1). In addition, 28 U.S. § 1408(2) allows a corporate debtor with multiple subsidiaries and affiliates to file its petition in any district that is appropriate for any single entity in its corporate family. Because principal place of business appears in both the federal diversity jurisdiction statute and the bankruptcy venue statute, the *Hertz* decision is relevant for both bankruptcy and non-bankruptcy courts.

Facts of the Case.

Individuals Melina Friend and John Nhieu filed suit against the Hertz Corporation in a California state court for violations of California's wage and hour laws. They sought relief on behalf of a class of California citizens who allegedly suffered the same damages.

Hertz filed a notice removing the case to federal district court, claiming that the class representatives and Hertz were citizens of different states. In support of its position that the federal court had diversity jurisdiction, Hertz submitted a declaration by its employee relations manager that alleged that Hertz was a citizen of New Jersey, not California. The declaration said that the corporation's principal place of business was in New Jersey because its core executive and administrative functions were carried out at its headquarters in Park Ridge, New Jersey. The declaration further stated that Hertz operated facilities in 44 states, and California accounted for only 273 of Hertz's 1,606 car rental locations, about 2,300 of its 11,230 full-time employees, and about \$3.8 million of its \$4.371 billion in annual revenue.

The California district court found diversity jurisdiction lacking and remanded the case back to state court. The district court applied Ninth Circuit precedent, which required it to first determine the amount of the corporation's business activity on a state-by-state basis. If the amount of activity was significantly larger or substantially predominated in one state, then the corporation's principal place of business was in that state. If no state predominated, the corporation's principal place of business was its nerve center, the place where a majority of its executive and administrative functions were performed. Applying this test, the district court held that Hertz's principal place of business was in California because the differential between the amount of business activities performed there and in the next closest state was significant. The Ninth Circuit upheld the district court's ruling, and Hertz appealed to the Supreme Court.

The Decision.

The Supreme Court vacated the Ninth Circuit's ruling and remanded for further proceedings consistent with its opinion. *See Hertz*, 2010 U.S. LEXIS 1897, at *37, 130 S. Ct. at 1195. The Court began its opinion with a brief history of diversity jurisdiction. It explained that the principal place of business phrase was added to the diversity jurisdiction statute to prevent abuses by corporations that had been incorporating in states only for the purpose of taking litigation into federal courts. *See Hertz*, 2010 U.S. LEXIS 1897, at *17-23, 130 S. Ct. at 1189-90. Because the phrase was not adequately defined, however, courts developed their own tests for determining a corporation's principal place of business. Some courts, like the Ninth Circuit, used a business activities approach that focused on the amount of business a corporation performed in each state. *See Hertz*, 2010 U.S. LEXIS 1897, at *24-27, 130 S. Ct. at 1191-2. Other courts used a nerve center approach that focused on the location where a corporation's officers direct, control, and coordinate activities, often its headquarters. *See id.* The Supreme Court stated that the number and types of tests employed by lower federal courts made it difficult to serve the purpose of diversity jurisdiction - to find the state where a corporation is least likely to suffer out-of-state prejudice when it is sued in a local court. *See Hertz*, 2010 U.S. LEXIS 1897, at *27, 130 S. Ct. at 1192.

After reviewing the various tests applied by the courts, the Supreme Court arrived at what it believed was the best definition of the principal place of business - "the place where a corporation's officers direct, control, and coordinate the corporation's activities." *Id.* This place, often called the nerve center, will normally be the place where a corporation maintains its headquarters. *See id.* The Court gave three reasons why this definition of principal place of business is superior to others. First, principal place of business is a singular term, so it should be a single location. *See Hertz, 2010 U.S. LEXIS 1897*, at *29, 130 S. Ct. at 1192-3. A headquarters is a single place within a state, just as the statute requires. Second, using the nerve center/headquarters definition promotes administrative simplicity and predictability. *See Hertz, 2010 U.S. LEXIS 1897*, at *31, 130 S. Ct. at 1193. Locating a corporation's headquarters is a simple matter, so litigants and courts will less frequently have to invest time and money in jurisdictional battles. Third, the nerve center/headquarters definition of principal place of business meets the simplicity benchmark established by legislative history. *See Hertz, 2010 U.S. LEXIS 1897*, at *32-33, 130 S. Ct. at 1194. The drafters of the diversity jurisdiction statute wanted a test that was not complex and impractical to apply. A nerve center test will be easy to apply in a way that a business activities test will not.

The Effect of the Decision: Even With a Better-Defined Principal Place of Business, Bankruptcy Law Gives Corporate Debtors Several Venue Options.

As the Supreme Court itself observed, the *Hertz* decision should increase predictability and preserve resources in federal diversity cases. Under the business activities test rejected by the Supreme Court, determining a corporation's principal place of business required a showing of the amount of business activities that the corporation engaged in on a state-by-state basis. The test required litigants to spend time and money tallying the corporation's revenue and assets in each state, and it required courts to spend time deciding whether the amount of revenue and/or assets generated in any state was significantly larger than the rest. Under the nerve center test adopted by the Supreme Court in *Hertz*, parties and courts will preserve resources by arriving much more quickly at predictable jurisdictional determinations. Parties will no longer have to marshal evidence related to a corporation's business because its nerve center, the place where a corporation's officers direct, control, and coordinate the corporation's activities, will most often be its headquarters. With much more predictable outcomes under the nerve center test, parties will also be less able to abuse the diversity jurisdiction statute to engage in forum-shopping.

Even with the *Hertz* clarification regarding principal place of business, however, debtors still have many choices when deciding where to file their cases. Section 1408(1) allows a bankruptcy debtor to file in the district of its domicile, residence, principal place of business, or the location of its principal assets. The *Hertz* decision will indeed most often limit the principal place of business to the location of a debtor's headquarters. But domicile and residence are often defined as the state in which a debtor is incorporated, so these venues are still available for every debtor. Especially for large corporate debtors, the location of the debtor's principal assets may be a third available venue, in addition to principal place of business and domicile/residence. Furthermore, 28 U.S.C. 1408(2) allows a corporate debtor with many subsidiaries and affiliates to file its petition in any venue that is appropriate for any single entity in its corporate structure. Because debtors have so many options, the *Hertz* decision will likely have little influence on debtors when making their decision where to file their petitions.

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2 of 197 DOCUMENTS

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Klee on Schwab v. Reilly

2010 Emerging Issues 5237

Professor Kenneth N. Klee on the Supreme Court's Holding in Schwab v. Reilly, 2010 U.S. LEXIS 4974 (2010)

By Prof. Kenneth N. Klee

August 3, 2010

SUMMARY: This Emerging Issues Analysis addresses issues of statutory interpretation. Klee examines the primary lesson from Schwab v. Reilly: If a statute contains a detailed definition of a term or concept that can have more than one interpretation, the Court may construe the statute to reduce the burden on bankruptcy administration and possibilities for abuse, even if it undermines the debtor's fresh start.

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ARTICLE: The Lesson to be Learned:

If a statute contains a detailed definition of a term or concept that can have more than one interpretation, the Court may construe the statute to reduce the burden on bankruptcy administration and possibilities for abuse, even if it undermines the debtor's fresh start.

Legal Background:

The Bankruptcy Code provides that, subject to statutory caps, certain property of the debtor is exempt from inclusion in the bankruptcy estate. n1 Broadly speaking, unless a state opts out, a debtor may choose between two subsets of exempt property: property specifically exempted under state law and non-bankruptcy federal law, n2 and property specifically listed in the Bankruptcy Code, in many instances subject to capped dollar amounts. n3

A debtor lists the interests in property claimed as exempt on Schedule C filed with, or shortly after, the bankruptcy petition. n4 Unless a party-in-interest objects to debtor's scheduled exemptions under Bankruptcy Rule 4003 within thirty days of the conclusion of the § 341(a) meeting, the exempt interests in property leave the bankruptcy estate and revert to the debtor. n5

Facts and Proceedings Below:

Respondent Nadejda Reilly ("Reilly") is a debtor residing in Pennsylvania. Reilly filed for chapter 7 bankruptcy protection on April 21, 2005. On her bankruptcy schedules, she listed an exemption of \$10,718 (the maximum amount available) in "tools of the trade" cooking equipment. The debtor valued the equipment at \$10,718. Petitioner William

Schwab ("Schwab"), the bankruptcy trustee appointed in her case, indicated to Reilly at her § 341(a) meeting that he disputed the debtor's valuation (\$17,200) for her cooking equipment, and would consequently seek to sell the equipment and distribute the proceeds in excess of the exempt amount to her creditors. Schwab, however, never timely objected to Reilly's exemption claim within the 30 days allowed in Bankruptcy Rule 4003.

After the bankruptcy court denied his request to sell the cooking equipment, n6 Schwab appealed to the district court. n7 The district court affirmed the bankruptcy judge's order, n8 finding that Reilly demonstrated her intent to exempt the full amount of the property, thereby requiring Schwab to object on a timely basis or lose his right to later sell the property. n9 Schwab appealed to the Third Circuit Court of Appeals. n10

The Third Circuit affirmed, holding that the Supreme Court's holding in *Taylor v. Freeland & Kronz* n11 meant that "where the debtor signals her intention to exempt certain property in its entirety by listing an identical entry for the property's value and the amount of the exemption, the trustee must object pursuant to Rule 4003 lest the property be rendered *fully exempt*." n12 (emphasis added). The court further clarified that:

[W]here a debtor shows her intent to exempt the entirety of certain property and the trustee does not object within Rule 4003's time-frame, the asset passes through the bankruptcy estate and becomes fully exempt, even if it is later discovered that the property has a higher value than the exempted amount. n13

By its own admission, the Third Circuit's ruling differed from contrary holdings in the Eighth and Ninth Circuits, but mirrored holdings in the Sixth and Eleventh Circuits. n14 The Supreme Court granted certiorari to resolve the circuit split. n15 The Court reversed, holding that the exemption of an interest in property for a stated dollar amount is not legally equivalent to exemption of the property itself. n16 The Court's opinion focused on the question:

Does an exemption claim for a property's full claimed value exempt the property or just the claimed amount?

Schwab, the bankruptcy trustee argued that the specific intention (and clear meaning) of § 522 was for only the "interest" in the property up to the specified dollar amount to be exempt. n17 He also noted that ruling in favor of Reilly would force trustees to file more pro forma objections or motions to extend, miring the judicial system in needless bureaucratic procedures. n18

In contrast, respondent Reilly, the debtor, argued that once property claimed as exempt passes the thirty day threshold for objections, it becomes fully exempt regardless of its ultimate value. n19 Reilly further argued that the Trustee's ability to deny debtor access to property claimed exempt "is [a] privilege that arises [only] from a timely and successful objection." n20

Writing for the majority in a 6-3 opinion, Justice Thomas sided with Schwab. Justice Ginsburg wrote the dissent.

Analysis:

In *Schwab v. Reilly*, the Supreme Court determined that a debtor's exemption claim for a property's full claimed dollar value protects only the value claimed, not the property itself, regardless of its ultimate value. The Court also determined that a trustee need not object to a debtor's scheduled exemption of property listed at a fixed dollar valuation within the thirty day window specified in Bankruptcy Rule 4003 ("Rule 4003") in order to later sell that property. Simply stated, the trustee has no quarrel with the dollar amount the debtor has exempted under § 522 of the Bankruptcy Code ("§ 522"), because the scheduled value matches the allowed exemption amount. The trustee only seeks the coverage above the listed dollar amount, and this does not require action within the 30 day period to object to exemptions.

In ruling, the Court rejected the reasoning of the Third Circuit that the trustee had to object to debtor Reilly's valuation within the thirty day window of Rule 4003 or lose the chance to later sell the asset. n21 The Third Circuit incorrectly reasoned that listing the dollar value of the asset as the maximum amount of the exemption was the same as

exempting the entirety of the asset no matter what its actual value might be.

In *Schwab v. Reilly*, the Court also clarified its holding in *Taylor v. Freeland & Kronz*,ⁿ²² in which the Court ruled that a trustee's failure to timely object to a debtor's exemption claim for her employee discrimination lawsuit, valuation "unknown," rendered the full amount of the lawsuit's proceeds exempt - despite the fact that the lawsuit later settled for \$110,000 and the debtor did not have a legal right to exempt this much.ⁿ²³ In *Taylor*, the debtor's listing of the valuation as "unknown" put the trustee on notice that the debtor intended to exempt the entire proceeds. Not so in *Schwab*, when the debtor's listing of a specific dollar amount did not evidence the debtor's intention to exempt portions of the interest in the cooking equipment in excess of the dollar value. *Taylor* remains good law when the debtor exempts the full amount of the property or lists the property value as "unknown."

Both the majority and dissent have policy arguments supporting their positions. On the one hand, from the majority's perspective, limiting the debtor to his "interest" in the exempt property tracks the explicit statutory language. Indeed, the majority reasons that the "property" specified in § 522 is merely the interest and not the underlying cooking equipment. Additionally, as pointed out by Schwab, allowing debtors to get around statutory exemption caps by slipping low valuations past unsuspecting trustees violates both the letter and intent of the Bankruptcy Code.

On the other hand, as the dissent notes, allowing trustees to later attack a property valuation in this manner encourages abuse by trustees and creditors. As pointed out in an amicus brief of the National Association of Consumer Bankruptcy Attorneys, allowing trustees to make an end run around Rule 4003 by reopening valuation at their leisure will incentivize them to take their time.ⁿ²⁴ And, as noted in *Collier on Bankruptcy*:ⁿ²⁵

Normally, if the debtor lists property as exempt, that listing is *interpreted* as a claim for exemption of the debtor's entire interest in the property, and the debtor's valuation of that interest is treated as the amount of the exemption claimed. Were it otherwise—that is, if the listing were construed to claim as exempt only that portion of the property having the value stated—the *provisions finalizing exemptions if no objections are filed would be rendered meaningless*. The trustee or creditors could always claim that the debtor's interest in the property was greater than the value claimed as exempt and still object to the debtor exempting his or her entire interest in the property *after* the deadline for objections had passed.

(emphasis added).

From a policy perspective, allowing trustees to later attack property that has ostensibly lapsed out of the chapter 7 estate values certainty and trustee economy above judicial efficiencyⁿ²⁶ and finality. It tempers the tenor of bankruptcy's "fresh start" in favor of ensuring that creditors have full access to debtor's assets. The direction these policy arguments cut depends on the values one believes the Bankruptcy Code is designed to enshrine.

Practice Tips:

As is the case with many Supreme Court decisions, the marketplace will adapt to the Court's ruling. Because the Court reaffirmed its holding in *Taylor*, debtors will be well-advised to list the property value as "unknown," unless they lack a good faith basis to do so. Plainly, deposit accounts, publicly traded stocks and bonds, and perhaps motor vehicles have a determinable value. With respect to other property, however, debtors honestly do not know the value, nor is the value easily ascertainable. Thus, they can safely list the value as unknown. So as not to unduly provoke the trustee into objecting to exemptions, however, debtors should employ this strategy selectively.

From a slightly different perspective, debtors' attorneys might want to adopt a written policy to distribute to their client's indicating the costs and benefits of exempting an interest in property for a dollar sum certain versus 100% of the value or "amount unknown." Assuming the consumer debtors' bar (and software providers) appropriately adjust their practices, debtors may continue to put trustees to the burden of objecting within 30 days or continuing meetings of creditors in order to assess and contest claims of exemptions in property whose value is subject to a dollar cap. On the other hand, *Schwab* will remain a trap for unwary debtors who seek to exempt such property in full notwithstanding

uncertainty about whether the property exceeds applicable dollar limits.

[Return to Text](#)

n1 *See 11 U.S.C. § 522* (2006).

n2 *See 11 U.S.C. § 522(b)(3)* (2006).

n3 *See 11 U.S.C. § 522(b)(2), (d)* (2006).

n4 *See 11 U.S.C. § 522(l)* (2006).

n5 *See id.*

n6 Because she did not want to part with the sentimental property, which had been given to her by her immigrant parents, Reilly had motioned the bankruptcy court for leave to withdraw her petition, which the bankruptcy judge had denied. However, the judge also denied Schwab's motion to sell, concluding that Reilly put him on notice that she intended to exempt the full amount of the property and that Schwab, having not timely objected, had lost the ability to bring the property into the estate. *See In re Reilly*, 534 F. 3d 173, 174 (3d Cir. 2008).

n7 *See id.*

n8 *Schwab v. Reilly (In re Reilly)*, 2006 U.S. Dist. LEXIS 98261 (M.D. Pa. Sept. 19, 2006).

n9 *See 534 F. 3d at 174-75.*

n10 *See id.*

n11 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed. 2d 280, 1992 U.S. LEXIS 2546 (1992). Taylor v. Freeland & Kronz is discussed in the Property of the Estate, Exemptions, and Exclusions from the Estate section at 272 of the author's book, *Bankruptcy and the Supreme Court* (LexisNexis 2008).

n12 *See In re Reilly*, 534 F.3d at 179.

n13 *Id.*

n14 *Id.* (citing and comparing *Allen v. Green (In re Green)*, 31 F.3d 1098 (11th Cir. 1994), and *Olson v. Anderson (In re Anderson)*, 377 B.R. 865 (B.A.P. 6th Cir. 2007), with *Stroebner v. Wick (In re Wick)*, 276 F.3d 412 (8th Cir. 2002) and *Hyman v. Plotkin (In re Hyman)*, 967 F.2d 1316 (9th Cir. 1992)).

n15 129 S. Ct. 2049, 173 L. Ed. 2d 1131, 2009 U.S. LEXIS 3246 (April 27, 2009).

n16 130 S. Ct. 2652, 177 L. Ed. 2d 234, 2010 U.S. LEXIS 4974 (June 17, 2010).

n17 *See Transcript of Oral Argument, Schwab v. Reilly*, No. 08-538, 2009 U.S. Trans. LEXIS 58 at *16-17 (Nov. 3, 2009).

n18 *See id.*

n19 *See, e.g., Brief for Respondent Nadeja Reilly, Schwab v. Reilly*, 2008 U.S. Briefs 538, 2009 U.S. S. Ct. Briefs LEXIS 931 (Sept. 18, 2009).

n20 See *Brief for Respondent Nadeja Reilly, Schwab v. Reilly*, 2008 U.S. Briefs 538, at *26, 2009 U.S. S. Ct. Briefs LEXIS 931, at *37 (Sept. 18, 2009).

n21 *Schwab v. Reilly*, 534 F.3d 173, 177-78 (3d Cir. 2008).

n22 530 U.S. 638 (1992).

n23 *Id.* at 642.

n24 See *Brief Supporting Respondent of Amici Curiae (I) National Association of Consumer Bankruptcy Attorneys and (II) Professors Kenneth N. Klee, Robert M. Lawless, Richard Lieb and Michael D. Sousa, Schwab v. Reilly*, No. 08-538, 2008 U.S. Briefs 538, at *4-5, 2009 U.S. S. Ct. Briefs LEXIS 985, at * 8-9 (Sept. 25, 2009).

n25 9 Collier on Bankruptcy 4003.02[1] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2005) (cited in *Schwab v. Reilly*, 534 F.3d 173, 180 (3d Cir. 2008)).

n26 Petitioner takes great pains to suggest the opposite, namely, that ruling to support this approach will increase judicial inefficiency by forcing trustees to make more pro-forma objections to debtor valuations. So the logic runs, a trustee would need to presumptively object in order to allow himself or herself time to make a sufficiently accurate valuation of the property in order to allow it to lapse out of the estate. This argument overstates the problem by ignoring the fact that trustees can simply continue the § 341(a) meeting and toll Rule 4003's thirty day clock. See Fed. R. Bankr. P. 4003(b)(1) (2006).

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Kenneth N. Klee is a founding member of Klee, Tuchin, Bogdanoff & Stern LLP, in Los Angeles, specializing in corporate reorganization, insolvency, and bankruptcy law. He is also a professor at the University of California, Los Angeles School of Law, where he teaches courses in bankruptcy law and Chapter 11 business reorganizations law, as well as a business simulation/clinical course dedicated to the topic of creating value through the renegotiation of

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Mr. Klee is a fellow of the American College of Bankruptcy, serves as a member of the American Law Institute, and is a founding member of the International Insolvency Institute. He was a member of the executive committee of the National Bankruptcy Conference from 1985 to 1988 and 1992 to 2000 and served as Chair of the National Bankruptcy Conference's legislation committee from 1992 to 2000. Mr. Klee was Associate Counsel, Committee on Judiciary, U.S. House of Representatives 1974-1977, where he was a principal draftsman of the Bankruptcy Code. From 1992 to 2000, he served as a member of the Advisory Committee on Bankruptcy Rules of the United States Judicial Conference.

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3 of 197 DOCUMENTS

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Key Employee Benefits Issues in a Sale of Assets under 11 U.S.C. § 363

2010 Emerging Issues 5185

Key Employee Benefits Issues in a Sale of Assets under Section 363 of the Bankruptcy Code

By John R. Cornell, Daniel C. Hagen, Tricia Eschbach-Hall and Lisa Rothman Jesner

July 8, 2010

SUMMARY: Debtors are now more frequently selling a significant portion of assets in bankruptcy under section 363 of the Bankruptcy Code, with an accompanying distribution of sale proceeds and disposition of remaining assets in a liquidating chapter 11 plan. This excerpt from the Second Edition of *Collier Monograph: Employee Benefits and Executive Compensation in Corporate Bankruptcy* looks at such sales in the context of pension plans.

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ARTICLE: This article is an excerpt from the forthcoming Second Edition of *Collier Monograph: Employee Benefits and Executive Compensation in Corporate Bankruptcy*, written by John R. Cornell, Daniel C. Hagen, Tricia Eschbach-Hall and Lisa Rothman Jesner. The authors are lawyers with the international firm of Jones Day, and practice in the firm's Employee Benefits and Executive Compensation practice in New York and Cleveland. n1

The breakdown in the credit markets that peaked in the second half of 2008 has had a significant impact on bankruptcy planning and strategy. With a severe lack of access to commercially reasonable debtor-in-possession financing, debtors are more frequently selling a significant portion of assets in bankruptcy under *section 363 of the Bankruptcy Code* (a "363 Sale"), with an accompanying distribution of sale proceeds and disposition of remaining assets in a liquidating chapter 11 plan.

Single Employer Defined Benefit Pension Plans in a 363 Sale

A 363 Sale may allow the debtor to sell assets free and clear of liability for underfunded pension plans. n2 Purchasers frequently choose (i) not to assume any pension plans or (ii) to assume only those plans they wish to maintain, leaving any other plans behind.

Several scenarios could occur in connection with the sale. First, if there was a plan termination during the bankruptcy, the PBGC would have a claim against the debtor's estate. The claim would be liquidated in the bankruptcy case. While ERISA provides that a lien is imposed in favor of the PBGC at the time of termination, courts have found that the PBGC lien does not attach in bankruptcy, as a result of the automatic stay. n3 Therefore, the acquirer who

purchases the debtor out of bankruptcy in a 363 asset sale should not be subject to those liens.

While it is somewhat unusual for the equity of a debtor to be purchased out of bankruptcy, it nevertheless is possible for the equity of a debtor to be sold in a 363 Sale. In addition, a debtor may sell the equity of a non-debtor subsidiary in connection with a 363 Sale. If the equity of an entity that is liable for an underfunded defined benefit plan is purchased in a 363 Sale, the PBGC typically takes the position that the sale of equity is not free and clear of pension liabilities. There is a risk that the transaction (as to the entities acquired in an equity sale) will be treated as a sale of equity. As a result, the PBGC may claim that the transferred entity is subject to joint and several liability and may threaten to impose liens against the transferred entity following the transaction. n4 The PBGC may seek to negotiate for additional consideration in exchange for a release of these potential liabilities. n5

It should be noted, however, that a PBGC lien could be imposed upon the stock of a debtor after emergence if the pension-related liability is not discharged in bankruptcy as to the debtor. If an underfunded pension plan is terminated and the amount of the unfunded benefit liability is not paid upon demand by the PBGC, a lien arises automatically in favor of the PBGC against the property of any controlled group member that is not protected by the automatic stay. n6 All members of the controlled group are jointly and severally liable for unfunded benefit liabilities upon plan termination. n7 Any lien for unfunded benefits is equal to the lesser of the amount of the liability or 30 percent of the combined net worth of the contributing sponsor and its controlled group. n8

Under certain circumstances, the PBGC may also impose a termination premium following the termination of an underfunded pension plan (\$1,250 per participant per year for each of three years). n9 In the event that the termination occurs during a chapter 11 case, the termination premium is not payable until after the debtor's discharge or dismissal from the case. n10 While there is no legal precedent discussing whether a purchaser in a 363 asset sale would be liable for the termination premium, there is no statutory basis for successor liability. n11

Where a debtor maintains ongoing defined benefit pension plans, subject to approval of a 363 Sale by the bankruptcy court, an acquirer could purchase assets, choosing not to assume assets and liabilities of the underfunded defined benefit pension plans. An acquirer should not be held liable for the underfunding of any pension plans left behind and later terminated because ERISA does not provide for successor liability in a sale of assets and such liability has never been imposed by a court in connection with a single employer pension plan. n12 It may also be possible for the acquirer to pick and choose which defined benefit pension plans it assumes. The acquirer could choose to maintain the plans with less underfunding, or plans subject to a CBA, while terminating plans in which participants are likely to recover their benefits under the PBGC benefit caps. A compromise may need to be struck with the PBGC, especially if the PBGC threatens to terminate plans and mature its claim (thereby reducing the consideration available to other creditors, and in some cases creating a lien and liability for non-debtor controlled group members) prior to consummation of the transaction.

The PBGC has become proactive in terminating plans prior to 363 Sales. n13 These involuntary terminations by the PBGC often occur with little or no warning and have the potential to disrupt the sale. Where the intention is to leave behind underfunded plans, the parties should consider the ramifications of a potential PBGC termination, regardless of whether the PBGC has been vocal during the pretransaction negotiations. The PBGC closely monitors underfunded defined benefit plans and, as described below, statutory notice requirements (including notice within 30 days of a bankruptcy filing) often alert the PBGC to closely monitor the debtor as well.

If the acquirer chooses to assume all or some of the defined benefit pension plans, the acquirer could freeze the benefit plan accruals (subject to statutorily protected rights to continue to reach certain eligibility requirements for benefit subsidies), n14 particularly with regard to non-collectively bargained plans. If plans are collectively bargained, the acquirer would have to examine contracts with the unions, and may have to face union negotiations in order to modify the benefits. If this modification occurs during the course of the bankruptcy case, the process under *section 1113 of the Bankruptcy Code* would have to be followed. n15

A 363 Sale may be challenged by creditors and by the PBGC. In fact, where the PBGC has a sizeable contingent claim, the PBGC may have a considerable voice. Creditors may object to the sale if their claims will be diluted by claims of the PBGC as a result. Creditors may argue that the debtor did not exercise sound business judgment in agreeing to the sale, or that the sale is a *sub rosa* chapter 11 plan. n16

Multiemployer Pension Plans in a 363 Sale

Multiemployer pension plans are collectively bargained pension plans to which more than one employer contributes. n17 A participating employer in a multiemployer plan enters into an agreement with the fund to make specified contributions on behalf of employees covered by a CBA. If an employer ceases to make payments or otherwise terminates its participation in the plan, the plan administrator may assess a withdrawal liability on that employer. n18 Multiemployer pension plan withdrawal liability is joint and several among controlled group members. n19

An asset sale typically results in a withdrawal from a multiemployer plan, as the sale results in a permanent cessation of the seller's obligation to contribute to the plan, or results in a cessation of all covered operations under the plan. n20 Where a purchaser assumes a CBA or other agreement governing contributions to the multiemployer plan and follows statutory procedures set forth in section 4204 of ERISA, withdrawal liability may be avoided. n21 Purchasers may seek to include language in the purchase agreement excluding liability for withdrawal or unpaid contributions to a multiemployer plan to add a layer of protection. n22

Successor COBRA Liability in a 363 Sale

Generally, a seller retains the obligation to provide COBRA coverage to all employees who lost coverage under the seller's group health plan prior to or in connection with the sale unless the seller terminates all of its group health plans. n23 Should the seller and its controlled group terminate all health plans (which is likely in the event of a debtor's liquidation following a 363 Sale), the buyer is obligated to provide COBRA coverage if (1) the termination of the seller's group health plans occurred *in connection with* the sale, and (2) in a sale of assets, the buyer is a *successor employer*. n24 For this purpose, an asset sale is a "transfer of substantial assets, such as a plant or division or substantially all the assets of a trade or business." n25

Although the definition of successor employer is not explicit, the applicable COBRA regulations do state explicitly that a buyer does not fail to be a successor employer in an asset sale "merely because the asset sale takes place in connection with a proceeding in bankruptcy under title 11 of the United States Code." n26 This creates a potential conflict with the Bankruptcy Code, which provides that assets are sold free and clear of liabilities in a 363 Sale.

While there are no reported cases specifically addressing whether assets can be sold in a bankruptcy proceeding free and clear of COBRA liability, bankruptcy courts have entered orders conveying assets free and clear of such liability, and federal courts have held that assets could be sold free and clear of other statutory liabilities. n27

Debtors should consider requesting that the court include a statement that the sale is free and clear of claims for COBRA continuation coverage in the sale order.

[Return to Text](#)

n1 The views set forth in this article are the personal views of the authors and do not necessarily reflect those of the law firm with which they are associated.

n2 11 U.S.C. § 363(f); see also 3 *Collier on Bankruptcy*, 363.06 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

n3 See, e.g., *PBGC v. Belfance (In re CSC Indus., Inc. & Copperweld Steel Co.)*, 232 F.3d 505 (6th Cir. 2000); 183 B.R. 841; *In re Divco Philadelphia Sales Corp.*, 64 B.R. 232 (E.D. Pa. 1986).

n4 For further discussion of foreign entities, see *Collier Monograph: Employee Benefits and Executive Compensation in Corporate Bankruptcy*, § 2[3][a][ii] (2d ed. 2010).

n5 For further discussion of the purchase of equity in a 363 Sale, see *Collier Monograph: Employee Benefits and Executive Compensation in Corporate Bankruptcy*, § 7[13][b] (2d ed. 2010).

n6 ERISA § 4068, 29 U.S.C. § 1368.

n7 ERISA § 4068(a), 29 U.S.C. § 1368(a); ERISA § 4062(a), 29 U.S.C. § 1362(a).

n8 *Id.* Entities with a negative net worth are calculated as if their net worth were zero. ERISA § 4068(d)(1), 29 U.S.C. § 1368(d)(1).

n9 ERISA § 4006(a)(7)(A), 29 U.S.C. § 1306(a)(7)(A).

n10 ERISA § 4006(a)(7)(B), 29 U.S.C. § 1306(a)(7)(B).

n11 See 11 U.S.C. § 363(f); see also 3 *Collier on Bankruptcy*, 363.06; Nell Hennessy, *PBGC Termination Premium: the Bankruptcy Code vs. ERISA*, Labor and Employment Comm. Newsletter (Am. Bankr. Inst., Alexandria, Va.), Dec. 2008, available at

<http://www.abiworld.org/committees/newsletters/employeebenefits/vol3num3/PBGC.html>.

n12 Some courts have stated that a purchaser of assets may be a successor employer for purposes of multiemployer plan liability. In *Upholsterers' Int'l Union Pension Fund v. Artistic Furniture of Pontiac*, the court looked to labor and employment principles of successorship to determine whether a purchaser of assets could be held liable by the plan for the seller's failure to make contribution payments to the plan. According to the court, these principles allow for more flexibility in who is deemed a successor employer. The court stated that allowing claims for unpaid contributions against a purchaser would "vindicate important statutory policies," and serve the same purposes as those behind the codification of the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"). Therefore, the court held that it was premature for the purchaser to bring a motion to dismiss, and the Seventh Circuit reversed and remanded to determine whether the purchaser would be subject to successor liability. 920 F.2d 1323, 1324-26 (7th Cir. 1990); see also *Chicago Truck Drivers, Helpers & Warehouse Workers Union (Independent) Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48, 33 C.B.C.2d 1456 (7th Cir. 1995) (stating that purchaser of assets could be assessed withdrawal liability as a successor employer, and that the multiemployer plan's participation in bankruptcy proceedings did not preclude it from bringing a claim against the purchaser). In addition, under ERISA a transaction can be ignored for purposes of imposing liability on a person if a principal purpose of that person entering the transaction was to evade liability under Title IV of ERISA. ERISA §§ 4069, 4212, 29 U.S.C. §§ 1369, 1392.

n13 Recent examples where the PBGC has terminated pension plans shortly before 363 asset sales include the terminations of the Metaldyne Corporation and Proliance International, Inc. pension plans in July and August of 2009, respectively. Information about these and other PBGC pension plan terminations has been published in PBGC press releases that are available on the PBGC website at www.pbgc.gov.

n14 I.R.C. § 411(d)(6); ERISA § 204(h), 29 U.S.C. § 1054(h).

n15 For a discussion of *section 1113 of the Bankruptcy Code*, see Collier Monograph: Employee Benefits and Executive Compensation in Corporate Bankruptcy, § 9[4] (2d ed. 2010); Collier on Bankruptcy, ch. 113.

n16 See *Chrysler LLC*, 576 F.3d 108.

n17 ERISA § 3(37)(A), 29 U.S.C. § 1002(37)(A). For a discussion of multiemployer plans, see *infra*.

n18 ERISA § 4201(A), 29 U.S.C. § 1381(A).

n19 ERISA § 4001(b)(1), 29 U.S.C. § 1301(b)(1).

n20 ERISA § 4203(a)(1)-(2), 29 U.S.C. § 1383(a)(1)-(2).

n21 See ERISA § 4204, 29 U.S.C. § 1384.

n22 See ERISA § 4201, 29 U.S.C. § 1381; see, e.g., *In re Pan Am Corp., 1991 Bankr. LEXIS 1063*, at *22 (S.D.N.Y. Aug. 12, 1991) (approving an asset purchase agreement containing provisions excluding liability for both unpaid contribution amounts as well as withdrawal liability).

n23 *Treas. Reg. § 54.4980B-9*, Q&A-8(a).

n24 *Treas. Reg. § 54.4980B-9*, Q&A-8(b), (c). A successor employer must provide COBRA coverage to former participants in the seller's plan whose employment prior to the qualifying event was associated with the assets or the stock being sold and whose qualifying event occurred in connection with or prior to the sale. *Id.* at Q&A-4.

n25 *Treas. Reg. § 54.4980B-9*, Q&A-1(c).

n26 *Treas. Reg. § 54.4980B-9*, Q&A-8(c).

n27 See, e.g., *In re TWL Corp. & TWL Knowledge Group, Inc., 2008 Bankr. LEXIS 3392* (Bankr. E.D. Tex. Dec. 15, 2008) (approving a sale motion free and clear of all successor liability, explicitly including COBRA liability). There are no published cases, however, regarding whether precluding COBRA liability for a purchaser in a section 363 Sale is proper.

RELATED LINKS: For a complete discussion of Bankruptcy Code section 363, see Collier on Bankruptcy, ¶ ch. 363.

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4 of 197 DOCUMENTS

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Jurs on Wolfe v. Greentree Mortgage Corp.

2010 Emerging Issues 5111

S. Andrew Jurs on Wolfe v. Greentree Mortgage Corp., 2010 U.S. Dist. LEXIS 6005 (N.D. W. Va. Jan. 26, 2010)

By S. Andrew Jurs

June 11, 2010

SUMMARY: This Emerging Issues Analysis considers a district court's decision that lays out the rules and standards for mandatory and equitable abstention. In the analyzed decision, mandatory abstention was not applicable because the action was a core proceeding and there was an adequate alternative basis for jurisdiction. And equitable abstention was not necessary given that the core proceeding would have a substantial effect on the bankruptcy estate.

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ARTICLE: Neither Mandatory Abstention Nor Equitable Abstention Was Warranted When a Lawsuit Was a Core Proceeding and Its Result Would Significantly Affect the Bankruptcy Case

In *Wolfe v. Greentree Mortgage Corporation*, 2010 U.S. Dist. LEXIS 6005 (N.D. W. Va. Jan. 26, 2010), the district court considered whether to continue exercising jurisdiction over an action commenced in state court but removed to the bankruptcy court, and subsequently to the district court, under 28 U.S.C. §1452. After determining that the Debtor's lawsuit was a core proceeding, the district court held that mandatory abstention was not required by 28 U.S.C. § 1334(c). The district court further held that mandatory abstention was not necessary when there was an adequate basis for asserting jurisdiction due to diversity of the parties. Finally, the district court balanced various factors and determined that equitable abstention was unwarranted where the lawsuit would have a large effect on the Debtor's bankruptcy estate.

Facts and Procedural History

On July 11, 2009, Debtor filed a voluntary bankruptcy petition in the United States Bankruptcy Court for the Northern District of West Virginia. On October 19, 2009, Debtor filed a lawsuit in the Circuit Court of Jefferson County, West Virginia, alleging seven claims against the defendants. These claims included (1) unconscionable inducement of a loan, rendering the deed of trust void; (2) misconduct by a notary public; (3) allegations of joint venture and agency; (4) breach of contract; (5) estoppel preventing foreclosure on the loan; (6) illegal debt collection; and (7) illegal return of payment. The Debtor's goal was to invalidate the deed of trust and obtain damages.

On November 24, 2009, defendant America's Servicing Company ("ASC") and defendant Deutsche Bank Trust Company Americas ("Deutsche Bank") removed the action to the U.S. District Court, asserting as alternate bases for removal the bankruptcy removal statute, 28 U.S.C. § 1452, and diversity removal, 28 U.S.C. § 1441(a).

Debtor subsequently moved to remand the case to state court. With respect to the removal under the bankruptcy statute, Debtor contended that mandatory abstention was required, and that, in the alternative, the District Court should remand the case under equitable remand.

Legal Analysis

Section 1334 of title 28 provides the requirements for mandatory abstention:

Upon timely motion of a party in a proceeding based upon a State law claim or State law cause of action, related to a case under title 11 but not arising under title 11 or arising in a case under title 11, with respect to which an action cannot have commenced in a court of the United States absent jurisdiction under this section, the district court shall abstain from hearing such proceeding if an action is commenced, and can be timely adjudicated, in a State forum of appropriate jurisdiction.

28 U.S.C. § 1334(c)(2). Applying this standard in a previous matter, the district court noted in *Mey v. Herbalife International, Inc.*, 2003 WL 23571253 (N.D. W.Va. Nov. 19, 2003):

"[A] district court must abstain from hearing a non-core, related matter if the action can be timely adjudicated in state court." *Howe v. Vaughan*, 913 F.2d 1138, 1142 (5th Cir. 1990). In order for mandatory abstention to apply, the plaintiff must show: (1) a timely motion to abstain has been made; (2) the proceeding is based upon a state law cause of action; (3) the proceeding is related to a Title 11 case, but is not a core proceeding; (4) the action could not have been commenced in federal court absent jurisdiction under § 1334; and (5) an action is commenced, and can be timely adjudicated, in state court with proper jurisdiction. See *Personette v. Kennedy (In re Midgard Corp.)*, 204 B.R. 764, 776-79 (BAP 10th Cir. 1997); *In re Futura Ind., Inc.*, 69 B.R. 831, 834 (Bank. E.D. Pa. 1987); see also *Busines and Commercial Litigation in Federal Courts*, § 45.5 (Robert L. Haig Ed., 1998).

2003 WL 23571253, at *3; see also *Barge v. Western Southern Life Ins. Co.*, 307 B.R. 541, 546 (S.D. W. Va. 2004).

Commentary

The district court's holding in *Wolfe* is noteworthy in that it addresses the process for determining whether an action should be remanded to state court. After applying the statutory requirements to the case at hand, the district court found that mandatory abstention was not applicable for two reasons: (1) the action was a core proceeding; and (2) there was an adequate alternative basis for jurisdiction. With mandatory abstention no longer an option, the district court determined that equitable abstention was not necessary given that the core proceeding would have a substantial effect on the bankruptcy estate.

The Action Is a Core Proceeding. Section 157(b)(2) of title 28 provides that core proceedings include, but are not limited to: (A) matters concerning the administration of the estate; (K) determination of the validity, extent, or priority of liens; and (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims. Because the Debtor sought, in large part, to invalidate the lien of the deed of trust, the district court found that the action fell squarely within 28 U.S.C. § 157(b)(2)(K). The district court based this conclusion on *In re Smith*, 300 B.R. 828, 829-30 (Bankr. M.D. Ga. 2003), which held that an action to determine the validity of a lien on real property is a core proceeding:

If Plaintiff's lien against the real estate is subject to rescission, the trustee may have a valuable asset to administer. 28 U.S.C. § 157(b)(2)(A), (K) (core proceedings include matters concerning administration of the estate and

determinations of the validity, extent, or priority of liens). The Court therefore must conclude that Debtor's adversary proceeding is a core proceeding in Defendant's bankruptcy case.

To the extent that mandatory abstention does not apply to core proceedings, therefore, the case could not be remanded on that ground.

An Alternate Basis for Jurisdiction Existed. According to the district court, even if the case were not a core proceeding, mandatory abstention would still not apply because the case could have been brought in federal court anyway due to the complete diversity between the Debtor and defendants. While the Debtor included a claim against a notary public Anthony Freda, the district court found that Mr. Freda was fraudulently joined. Under the doctrine of fraudulent joinder, a district court can assume jurisdiction over a case even if there are nondiverse named defendants at the time the case is removed. *Mayes v. Rapoport*, 198 F.3d 457, 461 (4th Cir. 1999); *Marshall v. Manville Sales Corp.*, 6 F.3d 229, 232-33 (4th Cir. 1993); *Cobb v. Delta Exports, Inc.*, 186 F.3d 675, 677 (5th Cir. 1999). The doctrine permits a district court to disregard, for jurisdictional purposes, the citizenship of certain nondiverse defendants, assume jurisdiction over a case, dismiss the nondiverse defendants and thereby retain jurisdiction. *Mayes*, 198 F.3d at 461.

In this case, the removing defendants did not meet their burden as to their claim against the notary. The Debtor alleged that Mr. Freda engaged in official misconduct by notarizing Debtor's signature on the deed of trust outside Debtor's presence and without witnessing Debtor sign the document. Debtor did not, however, deny that she in fact signed the deed of trust. Because the sole purpose of a notary is merely to acknowledge the authenticity of the signature, *Dickey v. Royal Banks of Missouri*, 111 F.3d 580, 584 (8th Cir. 1997), no damages could arise from the notary public's failure to properly acknowledge that signature. In other words, because there was no damage, there could be no judgment against defendant Freda, and without defendant Freda in the action, there was diversity among the parties. Accordingly, the action could have been brought in the district court and the Debtor could not satisfy the fourth requirement of mandatory abstention.

No Basis for Equitable Remand. In the alternative, the Debtor sought that the district court equitably remand the case. Section 1452(b) of title 28 provides, in relevant part: "The court to which such claim or cause of action is removed may remand such claim or cause of action on any equitable ground." Courts have described several factors concerning the issue of whether to remand under section 1452(b):

(1) the effect on the efficient administration of the bankruptcy estate; (2) the extent to which issues of state law predominate; (3) the difficulty or unsettled nature of the applicable state law; (4) comity; (5) the degree of relatedness or remoteness of the proceeding to the main bankruptcy case; (6) the existence of a right to a jury trial; and (7) prejudice to the party involuntarily removed from state court.

Barge v. Western Southern Life Ins. Co., 307 B.R. 541, 547 (S.D. W.Va. 2004) (citing *In re Riverside Nursing Home*, 144 B.R. 951, 956 (S.D. N.Y. 1992)); see also *Shubert v. Roche Holding Ag.*, 157 F.Supp.2d 542, 545 (E.D. Pa. 2001); *In re Merry-Go-Round Enterprises, Inc.*, 222 B.R. 254, 257 (D. Md. 1998).

The first consideration is the effect on the efficient administration of the bankruptcy estate. As the district court noted, the issue of the validity of the deed of trust is one that will have a large impact on the administration of the estate, since it may provide a free and clear asset that could inure to the benefit of creditors. The same is true of any money judgment, which may be obtained and which would inure to the benefit of the creditors. "Where the proceedings will affect the amount or existence of creditors' dividends, abstention is inappropriate." *In re Ascher*, 128 B.R. 639, 647 (Bankr. N.D. Ill. 1991) (citing *J.D. Marshall Internat'l v. Redstart*, 74 B.R. 651, 656 (N.D. Ill. 1987)).

The second consideration is the extent to which state law issues predominate. According to the district court, this factor militated *in favor* of remand.

In contrast, though, the third consideration favored no remand because there is the little difficulty or unsettled nature to the applicable state law. The district court had a large number of diversity cases on its docket that dealt with

same or similar issues, so it faced little difficulty in handling this case.

The fourth consideration is comity, and the district court found little difference one way or the other with regard to this factor. The case was removed very early in the litigation process and does involve a debtor in bankruptcy.

The fifth consideration is the degree of relatedness or remoteness of the proceeding to the main bankruptcy case. The resolution of the issues in the state lawsuit would have a large impact on the extent of the dividends to creditors. Further, this was a core proceeding. Accordingly, this case was very much related to the main bankruptcy matter, in which case remand would be inappropriate.

The sixth consideration is the existence of a right to a jury trial. In bankruptcy, there is no right to a trial by jury, which would be available in state court. The seventh and final consideration is prejudice to the party involuntarily removed from state court. According to the district court, the Debtor would not be unfairly prejudiced by proceeding in the federal court system.

Based upon these considerations, and especially given that the case was a core proceeding that may have a large effect on the bankruptcy estate, the district court declined to equitably remand this case.

Conclusion

The decision in *Wolfe v. Greentree Mortgage Corporation* is useful because it lays out the rules and standards for both mandatory and equitable abstention. In its decision, the district court gave substantial weight to the fact that the Debtor's lawsuit was a core proceeding such that mandatory abstention was not required by 28 U.S.C. § 1334. Additionally, the fact that diversity jurisdiction provided an adequate basis for jurisdiction further militated against mandatory abstention. Finally, of the various factors to be considered in determining whether to equitably abstain, the district court relied most heavily on the fact that this core proceeding would have a sufficiently large effect on the Debtor's bankruptcy estate such that abstention was unwarranted.

RELATED LINKS: For further discussion related to abstention under 28 U.S.C. § 1334(c), see Collier on Bankruptcy, ■ 1-3 Collier on Bankruptcy P 3.05

For analysis of other decisions relating to jurisdiction, procedure and litigation, click ■ here.

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5 of 197 DOCUMENTS

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Putting More Equity Into Equitable Mootness

2010 Emerging Issues 5091

Putting More Equity Into Equitable Mootness: Recent Cases in the Tenth and Fifth Circuits Signal More Appellate Review of Plan Confirmation Orders

By Phillip D. Anker, Craig Goldblatt and Lisa E. Ewart

June 3, 2010

SUMMARY: This Emerging Issues Analysis analyzes the judicially-created doctrine of "equitable mootness." Although equitable mootness has historically been viewed as a powerful tool for debtors to limit appellate review of orders confirming their chapter 11 plans, recent decisions in the Fifth and Tenth Circuits may suggest an inclination of some appellate courts to apply a more flexible standard toward review of confirmation decisions on appeal.

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ARTICLE: Introduction

The bankruptcy process often moves more quickly toward a final result than litigation in other courts. In many bankruptcy cases, courts recognize that urgent and final judicial action will better preserve the value of the debtor's assets, increase the chances for the debtor's successful reorganization and maximize recoveries for creditors. Indeed, chapter 11 plans of reorganization are often consummated just days after confirmation by the court-which can undermine the efforts of an objecting party to pursue an effective appeal, in part because of the judicially-created doctrine of "equitable mootness."

Although equitable mootness has historically been viewed as a powerful tool for debtors to limit appellate review of orders confirming their chapter 11 plans, recent decisions in the Fifth and Tenth Circuits may suggest an inclination of some appellate courts to apply a more flexible standard toward review of confirmation decisions on appeal.

What is equitable mootness?

Equitable mootness is the doctrine under which appellate courts refrain from hearing bankruptcy appeals relating to plan confirmation when it would be "inequitable" to do so. Distinct from "constitutional mootness," equitable mootness does not relate to an appellate court's inability to hear a case on the ground that there is no longer a live case or controversy, but the court's unwillingness to do so on the ground that providing relief after a plan has become effective is simply impractical. See *In re Pacific Lumber Co.*, 584 F.3d 229, 240 (5th Cir. 2009) (noting constitutional

mootness "prevents adjudication when cases are no longer 'live'" and equitable mootness "abdicates appellate review of very real, continuing controversies"). As the Fifth Circuit has aptly noted, equitable mootness is "a kind of appellate abstention that favors finality of reorganizations and protects the interrelated multi-party expectations on which they rest." *Id.*

The goal of equitable mootness is to "strike the proper balance between the equitable considerations of finality and good faith reliance on a judgment and competing interests that underlie the right of a party to seek review of a bankruptcy order adversely affecting him." *In re Manges*, 29 F.3d 1034, 1039 (5th Cir. 1994). Each of the 12 regional Circuit Courts of Appeals has adopted some form of the doctrine. n1

Generally, courts have agreed that the "substantial consummation" of a chapter 11 plan-the point when the debtor has implemented the major transactions contemplated by the plan-is the key moment after which a confirmation appeal may become equitably moot. For this reason, a party pursuing a confirmation appeal is best served by seeking and obtaining a stay pending appeal so that the debtor is enjoined from substantial consummation, and so that the plan's effectiveness is essentially put on hold while the appeal proceeds. But many times, an appellant is unsuccessful in obtaining a stay pending appeal because the bankruptcy court confirming the plan (and the appellate court considering a motion for an emergency stay) is concerned that a delay in plan implementation will adversely affect the debtor and creditors as a whole.

Recent decisions may suggest more flexibility for appellants

Whether the reorganization plan has been substantially consummated and whether a stay of the confirmation decision has been obtained pending appeal remain two important factors for courts considering equitable mootness. But three recent cases, one from the Fifth Circuit and two from the Tenth, make clear that, before a reviewing court refrains from hearing an appeal, it must consider the equities of the situation, including the equities as they relate to the appellant. These decisions may indicate a somewhat greater ability of an appellant to convince a district court, bankruptcy appellate panel, or court of appeals to hear the merits of an appeal even where there is no stay pending appeal and where the plan has already been substantially consummated.

In re Blast Energy Services, Inc., 593 F.3d 418 (5th Cir. 2010)

First, in *Blast*, the Fifth Circuit Court of Appeals criticized the district court for too easily reaching a conclusion that a confirmation appeal was equitably moot.

In *Blast*, Alberta Energy Partners ("Alberta") sought to appeal two orders: (1) the denial of its motion for rehearing of the district court's earlier dismissal of Alberta's appeal of the confirmation order; and (2) the district court's denial of Alberta's appeal of the rulings permitting debtors-Blast Energy Services, Inc. and Eagle Domestic Drilling Operations, LLC ("Blast")-to assume an executory contract between Alberta and the debtors. Although Alberta had been unsuccessful in obtaining a stay and the plan had been substantially consummated, the parties stipulated that the confirmation order would have no effect with respect to the appeals relating to the assumption of the executory contract and that granting that relief would not affect the reorganization or any third parties. The parties also agreed and represented to the district court that the assumption of the contract was not essential to Blast's reorganization. Despite these representations, the district court dismissed all appeals as equitably moot and also as statutorily moot pursuant to *Section 1127(b) of the Bankruptcy Code*, a provision of the Bankruptcy Code that permits a debtor to modify a plan, with court approval, between confirmation and substantial consummation "if circumstances warrant such modification." 11 U.S.C. § 1127(b).

With respect to statutory mootness, the district court reasoned that the appeals "would require modification of the substantially consummated Plan" in violation of 11 U.S.C. § 1127(b). *In re Blast Energy Services, Inc.*, 593 F.3d at 423 n.1. But the Fifth Circuit disagreed, holding-consistent with the statutory language-that Section 1127(b) applies only to bar changes to reorganization plans by the plan proponent post-confirmation, and does not apply to changes in a plan

necessitated by a confirmation appeal by a party objecting to confirmation. *Id.* at 426-27.

As for equitable mootness, the Fifth Circuit reiterated its previously-announced three-pronged analysis under which a court weighs the following factors to determine whether an appeal is equitably moot: (1) whether a stay has been obtained; (2) whether the plan has been substantially consummated; and (3) whether the relief requested would affect either the rights of the parties not before the court or the success of the plan. *Id.* at 424. In addition, a court may also consider (1) the degree of prejudice to third parties and to some of the litigants and (2) the "arbitrariness" of the ruling being appealed. *Id.* at 425 n.4.

The Fifth Circuit found that, in the face of the parties' stipulation, the district court's unsupported conclusion that "the parties not before the court, including the recipients of the monies already distributed, would be harmed by the modification or that the modification would put the success of the Plan at risk" was clearly erroneous. Accordingly, the district court had abused its discretion in refusing to hear the merits of the appeal on the ground that it was equitably moot. The Fifth Circuit remanded the matter to the district court with instructions to fully consider the equitable mootness question and to "articulate in detail the reasons for its conclusion, with references to the record." *Id.* at 426.

Search Market Direct v. Jubber (In re Paige), 584 F.3d 1327 (10th Cir. 2009)

Second, in *Paige*, the Tenth Circuit Court of Appeals announced a new rule for equitable mootness that requires the reviewing court to conduct a more detailed analysis of the circumstances surrounding the appeal before it may reach the conclusion that an appeal from plan confirmation is equitably moot.

Paige involved competing bankruptcy reorganization plans. The plan confirmed by the bankruptcy court was not supposed to become effective until after "any pending appeals were resolved," but that requirement was waived by the plan proponents. Fearing substantial consummation, the sponsor of the rejected plan-SMDI-sought a stay pending appeal. The bankruptcy court denied the stay, and SMDI appealed the confirmation order to the district court. The district court dismissed the appeal as both constitutionally and equitably moot.

As for the former, the Tenth Circuit held that so long as some form of relief on appeal-even partial relief-could be granted, an appeal is not constitutionally moot. *In re Paige*, 584 F.3d at 1336. In this case, because the court could reverse the confirmation order and provide SMDI an opportunity to seek approval of its own plan or to propose a new plan, some relief was possible. *Id.*

With respect to equitable mootness, the court outlined a six factor test:

It seems that under the doctrine of equitable mootness a court should decline to hear an appeal of a bankruptcy court's decision where the answers to the following six questions indicate that reaching the merits would be unfair or impracticable: (1) Has the appellant sought and/or obtained a stay pending appeal? (2) Has the appealed plan been substantially consummated? (3) Will the rights of innocent third parties be adversely affected by reversal of the confirmed plan? (4) Will the public-policy need for reliance on the confirmed bankruptcy plan-and the need for creditors generally to be able to rely on bankruptcy court decisions-be undermined by reversal of the plan? (5) If appellant's challenge were upheld, what would be the likely impact upon a successful reorganization of the debtor? And (6) based upon a quick look at the merits of appellant's challenge to the plan, is appellant's challenge legally meritorious or equitably compelling?

Id. at 1338-39.

The Tenth Circuit stated that the plan proponent seeking to prevent appellate review bears the burden of proving that, in light of these factors, the court should abstain from reaching the merits. In this regard, it rejected the view of other Circuits that if the plan has been substantially consummated, the burden shifts to the party seeking review of the challenge to the plan. *See id.* at 1340 (rejecting *In re Chateaugay Corp.*, 94 F.3d 772, 776 (2d Cir. 1996)).

The Tenth Circuit also noted that the six factors it had identified "are not necessarily conclusive, nor will each factor always merit equal weight." *Id.* at 1339. But the court provided some guidance into the application of these factors. For example, if the plan proponents have tried to accelerate the consummation process, courts should be less inclined to find the appeal to be equitably moot. *Id.* at 1341-42. With respect to the stay factor, the court noted that if a party sought a stay of the appeal-regardless of whether a party was successful-the court would be more inclined to review the merits of the decision below. *Id.* at 1340-41. The Tenth Circuit also held that it is important for the district court to take a "quick look" at the merits of the claim because claims that went to the integrity of the bankruptcy process or the good faith of the parties "should not be lightly swept under the rug in the name of equitable mootness." *Id.* at 1348.

In re Centrix Financial LLC, 355 Fed. Appx. 199, 2009 U.S. App. LEXIS 26716 (10th Cir. 2009)

Third, in *Centrix Financial*, the Tenth Circuit had an opportunity to apply the new standard it had announced in *Paige*.

In *Centrix Financial*, the appellants had filed a notice of appeal of the confirmation order, but had not sought a stay of consummation of the plan pending appeal. The trustee of the liquidating trust created under the plan thereafter filed a motion to dismiss the appeal, arguing that, because the plan had been substantially consummated, a reversal of confirmation was impractical and inequitable. The district court agreed and determined that the appeal was equitably moot.

On appeal, the Tenth Circuit noted that the district court had decided the question before the Tenth Circuit had issued its decision in *Paige*, and therefore, the district court had not had the benefit of the Tenth Circuit's guidance that it should consider all of the factors outlined in the *Paige* decision. Specifically, the district court had not considered the sixth question of the analysis: "whether Appellants' challenge to the Plan is legally meritorious or equitably compelling 'based upon a quick look at the merits.'" *In re Centrix Financial LLC*, 355 Fed. Appx. 199, 202, 2009 U.S. App. LEXIS 26716, at *7. The court of appeals also drew a distinction between the question that the district court had considered-whether the relief requested by Appellants would affect the success of the plan-and the question that the Tenth Circuit had found relevant in *Paige*-the likely impact of an appellant's challenge to the successful reorganization of the debtor (whether under this or another plan). *Id.* The Tenth Circuit remanded the case to the district court to allow it to weigh and apply those factors in the first instance.

What are the implications?

These decisions highlight efforts by the appellate courts to reconcile a federal court's "virtually unflagging obligation" to exercise the jurisdiction Congress has granted by statute with the need for finality in bankruptcy reorganization plans, and suggest that the balance may be tipping in favor of exercising jurisdiction. In all three decisions, the courts gave teeth to the equity component of the analysis by making clear that the reviewing court must engage in an analysis of the equities of the case and that the failure of the would-be appellant to obtain a stay and the appellee's substantial consummation of a reorganization plan by themselves are not enough to invoke the equitable mootness doctrine. The Tenth Circuit went even further and required the district court to take "a quick look at the merits" to consider whether the appellant's challenge is legally meritorious or equitably compelling.

To the extent these decisions suggest a trend of favoring review of confirmation orders over abstention, plan proponents should be prepared to defend confirmation orders on appeal even when their plans have been substantially consummated. In addition, the possibility of review and reversal on appeal makes it all the more important for plan proponents to try to build consensus and to make their best effort to settle disputes before confirmation in order to avoid the risk associated with reversal of a substantially consummated plan. Indeed, if a higher likelihood of review exists, objecting parties may find themselves with more leverage in confirmation disputes.

[Return to Text](#)

ⁿ¹ See *In re Pub. Serv. Co. of New Hampshire*, 963 F.2d 469, 473 (1st Cir. 1992); *In re Chateaugay*, 988 F.2d 322, 325 (2d Cir. 1993); *In re Continental Airlines*, 91 F.3d 553, 559 (3d Cir. 1996); *Mac Panel Co. v. Virginia Panel Corp.*, 283 F.3d 622, 625 (4th Cir. 2002); *In re Manges*, 29 F.3d 1034, 1038-39 (5th Cir. 1994); *In re United Producers*, 526 F.3d 942, 947 (6th Cir. 2008); *In re UNR Indus., Inc.*, 20 F.3d 766, 769 (7th Cir. 1994); *In re Smith*, 209 Fed.Appx. 607, 607 (8th Cir. Dec. 14, 2006) (unpublished) (per curiam); *In re Roberts Farms, Inc.*, 652 F.2d 793, 798 (9th Cir. 1981); *In re Paige*, 584 F.3d 1327, 1337 (10th Cir. 2009); *In re East Coast Beverage Corp.*, 143 Fed.Appx. 259, 260 (11th Cir. Aug. 30, 2005) (unpublished) (per curiam); *In re AOV*, 792 F.2d 1140, 1147 (D.C. Cir. 1986).

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6 of 197 DOCUMENTS

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In re Lehman Bros. Holdings Inc.

2010 Emerging Issues 5094

In re Lehman Bros. Holdings Inc. Raises Questions About Application of Safe Harbors to Complex Financial Products

By Jeannette K. Boot, Craig Goldblatt and Lisa E. Ewart

June 3, 2010

SUMMARY: This Emerging Issues Analysis analyzes a case that narrowed the protections that the Bankruptcy Code was thought to provide to participants in the derivatives markets. The court ruled that "flip" provisions of swap documents triggered by a Lehman Brothers bankruptcy are unenforceable and that actions to enforce the swap documents violate bankruptcy's automatic stay, notwithstanding the Bankruptcy Code's "safe harbors" for swap agreements.

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ARTICLE: In a decision issued on January 25, 2010, the U.S. Bankruptcy Court for the Southern District of New York substantially narrowed the protections that the Bankruptcy Code was thought to provide to participants in the derivatives markets. *Lehman Bros. Special Fin. Inc. v. BNY Corporate Tr. Servs. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010). Specifically, the bankruptcy court granted summary judgment in favor of Lehman Brothers Special Financing Inc. ("LBSF") and against the Trustee (the "Trustee") with respect to a series of notes, ruling that "flip" provisions of swap documents triggered by a Lehman Brothers bankruptcy are unenforceable and that actions to enforce the swap documents violate bankruptcy's automatic stay, notwithstanding the "safe harbors" for swap agreements contained in the Bankruptcy Code. The decision has several important implications for the financial community.

The Underlying Structure: Swaps and Flips

This case involves two series of credit-linked synthetic portfolio notes (the "Notes") issued by Saphir Finance Public Limited Company ("Saphir")-a special-purpose entity created by Lehman Brothers International (Europe)-in connection with a multi-issuer secured obligation program. Each series of Notes was governed by a supplemental trust deed (a "Supplemental Trust Deed") which referenced a credit default swap agreement (a "Swap Agreement") linked to that series. Each Swap Agreement was evidenced by a written confirmation and related ISDA Master Agreement, schedules, and annexes entered into between Saphir, as the issuer of the Notes, and LBSF, as the swap counterparty.

The Notes were secured by collateral held by the Trustee in trust for the benefit of the creditors of Saphir. Saphir's

creditors included Perpetual Trustee Company Limited, as the holder of the Notes (the "Noteholder"), and LBSF, as the swap counterparty. Under the Supplemental Trust Deed, the rights of LBSF to the collateral would normally take priority over those of the Noteholder. The documents provided, however, that in the event of default by LBSF under the Swap Agreement, the order of priority "flipped," so that the Noteholder would be entitled to priority over amounts otherwise payable to LBSF. In addition, as is often the case in derivatives contracts, the Swap Agreement provided that a bankruptcy filing by either LBSF or its parent, Lehman Brothers Holdings Inc. ("LBHI"),ⁿ¹ would be an event of default and therefore a trigger for the "flip" provision.

The Bankruptcy: Ipso Facto Provisions and the Automatic Stay

LBHI filed for bankruptcy on September 15, 2008. LBSF filed for bankruptcy 18 days later, on October 3, 2008.

On November 25, 2008, counsel to the Lehman Brothers entities sent a letter to the Trustee, advising it of the "automatic stay" in place as a result of the bankruptcy filings under Section 362 of the Bankruptcy Code,ⁿ² and asserting that contractual provisions purporting to subordinate LBSF's claims were unenforceable. On December 1, 2008, Saphir sent notices to LBSF terminating the Swap Agreement.

On May 20, 2009, LBSF commenced its adversary proceeding, seeking a declaratory judgment that (1) the "flip" provisions of the Swap Agreement that modify LBSF's payment priority upon an event of default constitute an unenforceable ipso facto clause under Sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code, and (2) any action to enforce the payment provisions modifying LBSF's payment priority violates the Code's automatic stay provisions.

The Decision

The bankruptcy court found in favor of LBSF. Three particular aspects of the opinion warrant attention.

1. The bankruptcy case of a "sufficiently related debtor" can trigger the ipso facto protections of Sections 365(e)(1) and 541(c)(1)(B).

Sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code bar the enforcement of so-called ipso facto clauses-contractual provisions that alter parties' rights based on the filing of a bankruptcy petition. But until this decision, it was generally understood that these provisions of the Bankruptcy Code applied only to contractual provisions tied to bankruptcy filings by the contractual counterparty. A contractual provision that was triggered by the bankruptcy filing of a third party, by contrast, was widely believed to be fully enforceable as against the contractual counterparty.

This decision calls that conventional wisdom into question. Noting that "each of these sections of the Bankruptcy Code prohibits modification of a debtor's right solely because of a provision in an agreement conditioned upon the commencement of a case under this title," the bankruptcy court concluded that LBSF could assert the protections of these provisions based on the bankruptcy filing of LBHI, even though LBSF did not file for bankruptcy itself until 18 days later. *In re Lehman Bros.* at 419 (emphasis in original). In reaching this conclusion, the bankruptcy court relied on the absence of the language in the statute that limited "a case" to one "by or against the debtor" and the fact that early drafts of the legislation-not adopted by Congress-did include such a modification. *Id.*

2. The "safe harbor" provisions of the Bankruptcy Code apply only to the Swap Agreement-the ISDA Master Agreement, schedules and written confirmation-and not related documents.

Even if the change in priority distribution effected by the "flip" provision would otherwise violate the ipso facto restriction in the Bankruptcy Code, the Code includes a "safe harbor" that allows parties to a swap agreement to terminate that agreement in the event of a counterparty's bankruptcy.ⁿ³ This "safe harbor" is part of a broad set of statutory protections intended to exempt derivatives contracts from the application of bankruptcy law and guard against instability in financial markets as a result of one market participant's bankruptcy.

But this transaction was not a simple swap agreement; rather it was a more complex structured transaction involving swaps. It therefore presented the question whether the safe harbor provision protects the exercise of a contractual term that changes the priority of distribution of collateral when that term is included in a related document, rather than in the swap agreement itself. In *re Lehman Bros.* at 421. The bankruptcy court reviewed the language of Section 560 and determined-notwithstanding the statute's broad language extending to contractual provisions "arising under or in connections with the termination . . . of one or more swap agreements," and notwithstanding the Trustee's argument that the Swap Agreement expressly incorporated the terms of the Supplemental Trust Deed-that the alteration of distribution rights are not protected by the safe harbor. Because the provisions modifying distribution were contained in the Supplemental Trust Deed and not in the Swap Agreement itself, the bankruptcy court concluded that the exercise of any such provision is not protected by the statutory safe harbor. *Id.*

3. Decisions of foreign courts that do not appropriately consider United States bankruptcy law should not be provided comity.

It is also noteworthy that in a prior judicial decision in the United Kingdom (the "UK Decision"), the UK court held that LBSF's interest in the collateral securing the Swap Agreement was "always limited and conditional" and that the change in priority distribution became effective on the date of LBHI's bankruptcy. The Trustee argued that the agreements between the parties are governed by and construed in accordance with English law, and that the bankruptcy court should defer to the UK Decision. The bankruptcy court disagreed, noting that the United States has a strong interest in having a bankruptcy court resolve issues of federal bankruptcy law and that although the court may choose to give preclusive effect to a judgment rendered by a foreign court on the basis of comity, it is not obligated to do so. Because the bankruptcy court concluded that the UK Decision did not take sufficient account and consideration of the applicability and impact of United States bankruptcy laws, the court declined to give those decisions preclusive effect.

Implications

The potential implications of this decision are far-reaching.

First, the bankruptcy court purports to limit its holding that the ipso facto protections can be triggered on account of another entity's bankruptcy by stressing the unique complexity of the bankruptcies involving the Lehman-related entities and states that "nothing in this decision is intended to impact issues of substantive consolidation, the importance of each of the separate petition dates for purposes of allowing claims against each of the debtors or any other legal determination that may relate to the date of commencement of a case." In *re Lehman Bros.* at 419-420. The decision nevertheless raises an important question: if a contractual counterparty terminates a contract against a non-debtor subsidiary on account of a bankruptcy by another affiliate (such as a parent guarantor), may that otherwise proper termination later be invalidated if the subsidiary-counterparty itself later seeks bankruptcy protection? If so, under what circumstances? Beyond indicating that the result in this case was heavily influenced by the complexity of the Lehman bankruptcy, the court's decision provides relatively little guidance on the extent to which a different timing of the contract termination would affect the analysis of these issues.

Second, the bankruptcy court's holding that a bankruptcy termination clause needs to be in the same piece of paper as the swap agreement (and implicit holding that being incorporated by reference into the swap agreement was insufficient) in order to be protected by the safe harbor may raise questions about the application of the safe harbor provisions to other complex financial products. If the decision withstands appellate review, it may also require parties to complex financial products that involve swap arrangements to alter the structure of the agreements, or the manner in which they are documented, to ensure that swap counterparties are able to claim the protection of the statutory safe harbor.

Finally, the decision highlights the challenges and complexities involved when multi-national bankruptcies proceed in various jurisdictions.

[Return to Text](#)

n1 LBHI acts as credit support provider for LBSF's payment obligations under the Swap Agreement.

n2 References to Bankruptcy Code sections are references to *11 U.S.C. § 101* et seq.

n3 Specifically, Section 560 of the Bankruptcy Code permits "the exercise of any contractual right of any swap participant . . . to cause the liquidation, termination, or acceleration of one or more swap agreements because [of the filing of a bankruptcy] or to offset or net out any termination values or payment amounts arising under or in connections with the termination . . . of one or more swap agreements."

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7 of 197 DOCUMENTS

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James M. Lawniczak on the Doctrine of Equitable Mootness

2010 Emerging Issues 5079

James M. Lawniczak on the Doctrine of Equitable Mootness

By James M. Lawniczak

May 26, 2010

SUMMARY: James M. Lawniczak considers the circumstances under which the doctrine of equitable mootness prevents appellate review of a consummated plan of reorganization. In particular, he focuses on three recent appellate cases, from the Fifth, Sixth and Tenth Circuits, and analyzes the different approaches they follow. There is much disagreement as to the standard of review on subsequent appeal and the actual factors to be applied in the final decision.

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ARTICLE: Recently, Three Courts of Appeals Have Addressed the Doctrine of Equitable Mootness, Considering Whether to Dismiss an Appeal from a Confirmed Plan of Reorganization That Has Been Substantially Consummated

"Equitable mootness" is a doctrine developed by appellate courts that provides under certain circumstances for the dismissal of appeals from bankruptcy court orders confirming plans. It is applied where a plan of reorganization has been "substantially consummated" such that the appellate court determines that it would be inequitable or impractical to grant relief to the appellant.

There have been a number of recent circuit court of appeals cases that have discussed and applied the doctrine of equitable mootness in a bankruptcy context. There is a split among the courts of appeals as to whether the standard of review of a lower court's decision on equitable mootness should be *de novo* or a more deferential standard, such as clearly erroneous or abuse of discretion. There are also differences among the courts of appeals as to the factors that are to be considered in making a determination whether to apply the doctrine. Those differences will be discussed below, following an introduction to the doctrine and a discussion of the facts of several of the recent courts of appeals cases.

What Is Equitable Mootness?

Chapter 11 plans of reorganizations can be quite complex and generally contain myriad concepts that combine to conclude a chapter 11 case. Oftentimes, parties who disagree with their treatment in such a plan object and, if they lose, appeal from the adverse decision. In those cases where the aggrieved party has a minor role in the scheme of the entire

plan, the party may not be able, or even want, to post a large bond to stay consummation of a global plan, pending the appeal of its more narrow issue.

Thus, plans of reorganization are often consummated shortly after the confirmation order is entered, even if there are appeals pending from individual issues resolved by the plan. "Substantial consummation" is defined in 11 U.S.C. § 1101(2) as (A) transfer of all or substantially all of the property proposed by the plan to be transferred, (B) assumption by the debtor or its successor of the business or management of all or substantially all the affected property and (C) commencement of distribution under the plan.

Courts have developed the doctrine of "equitable mootness" to protect plans that have been substantially consummated from being overturned on appeal where the appellate court believes it would be inequitable under the circumstances to grant relief to the appellant because of the harm it would due to others. Each of the 12 circuit courts of appeals have adopted the doctrine, although the cases vary as to the elements or factors that the doctrine delineates. See *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327, 1337-38 (10th Cir. 2009), and the cases from each of the other 11 circuits cited therein.

Indeed, the courts have noted that the word "mootness" is incorrectly used. The doctrine does not require that the issues on appeal be completely "moot" for the appeal to be dismissed. Rather, a bankruptcy appeal is dismissed due to "equitable," "prudential" or "pragmatic" considerations. *Paige*, 584 F.3d at 1337; *In re UNR Ind., Inc.*, 20 F.3d 766, 769 (7th Cir. 1994) (banishing the term "equitable mootness" from the "(local) lexicon" and using instead whether "it is prudent to upset the plan of reorganization at this late date"). However, the term "equitable mootness" has so long been employed by the courts that it continues to be misused in all circuits except for the Seventh. See, e.g., *In re Continental Airlines*, 91 F.3d 553, 559 (3d Cir. 1996), cert. denied, 519 U.S. 1057, 117 S. Ct. 686, 136 L. Ed.2d 610 (1997) (recognizing that "'equitable mootness' is an inapt description of the doctrine at issue here" but using it because "past cases have used that term").

There is also a narrower doctrine that applies to all appeals, called "constitutional mootness." This doctrine is based on the requirement in Article III, section 1 of the Constitution that federal courts adjudicate only actual cases or controversies. Therefore, any appeal will be dismissed as moot, if it has become impossible for the appellate court to grant any effectual relief whatsoever. *Church of Scientology v. United States*, 506 U.S. 9, 12, 113 S. Ct. 447, 449, 121 L. Ed.2d 313 (1992). Courts have made it clear that constitutional mootness is to be very strictly applied, requiring the inability to fashion any meaningful relief; it is not to be applied merely because a court can give only partial redress. See, e.g., *Paige*, 584 F.3d at 1336.

The Two-Tiered System of Bankruptcy Appeals

Except for the rare case where an appeal is taken directly from a decision of the bankruptcy court to the court of appeals, 28 U.S.C. § 158(d)(2), n1 appeals from bankruptcy courts are taken in the first instance either to the district court or a bankruptcy appellate panel. 28 U.S.C. § 158(a), (b) and (c). Therefore, in most cases, the initial decision on whether the appeal is equitably moot will be presented to the district court or the bankruptcy appellate panel. A further appeal of right is then allowed from that decision to the appropriate circuit court of appeals. 28 U.S.C. § 158(d)(1).

The Facts of *Blast Energy*

In *Alberta Energy Partners v. Blast Energy Services, Inc. (In re Blast Energy Services, Inc.)*, 593 F.3d 418 (5th Cir. 2010), the debtor's confirmed plan of reorganization provided for the assumption of an executory contract with a third party. The prepetition contract had transferred a 50 percent interest in certain technology and governed the further development and management of the technology. 593 F.3d at 421-22. The third party appealed from the confirmation order, but its request for a stay was denied. Over \$2 million was distributed under the plan, and the plan was substantially consummated. 593 F.3d at 422. The debtor entered into a stipulation with the third party that even though the plan was substantially consummated, granting relief to the third party "would not affect the reorganization or any

third parties." *Id.* Notwithstanding the stipulation, the district court dismissed the appeal as moot.

The Facts of *Paige*

The debtor in *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327, 1330 (10th Cir. 2009), had a very valuable asset—the web domain name "FreeCreditScore.com." Two competing plans were advanced by parties who had been purchasing substantial portions of creditors' claims and whose true intentions were to acquire the name as cheaply as possible. *Id.* One of the plans was confirmed and substantially consummated with most of the estate's creditors paid. *Id.* The losing party appealed, but the district court dismissed the appeal as moot.

The Facts of *United Producers*

In *Curreys of Nebraska, Inc. v. United Producers, Inc. (In re United Producers, Inc.)*, 526 F.3d 942, 945 (6th Cir. 2008), the debtor, an agricultural cooperative, was subject to a large \$17 million prepetition judgment for breach of contract, fraud and conversion regarding cattle marketing. It proposed, and obtained confirmation of, a plan of reorganization paying creditors only a fraction of the judgment. Those creditors appealed, although they did not seek a stay. The plan was substantially consummated. *Id.*

The debtor moved the bankruptcy appellate panel to dismiss the appeal on grounds of equitable mootness, submitting the affidavit of the man who had been president of the debtor and was president of the reorganized debtor. The creditors disputed the evidence contained in the affidavit, and the appellate panel therefore remanded the matter to the bankruptcy court to hold a hearing on substantial consummation and third-party reliance on the plan. The bankruptcy court then found that the plan had been substantially consummated and that innocent third parties would be adversely affected if the plan were unwound. 526 F.3d at 945-46. The bankruptcy appellate panel dismissed the appeal under the equitable mootness doctrine.

Burden of Proof When Equitable Mootness Is Raised

In *Aetna Casualty & Surety Co. v. LTV Steel Co., Inc. (In re Chateaugay Corp.)*, 94 F.3d 772, 776 (2d Cir. 1996), the court indicated that it would presume it would be inequitable or impractical to grant relief of a consummated plan of reorganization. The court indicated this presumption could be overcome by a showing of five factors. In essence, this shifted the burden of proof to the appellant to establish those five factors in cases where a plan has been substantially consummated.

This shifting of the burden of proof was expressly rejected by the *Paige* court. The court held there that a party "inviting the court not to reach the merits of an appeal always carries the burden." 584 F.3d at 1340.

What Standard of Review Should Be Used by a Court of Appeals Reviewing a Decision on Whether to Apply the Equitable Mootness Doctrine?

To the extent a lower court makes findings of fact based on an evidentiary record below, the court of appeals will examine those findings under the "clear error" standard. See *Blast Energy*, 593 F.3d at 423 ("[a] ruling based on . . . a clearly erroneous assessment of the evidence is an abuse of discretion"); *Paige*, 584 F.3d at 1334; *United States ex rel. FCC v. GWI PCS 1 Inc. (In re GWI PCS 1 Inc.)*, 230 F.3d 788, 799 (5th Cir. 2000).

However, there is a split in the circuits as to the standard of review that should be used on the lower court's ultimate determination whether to apply the equitable mootness doctrine. One view is that the review should be *de novo*. The other is that the decision of the lower court is entitled to deference, so that it should be overturned only if clearly erroneous or if it constitutes an abuse of discretion.

De Novo Review. The courts that use *de novo* review rationalize that the initial decision on whether to dismiss a bankruptcy appeal as equitably moot was made on appeal by a court sitting as an appellate court, and therefore the court

of appeals on the further appeal is in just as good a position to make the determination. *See, e.g., United Producers*, 526 F.3d at 946-47 (6th Cir.); *GWI PCS 1 Inc.*, 230 F.3d at 799-800 (5th Cir.); *First Union Real Estate Equity & Mortgage Inv. v. Club Assocs. (In re Club Assocs.)*, 956 F.2d 1065, 1069 (11th Cir. 1992).

Abuse of Discretion. Other courts apply an abuse of discretion standard even as to the lower court's ultimate legal determination of the equitable mootness issue. *See, e.g., Paige*, 584 F.3d at 1135 (10th Cir.); *In re Continental Airlines*, 91 F.3d 553, 560 (3d Cir. 1996) (*en banc* 7-6 decision); *In re AOV Ind., Inc.*, 792 F.2d 1140, 1148 (D.C. Cir. 1986). Those courts note that the decision on equitable mootness "involves a discretionary balancing of equitable and prudential factors," which is why they conclude the abuse of discretion standard is the appropriate one. *See Nordhoff Invs., Inc. v. Zenith Elec. Corp.*, 258 F.3d 180, 182 (3d Cir. 2001). The *Paige* court noted that the disagreement over the standard "is likely based on the unique role of the district courts in the bankruptcy context." 584 F.3d at 1335.

When Should the Doctrine of Equitable Mootness Be Applied?

All courts that have addressed the equitable mootness doctrine agree that it is highly fact specific and requires consideration of a wide range of factors, which the court then examines through "equitable," "prudential" and "pragmatic" eyes. *Paige*, 584 F.3d at 1337-38. There are no "rigid rules," to be followed; instead, the analysis is one of examination of the totality of the circumstances. *Mac Panel Co. v. Virginia Panel Corp.*, 283 F.3d 622, 625 (4th Cir. 2002).

Several of the cases make the point that courts should be cautious before completely eliminating appellants' rights due to equitable mootness and apply the doctrine "with a scalpel rather than an axe." *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229, 240 (5th Cir. 2009). Each individual claim must be tested. 584 F.3d at 241. Even though full relief may no longer be available to an appellant, the court should nonetheless consider whether partial relief would be pragmatic and equitable before determining that the appellant's entire claim can no longer be pursued. *Id.*

There is a divergence among the courts of appeals as to the factors to employ in making an equitable mootness determination. The Fifth and Sixth Circuits use a three factor test: (1) whether a stay has been obtained; (2) whether the plan has been substantially consummated; and (3) whether the relief requested would affect the rights of parties not before the court or the success of the plan. *Blast Energy*, 593 F.3d at 424; *United Producers*, 526 F.3d at 947-48.

There are many more factors to be considered in the Tenth Circuit. The *Paige* court listed six questions, the answers to which would indicate whether reaching the merits of the appeal would be unfair or impracticable: (1) did appellant seek or obtain a stay; (2) has the plan been substantially consummated; (3) will the rights of innocent third parties be adversely affected by a reversal of the confirmation of the plan; (4) will public policy, considerations of reliance on decisions, be undermined; (5) what would be the likely impact of reversal on the likely success of the reorganization; and (6) based on a quick look at the merits of the appeal, is the appellant's challenge legally meritorious or equitably compelling? 584 F.3d at 1339.

In *In re Continental Airlines*, 91 F.3d 553, 559, 560 (3d Cir. 1996), *cert. denied*, 519 U.S. 1057, 117 S. Ct. 686, 136 L. Ed.2d 610 (1997), the Third Circuit noted five factors-essentially the first five questions noted in *Paige*. The *Continental Airlines* court stated that whether the plan had been substantially consummated was the most important of the factors, particularly where the reorganization is "intricate." 91 F.3d at 560-61.

The substantial consummation factor is even more important in the Second Circuit. In *Aetna Casualty & Surety Co. v. LTV Steel Co., Inc. (In re Chateaugay Corp.)*, 94 F.3d 772, 776 (2d Cir. 1996), the court noted that reviewing courts will presume that it will be inequitable or impractical to grant relief after substantial consummation of a plan. That presumption will be overcome only if each of five factors exist: (1) the court can still provide effective relief; (2) granting relief will not affect the re-emergence of the debtor as a revitalized entity; (3) granting relief will not unravel the transactions; (4) the parties who might be adversely affected have received notice and an opportunity to be heard;

and (5) the entity seeking relief has diligently pursued a stay throughout the proceedings.

A recent case in the Fifth Circuit, *Bank of New York Trust Co, NA v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229, 243 (5th Cir. 2009), stated that rights of secured creditors must be given additional weight in equitable mootness decisions. "Secured credit represents property rights that ultimately find a minimum level of protection in the takings and due process clauses of the Constitution." *Id.* Thus, federal courts should proceed with caution when declining to review the treatment that secured creditors have received in a plan. *Id.* Indeed, the *Pacific Lumber* court held that equitable mootness did not prevent review of the secured creditors' appeal, but went on to hold that secured creditors do not have an absolute right to credit bid when their collateral is being sold pursuant to a plan. 584 F.3d at 245; see *James M. Lawnczak on a Secured Creditor's Absolute Legal Right to Credit Bid under 11 U.S.C. § 1129(b)(2)(A)*, 2010 *Emerging Issues* 4957 (Apr. 10, 2010).

The Results in the *Blast Energy*, *Paige* and *United Producers* Cases

In *Blast Energy*, the court of appeals reversed the district court's order determining that the appeal of the other party to the assumed executory contract was moot. The district court had focused on the importance of executory contracts generally to reorganizations, without looking closely at the specific contract at issue. Because the evidence did not show that the contract was of importance to the reorganization, the appeal could go forward. 593 F.3d at 425-26.

In addition, *Blast Energy* court had to consider a legal issue determined below. The district court had ruled that 11 U.S.C. § 1127(b), which permits modification of a plan by a proponent before it has been substantially consummated, would prevent an appellate court from requiring a modification by ruling on an appeal after substantial consummation. The court ruled instead that it is the equitable mootness doctrine that limits post-consummation challenges to plans, not section 1127(b), reversing the lower court on this issue as well. 593 F.3d at 427.

In *Paige*, the court also found that equitable mootness did not prevent the appeal from going forward, thus reversing the decision of the district court. The court noted that on the issue of the effect of a possible reversal on third parties not before the court, the district court had improperly placed the burden of proof on the appellant. The fact that the appellees had not shown that relief to the appellant would adversely affect third parties was critical to the court's decision to reverse. 584 F.3d at 1343-44.

In *United Producers*, the district court's decision to dismiss the appeal was affirmed. The main focus of the court was on the consummated reorganization plan and the complex and substantial financing that had gone into it. Any modification of the plan would be a default under that financing. Thus, the court declined to consider any such modifications. 526 F.3d at 950-51.

How Does the District Court Sitting as a Court of Appeals Determine the Facts Relevant to a Decision Whether to Apply the Doctrine of Equitable Mootness?

The issue of "equitable mootness" is usually brought to the initial appellate court by motion with the facts explained by affidavit. If those facts are not disputed, then the appellate court is likely to accept them as correct and proceed to make a legal determination based thereon. However, if the appellant disagrees, then an evidentiary hearing is appropriate. In most cases, that hearing will take place in the bankruptcy court on remand, and the bankruptcy court will make findings of fact. This is what happened in *United Producers*, 526 F.3d at 946-47.

Other Circumstances Where Appellate Courts Will Dismiss Appeals Where Events Have Occurred Following Entry of the Order Appealed From

Confirmation of plans comprise the vast majority of cases where courts of appeals consider whether equitable mootness requires dismissal of an appeal. However, it is possible that other types of orders in a bankruptcy case could be viewed in a similar vein. For example, in *South Street Seaport Ltd. Partnership v. Burger Boys, Inc. (In re Burger Boys, Inc.)*, 94 F.3d 755, 759-60 (2d Cir. 1996), the court, considering an appeal from an order providing for the

assumption of a lease, noted that the doctrines of constitutional mootness and equitable mootness apply to bankruptcy appeals. However, the court's holding was that the closing of the transaction did not render the appeal moot, as the court could simply undue the assumption. It would likely be a very rare case, where an order, other than a confirmation order, would indeed be equitably moot.

The Bankruptcy Code itself describes two situations when the consummation of transactions provided for in orders requires the dismissal of an appeal. This is called "statutory mootness." If an order providing for the sale or lease of an asset or assets or an order approving a financing is entered, and the transaction is closed before a stay is entered, then under the circumstances provided for in the statute, the appeal must be dismissed. *11 U.S.C. §§ 363(m), 364(e)* (in either case protecting entities that acted "in good faith"); see *Contrarian Funds LLC v. Aretex LLC (In re Westpoint Stevens, Inc.)*, 600 F.3d 231 (2d Cir. 2010) (discussing "statutory mootness" of a section 363 sale).

Practical Pointers

Because the doctrine of "equitable mootness" is so fact specific and is subject to a determination by a judge based on equitable, pragmatic and practical considerations, it is uncertain how important the standard of review and the factors to be considered are in reality. In the end, it comes down to whether the judge believes it is fair, under all the circumstances, to fashion some relief for the appellant.

Parties dealing with equitable mootness issues must, of course, be aware of the appropriate standard of review and factors to be considered in the circuit where the case is pending. They must then fashion their arguments to take those matters into account. However, the main focus should be on the specific facts of each case. The party asserting equitable mootness should focus on the unfairness, particularly to third parties, that any relief would cause. The appellant opposing equitable mootness must identify specific relief, even if only partial relief, that could be granted and show the court how that would be an appropriate result under all the circumstances.

Conclusion

Although all circuit courts of appeals agree that the doctrine of "equitable mootness" requires an appeal to be dismissed when effective relief can no longer be granted, there is much disagreement as to the standard of review on subsequent appeal and the actual factors to be applied to the ultimate decision. It is, therefore, critical to address the appropriate standards in the circuit where the case is pending.

[Return to Text](#)

ⁿ¹ *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229, 236 (5th Cir. 2009), discussed below, is an example of a direct appeal.

RELATED LINKS: For discussion of substantial consummation of a chapter 11 plan, see Collier on Bankruptcy, [■ 7-1101 Collier on Bankruptcy P 1101.02](#)

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Mr. Lawniczak is a frequent author and lecturer in his field. He is a contributing author to *Collier on Bankruptcy*, the leading national treatise on bankruptcy law. He is also the author of the bankruptcy chapters of the Matthew Bender treatises *Asset Based Financing* and *Business Organizations with Tax Planning*. He has been listed in multiple editions of *Chambers USA* as a *Leading Lawyer* for bankruptcy and restructuring and is recognized as one of the *Best Lawyers in America*.

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8 of 197 DOCUMENTS

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Klee on United Student Aid Funds, Inc. v. Espinosa

2010 Emerging Issues 4966

Professor Kenneth N. Klee on the Supreme Court's holding in *United Student Aid Funds, Inc. v. Espinosa*, 176 L. Ed. 2d 158; 2010 U.S. LEXIS 2750 (2010)

By Prof. Kenneth N. Klee

April 15, 2010

SUMMARY: Parties challenging a bankruptcy court's final order almost always must take a direct appeal or be forever barred from collateral attack, even when the order contains a clear legal error. Further, when a statute permits a court to act only if certain findings are made or conditions exist, the court must make an independent determination of the finding or condition, even if no party objects (with few exceptions).

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ARTICLE: The Lessons to be Learned:

First, we learn the same lesson as in *Travelers Indemnity Co. v. Bailey*, 129 S. Ct. 2195, 2009 U.S. LEXIS 4537 (2009): Parties challenging a bankruptcy court's final order almost always must take a direct appeal or be forever barred from collateral attack, even when the order contains a clear legal error. Second, when a statute permits a court to act only if certain findings are made or conditions exist, the court must make an independent determination of the finding or condition, even if no party objects (unless, perhaps, the parties jointly waive the findings or conditions).

Legal Background:

A chapter 13 debtor may obtain a discharge of student loan debt under Bankruptcy Code § 1328(a)(2) & (c)(2) only when the bankruptcy court finds that failure to do so would impose an "undue hardship" on the debtor or his dependents in accordance with Bankruptcy Code § 523(a)(8). Federal Rule of Bankruptcy Procedure 7001(6) requires an adversary proceeding, initiated by a properly served summons and complaint, to make such a dischargeability determination.

Additionally, Federal Rule of Civil Procedure Rule 60(b)(4) allows a court to relieve a party from a final judgment when the judgment is "void." The Supreme Court has traditionally held that Rule 60(b)(4)'s relief applies in exceptional cases only when a judgment is premised either on (1) a certain type of jurisdictional error when the court lacks even an arguable basis for jurisdiction; or (2) a violation of due process that deprives a party of notice or the opportunity to be heard.

Facts and Proceedings Below:

Francisco Espinosa ("Espinosa") is an individual who incurred student loan debt. He filed a petition for relief under chapter 13 of the Bankruptcy Code. His chapter 13 plan listed his student loan debt as his only specific indebtedness, and proposed repaying only the principal on such debt. The student-loan creditor, United Student Aid Funds, Inc. ("United"), received notice of the plan, but did not object, instead filing a proof of claim for the value of the debt plus accrued interest. Less than a year later, the bankruptcy court confirmed Espinosa's plan without conducting an adversary proceeding regarding the discharge of Espinosa's student loan interest. A month later, the chapter 13 Trustee notified United that the amount of its proof of claim differed from the confirmed plan, and informed United that it had 30 days to notify the Trustee if it wished to dispute the difference. United did not take any action.

Four years later, Espinosa completed his payment plan, and the bankruptcy court discharged his debt, including interest on his student loan debt. Three years after discharge, the Department of Education commenced collection on Espinosa's unpaid interest, and Espinosa filed a motion in the bankruptcy court to enforce its discharge order. Although United opposed this motion and cross-moved under Rule 60(b)(4) to void the confirmation order, the bankruptcy court upheld its confirmation order and enforced its discharge order to discharge the interest on the student loan debt.

United appealed to the federal district court, which reversed the bankruptcy court's decision on United's 60(b)(4) motion because it determined United had been denied due process because no complaint and summons had been served on it.

After ruling and remanding on a clerical issue, the Ninth Circuit reversed the district court, denying United's 60(b)(4) motion because legal error was not a basis for setting aside a final judgment and United had received actual notice of Espinosa's plan and had not timely objected.

The Ninth Circuit's ruling on Rule 60(b)(4) differed from several sister circuits and created a circuit split among the Second, Fourth, Sixth, Seventh, Ninth and Tenth Circuits. The Supreme Court granted certiorari to consider all three questions and reconcile the circuit split.

Analysis:

Writing for a unanimous Court, Justice Thomas authored an opinion holding that Federal Rule of Civil Procedure 60(b)(4) did not apply to void the order confirming Espinosa's chapter 13 plan because the bankruptcy court had subject matter jurisdiction to enter the order and the lender was not denied due process of law. In *Kontrick v. Ryan*, 540 U.S. 443, 454 (2004), the Court held that a procedural rule cannot be jurisdictional. Specifically, in this case, Bankruptcy Rule 7001(6)'s requirement of an adversary proceeding to determine dischargeability of the debt for student loan interest was not jurisdictional. Nor were Bankruptcy Code §§ 523(a)(8) & 1328(a)(2)'s discharge requirement of a court determination of undue hardship jurisdictional. As such, the confirmation order was not void. Because the lender failed to object to confirmation and appeal the confirmation order, the order could not be collaterally attacked.

Moreover, the lender was not denied due process based on its failure to receive the required complaint and summons because it had actual notice of the chapter 13 case and that the plan might alter its rights. In fact, the lender filed a proof of claim in the case for payment of the principal and interest on its student loan debt. Even though no creditor objected, however, before confirming the plan, the bankruptcy court was required to make a determination that failure to discharge the student loan interest would impose an undue hardship on the debtor or his dependents.

In short, the Court refused to expand Rule 60(b)(4) to void judgments based on clear legal error. Instead, the Court noted that Rule 60(b)(4) applies narrowly to void judgments when a court clearly lacks subject matter jurisdiction or a party is denied due process of law; it may not be used as a substitute for the lender's failure to appeal the erroneous confirmation order. Thus, a bankruptcy court is required to make a finding of undue hardship before it may discharge all or part of a student loan debt, but its failure to do so does not make its confirmation order void for purposes of Rule 60(b)(4).

Practice Tips:

Creditors holding student loan debts cannot sit back and rest on their rights expecting that they will be protected unless they receive a complaint and summons. Creditors that are dissatisfied with the provisions of an improper plan must object to confirmation and take a direct appeal of the confirmation order. Klee, *Bankruptcy and the Supreme Court* at 232-238.

Moreover, even though the Bankruptcy Rules might require an adversary proceeding to be commenced to determine the dischargeability of a debt, constitutional due process may nevertheless be satisfied if the creditor has actual notice of the bankruptcy case or proceeding which generally alerts the creditor that its rights may be altered. For an in depth discussion of constitutional due process in the bankruptcy context, see Klee, *Bankruptcy and the Supreme Court* at 142-148.

Dictum to Watch:

In footnote 9, the Court states in *obiter dictum* that the statutory time limit to revoke confirmation of a plan in Bankruptcy Code § 1330 is not jurisdictional. The same reasoning should apply to revocation of confirmation orders in chapters 9, 11, and 12. See Bankruptcy Code §§ 901, 1144 & 1230.

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Mr. Klee is a fellow of the American College of Bankruptcy, serves as a member of the American Law Institute, and is a founding member of the International Insolvency Institute. He was a member of the executive committee of the National Bankruptcy Conference from 1985 to 1988 and 1992 to 2000 and served as Chair of the National Bankruptcy Conference's legislation committee from 1992 to 2000. Mr. Klee was Associate Counsel, Committee on Judiciary, U.S. House of Representatives 1974-1977, where he was a principal draftsman of the Bankruptcy Code. From 1992 to 2000, he served as a member of the Advisory Committee on Bankruptcy Rules of the United States Judicial Conference.

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9 of 197 DOCUMENTS

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Paul H. Zumbro and Robert H. Trust on In re Philadelphia Newspapers

2010 Emerging Issues 4956

Paul H. Zumbro and Robert H. Trust on In re Philadelphia Newspapers, LLC, 2010 U.S. App. LEXIS 5805 (3d Cir. Mar. 22, 2010)

By Paul H. Zumbro and Robert H. Trust

April 12, 2010

SUMMARY: Authors from Cravath, Swaine & Moore consider the Third Circuit's decision in *In re Philadelphia Newspapers*. This decision, along with the decision in *In re Pacific Lumber*, marks a significant departure from long-held expectations of secured creditors and could endanger protections traditionally thought to be afforded under the Bankruptcy Code. Secured lenders are likely to use at least three tactics to mitigate the effects of the decision.

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ARTICLE: Debtors May Preclude Secured Lenders from Credit Bidding in a Free-and-Clear Sale in a Chapter 11 Cramdown Plan

The United States Court of Appeals for the Third Circuit, in *In re Philadelphia Newspapers, LLC*, 2010 U.S. App. LEXIS 5805 (3d Cir. Mar. 22, 2010), ruled that a chapter 11 debtor may evade the secured lenders' protection of credit bidding at a sale of their collateral through a cramdown chapter 11 plan. The court permitted such a plan under section 1129(b)(2)(A)(iii) of the Bankruptcy Code, as long as the secured lenders receive the "indubitable equivalent" of their claims. The decision is particularly significant because it is from the court of appeals that sets precedent for bankruptcies in Delaware, a state in which many significant bankruptcy cases are filed.

The decision could substantially increase the risk to secured creditors of undervaluation of collateral in bankruptcy asset sales, reduce the amount of secured lenders recoveries and depress the trading value of distressed leveraged loans.

Background

Section 1129 of the Bankruptcy Code permits a debtor to confirm a chapter 11 plan by "cramming down" the plan over the objection of creditors if "the plan does not discriminate unfairly and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1). For a cramdown of secured lenders to be fair and equitable, section 1129(b)(2)(A) requires that the plan provide (i) that the secured lenders retain their liens and receive deferred cash payments totaling at least to the value of the collateral

securing their claims, (ii) for the sale, subject to the secured lenders' ability to credit bid, of the collateral free and clear of the secured lenders' liens, with such liens attaching to the proceeds of the sale, or (iii) that the secured lenders receive the "indubitable equivalent" of their claims. n1

The Debtors-Philadelphia Newspapers, LLC, along with eight affiliates-filed a chapter 11 plan in which they proposed to sell substantially all of their assets free and clear of any interests in a public auction pursuant to bidding procedures that precluded their secured lenders (the "Lenders") from credit bidding their claims. Instead, the Debtors insisted that any qualified bidder fund its purchase with cash. Simultaneously, the Debtors entered into a "stalking horse" asset purchase agreement with Philly Papers, LLC, an entity that was controlled by the Debtors' former management and equity holders. Under the plan, the Lenders would receive \$37 million cash, the Debtors' headquarters building (which the Debtors valued at \$29.5 million), subject to a two-year rent-free lease for the entity that purchased the assets, and any cash generated by a higher bid at a public auction. The Debtors argued that the sale satisfied clause (iii) of section 1129(b)(2)(A) because the Lenders would receive the "indubitable equivalent" of their claims under the plan, which totaled over \$318 million. The Lenders objected to the plan, arguing that section 1129(b)(2)(A) requires all sales of assets free and clear of liens to permit credit bidding.

The Decision

The Bankruptcy Court rejected the Debtors' proposed bidding procedures, reasoning that section 1129(b)(2)(A), when analyzed in the context of other sections of the Bankruptcy Code, requires that any sale of a debtor's assets free and clear of liens under a chapter 11 plan allow secured lenders to credit bid. The United States District Court for the Eastern District of Pennsylvania reversed the Bankruptcy Court, and the Court of Appeals for the Third Circuit affirmed.

The court of appeals, relying heavily on a plain meaning interpretation and a recent Fifth Circuit decision, n2 concluded that the three clauses of section 1129(b)(2)(A) list possible alternatives under which a plan may be considered to be "fair and equitable" and therefore confirmable. Because the three options are separated by the disjunctive word "or," the court reasoned that each clause represented a distinct and independent method by which a plan may be confirmed over the objection of a class of secured creditors. Although the second clause specifically mandates the presumptive right n3 to credit bid in a free and clear sale of assets, the court found that a free and clear sale without credit bidding could still be permissible under the third clause as long as the sale provides the "indubitable equivalent" of the Lenders' claims. The court interpreted the term "indubitable equivalent" to be purposefully broad to allow for flexibility in formulating chapter 11 plans and not to require credit bidding in every free and clear asset sale. Moreover, the court found that its decision did not directly contradict the overall structure of and legislative intent behind the Bankruptcy Code's treatment of secured creditors. Even though the court held that the Lenders did not have an absolute right to credit bid in a sale under a plan, it did, however, note that "a lender can still object to a plan confirmation [on the basis that] the absence of a credit bid did not provide it with the 'indubitable equivalent' of its collateral," seemingly inviting the bankruptcy court to undo the outcome the court of appeals felt compelled to reach as a matter of statutory interpretation.

In an extensive dissent, Judge Thomas Ambro argued that there was more than one reasonable reading of the statute and that it had to be interpreted by reference to other provisions of the Bankruptcy Code, and in light of the statute's legislative history and the overall structure of the Bankruptcy Code. Given such an analysis, he argued that the three clauses of section 1129(b)(2)(A) describe three exclusive and "distinct routes that apply specific requirements depending on how a given plan proposes to treat the claims of secured creditors." 2010 U.S. App. LEXIS 5805, at *76. As such, any plan that proposes a free and clear asset sale must presumptively allow for credit bidding, as is required in the second clause, and should not be permitted under the "indubitable equivalent" prong of section 1129(b)(2)(A)(iii).

The Effect of the Decision

This decision, coupled with the recent Fifth Circuit decision *In re Pacific Lumber Co.*, marks a significant

departure from long-held expectations of secured creditors and could endanger protections traditionally thought to be afforded to them under the Bankruptcy Code. As noted in the dissent, as a result of this decision, debtors that wish to preclude secured creditors from credit bidding (because, for example, they are unduly influenced by existing equity holders or other insiders) are more likely to try to sell their assets in a sale under a chapter 11 plan rather than through a sale under section 363. This could represent a significant erosion of secured creditor protections under the Bankruptcy Code, as credit bidding is an important safeguard that ensures against the undervaluation of collateral in an asset sale. As Judge Ambro points out in his dissent, "while many of the valuation mechanisms (such as judicial valuation or a market auction) may theoretically result in a perfect valuation, Congress has provided the credit bid mechanism as insurance for secured creditors to protect against an undervaluation of the assets sold. Secured creditors who believe their collateral is being sold for too low a price may bid it higher and use as credit the dollars they have already extended . . . to the debtors." 2010 U.S. App. LEXIS 5805, at *99. The loss of the important check on valuation that the ability to credit bid provides would be a significant adverse development for secured creditors.

As the dissent points out, the only party that stands to benefit from an undervaluation of the assets is the purchaser, in this case, most likely the stalking horse bidder "with substantial insider and equity ties." *Id.* at *111. The dissent also argues that the majority improperly shifted the burden on the issue of the availability of credit bidding from the debtors to the creditors, leaving the secured creditors "with only a belated court inquiry at confirmation to determine whether the denial of credit bidding was 'fair and equitable' to [them]." *Id.* at *101. This construct will likely lead to higher litigation costs and possibly reduced recoveries as secured creditors who are denied the ability to credit bid may have to litigate valuation issues as part of the confirmation process, as opposed to having valuation determined through an open auction process. Ultimately, the decision may depress the trading value of distressed leveraged loans, because of the increased risk to chapter 11 recoveries, and could have the unwelcome (from the perspective of secured lenders) consequence of making it easier for debtors to structure transactions in a manner that benefits existing equity and other insiders at the expense of secured creditors.

Secured lenders are likely to use at least three tactics to mitigate the effects of this decision. First, they may litigate the issues left open by the decision-whether the plan is actually fair and equitable and provides the indubitable equivalent of their claims. Litigation is likely to center on independent valuation and the Supreme Court's 1999 decision n4 casting a jaundiced eye toward insider plans that attempt to cram down secured lenders. Second, they may, if they are providing debtor-in-possession financing or consenting to use of cash collateral, attempt to negotiate limits on the kind of plan the debtor may file. Finally, they may use a daylight loan, when available, to permit a "cash" bid at the auction. The mere presence of the ability to use a daylight loan may take away the debtor's leverage in proposing a cash-only auction.

Return to Text

n1 Indubitable equivalence is a concept unique to bankruptcy law that is derived from a 1935 Second Circuit decision by Judge Learned Hand, *re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935). The Bankruptcy Code does not contain a definition of "indubitable equivalent"; rather, the "indubitable equivalent" standard has been developed through caselaw. As the *Pacific Lumber* court noted, the phrase is "rarely explained in caselaw, because most contested reorganization plans follow familiar paths outlined in Clauses (i) and (ii) [of section 1129(b)(2)(A)]." *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229, 246 (5th Cir. Tex. 2009).

n2 *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*,

584 F.3d 229 (5th Cir. Tex. 2009). Although decided on similar grounds, the decision in *Pacific Lumber* related to a different procedural situation from the one in *Philadelphia Newspapers*. *Pacific Lumber* dealt with an appeal of the confirmation of a plan involving a free and clear asset sale that precluded credit bidding, while *Philadelphia Newspapers* was an appeal of the bankruptcy court order disapproving bidding procedures that precluded credit bidding (i.e., before the asset sale had actually taken place).

n3 It is a presumptive right, because the "court [can] for cause order[] otherwise" under section 363(k).

n4 *In re 203 N. La Salle St. P'ship*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999).

RELATED LINKS: For discussion of Code section 1129(b)(2)(A), see Collier on Bankruptcy, ■ 7-1129 Collier on Bankruptcy P 1129.04[2].

For discussion of Code section 363(k), see Collier on Bankruptcy, ■ 3-363 Collier on Bankruptcy P 363.09.

For analysis of other decisions relating to corporate reorganization, click ■ [here](#).

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10 of 197 DOCUMENTS

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Lawniczak on a Secured Creditor's Absolute Legal Right to Credit Bid

2010 Emerging Issues 4957

James M. Lawniczak on a Secured Creditor's Absolute Legal Right to Credit Bid under 11 U.S.C. § 1129(b)(2)(A)

By James M. Lawniczak

April 12, 2010

SUMMARY: In this Emerging Issues Analysis, James M. Lawniczak addresses decisions from the Third and Fifth Circuits holding that secured creditors do not have an absolute legal right to credit bid when their collateral is sold through a plan of reorganization. While there may be a small swing in negotiation power towards plan proponents and away from secured creditors, he concludes that the decisions may not have that much practical significance.

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ARTICLE: Two Circuit Courts of Appeals Hold that Secured Creditors Do Not Have an Absolute Legal Right to Credit Bid When Their Collateral Is Sold Through a Plan of Reorganization

In September 2009 and in March 2010, the Courts of Appeals for the Fifth and Third Circuits each considered whether a plan of reorganization could be confirmed over the objection of a secured creditor where the collateral was sold and the secured creditor was not given an opportunity to credit bid. *In re Philadelphia Newspapers, LLC*, 2010 U.S. App. LEXIS 5805 (3d Cir. Mar. 22, 2010); *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. Tex. 2009). Section 1129(b)(2)(A) of the Bankruptcy Code was the applicable statutory provision that the two courts considered and interpreted.

The legal issue before each court was one of statutory interpretation-whether Bankruptcy Code section 1129(b)(2)(A)(ii), which provides that a plan can be confirmed over the objection of a secured creditor where the collateral is being sold and the secured creditor has the right to credit bid, is the exclusive provision of the Bankruptcy Code applicable to sales pursuant to a plan. The interpretation adopted by both courts of appeals allows plans to be confirmed over the objection of a secured creditor that is given the "indubitable equivalent" of its claim, because section 1129(b)(2)(A)(iii) is also available to a plan proponent even when collateral was being sold. Therefore, according to both courts, the right to credit bid when collateral is sold under a plan of reorganization is not absolute.

The Facts of the *Philadelphia Newspapers* Case

The debtors in *Philadelphia Newspapers* own and operate the Philadelphia Daily News and the Philadelphia

Enquirer, plus an online publication, philly.com, all of which they acquired in 2006 for \$515 million. 2010 U.S. App. LEXIS 5805, at *2-*3. They owe their secured lenders, who hold liens in "substantially all of the Debtors' real and personal property," approximately \$318 million.

The debtors proposed a chapter 11 plan of reorganization, providing for essentially all their assets to be sold to a group comprised mostly of insiders for \$37 million in cash, plus the surrender of the headquarters building valued at \$29.5 million but subject to a two-year rent free lease for the purchaser. As can readily be seen, the value of the business had plummeted in the three years since the acquisition by the debtors. The plan proposed that the sale would be pursuant to an auction, with the insider purchaser acting as the "stalking horse bidder." 2010 U.S. App. LEXIS, at *4-*5.

The plan of reorganization further provided that the secured lenders were not entitled to credit bid at the proposed auction. 2010 U.S. App. LEXIS, at *5-*6. They objected, and the bankruptcy court refused to allow the sale to proceed in the absence of credit bidding. 2009 Bankr. LEXIS 3814 (Bankr. E.D. Pa. Oct. 8, 2009). The debtors appealed to the district court, which reversed and held that the lenders did not have an absolute legal right to credit bid. *In re Philadelphia Newspapers, LLC*, 418 B.R. 548 (E.D. Pa. Nov. 10, 2009). An appeal to the Court of Appeals for the Third Circuit followed, and the court granted a stay pending resolution of the appeal. 2010 U.S. App. LEXIS, at *8.

Thus, in *Philadelphia Newspapers*, the legal issue of whether credit bidding must be provided a secured creditor whose collateral was being sold pursuant to a plan came up at the beginning of the plan process, before the auction, before solicitation of votes for the plan and well before the end stage of the process, plan confirmation.

The Facts of the *Pacific Lumber* Case

In *Pacific Lumber*, the debtors' business involved growing, harvesting and processing redwood timber in California. 584 F.3d 229, 236. Exclusivity was terminated, and several plans of reorganization were proposed. Two entities who held some of the secured debt of the debtors proposed the plan that was eventually confirmed. 584 F.3d at 237. The plan that was confirmed provided that certain secured noteholders, who were not plan proponents, would be paid \$513 million on their secured claims, which was the value of their collateral determined by the bankruptcy court after an evidentiary hearing. 584 F.3d at 238. These secured noteholders voted against the plan and objected, contending among other things that they were entitled to credit bid their secured debt rather than being forced to accept the value of their collateral as determined by the bankruptcy court. The bankruptcy court confirmed the plan, holding that the secured creditors had received the "indubitable equivalent" of the secured claims by the payment of the \$513 million. 584 F.3d at 238. A direct appeal followed.

In contrast to the posture in the *Philadelphia Newspapers* case, the issue of whether the secured creditors had a right to credit bid as part of the plan process came before the Fifth Circuit at the very end of the plan process. The secured creditors' collateral had already been valued, the plan confirmed, and indeed the plan had even been consummated. There would be no further legal action to take following the decision of the court.

Review of the Applicable Statutory Provisions

Sales of assets outside the ordinary course of business are generally governed by section 363(b) of the Bankruptcy Code. Section 363(k) provides that, in a sale governed by section 363(b), a secured creditor has the right to credit bid its claim, "unless the court for cause orders otherwise."

Sales pursuant to a plan of reorganization are governed by subchapter II of chapter 11 of the Bankruptcy Code, principally sections 1123 and 1129. Section 1123(a)(5) states that a chapter 11 plan of reorganization shall provide adequate means for implementation, thereafter listing 10 nonexclusive examples of what might be such adequate means, including (D), "sale of all or any part of the property of the estate, either subject to or free of any lien . . ."

Section 1129(a) of the Bankruptcy Code describes what is required to confirm a chapter 11 plan. A plan can be

confirmed if it is approved by the affected creditors. However, under appropriate circumstances, a plan that meets minimum requirements can be approved even if certain classes of creditors vote against it. Section 1129(b)(1) provides that a plan can be confirmed if all required elements of confirmation in section 1129(a) are met except 1129(a)(8), if the plan "does not discriminate unfairly, and is fair and equitable" as to the dissenting classes. This is called the "cramdown" power, as it permits a bankruptcy court to cram a plan through despite the objections of creditors. See Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L.J. 133 (1979).

Section 1129(b)(2) goes on to add certain conditions that must be met for a plan to be fair and equitable-in subsection (A) as to classes of secured claims, in subsection (B) as to classes of unsecured claims and in subsection (C) as to classes of interests. Section 1129(b)(2)(A) provides three further subsections that address what a plan must provide in order to meet the minimum requirements for cramdown. Section 1129(b)(2)(A)(i) describes plans that provide for the secured creditor to retain their liens and a specific requirement for the payment stream that must be provided in that case. Section 1129(b)(2)(A)(ii) describes plans that provide for the sale of the collateral free and clear of liens, in which case, the sale must be subject to the right of the secured creditor to credit bid under section 363(k) and, further, the proceeds must be distributed to the secured creditor in accordance with the requirements of clause (i) or (iii). Finally, section 1129(b)(2)(A)(iii) describes plans that provide the secured creditor with "the realization by such holders of the indubitable equivalent of such claims."

The Legal Issue Presented by *Philadelphia Newspapers* and *Pacific Lumber*

The question before the courts of appeals in *Philadelphia Newspapers* and *Pacific Lumber* was whether a plan proponent seeking cramdown against a secured creditor class that does not accept the plan must use clause (ii) of section 1129(b)(2)(A). If yes, then the secured creditor would have an absolute right to credit bid unless, under section 363(k), "the court for cause orders otherwise." If the answer is no, then the plan proponent could proceed under clause (iii) and attempt to confirm the plan by proving that it had provided the secured creditor with the "indubitable equivalent" of its claim.

In reaching their conclusions, each court used traditional methods of statutory interpretation, including "plain meaning," to resolve the legal question before it. For a discussion of the correct approach to statutory interpretation in a bankruptcy context, see Kenneth N. Klee, *Bankruptcy and the Supreme Court*, 14-36 (LexisNexis 2008), and James M. Lawniczak on *Statutory Interpretation in Bankruptcy Matters*, 2009 *Emerging Issues* 3542 (LexisNexis Apr. 21, 2009).

Legal Analysis of the *Philadelphia Newspapers* Court Majority on the Issue of Whether the Secured Creditor Had to Be Given the Opportunity to Credit Bid When Collateral Was Sold Pursuant to the Plan

The majority in the *Philadelphia Newspapers* case essentially relied upon the plain meaning of the text of section 1129(b)(2)(A). The statute lists three elements, one of which must be satisfied in order for a plan to be confirmed over the objection of the secured creditor. The three elements are separated by "or," which Bankruptcy Code section 102(5) tells us is not exclusive. See 2 Collier on Bankruptcy 102.06 (16th ed. 2009). Viewing the language as "unambiguous," the court determined that the plan proponent was entitled to use any subsection of section 1129(b)(2)(A) to confirm a plan. Thus, if the plan proponent could show that the secured creditor was receiving the "indubitable equivalent" of its claim, without the right to credit bid, then the plan could be confirmed. 2010 U.S. App. LEXIS 5805, at *11-*19.

The court went on to determine that a right to credit bid was not absolutely necessary in order to meet the "indubitable equivalent" standard. 2010 U.S. App. LEXIS 5805, at *37-*38. Instead, the court noted that there were proposed bid procedures now in place, and that the bankruptcy court would be able to consider whether the secured creditors actually received the "indubitable equivalent" of their claims during the upcoming plan confirmation hearing. *Id.* at *39. The court affirmatively noted that the secured lenders can still object to plan confirmation on many different bases, "including that the absence of a credit bid did not provide it with the 'indubitable equivalent' of its collateral." *Id.* at *53. Indeed, the lenders stated publically that they planned to put in a "cash bid" in the auction process, which they

were entitled to do under the bidding procedures. They did so and prevailed.

Each of the three separate opinions in the *Philadelphia Newspapers* case discussed how to use legislative history as an indicator of legislative intent. The dissenting opinion of Judge Ambro referred to floor statements of the bill sponsors that sales of property under section 363 or a plan operated to deprive secured lenders of the right to make a section 1111(b) election because of the right to credit bid. According to Judge Ambro, this evidenced legislative intent that the right to credit bid be incorporated into the plan process. *Id.* at *106-*110. The main opinion by Judge Fisher cited the same legislative history, but discounted it because it did not discuss or take into account that there are certain circumstances where credit bidding is not allowed. *Id.* at *52-*53. In concurring, Judge Smith rejected any recourse to legislative history at all where the statutory text was clear. *Id.* at *54-*55.

Analysis of the *Pacific Lumber* Court on the Statutory Interpretation Issue

The *Pacific Lumber* court also relied upon the statute's "plain meaning." The court noted that the three alternatives of section 1129(b)(2)(A) are not exhaustive in any event—a plan must still "not discriminate unfairly" and be "fair and equitable" under section 1129(b)(1), even if one of the three (b)(2)(A) alternatives is met. 584 F.3d 229, 245. The court expressly rejected the secured creditors' argument that paying them off in cash deprived them of any subsequent increase in the value of the collateral, as the Bankruptcy Code does not provide such protection for secured creditors. 584 F.3d at 247. Instead, the court indicated that "paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the . . . collateral." 584 F.3d at 247.

Analysis of the Dissenting Opinion in *Philadelphia Newspapers*

In his dissent in *Philadelphia Newspapers*, Judge Ambro challenged the "plain meaning" result in a lengthy opinion. Judge Ambro believes that section 1129(b)(2)(A) is ambiguous and capable of two different meanings. The first possible meaning is the one given to it by the majority. But the second meaning is that Congress required plans that allow the secured creditor to retain its lien to comply with clause (i) and required plans that provide for a sale free and clear of liens to comply with clause (ii); only other types of plans are governed by clause (iii). Judge Ambro notes that the use of "or" as nonexclusive depends on context, that there are certain contexts where "or" has to be limiting and that this is one of those situations. 2010 U.S. App. LEXIS, at *74-*75 (citing to 2 Collier on Bankruptcy 102.06 (16th ed. 2009)).

The dissent noted that the operative verb in section 1129(b)(2)(A) is not "includes," which would support the majority's position, but rather "provides," which supports the dissent. *Id.* at *75-*76. Then, Judge Ambro invoked two canons of statutory construction, which support the view that credit bidding is required. First, specific provisions prevail over general ones. With that canon in mind, the specific provision of section 1129(b)(2)(A)(ii) should prevail over the general provision of section 1129(b)(2)(A)(iii). *Id.* at *87-*92. Second, the canon that a statute should not be interpreted so that a provision is superfluous also supports the interpretation of the dissent. If clause (iii) completely engulfs clause (ii), then clause (ii) has no separate function or meaning and would indeed be superfluous. *Id.* at *92-*94.

The underlying theme of the dissenting opinion is confidence in credit bidding as a way to come to a correct decision on the valuation of assets. It is a way "to protect against an undervaluation of assets sold." *Id.* at *99. The dissent recognized that one result of the majority's decision will be to shift the burden of proof on issues of credit bidding. Under the dissent's view of the law, the burden should be on the entity seeking to eliminate the right to credit bidding to show cause for such elimination under the language of section 363(k). Under the majority's view of the law, a debtor can unilaterally deny credit bidding with "only a belated court inquiry at confirmation to determine whether the denial of credit bidding was 'fair and equitable' to the secured lenders." *Id.* at *100-*101.

One Point of Statutory Construction Not Considered by the Courts

Further support for the decisions in the *Philadelphia Newspapers* and *Pacific Lumber* cases that was not discussed in either case is that if Congress had meant what the dissent in *Philadelphia Newspapers* believed it did, it could easily

have restructured the statutory language to require that result. All that would need to have been done would be to note that clause (i) applies to all situations where the lien was retained, clause (ii) applies to all situations where a sale free and clear of liens was used and clause (iii) applies to all other situations.

Other Cases and Articles That Have Discussed the Legal Issue Whether Credit Bidding Is Absolutely Necessary as to a Sale Pursuant to a Plan

Cases and an Article Supporting the Result in the Fifth and Third Circuits. In *In re Criimi Mae, Inc.*, 251 B.R. 796, 806 (Bankr. D. Md. 2000), the court determined that the three clauses of section 1129(b)(2)(A) are each available to a plan proponent. In so holding, the court rejected the claim that clause (ii) is the only one that can be used when a sale free and clear of liens is contemplated.

Sometimes courts that discuss statutes in the abstract, without actually reviewing them in the context of a specific issue, will give a "plain meaning" reading of the statute simply because the court is giving its actual impressions of the statutory language with no attempt to reach a specific desired result. The case of *Arnold & Baker Farms v. United States* (*In re Arnold & Baker Farms*), 85 F.3d 1415, 1420 (9th Cir. 1996), did just that. The case discussed the structure of section 1129(b)(2)(A) in the abstract, and noted that to be fair and equitable a plan must satisfy "one of the following three tests." Thus, the court read the statute in the same way that the *Philadelphia Newspapers* and *Pacific Lumber* cases did. A similar reading of the statute was made in *Corestates Bank, N.A. v. United Chemical Tech., Inc.*, 202 B.R. 33, 48 (E.D. Pa. 1996), and in the article Friedman, *What Courts Do to Secured Creditors in Chapter 11 Cram Down*, 14 *Cardozo L. Rev.* 1495, 1501 n.19 (1993).

In addition, several cases have determined that any of the three subsections of section 1129(b)(2)(A) can be used independently to support confirmation in contexts other than the credit bid situation. Thus, in *Wade v. Bradford*, 39 F.3d 1126 (10th Cir. 1994), the court held that a plan that satisfied the first prong of the three part test did not also have to satisfy the third prong, indubitable equivalence. *Accord Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enterprises, Ltd.*, 994 F.2d 1160, 1168 (5th Cir. 1993).

Cases and Articles Supporting the Absolute Right to Credit Bid. There are several cases and articles that support the proposition asserted by Judge Ambro's dissent in the *Philadelphia Newspapers* case that when assets are sold free and clear of liens in a plan only subsection 1129(b)(2)(A)(ii) can be used. See, e.g., *In re River Village Assocs.*, 181 B.R. 795, 805-06 (E.D. Pa. 1995) ("Congress did not intend to deprive creditors of the right to bid their full claim under a reorganization plan"); *In re Kent Terminal Corp.*, 166 B.R. 555, 566-67 (Bankr. S.D.N.Y. 1994); *John Hancock Mutual Life Ins. Co. v. California Hancock, Inc.* (*In re California Hancock, Inc.*), 88 B.R. 226, 230 (B.A.P. 9th Cir. 1988); Brubaker, *Cramdown of an Undersecured Creditor Through Sale of the Creditor's Collateral: Herein of Indubitable Equivalence, the § 1111(b) Election, Sub Rosa Sales, Credit Bidding, and Disposition of Sale Proceeds*, 29 No. 12 Bankruptcy Law Letter 1 (Dec. 2009).

Practical Pointers

Although the issue whether a secured creditor has the absolute right to credit bid in a plan is a very important one for secured creditors and the results in *Philadelphia Newspapers* and *Pacific Lumber* have generated substantial discussion, the cases may not have all that much practical consequence. In fact, in *Philadelphia Newspapers*, on remand from the court of appeals, the senior lenders prevailed at the auction with a cash bid of \$139 million, approximately \$100 million more than the original stalking-horse bid. Even if section 363(k) must be followed as to sales in plans, the section itself allows credit bidding to be eliminated "for cause." At the same time, the bankruptcy court, in making factual findings as to a plan, will have the ability to ensure that a secured creditor receives the benefit of its bargain and is not forced to accept a speculative payment.

Credit bidding will remain a strongly protected right, even if it is not absolutely required in plan sales. Indeed, as the dissent in *Philadelphia Newspapers* noted throughout, the right to credit bid has long been integral to the sales

process both inside and outside of bankruptcy. 2010 U.S. App. LEXIS, at *113-*115. The *Collier* bankruptcy treatise notes the right of a court to eliminate credit bidding under the language of section 363(k) itself, but goes on to opine that "this will rarely occur in the context of a chapter 11 plan." 7 *Collier on Bankruptcy*, 1129.04[2][b][ii] (16th ed. 2009). The treatise continues with the following observation: "Indeed, most courts jealously protect the secured creditor's right to credit bid, and will deny confirmation if that right is significantly impaired." *Id.* The treatise concludes by noting that a plan that structures a sale with conditions that cannot be matched by the secured creditor is not only unlikely to meet the "fair and equitable standard" but also to "fail the good faith test of section 1129(a)(3) as well." *Id.*

Bankruptcy courts are reluctant to force speculative valuations of collateral on secured creditors when other more direct and reasonable methods of determining value are available. Thus, the actual sales price of assets determines value, not separate appraisals. *See, e.g., Romley v. Sun Nat'l Bank (In re The Two "S" Corp.)*, 875 F.2d 240, 243 (9th Cir. 1989) (rejecting the trustee's contention that appraised value rather than sales price should be used to determine the amount to be paid on the secured creditor's claim as "the price paid at a commercially reasonable sale is the best evidence of value"). Moreover, it is accepted that an open and competitive sale process is the best method of determining current value.

Indeed, the courts' reluctance to use appraisal testimony is the genesis of the current practice of section 363 sales. Rather than allowing private sales with competing appraisers trying to convince the court that an offered sales price is appropriate, the open auction practice developed instead. *See* 2 *Asset Based Financing: A Transactional Guide* § 16.11[2][c] (LexisNexis 2007). In essence, a bankruptcy judge asks anyone who objects to a sale based on inadequate price: "Are you willing to pay more?" If not, then the offered price is usually determined to be adequate; but if the objecting party or someone else is willing to pay more and has the means to do so, the price has been determinatively shown to be insufficient.

Thus, the impact of the *Philadelphia Newspapers* and *Pacific Lumber* cases is likely to be felt more in terms of negotiation power. In circuits that accept that secured creditors do not have an absolute right to credit bid in a plan, the plan proponents will have a leg up in plan negotiations, and the secured creditors may agree to slightly less favorable terms than if the right to credit bid were absolute.

How Can the "Indubitable Equivalent" Standard Be Met? The *Philadelphia Newspapers* case was made on a preliminary record that preserved for later consideration whether the secured lenders would indeed receive the "indubitable equivalent" of their claims. The discussion of what "indubitable equivalent" means is highly instructive and suggests that it is a very high standard indeed, very difficult for a plan proponent to meet.

The court first discussed the genesis of the phrase from a Judge Learned Hand opinion, *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935). Judge Hand determined that a debtor could not pay the balance of a secured loan in a balloon payment 10 years after confirmation because a secured creditor cannot be deprived of collateral "unless by a substitute of the most indubitable equivalence." 2010 U.S. App. LEXIS 5805, at *30-*31. The *Philadelphia Newspapers* case went on to discuss the normal meaning of "indubitable equivalent." Indubitable means "not open to question or doubt." *Id.* at *31. It would thus appear that the standard would be even higher than the burden of proof in a criminal case, where conviction is only acceptable if guilt is established beyond a "reasonable doubt." The standard here would require *no* question or doubt.

Indeed, most authorities discussing "indubitable equivalent" require a very high standard to be met before "indubitable equivalent" can be found. *See, e.g., In re Criimi Mae, Inc.*, 251 B.R. 796, 808 n.12 (Bankr. D. Md. 2000) (noting that the definition requires that the matter be "without question, or doubt," so that a plan proponent "faces a formidable task" to meet the standard).

What then can we make of the decision in *Pacific Lumber* finding indubitable equivalence of the dissenting secured creditors' collateral by an appraisal valuation method? A careful review of all the facts and circumstances in the case suggests that there were many other reasons for the court's decision, beyond a simple finding that there is

indubitable equivalence whenever a bankruptcy court makes a valuation determination.

First, the *Pacific Lumber* case was a large and complex case with many differing creditor groups, including more than one class of secured creditor. The exclusivity period had been eliminated and several plans were proposed, but only one confirmed. The plan had been consummated and the plan proponents raised issues of equitable mootness, although the court determined that mootness did not prevent an examination of the secured creditor issues before it, including the proper interpretation of section 1129(b)(2)(A). 584 F.3d 229, 243.

Indeed, the *Pacific Lumber* court affirmatively noted that courts should "be wary of the shortcomings of judicial valuation proceedings." 584 F.3d at 247. However, the court then went on to discuss the "procedural history" of the case before it, which supports the use of the judicial valuation, under the specific facts of the case before the court. The property was thoroughly marketed with substantial interest but no firm offer. 584 F.3d at 247-48. The court relied heavily on the fact that no firm bid was ever received. 584 F.3d at 248.

Then, the court noted that the secured creditors were not objecting very strenuously to the actual valuation determination and focused on the fact that the secured creditors' briefing dwelt more on the shortcomings of the process "than on the bankruptcy court's final result." 584 F.3d at 248. The valuation hearing itself was extensive, with testimony "from eight valuation experts." *Id.* A fair middle ground was reached between the valuation proposed by the secured creditors, approximately \$575-\$605 million, and that proposed by the plan proponents. *Id.* The court ended by concluding that the secured creditors "have made little effort to prove a clear error." *Id.*

One factor that the court did not mention was that the secured creditor never made an offer of its own to acquire the properties instead of taking the cash. It appears that a good part of the reasoning of the *Pacific Lumber* court on the issue of "indubitable equivalent" was the court's view that the secured creditors really did not want to credit bid but rather just wanted more money for their collateral. Thus, *Pacific Lumber* suggests that it should be the very rare case where a judicial valuation of collateral would result in a finding that the "indubitable equivalent" standard had been met.

Does Allowing Credit Bidding Chill the Bidding? Part of the discussion in *Philadelphia Newspapers* was of the Third Circuit case of *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 461 (3d Cir. 2006), which held that a secured creditor credit bidding under section 363(k) is entitled to credit bid up to the full amount of its total claim, not just to the value of its collateral, which would be its secured claim under section 506(a). *Accord In re Suncruz Casinos, LLC*, 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003). In essence, this is because the collateral's value is established each time the secured creditor credit bids. Those holdings make the secured creditor with credit bidding rights a very powerful player in an auction process.

There has been some discussion in the authorities as to whether allowing credit bidding chills the auction process by inhibiting other bids and therefore should be curtailed. The dissenting opinion in *Philadelphia Newspapers* gave a very good example of why allowing someone with very large to infinite resources to participate in a bidding process is not inherently unfair and will not usually chill bidding. For example, if Warren Buffett is bidding, everyone knows that nearly unlimited resources are likely behind him, yet still no one expects him to bid unreasonably-i.e., the ability to bid high does not equate into a willingness to overpay for assets. 2010 U.S. App. LEXIS 5805, at *64 n.4. Similarly, when a secured creditor credit bids, the other bidders will understand that they will get the property if they bid one increment above the value the creditors have placed on the property.

The above analysis may not be true when an equity player has bought the secured debt in a "loan to own" strategy in order to acquire the target company. In that case, the other bidders may correctly feel that they have no legitimate chance to acquire the target themselves. See generally 2010 U.S. App. LEXIS 5805, at *112 (Ambro, J. dissenting).

Other authorities believe that credit bidding can indeed chill bidding and be inappropriate. For example, in *In re Antaeus Tech. Services, Inc.*, 345 B.R. 556, 564 (Bankr. W.D. Va. 2005), the court noted that there was not a level playing field where one bidder was "playing poker to see what is the highest bid which the independent bidder is willing

to make." On the other hand, the credit bidder who does not actually want to take title to the assets risks just that if credit bidding continues beyond the point of the credit bidder's view of the true value of the target assets.

Conclusion

With two courts of appeals now reading Code section 1129(b)(2)(A) as allowing any of the three alternatives to be used in all contexts, and with that result supported by the text of the statute itself, it seems likely that plan proponents have great flexibility in proposing plans. However, plan proponents still need to get to confirmation. The indubitable equivalent standard is a very high one. Although there may have been a small swing in negotiation power towards plan proponents and away from secured creditors, good negotiation and give and take are still the essentials to reaching a fair and appropriate solution.

RELATED LINKS: For discussion of Code section 1129(b)(2)(A), see Collier on Bankruptcy, [■ 7-1129 Collier on Bankruptcy P 1129.04.](#)

For discussion of Code section 363(k), see Collier on Bankruptcy, [■ 3-363 Collier on Bankruptcy P 363.09.](#)

For discussion of the sale of the estate's assets pursuant to Code section 363(b), see Collier on Bankruptcy, [■ 3-363 Collier on Bankruptcy P 363.02.](#)

For a discussion of sales of substantially all the assets of a chapter 11 debtor and the role of stalking horse bidders therein, see 2 Asset Based Financing: A Transactional Guide, [■ 2-16 Asset Based Financing: A Transactional Guide § 16.11.](#)

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11 of 197 DOCUMENTS

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Klee on Milavetz, Gallop & Milavetz, P.A. v. United States

2010 Emerging Issues 4933

Professor Kenneth N. Klee on the Supreme Court's holding in *Milavetz, Gallop & Milavetz, P.A. v. United States*, 2010 U.S. Lexis 2206 (2010)

By Kenneth N. Klee

March 30, 2010

SUMMARY: In this LexisNexis Emerging Issues Analysis, Professor Kenneth N. Klee discusses the holding in *Milavetz, Gallop & Milavetz, P.A. v. United States*, 2010 U.S. Lexis 2206 (2010), which concerns the constitutionality of bankruptcy legislation regulating attorney conduct.

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ARTICLE: The Lessons To Be Learned: parties challenging the constitutionality of the federal bankruptcy legislation regulating attorney conduct face long odds; the Court will not hesitate to interpret legislation to apply to attorneys; the Court will interpret legislation and construe statutory language narrowly to avoid constitutional questions.

In *Milavetz, Gallop & Milavetz, P.A. v. United States*, 2010 U.S. Lexis 2206, 176 L. Ed. 2d 79 (2010), the Supreme Court granted certiorari to review the Eighth Circuit's decision in *Milavetz, Gallop & Milavetz, P.A. v. United States*, 541 F.3d 785 (8th Cir. 2008), interpreting several aspects of the 2005 BAPCPA amendments dealing with debt relief agencies. Among other changes, BAPCPA imposed certain regulations on "debt relief agencies," defined by § 101(12A) of the statute as "any person who provides any bankruptcy assistance to an assisted person in return for . . . payment . . . or who is a bankruptcy petition preparer." BAPCPA further amended § 101(4A) of the Bankruptcy Code to define "bankruptcy assistance" as "goods or services 'provided to an assisted person with the express or implied purpose of providing information, advice, counsel, document preparation, or filing, or attendance at a creditors' meeting or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding.'" BAPCPA also amended § 101(3) of the Bankruptcy Code to define an "assisted person" as "someone with limited nonexempt property whose debts consist primarily of consumer debts."

Under Bankruptcy Code § 528, as enacted by BAPCPA, debt relief agencies must self disclose as such and include prominent disclaimers in their advertisements informing the general public that they provide bankruptcy assistance services. Moreover, BAPCPA enacted Bankruptcy Code § 526(a)(4) to restrict debt relief agencies from "advis[ing] an assisted person . . . to incur more debt in contemplation of such person filing a case under this title." The statute was silent, however, on the precise contours of this provision, leading some to wonder if the provision was unconstitutionally overbroad. *Milavetz, Gallop & Milavetz, P.A.* ("Milavetz"), a debtors' firm located in Edina,

Minnesota, brought just such a challenge.

In December 2006, Milavetz brought a pre-enforcement action against the United States seeking declaratory relief from these debt relief agency provisions. The district court granted Milavetz relief, holding that the "debt relief agencies" described under § 101(12A) did not include attorneys. In the alternative, the district court held that the disclosure requirements under § 528 and the limitations on legal advice under § 526(a)(4) were unconstitutional as applied to attorneys.

The Eighth Circuit affirmed in part, and reversed in part, overruling the district court on the question of whether attorneys were debt relief agencies and subject to disclosure requirements, but affirming the district court's assessment that § 526(a)(4) was unconstitutionally overbroad. The Eighth Circuit's ruling on § 526(a)(4) differed from the Fifth Circuit's opinion *Hersh v. United States ex rel. Mukasey*, 553 F.3d 743, 761, 764 (5th Cir. 2008), which had narrowly tailored the scope of § 526 to apply only to "advise to abuse or manipulate the bankruptcy system." The Supreme Court granted certiorari to consider all three questions and reconcile the circuit split.

The *Milavetz* case is the most recent in a long line of Supreme Court bankruptcy and insolvency cases interpreting a bankruptcy statute in accordance with its plain meaning. As explained more fully in the author's recent book, *Bankruptcy and the Supreme Court* (LexisNexis 2008):

When the language of the statute is unambiguous, courts must interpret the language in accordance with its plain meaning without regard to legislative history, except in the rare case in which the literal application of the "statute will produce a result demonstrably at odds with the intentions of its drafters."

See *Bankruptcy and the Supreme Court* at 15-16 (footnotes omitted). But when the plain meaning of the statute would render the statute unconstitutionally overbroad, the Court will be guided by its object and policy to support a narrow interpretation that passes constitutional muster. See *Bankruptcy and the Supreme Court* at 17 & n.56.

Based on Supreme Court precedents supporting these principles of statutory interpretation, the Court had little trouble deciding the *Milavetz* case unanimously, although Justices Scalia and Thomas authored separate concurrences on small parts of the decision.

Are Consumer Debtors' Attorneys Debt Relief Agencies?

The March 8, 2010 opinion, written by Justice Sotomayor, first addressed the threshold question of whether attorneys are debt relief agencies. Milavetz raised four arguments against the government's contention that Bankruptcy Code § 101(12A) applied to attorneys. First, Milavetz argued that because attorneys were not specifically included in the list of professionals described in § 101(12A), Congress could not have intended them to be included. Next, Milavetz argued that another Bankruptcy Code provision, § 526(d)(2), which instructed that §§ 526 & 528 "should not be 'deemed to limit or curtail' States' authority to 'determine and enforce qualifications for the practice of law,'" indicated that Congress did not wish to apply § 101(12A) to attorneys. Third, Milavetz contended that certain exceptions in § 101(12A) for "'officer[s], director[s], employee[s], or agent[s] of a person who provides' bankruptcy assistance" would be unfairly applied against law firms because it did not include "partners." Finally, Milavetz urged that the canon of constitutional avoidance required the Court to exclude attorneys from the scope of § 101(12A) so as to avoid doubts as to the validity of §§ 526 & 528.

The Court rejected each of Milavetz's arguments. The Court found that it was not "credibl[e] . . . that only professionals expressly included in the definition are debt relief agencies," but, rather, that such a professional could either be specifically listed or found in the umbrella category of anyone who "provides any bankruptcy assistance to an assisted person." In terms of § 526(d)(2), the Court found the opposite congressional intent, noting that section "526(d)(2) supports the opposite conclusion, as Congress would have had no reason to enact that provision if the debt-relief-agency provisions did not apply to attorneys." The Court found Milavetz's unfairness argument unpersuasive, observing that "[t]o the extent that partners may be subject to the debt-relief-agency provisions by

association, that result is consistent with the joint responsibilities that typically flow from the partnership structure." The Court also rejected the avoidance argument, holding that the canon only applied to constructions that were "fairly possible," and concluding that reading attorneys out of § 101(12A) was not. Later, when addressing the scope of the disclosure requirements, the Court limited the provisions to "govern only [those] professionals who offer bankruptcy-related services to consumers," further constraining the scope of § 101(12A).

How do the Restrictions of § 526(a)(4) Impact Debt Relief Agencies?

The Court next turned to § 526(a)(4) and the breadth of its restrictions on "advice." Recall that the Eighth Circuit had found § 526(a)(4) unconstitutionally overbroad because it "broadly prohibit[ed] a debt relief agency from advising an assisted person ... to incur any additional debt when the assisted person is contemplating bankruptcy." See *541 F.3d 785, 793 (8th Cir. 2008)*. Milavetz argued for this interpretation, further explaining that a broad interpretation "forb[ade] not only affirmative advice but also any discussion of the advantages, disadvantages, or legality of incurring more debt." Milavetz saw support for this broad view in the Court's opinion in *Conrad, Rubin & Lesser v. Pender*, 289 U.S. 472 (1933). Milavetz further argued that even a narrow interpretation of the clause would still be so vague as to chill permissible speech.

In response, the Court did not strike down § 526(a)(4) as unconstitutional, but, rather, distinguished the *Pender* decision and adopted a statutory interpretation limiting the scope of § 526(a)(4). The Court determined that § 526(a)(4) must be read in light of Congress' desire to target bankruptcy abuse, finding that "[i]n context, § 526(a)(4) is best understood to provide an additional safeguard against the practice of loading up on debt prior to filing." The Court observed that since the purpose of the provision was to protect consumer debtors, and a consumer debtor could risk his or her discharge (through other BAPCPA provisions) by abusively piling on debt before filing for bankruptcy, this was the only sensible reading of § 526(a)(4). The Court concluded that section "526(a)(4) prohibits a debt relief agency only from advising an assisted person to incur more debt when the impelling reason for the advice is the anticipation of bankruptcy." Later, the Court refined "advising" to mean only "instructing or encouraging," and provided a safe harbor for "full and frank" discussions "about the incurrence of debt in contemplation of filing a bankruptcy case." The Court also described that it would not be enough to merely advise a debtor to take on additional debt prior to filing, but that to be proscribed such advice would have to be "principally motivated by [the] likelihood" of later discharging the debt in bankruptcy, as opposed to for a legitimate purpose (such as "advice to refinance a mortgage or purchase a reliable car").

So refined, the Court dismissed Milavetz's vagueness challenge to the Court's narrowed statutory interpretation. The Court, however, specifically declined to address whether the narrowed interpretation "withstands First Amendment scrutiny."

What Sort of Disclosures Must Debt Relief Agencies Make?

Finally, the Court addressed Milavetz's challenge to the disclosure requirements under § 528. Despite the lack of "a developed record," Milavetz made an "as applied" challenge to the disclosure requirements, arguing that under an intermediate level of scrutiny they did not "'directly advance[e] a substantial governmental interest," and were "'n[o] more extensive than is necessary to serve that interest.'" In the alternative, Milavetz argued that certain disclosures required by § 528 were "confusing and misleading" and could not be "'reasonably related' to the Government's interest in preventing consumer deception."

The Court disagreed that § 528 falls under the higher intermediate scrutiny, concluding that the correct standard is the lower "reasonably related" standard articulated in *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626, 651 (1985). The Court also rejected Milavetz's argument that the term "debt relief agency" was "confusing and misleading," noting that the required disclosure was only a minimum threshold and that Milavetz could easily provide "[o]ther information" that would ensure "that consumers will not misunderstand the term." Finally, the Court rejected Milavetz's contention that the statute was not reasonably related to a governmental interest by noting the potential for fraud without such disclosures.

Advocacy Tip:

As in so many cases, the plain meaning of a phrase in large part controlled the outcome of the first part of this decision. Had the Court determined that attorneys were not debt relief agencies, it would have ducked the other issues. Like it or not, familiarity with the Court's plain-meaning jurisprudence remains a staple of modern practice. On the other hand, when a plain meaning interpretation of § 526(a)(4) would have lead the Court to hold the statute unconstitutionally overbroad, the Court narrowly interpreted the statutory language to give effect to the purpose of the legislation. For an in depth discussion of "plain meaning" and other maxims of statutory construction, see *Bankruptcy and the Supreme Court* at 14-36.

Practice Tip:

Although the Court narrowly construed Bankruptcy Code § 526(a)(4) to proscribe debtors' attorneys from counseling clients to incur debts that would abuse the bankruptcy laws, *Milavetz* leaves a trap for the unwary. Regrettably, a debtor's counsel's advice will be viewed *ex post*, and what might seem like prudent advice *ex ante* for the debtor to take out a third mortgage or refinance an automobile loan might be viewed as abusive *ex post*. Just as debtors' lawyers have struggled for years over the appropriate scope of converting non-exempt assets into exempt property on the eve of filing, debtors' lawyers will struggle with the contours of *Milavetz* in counseling debtors whether to incur debts before a bankruptcy filing. Prudent practice might include documenting the attorney's advice with a memo to file memorializing the non-abusive legitimate reasons for the client to incur the debt.

Unanswered Questions:

Milavetz raises many unanswered questions, particularly with respect to Bankruptcy Code § 526(a)(4). The Court specifically left open whether the narrowly-construed § 526(a)(4) violates the First Amendment. Moreover, it remains to be seen whether the consumer debtor is the only party with standing to sue a consumer debtor's attorney for violating § 526(a)(4). Is it permissible for a creditor who extends credit shortly before bankruptcy to sue the debtor's attorney who counseled the debtor to incur such credit abusively? If there is such a private right of action, may or must the debtor's attorney assert attorney-client privilege to block discovery into the advice given to the consumer debtor with respect to the debt? Would counseling a debtor to incur abusive debt fall within the crime-fraud exception to assertion of the attorney-client privilege? As part of a settlement of nondischargeability litigation, may a creditor bargain with the debtor to waive the debtor's attorney-client privilege?

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12 of 197 DOCUMENTS

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Ability of Creditor to Offset Preferential Transfers By New Value

2010 Emerging Issues 4922

Commentary on the Ability of Creditor to Offset Preferential Transfers By New Value

By Leslie Treff

March 23, 2010

SUMMARY: The circuits are split as to whether the "subsequent new value" defense in *11 U.S.C. § 547(c)(4)* may be invoked by a creditor only when new value was unpaid at the end of the preference period, or only so long as the debtor does not make an otherwise unavoidable transfer on account of the new value. This commentary reviews the law and suggests that the "subsequent advance" approach is a preferable interpretation of Section 547(c)(4)(B).

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ARTICLE: *Section 547(c)(4)(B) of the Bankruptcy Code* has been interpreted by the Third, Seventh, and Eleventh Circuits to require that "new value" remain unpaid at the end of the preference period to be used by a creditor to offset its preference liability. The Fourth, Fifth, and Ninth Circuits, however, have held that Section 547(c)(4)(B) does not require that the "new value" remain unpaid. Rather, these latter circuits have interpreted the statute to focus only on whether or not the "new value" has been paid for by an otherwise unavoidable transfer, and if it has not, then those courts have allowed the creditor to invoke the "subsequent new value" defense. Although more circuits have employed the "remains unpaid" test, the "subsequent advance" approach used in the Fourth, Fifth, and Ninth Circuits is more consistent with the wording and intention of the statute.

The Statute

Section 547(c)(4) provides that a trustee may not avoid an otherwise avoidable transfer, "to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor--(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value, the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

The legislative history of the section indicates that when "the creditor and debtor have more than one exchange during the 90-day period, the exchanges are netted out according to the formula in paragraph (4). Any new value that the creditor advances must be unsecured in order for it to qualify under this subsection."

The section has two purposes. First, "[i]n the ordinary course of business, suppliers provide goods to businesses on

credit. The financial pressure that would result if creditors were to force an ailing company to pay for supplies up front could turn many a troubled company into a bankrupt one. By allowing creditors to rely on payments of back debt in shipping new goods, Section 547(c)(4) serves the purpose of avoiding unnecessary bankruptcies." n1 Second, the section provides for fair treatment of creditors who deal with troubled companies. n2

History of the Split On Whether Subsequent New Value Must Go Unpaid

Since the 1980s, there has been a split in thinking as to whether the subsequent new value advanced by a creditor must go unpaid to take advantage of Section 547(c)(4)'s exception. At the time, the lower courts were in almost total agreement that the new value must be unpaid for the section to apply. n3 However, several courts held otherwise in the mid 1980s. n4

In *In re Jet Florida System, Inc.*, n5 the Eleventh Circuit engaged in a thorough review of the section and its requirements; however, the "new value" remained unpaid in that case, and there was no in-depth discussion of the matter. The court in *New York City Shoes, Inc.* similarly discussed the three requirements for a creditor to invoke the exception in Section 547(c)(4). However, although that court is often cited for the proposition that "new value" must go unpaid, the Third Circuit was not called upon to rule on it. Instead, the court was giving background to the issue at hand, which concerned the presumption that post-dated checks were transferred either on the date on the face of the check or when the check clears the bank.

Despite the overwhelming majority of courts following the requirement that the "new value" remain unpaid in the 1990s, the "minority position" gained momentum as the courts undertook a more thorough analysis of the double negative language of the statute as well as the legislative history of the section. n6

The court in *In re Transport Associates, Inc.* determined that its method allowed "each advance of 'new value' to be used to offset all prior preferences, not limited to only the one immediately preceding preference." It continued that "[t]his approach better serves the legislative goal of encouraging creditors to continue doing business with financially troubled debtors." The concern of this court and the others that adopted the "minority position" was that requiring "new value" to remain unpaid discourages "creditors from advancing new value in excess of the amount of the prior invoice paid, regardless of debtor's need for an infusion of new value," n7 in essence, negating the agreed upon legislative intent of the section.

Section 547(c)(4) in the 2000s and Beyond

More courts began to defect from the requirement that "new value" remain unpaid in the 2000s. These courts claim to follow the unambiguous language of the statute to find that a "new value" defense is permitted unless the debtor repays the new value by a transfer that is otherwise unavoidable. n8 Over the past year, the debate over the proper implementation of Section 547(c)(4) has grown louder. Some courts are still following the "remains unpaid" test, n9 but more and more are moving toward the emerging approach, in which each advance of new value is offset against all prior preferences. n10

Nowhere has the divergence been more apparent than within the courts of the Third Circuit. In *In re Winstar Communications, Inc.* n11, the Third Circuit Court of Appeals addressed issues regarding Section 547(c)(4) and, once again, recited the requirements of the twenty-year old *In re New York City Shoes, Inc.* n12 decision. Significantly, the *Winstar* court stated, "[t]his court has held that § 547(c)(4) imposes three requirements: '1) the creditor must have received a transfer that is otherwise voidable as a preference under § 547(b); (2) after receiving the preferential transfer, the preferred creditor must advance 'new value' to the debtor on an unsecured basis; and (3) the debtor must not have fully compensated the creditor for the 'new value' as of the date that it filed its bankruptcy petition.'" n13 Not eight months later, the Delaware bankruptcy court held that, because the *Winstar* court was not required to consider directly the third element (§ 547(c)(4)(B)) of the subsequent new value defense, it could look at the plain language of the statute, apply a "subsequent advance" approach, and allow each extension of "new value" to be setoff against the total

preference amount. n14

Conclusion

It remains to be seen where the Third Circuit will wind up on this issue, but the Delaware court makes a strong case for its "subsequent advance" approach. That approach, whereby a creditor is not penalized for continuing to make advances to a struggling business in hope of forestalling a bankruptcy petition, is in accordance with the universally agreed upon purpose of Section 547(c)(4)'s exception. Although the language of subsection (B), which includes a double negative, is complicated to read, it is not ambiguous. When a close reading of the statute is performed with an understanding of the workings of the "subsequent advance" approach, all becomes clear.

[Return to Text](#)

n1 *In re New York City Shoes, Inc.*, 880 F.2d 679, 680-681 (3rd Cir. 1989); see also *Matter of Kroh Bros. Development Co.*, 930 F.2d 648, 24 C.B.C.2d 1757 (8th Cir. 1991).

n2 See *In re New York City Shoes, Inc.*, 880 F.2d 679, 680-681 (3rd Cir. 1989); see also *In re Jet Florida System, Inc.*, 841 F.2d 1082 (11th Cir. 1988); *In re IRFM, Inc.*, 52 F.3d 228, 33 C.B.C.2d 237 (9th Cir.1995); *In re Gold Coast Seed Co.*, 30 B.R. 551 (9th Cir. BAP 1983).

n3 See *Pettigrew v. Trust Company Bank (In re Bishop)*, 5 C.B.C.2d 1515, 17 B.R. 180 (Bankr. N.D. Ga.1982); see also *Erman v. Armco, Inc. (In re Formed Tubes, Inc.)*, 46 B.R. 645 (Bankr. E.D. Mich. 1985); *Bernstein v. RJL Leasing (In re White River Corp.)*, 50 B.R. 403 (Bankr. D. Colo. 1985); *Remes v. Yeomans (In re Quality Plastics, Inc.)*, 11 C.B.C.2d 163, 41 B.R. 241 (Bankr. W.D. Mich. 1984); *Columbia Packing Co. v. Allied Container Corp. (In re Columbia Packing Co.)*, 11 C.B.C.2d 1439, 44 B.R. 613 (Bankr. D. Mass. 1984); *Keydata Corp. v. Boston Edison Co. (In re Keydata Corp.)*, 37 B.R. 324 (Bankr. D. Mass. 1983); *Rovzar v. Prime Leather Finishes (In re Saco Local Development Corp.)*, 30 B.R. 859 (Bankr. D. Me. 1983).

n4 See *In re Thomas W. Garland, Inc.*, 6 C.B.C.2d 1259, 19 B.R. 920 (Bankr. E.D. Mo. 1982); see also *Matter of Isis Foods, Inc.*, 39 B.R. 645 (W.D. Mo. 1984); *In re Paula Saker & Co., Inc.*, 53 B.R. 630 (Bankr. S.D.N.Y. 1985).

n5 841 F.2d 1082 (11th Cir. 1988).

n6 See *In re IRFM, Inc.*, 27 C.B.C.2d 321, 144 B.R. 886 (Bankr. C.D. Cal. 1992), *aff'd*, 52 F.3d 228, 33 C.B.C.2d 237 (9th Cir. 1995); see also *Matter of Toyota of Jefferson, Inc.*, 14 F.3d 1088, 30 C.B.C.2d 1054 (5th

Cir. 1994); *In re Check Reporting Services, Inc.*, 140 B.R. 425 (Bankr. W.D. Mich. 1992); *In re Transport Associates, Inc.*, 31 C.B.C.2d 994, 171 B.R. 232 (Bankr. W.D. Ky. 1994).

n7 *In re Transport Associates, Inc.*, 31 C.B.C.2d 994, ___, 171 B.R. 232, 238-239 (Bankr. W.D. Ky. 1994).

n8 See *In re Roberds, Inc.*, 315 B.R. 443 (Bankr. S.D. Ohio 2004); see also *In re Intercontinental Polymers, Inc.*, 54 C.B.C.2d 710, 359 B.R. 868 (Bankr. E.D. Tenn. 2005); *Van Dyck/Columbia Printing v. Katz*, 50 C.B.C.2d 560, 289 B.R. 304 (D. Conn. 2003).

n9 See *In re Landreth Lumber Co.*, [8209][8209][8209] B.R. [8209][8209][8209][8209], 2009 Bankr. LEXIS 3686 (Bankr. S.D. Ill. Nov 23, 2009); see also *In re JSL Chemical Corp.*, [8209][8209][8209] B.R. [8209][8209][8209][8209], 2010 Bankr. LEXIS 443 (Bankr. S.D. Fla. Feb 10, 2010);

n10 See *In re Smith Min. and Material, LLC*, 405 B.R. 589, 62 C.B.C.2d 103 (Bankr. W.D. Ky. 2009).

n11 554 F.3d 382, 402 (3rd Cir. 2009).

n12 880 F.2d 679, 680 (3rd Cir. 1989).

n13 *Shubert v. Lucent Techs. Inc (In re Winstar Communs., Inc.)*, 554 F.3d 382, 402 (3rd Cir. Del. 2009).

n14 See *In re Pillowtex Corp.*, 416 B.R. 123 (Bankr. D. Del. 2009).

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13 of 197 DOCUMENTS

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Braucher on In re North Shore Hematology-Oncology Associates

2010 Emerging Issues 4871

Anne Braucher on *In re North Shore Hematology-Oncology Associates P.C.*, 400 B.R. 7 (Bankr. E.D.N.Y. 2008): A Bankruptcy Court Will Not Appoint a Healthcare Ombudsman Without Evidence of Patients' Dire Circumstances

By Anne Braucher

March 15, 2010

SUMMARY: *In re North Shore Hematology-Oncology Associates* held that appointment of a healthcare ombudsman is not necessary unless patients' rights to quality care and privacy have already been violated. The threshold for appointing a healthcare ombudsman is very high and requires evidence that patients are already in dire circumstances when a bankruptcy case is filed. This commentary discusses the import of this decision.

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ARTICLE: Anne Braucher on *In re North Shore Hematology-Oncology Associates, P.C.*, 400 B.R. 7 (Bankr. E.D.N.Y. 2008)

A Bankruptcy Court Will Not Appoint a Healthcare Ombudsman Without Evidence of Patients' Dire Circumstances.

The United States Bankruptcy Court for the Eastern District of New York has declined to appoint a healthcare ombudsman in the chapter 11 case of a physician-owned, for-profit healthcare practice with five offices located in the state of New York. The decision, *In re North Shore Hematology-Oncology Associates, P.C.*, 400 B.R. 7 (Bankr. E.D.N.Y. 2008), suggests that the threshold for appointing a healthcare ombudsman under 11 U.S.C. § 330(a) is very high and requires evidence of dire circumstances. The Court declined to appoint an ombudsman for the North Shore practice based upon evidence that the business was operating successfully and had a low ratio of patient complaints to patients served.

Background

Section 330(a) of the Bankruptcy Code provides that a court will appoint an ombudsman to "monitor the quality of patient care and to represent the interests of the patients" no later than 30 days after a healthcare provider files a bankruptcy petition. 11 U.S.C. § 330(a)(1). The court need not appoint an ombudsman within the first 30 days, however, if it finds that the debtor's patients do not need protection given the circumstances of the case. *Id.* A court can

instead, on the motion of the United States Trustee or a party in interest, appoint an ombudsman at any time during the case that such appointment becomes necessary. *See Fed. R. Bankr. P. 2007.2(b)*. Because the Code does not provide guidance on the circumstances under which ombudsmen should be appointed, courts have begun developing their own tests. The United States Bankruptcy Court for the Southern District of Florida, for example, has laid out a list of non-exclusive factors for a court to consider:

- (1) The cause of the bankruptcy;
- (2) The presence and role of licensing or supervising entities;
- (3) Debtor's past history of patient care;
- (4) The ability of the patients to protect their rights;
- (5) The level of dependency of the patients on the facility;
- (6) The likelihood of tension between the interests of the patients and the debtor;
- (7) The potential injury to the patients if the debtor drastically reduced its level of patient care;
- (8) The presence and sufficiency of internal safeguards to ensure appropriate level of care; and
- (9) The impact on the likelihood of a successful reorganization.

See In re Alternate Family Care, 377 B.R. 754,758 (Bankr. S.D. Fla. 2007). Courts can exercise discretion in determining how much weight to give each of these factors. *See In re Valley Health Sys.*, 381 B.R. 756, 762 (Bankr. C.D. Cal. 2008). n1

The debtor, North Shore Hematology-Oncology Associates, was a physician-owned healthcare practice that provided treatment for cancer and blood disorders. *See In re North Shore Hematology-Oncology Assocs.*, 400 B.R. at 9. The debtor provided all of its services, including radiation therapy and chemotherapy, on an out-patient basis. *See id. at 12*. After filing its chapter 11 petition, the debtor remained in possession of its assets and continued to operate its business. *See id. at 9*. The court scheduled a hearing on the need for an ombudsman approximately two weeks after the case commenced. *See id.* Prior to the hearing, the debtor filed a statement that an ombudsman was not necessary. *See id.* The United States Trustee also stated its position that the debtor was a health care business, as defined by 11 U.S.C. § 101(27A), and that an ombudsman was not necessary. *See id. at 10*.

The Decision

Following hearing, the United States District Court for the Eastern District of New York waived the appointment of healthcare ombudsman without prejudice to reconsidering the matter at a later time. *See id. at 8*. The court first agreed with the United States Trustee that the debtor was a health care business because of the types of services the debtor provided to its patients. *See id. at 10*. This made it appropriate for the court to examine the need for a healthcare ombudsman.

The court then held that appointing an ombudsman was not necessary based upon the details of the debtor's healthcare practice. Specifically, the court found the following factors compelling:

- The debtor had a formal program for compliance with the Health Insurance Portability and Accountability Act;
- The debtor was able to pay for the medicines necessary to provide uninterrupted cancer treatment to its patients;
- The debtor did not plan to reduce its staff, so it could continue the historical level of service to its 30,000 patients;
- The debtor did not provide any in-patient services, so its patients were not dependent on the debtor's facilities for long-term treatment;
- The debtor had not received any complaints from its patients since the commencement of the case, and the

bankruptcy had not affected the scheduling of appointments;

- The debtor's patients were able to file complaints with the New York state medical board, and the debtor had its own procedures in place to address patient complaints;
- The debtor complied with state and federal record keeping obligations;
- The debtor's senior physicians had considerable experience in hematology and cancer treatment;
- The debtor's operations were monitored and certified by state and federal health agencies; and
- The debtor had received only three to five patient complaints in the previous fourteen months.

See id. at 12.

After listing these factors, however, the court stressed the importance of some more than others. The court suggested that its decision not to appoint an ombudsman was based in particular on the debtor's low ratio of patient complaints to patients served. *See id. at 13* (stating that "for a practice that serves more than 30,000 critically ill patients, having only three to five complaints, equating to a complaint rate that is a fraction of 1%, is very significant"). The court also suggested that the continued smooth operation of the debtor's business held particular significance. It noted that the debtor's business was healthy because it did not provide in-patient services that required long-term operational commitments, and appointing an ombudsman would impose costs on the estate that might affect the debtor's ability to operate at its current, successful level. *See id.*

The Effect of the Decision: The Threshold for Appointment of a Healthcare Ombudsman Appears to Require Evidence of Dire Circumstances.

Protecting patients' rights is obviously an important part of any healthcare-related bankruptcy case. Patients may suffer both physically and financially when a health care business liquidates because it cannot maintain a sufficient standard of care following its bankruptcy filing. The suffering may be particularly acute when the patients at issue need specialized care that is difficult to find and/or necessary on a regular basis.

The *North Shore* decision, however, suggests that a court will immediately appoint a healthcare ombudsman only on evidence that dire circumstances already exist. The Eastern District of New York Bankruptcy Court noted that the Bankruptcy Court for the Northern District of California declined to appoint ombudsman in the *Valley Health Systems* case because there was no evidence that problems with the quality of its patient care or "tension between the interests of the patients and the [debtor] or actual conflicting interests of the [debtors'] employees" existed before the case was filed. *Id. at 11* (quoting *In re Valley Health Sys.*, 381 B.R. at 765). Similarly, the New York court noted that the Bankruptcy Court for the District of Colorado declined to appoint an ombudsman in the *In re William L. Saber, M.D.* case in part because "the Chapter 11 filing was not precipitated by concerns related to the quality of patient care or to patient privacy matters." *In re North Shore Hematology-Oncology Assocs.*, 400 B.R. at 12. According to these decisions, an ombudsman is not immediately necessary unless a very high threshold is met - the debtor has a history of poor quality patient care or the case was filed because the debtor had already failed to provide quality patient care and protect patients' privacy rights. The debtor and its patients must be in dire circumstances before an ombudsman steps into a bankruptcy case.

Because the *North Shore* decision establishes this high threshold, the Bankruptcy Code's healthcare ombudsman provision appears somewhat weak. It will not prevent the violation of patients' rights to high quality care and privacy in a newly-filed case. It will perhaps affect patients only after their rights have already been violated. Congress may have taken a step in the right direction when it added the ombudsman provision to the Code, but it certainly did not establish a strong mechanism for protecting patients' rights in a healthcare-related bankruptcy case.

[Return to Text](#)

n1 The United States Bankruptcy Court for the Central District of California has provided additional factors: (1) the high quality of the debtor's existing patient care; (2) the debtor's financial ability to maintain high quality patient care; (3) the existence of an internal ombudsman program to protect the rights of patients; and/or (4) the level of monitoring and oversight by federal, state, local, or professional association programs which renders the services of an ombudsman redundant. *See Valley Health Sys.*, 381 B.R. at 762.

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14 of 197 DOCUMENTS

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Jurs on Commercial & Residential Maintenance, Inc. v. Abblitt (In re Abblitt)

2010 Emerging Issues 4898

Bankruptcy Court in In re Abblitt Ruled that treble damages award on default judgment in state RICO case was nondischargeable under section 523 of the Bankruptcy Code

By S. Andrew Jurs

March 2, 2010

SUMMARY: In *Commercial and Residential Maintenance, Inc. v. Abblitt (In re Abblitt)*, 2009 Bankr. LEXIS 4084 (Bankr. D. Or. Dec. 21, 2009), the bankruptcy court was confronted with whether an award of treble damages under a state RICO statute could be the basis for a nondischargeable debt. Even though the treble damages had been awarded pursuant to a default judgment, the debt was nondischargeable pursuant to section 523 of the Bankruptcy Code.

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ARTICLE: In *Commercial and Residential Maintenance, Inc. v. Abblitt (In re Abblitt)*, 2009 Bankr. LEXIS 4084 (Bankr. D. Or. Dec. 21, 2009), the bankruptcy court determined that treble damages awarded pursuant to a default judgment under Oregon's RICO statute were nondischargeable in bankruptcy. According to the bankruptcy court, the state court had subject matter jurisdiction to enter the judgment, and the findings in support of the judgment were sufficient to support an award of treble damages. Accordingly, a creditor could obtain an order denying the dischargeability of the treble damages award under 11 U.S.C. § 523.

Facts and Procedural History

The Debtor was employed by Commercial and Residential Maintenance, Inc. d/b/a C & R Maintenance ("C&R"), and was in charge of inventory and purchasing. Between January and July 2005, Debtor ordered goods and equipment from various sources on C&R's account and converted them to his own benefit. In July 2005, Debtor was arrested, and he admitted to the unauthorized purchases for his own benefit.

On July 19, 2005, the Jackson County District Attorney filed an indictment against the Debtor for aggravated theft in the first degree. Debtor pleaded guilty two months later and was convicted of theft in the first degree. The Jackson County Circuit Court, as part of its sentencing, ordered Debtor to pay restitution to C&R in the amount of \$ 23,714.36.

On July 27, 2005, C&R filed a civil complaint in Jackson County Circuit Court for fraud, conversion, unjust enrichment, and for violations of the Oregon Racketeer Influenced and Corrupt Organizations Act, ORS §§ 166.715 -

735 ("ORICO"). Debtor failed to appear, and the state court entered a general money judgment in the amount of \$ 63,792.33 on C&R's motion for default judgment. The judgment was based on ORICO violations which provide for treble damages pursuant to ORS § 166.725(7)(a).

Debtor filed a chapter 7 bankruptcy petition on April 21, 2009. C&R subsequently filed a Complaint pursuant to 11 U.S.C. § 523(a)(2), (4), (6) and/or (7) objecting to the discharge of the debt owed to it by Debtor, and the Debtor filed an Answer denying its nondischargeability. C&R thereafter filed a motion for summary judgment, and the bankruptcy court decided the matter without hearing.

Legal Analysis

The ORICO statute provides:

(7)(a) Any person who is injured by reason of any violation of the provisions of ORS § 166.720(1) to (4) shall have a cause of action for three-fold the actual damages sustained and, when appropriate, punitive damages:

(A) If a criminal conviction for the racketeering activity that is the basis of the violation has been obtained, any rights of appeal have expired and the action is against the individual convicted of the racketeering activity; or

(B) If the violation is based on racketeering activity as defined in ORS § 166.715(6)(a)(B) to (J), (K) as it relates to burglary and criminal trespass, (L) to (P), (S), (T), (U), (V), (X) to (Z), (AA) to (DD), (KK), (LL) or (OO) to (VV).

ORS § 166.725(7)(a).

Section 523(a)(4) of the Bankruptcy Code provides for nondischargeability of debts "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny," which would encompass the restitution award based on the criminal judgment for theft in the first degree.

Commentary

The bankruptcy court's holding in *Abblitt* is noteworthy in that it addresses the process for determining dischargeability of treble damages claims awarded pursuant to a default civil judgment. Additionally, the bankruptcy court engaged in a useful analysis of the extent to which a criminal conviction would have a preclusive effect in determining whether a debtor engaged in conduct which would render a civil judgment nondischargeable. To get there, however, the bankruptcy court first had to determine the viability of the state court's judgment. Only if the judgment was valid would the bankruptcy court have to decide whether a default judgment on RICO claims would be nondischargeable.

A. Subject Matter Jurisdiction of the Oregon Circuit Court

Oregon Circuit Courts "have subject matter jurisdiction over all actions unless a statute or rule of law divests them of jurisdiction." *Oregon v. Daniel*, 222 Ore. App. 362, 368, 193 P.3d 1021, 1025 (2008) (internal citation omitted). "Subject matter jurisdiction depends on whether a court has constitutional or statutory authority to make an inquiry." *Matter of Marriage of Watanabe*, 140 Ore. App. 85, 88, 914 P.2d 701, 702 (1996). A judgment issued from a court lacking subject matter jurisdiction is said to be void and is subject to collateral attack; however, "when a trial court has both subject-matter and personal jurisdiction, a judgment issued in excess of the court's authority is voidable, not void." *Oregon v. McDonnell*, 343 Ore. 557, 562, 176 P.3d 1236, 1240 (2007). See also *Wood v. White*, 28 Ore. App. 175, 178-79, 558 P.2d 1289, 1291 (1977) ("[T]here is a fundamental distinction between the absence of jurisdiction and the erroneous exercise of that jurisdiction."). A voidable judgment is subject only to direct attack. *Oregon v. McDonnell* at

562.

Debtor argued that C&R filed its ORICO action prematurely because the lawsuit was filed prior to Debtor's September 19, 2005 conviction for first degree theft, in which case the state circuit court did not have subject matter jurisdiction. If true, the judgment would be void. C&R countered that the actual civil judgment was not obtained until after the conviction, thus meeting the requirements of ORS 166.725(7)(a)(A). Moreover, according to C&R, the complaint filed in Circuit Court listed independent instances of racketeering conduct, thus allowing the filing of the ORICO complaint under subsection (B). Although the issue of whether an ORICO action can be filed prior to conviction if the judgment itself was obtained after conviction was one of first impression, the bankruptcy court found a statement by the Oregon Supreme Court, in *dicta*, that the phrase "has been obtained" states a condition that must exist when a plaintiff files an ORICO claim. *Black v. Arizala*, 337 Ore. 250, 271, 95 P.3d 1109, 1119-20 (2004). Even in light of this, however, the bankruptcy court determined that this in itself would not be sufficient to find that the Circuit Court lacked subject matter jurisdiction over the ORICO claim. According to the bankruptcy court, the Circuit Court had jurisdiction over the ORICO claim at the moment of filing, and the Circuit Court had the statutory and constitutional authority to make an inquiry into the merits of the ORICO claim. If the claim had not yet accrued under ORICO, it was Debtor's responsibility to bring it to the Circuit Court's attention through a motion to dismiss or an affirmative defense. Once the Circuit Court obtained subject matter and personal jurisdiction, any judgment awarded in excess of the court's jurisdiction would render the judgment only voidable, not void. For that reason, the ORICO judgment could not be subject to collateral attack in any court, including the bankruptcy court.

B. Nondischargeability of the treble damages award under ORICO

Debtor did not dispute that the actual damages awarded by the Circuit Court as restitution for the criminal offenses to which he pleaded guilty were nondischargeable under 11 U.S.C. § 523. Instead, he limited his arguments to the contention that the civil judgment of treble damages awarded under the ORICO claim was dischargeable.

The Court of Appeals for the Ninth Circuit, in a case involving nondischargeability under section 523(a)(2)(A), stated that

The preclusive effect of a state court judgment in a subsequent federal lawsuit generally is determined by the full faith and credit statute [28 U.S.C. § 1738], which provides that state judicial proceedings 'shall have the same full faith and credit in every court within the United States...as they have by law or usage in the courts of such...state from which they are taken.

Gayden v. Nourbakhsh (In re Nourbakhsh), 67 F.3d 798, 800 (9th Cir. 1995). Oregon courts give collateral estoppel effect to prior judgments when the issues in the two proceedings are identical, were actually litigated, and were essential to a final decision in the prior proceeding. *Nelson v. Emerald Peoples' Utility District*, 318 Ore. 99, 104, 862 P.2d 1293, 1296-1297 (1993). The party subject to preclusion must have been a party in the prior case, or in privity with a party, and must have had a full and fair opportunity to be heard on the issue. *Id.*

Under Oregon law, the issues in a case resulting in a default judgment are deemed to be fully litigated, and judgments entered in such cases "have the same solemn character as judgments entered after trial." See *Watson v. State*, 71 Ore. App. 734, 738, 694 P.2d 560, 562, rev. withdrawn 299 Ore. 204, 701 P.2d 432 (1985). A default judgment establishes the truth of all material factual allegations contained in the complaint. *Kershner v. Smith*, 121 Ore. 469, 256 P. 195 (1927), *State ex rel. Nilson v. Cushing*, 253 Ore. 262, 265, 453 P.2d 945, 947 (1969), *Rajneesh Foundation International v. McGreer*, 303 Ore. 139, 142, 734 P.2d 871, 873 (1987). Accordingly, under Ninth Circuit precedence and the "full faith and credit" clause, the bankruptcy court was required to apply the same standard of preclusiveness for default judgments, with respect to the ORICO judgment entered against Debtor, as Oregon courts would apply.

With regard to debts from arising from embezzlement or larceny, *Bankruptcy Code section 523(a)(4)* provides an exception to discharge when the debts result from "the fraudulent appropriation of another's property, whether the

appropriation was unlawful at the onset, and therefore a larceny, or whether the appropriation took place unlawfully after the property was entrusted to the debtor's care, and therefore was an embezzlement." 4 *Collier on Bankruptcy*, 523.10[2] (Matthew Bender).

C&R's state court civil complaint alleged that the Debtor ordered goods and equipment on C&R's account and converted those items to his own personal use. According to the bankruptcy court, such conduct would constitute either embezzlement or larceny under section 523(a)(4). Additionally, the Debtor pleaded guilty to, and was convicted of, aggravated theft in the first degree. A person commits "theft," as defined at ORS § 164.015, when, "with intent to deprive another of property or to appropriate property to the person or to a third person, the person: (1) Takes, appropriates, obtains or withholds such property from the owner thereof." This definition is analogous to the definitions of larceny and embezzlement in *Bankruptcy Code section 523(a)(4)*. Because the ORICO judgment was based on the same conduct for which the Debtor was convicted in the criminal action and for which restitution was ordered, it followed, according to the bankruptcy court, that the ORICO judgment would be similarly nondischargeable under section 523(a)(4).

Conclusion

The decision in *Commercial and Residential Maintenance, Inc. v. Abblitt (In re Abblitt)* is useful because it addresses several issues: (1) the dischargeability of default state court judgments, and (2) the preclusive effect of criminal convictions in assessing the dischargeability of debts arising from a civil judgment based on the same conduct that formed the basis for conviction. In its decision, the bankruptcy court identified that it was bound by the "full faith and credit" clause to give the conviction and default judgment the same preclusive effect as they would have had under state law, which meant that the Debtor's conduct, which formed the basis for the default civil judgment, could also be the basis for a determination that the treble damages awarded under the Oregon RICO statute were similarly nondischargeable.

RELATED LINKS: For further discussion related to the nondischargeability under 11 U.S.C. § 523, see *Collier on Bankruptcy*,

■ ch. 523

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Lawniczak on Immunity of "Settlement Payments" from Fraudulent Transfer Suits

2010 Emerging Issues 4890

James M. Lawniczak on Immunity of "Settlement Payments" from Fraudulent Transfer Suits

By James M. Lawniczak

February 25, 2010

SUMMARY: In this Emerging Issues Analysis, author James M. Lawniczak looks at the 2009 appellate decisions establishing the majority view that buyout payments made to departing shareholders in leveraged buyout situations will be protected from avoidance actions under Code section 546(e) so long as the payments were made by a financial institution or other similar entity.

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ARTICLE: In 2009, Three Courts of Appeals Held that Shareholders of Privately Held Corporations Who Receive Buyouts through "Settlement Payments" Are Immune from Fraudulent Transfer Suits

In 2009, the Courts of Appeals for the Eighth, Sixth and Third Circuits each considered whether *11 U.S.C. § 546(e)* provides immunity to shareholders of privately held corporations against subsequent fraudulent transfer suits to recover buyout payments made in the form of settlement payments from financial institutions. In *Brandt v. B.A. Capital Co. LP (In re Plassein Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2009), 590 F.3d 252 (3d Cir. 2009), the trustee of a privately held corporation that had undergone a leveraged buyout prior to its bankruptcy filing sued former shareholders who had received the buyout payments. The shareholders asserted that where the payments were made by a third-party financial institution, *section 546(e) of the Bankruptcy Code* applied to prevent any fraudulent transfer suit against them. The Court of Appeals for the Third Circuit agreed, joining 2009 cases from the Sixth and Eighth Circuits that held likewise.

The Facts of *Brandt*

Plassein International Corporation and its related corporations (collectively, "Plassein") were formed in 1999 to acquire privately held manufacturing corporations in a series of leveraged buyout transactions. The payments to the shareholders to buy out their interests were financed by loans taken out by the various Plassein entities with their assets

pledged as collateral. Because each Plassein entity was liable for the entire debt to the bank, each entity had potential debts well in excess of its assets. 590 F.3d at 254-55.

The selling corporations were privately held, most with only a few shareholders. The selling shareholders delivered their shares to Plassein, which in turn directed Fleet Bank to wire the purchase price to the shareholders at accounts at their various banks. The parties did not make use of the typical third-party clearing agency "settlement system" customarily used in securities transactions. 590 F.3d at 255 n.1.

Plassein began defaulting on its obligations only a few months after the acquisitions. Eventually, the Plassein entities filed chapter 11 petitions, which cases were converted to chapter 7 proceedings. William Brandt was appointed as chapter 7 trustee.

Mr. Brandt instituted adversary proceedings against various selling shareholders, alleging that the amounts they received in payment for their stock in the leveraged buyouts were fraudulent transfers that could be avoided. The shareholders filed motions to dismiss, relying on *section 546(e) of the Bankruptcy Code*. The bankruptcy court dismissed the cases and district court affirmed on the initial appeal. 590 F.3d at 255.

Review of the Applicable Statutory Provisions

The trustee's suits in the *Brandt* case were brought under *section 544(b)(1) of the Bankruptcy Code*, which allows trustees to assert avoidance claims available to creditors under applicable state law, here Delaware fraudulent transfer law. The shareholders' motions to dismiss were premised on *section 546(e) of the Bankruptcy Code*, which provides in part that a trustee may not avoid transfers that are "settlement payments" as defined in either *section 101* or *741 of the Bankruptcy Code*, "made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency."

The definition in *section 101(51A) of the Bankruptcy Code* applies to forward contract provisions and thus is not relevant to the *Brandt* case. However, *section 741(8)*'s definition is broader and refers to a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." This definition is a bit circular, for "settlement payment" is defined by adding various modifying phrases such as "preliminary" and "partial" but then simply uses the term "settlement payment" within the very definition itself.

Legal Analysis of the *Brandt* Court on the Issue of Whether the Payments to Shareholders of Privately Held Corporations Could Be Settlement Payments

The *Brandt* court began by noting that leveraged buyouts in corporate transactions are generally subject to fraudulent transfer laws. 590 F.3d 252, 256 (citing *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1297 (3d Cir. 1986)). Certainly, in a leveraged buyout, the shareholders are paid on their equity in the corporation and do not give a reasonable equivalent value for the payment. Thus, if the corporation is either insolvent, unreasonably capitalized or unable to pay its debts as they become due as a result of the transaction, the transfer can be set aside as a constructive fraud on creditors.

Previously, in *Lowenschuss v. Resorts International, Inc. (In re Resorts International, Inc.)*, 181 F.3d 505 (3d Cir. 1999), the Court of Appeals for the Third Circuit had held that payments to a shareholder of a publicly held corporation who tendered his shares to his broker and then received payment from the tender agent were exempt from a fraudulent transfer suit under *section 546(e)* as a settlement payment. The *Brandt* case noted that *Resorts International* reached this result even though the clearing agency was not generally involved in the settlement of the shares and the financial institutions acted only as conduits. 590 F.3d at 257.

Thus, the issue before the court in *Brandt* was whether there should be a different result from that reached in *Resorts International* because the buyout was of a privately, rather than a publically, held company. The trustee argued

that the term "securities trade" in the definition of settlement payment referred to the industry dealing with publicly held companies and the business of buying and selling publicly held shares. The *Brandt* court disagreed.

The court focused on how the term "settlement payment" was used by those who work in the securities trade, and noted that the *Resorts International* case determined that the securities trade used that term to refer to payments that complete a leveraged buyout. 590 F.3d at 258. Indeed, in the *Resorts International* case, the court had stated that "[i]n the securities industry, a settlement payment is generally the transfer of cash or securities made to complete a securities transaction," 181 F.3d 505, 515 (citing *Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 913 F.2d 846, 849 (10th Cir. 1990)).

Thus, in order to meet the statutory definition, settlement payments do not have to travel through the settlement system, but simply can be made, as here, by a "financial institution." The plain language of the Bankruptcy Code compels the result that the transfers to the shareholders are protected by section 546(e). 590 F.3d at 259.

Analysis of the Other Court of Appeals Cases Extending the 546(e) Exemption to Buyout Payments to Shareholders of Privately Held Companies

The issue whether leveraged buyout payments to shareholders of privately held companies are protected by section 546(e) was also discussed in two other 2009 court of appeals cases. In *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545 (6th Cir. 2009), the court held that section 546(e) applied to protect buyout payments made by a financial institution. The trustee in *QSI Holdings* had argued that the purpose of section 546(e) was to protect the "nation's public securities markets" and that it was not intended to allow shareholders of privately held companies to avoid liability by merely funneling the payments through a financial institution. 571 F.3d at 549.

However, the Court of Appeals for the Sixth Circuit determined, as the Third Circuit did in *Brandt*, that the statutory language was broad enough to cover the transactions. Despite the fact that the definition of "settlement payment" in section 741(8) is "somewhat circular," it is still extremely broad. 571 F.3d at 549. The *QSI Holdings* court noted that the securities trade was implicated as to a leveraged buyout transaction of a privately held company, which involved a merger of "nearly equal companies," with substantial value.

The court distinguished the case of *In re Norstan Apparel Shops, Inc.*, 367 B.R. 68, 76 (Bankr. E.D.N.Y. 2007), which found that a sale by two sole shareholders of a closely held Subchapter S corporation did not implicate public securities markets and lacked many of the indicia of transactions "commonly used in the securities trade." The *QSI Holdings* court thus suggested that the result likely would be different if a small, very privately held company was sold in a manner where a financial institution made the final payment to a very few retiring shareholders. 571 F.3d at 550. This is inconsistent with the facts and language of *Brandt*, where in some of the transactions only a few shareholders were involved and which recognized "that persons who work in the securities trade use the term 'settlement payment' when referring to the payment that completes a leveraged buyout." 590 F.3d at 258.

Similarly, in *Contemporary Industries Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009), the court ruled that section 546(e) applied to exempt leveraged buyout payments to shareholders of a privately held corporation from a fraudulent transfer claim. The court noted that nothing in the statute "suggests Congress intended to exclude these payments from the statutory definition of 'settlement payment' simply because the stock at issue was privately held." 564 F.3d at 986.

Courts That Applied the Section 546(e) Exemption to Buyout Payments to Shareholders of Public Companies

In addition to the *Resorts International* case, 181 F.3d 505 (3d Cir. 1999), which was relied upon heavily by the *Brandt* court and discussed in more detail above, the Court of Appeals for the Tenth Circuit, in *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1239-40 (10th Cir. 1991), also held that the section

546(e) exemption for settlement payments applies to protect buyout payments to shareholders of public companies made by financial institutions. The two cases discussed above focused on the "language of the statute itself," noting that "settlement payment" is a broad term that includes almost all securities transactions. *Kaiser Steel*, 952 F.2d at 1237; see *Resorts Int'l*, 181 F.3d at 515.

Courts Disagreeing with the *Resorts International* Holding That Leveraged Buyouts Are Governed by Section 546(e)

Some bankruptcy and district court cases have disagreed with the holdings of the four circuit courts of appeals that leveraged buyout payments are covered by section 546(e). Instead, those courts focus on the fact that "the system of intermediaries and guarantees" that are involved in normal securities transactions are not in play in a leveraged buyout. See, e.g., *Zahn v. Yacaipa Capital Fund*, 218 B.R. 656, 675-76 (D.R.I. 1998); *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 664-65 (N.D. Ill. 1991); *Norstan Apparel Shops*, 367 B.R. 68, 76-77 (Bankr. E.D.N.Y. 2007) (where a transfer "does not involve publicly traded securities or otherwise implicate the public securities markets, the transfer is not a 'settlement payment'").

Court of Appeals Case Holding That Leveraged Buyout Payments Made by a Financial Institution Were Not Protected by Section 546(e) Because the Institution Was Only a Conduit

In *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604 (11th Cir. 1996), the Court of Appeals for the Eleventh Circuit became the only court of appeals court to date to determine that leveraged buyout payments are not "settlement payments" protected by section 546(e). The *Munford* court held that the payments made to shareholders in a leveraged buyout were not actually made by a financial institution as required by the definition of "settlement payment" because those payments were actually made by the corporation itself to the shareholders involved. While "a section 546(e) financial institution was presumptively involved," it was nothing more than an intermediary or conduit, never acquiring a beneficial interest in the funds or the shares. 98 F.3d at 610.

This argument was made in each of the three 2009 court of appeal cases dealing with leveraged buyouts of privately held companies, and specifically rejected by each. In each of the three cases, the courts relied on the plain language of the statute, which requires only that the payments be made by a financial institution, not that the financial institution have a beneficial interest in the funds involved. *Brandt*, 590 F.3d at 257-58; *QSI Holdings*, 571 F.3d at 551; *Contemporary Indus.*, 564 F.3d at 986-87.

Some Examples of Payouts to Shareholders That Are Not Protected as "Settlement Payments"

Although the cases discussed above have all noted that the definition of "settlement payment" is very broad, it is not unlimited. For example, in *Kipperman v. Circle Trust F.B.O. (In re Grafton Partners, L.P.)*, 321 B.R. 527, 540-41 (B.A.P. 9th Cir. 2005), the court held that section 546(e) was not applicable to payments made by a company involved in a Ponzi scheme, because a transaction involving nonpublic securities was not in any way normal in the securities industries as it involved substantial illegalities. Likewise, in *Enron Corp. v. Bear, Stearns Int'l Ltd. (In re Enron Corp.)*, 323 B.R. 857 (Bankr. S.D.N.Y. 2005), payment by a corporation to acquire its own shares was not a "settlement payment" as there was no "securities trade" involved, particularly where the transaction was illegal under state law.

Practice Pointer

Because the courts have broadly applied section 546(e) to leveraged buyouts of both publicly and privately held companies, departing shareholders and their attorneys should make certain in each case that the payments for the shares are made by one of the entities described in section 741, such as a "financial institution." The payments should not come directly from the acquiring company.

Conclusion

As a result of the three courts of appeals cases decided in 2009, the majority view is that buyout payments made to departing shareholders in leveraged buyout situations will be protected from avoidance actions under *section 546(e) of the Bankruptcy Code*, so long as the payments are made by a financial institution or other similar entity. This is true whether the selling corporation is publicly or privately held.

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For discussion of Code section 546(e), see Collier on Bankruptcy,

■ " 546.06.

For discussion of Code section 544(b), see Collier on Bankruptcy,

■ " 544.07.

For discussion of Code section 741, see Collier on Bankruptcy,

■ ch. 741.

For discussion of Code section 101(51A), see Collier on Bankruptcy,

■ " 101.51A.

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16 of 197 DOCUMENTS

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Jurs on Jones v. Wells Fargo Home Mortgage, Inc. (In re Jones)

2010 Emerging Issues 4888

S. Andrew Jurs on Jones v. Wells Fargo Home Mortgage, Inc. (In re Jones), 418 B.R. 687 (Bankr. E.D. La. 2009)

By S. Andrew Jurs

February 24, 2010

SUMMARY: This Emerging Issues Analysis examines a bankruptcy court's decision to order the implementation of certain accounting procedures where punitive damages alone would not make the mortgage company change its behavior. The court relied on its own inherent authority as well as the authority granted by 11 U.S.C. § 105(a).

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ARTICLE: Bankruptcy Court Ruled That It Had Inherent Authority and Authority Under Section 105 to Order Mortgage Company to Implement Certain Accounting Procedures

In *Jones v. Wells Fargo Home Mortgage, Inc. (In re Jones)*, 418 B.R. 687, 2009 Bankr. LEXIS 3317 (Bankr. E.D. La. Oct. 1, 2009), the bankruptcy court considered how to enforce its earlier judgment that a mortgage creditor willfully and egregiously violated the automatic stay imposed by 11 U.S.C. § 362 when it charged the debtor's account with unreasonable fees and costs. The court concluded that it could consider alternate remedies, such as punitive damages, but ultimately decided that punitive damages would not have the desired effect of getting this particular mortgage company to change its behavior. Accordingly, the court used its authority under 11 U.S.C. § 105(a), and its inherent authority, to order the implementation of certain accounting procedures designed to ensure that the pleadings filed by the mortgage creditor would be accurate or immediately corrected.

Facts and Procedural History

In August 2003, Michael L. Jones ("Jones" or "Debtor") filed a chapter 13 bankruptcy petition. At the time of his filing, Debtor was obligated to Wells Fargo on a debt secured by his residence. Wells Fargo filed a proof of claim setting forth the amounts owed by Debtor as of the petition date. In August 2005, Debtor filed a motion requesting authority from the court to refinance the Wells Fargo debt. As part of this process, Debtor requested a payoff of the

amounts due. On January 3, 2006, Wells Fargo faxed a payoff statement indicating a payoff of \$231,463.97. The payoff was itemized but contained no explanation or substantiation for the amounts owed.

When Debtor received the payoff statement, he questioned the amounts Wells Fargo alleged were due; however, he was unable to obtain an accounting from Wells Fargo explaining its calculations. Because Debtor's new loan could not be closed without a release of the Wells Fargo mortgage, Debtor was forced to pay the amount demanded or lose his loan.

Following the closing, Debtor requested an accounting from Wells Fargo. On January 12, 2006, Wells Fargo acknowledged that it had collected more money than necessary to satisfy the loan. Wells Fargo gave no explanation as to how much was due or why the amounts collected were in excess of the amounts owed. Debtor was advised that he would be reimbursed the excess amount.

On March 30, 2006, Debtor filed an adversary proceeding when no reimbursement was received. Thereafter, on April 20, 2006, Wells Fargo forwarded \$7,598.64 as reimbursement. At trial, Wells Fargo offered into evidence an accounting from the date of the loan's inception to payoff, reflecting charges made against the loan, as well as the amounts received in payment.

Debtor disputed the accounting, particularly the accrual and payment of postpetition inspection fees, attorney's fees, and statutory expenses, as well as prepetition sheriff's commissions. Debtor also objected to the calculation of interest. Wells Fargo did not dispute Debtor's allegation that the charges were not previously disclosed to Debtor, the court, or the trustee. Wells Fargo alleged, though, that the amounts claimed were correctly calculated and that the postpetition charges were authorized under the loan documents. It further maintained that because Debtor voluntarily paid the sums owed, he could not recover any amounts improperly charged.

After trial, the bankruptcy court entered a partial judgment on April 13, 2007 (the "Partial Judgment"). In the Partial Judgment, the court found that Wells Fargo collected undisclosed, unapproved fees and costs and diverted estate property without authority to satisfy those fees and costs. Additionally, the court determined that Wells Fargo willfully and egregiously violated the automatic stay imposed by 11 U.S.C. § 362 when it charged the unreasonable fees and costs. The Partial Judgment ordered Wells Fargo to return \$ 16,852.01 to Jones, representing the amount overcharged.

At a subsequent hearing to consider sanctions, on May 29, 2007, counsel for Wells Fargo stated that his client was prepared to implement accounting procedures and to audit every account before discharge. In fact, later in the hearing, Wells Fargo's Vice President for Bankruptcy stated that it was willing to enter into a consent order, which led to a lengthy discussion with court regarding the form and substance of potential accounting procedure changes. In light of those discussions, the bankruptcy court asked the parties to draft a consent agreement implementing accounting procedures and settling the Debtor's request for damages.

Eventually, the parties reported that they were unable to reach agreement, after which the bankruptcy court entered an Amended Judgment requiring Wells Fargo to implement procedures for: (1) proper application of payments and (2) improved notice to debtors of fees or charges assessed against their accounts (the "Accounting Procedures"). The court also ordered Wells Fargo to pay \$ 67,202.45 to the Debtor as actual damages for attorney's fees and costs.

Wells Fargo appealed both the Partial Judgment and the Amended Judgment. The district court generally affirmed the judgments but remanded the case for additional findings regarding the Accounting Procedures. n1 The district court also determined that Wells Fargo, by filing the appeals, had withdrawn its consent to the imposition of the Accounting Procedures. Since the Accounting Procedures were a form of injunctive relief, the matter was remanded to the bankruptcy court to consider the propriety of the relief in light of Wells Fargo's lack of consent. Before the bankruptcy court could address the case on remand, Wells Fargo appealed the district court's judgment to the Court of Appeals for the Fifth Circuit. The bankruptcy court stayed the case until the Fifth Circuit dismissed the appeal for lack of jurisdiction, after which the bankruptcy court conducted a hearing on the appropriateness of the injunctive relief.

Legal Analysis

Authority Under Section 105. The authority of bankruptcy courts to issue civil sanctions is well settled. *In re Terrebonne Fuel & Lube, Inc.*, 108 F.3d 609 (5th Cir. 1997). It springs from two sources: section 105 of the Bankruptcy Code, *id.* at 613, and the court's inherent authority, *see, e.g., In re Yorkshire LLC*, 540 F.3d 328 (5th Cir. 2008) (affirming bankruptcy court's inherent authority to issue sanctions); *Citizens Bank & Trust Co. v Case*, 937 F.2d 1014, 1023 (5th Cir. 1991). Section 105(a) provides:

The court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

While section 105(a) gives the court a broad range of power, any action executed under that section's authority "cannot be used in a manner inconsistent with the commands of the Bankruptcy Code." *In re Ludlow Hosp. Society, Inc.*, 124 F.3d 22, 27 (1st Cir. 1997).

Inherent Authority. Bankruptcy courts also have inherent authority to sanction parties and control their courts. "It is well-settled that a federal court, acting under its inherent authority, may impose sanctions against litigants or lawyers appearing before the court so long as the court makes a specific finding that they engaged in bad faith conduct." *Yorkshire LLC*, 540 F.3d 328, 332. "Courts of justice are universally acknowledged to be vested, by their very creation, with power to impose silence, respect, and decorum in their presence and submission to their lawful mandates." *Chambers v. NASCO, Inc.*, 501 U.S. 32, 43, 111 S. Ct. 2123, 2132, 115 L. Ed. 2d 27 (1991). This inherent power is "governed not by rule or statute but by the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases." *Id.*

A bankruptcy court has the power "to protect its jurisdiction and judgments and to control its docket." *Ferguson v. Mbank Houston, N.A.*, 808 F.2d 358, 360 (5th Cir. 1986). It has been a long-standing rule that "[t]he power to issue an injunction when necessary to prevent the defeat or impairment of its jurisdiction is, therefore, inherent in a court of bankruptcy." *Continental Illinois Nat'l Bank & Trust. Co. of Chicago v. Chicago R.I. & P. Ry. Co.*, 294 U.S. 648, 675, 55 S. Ct. 595, 606, 79 L. Ed. 1110 (1935). Finally, the Judicial Code provides that "[t]he Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." 28 U.S.C.A § 1651(a).

Appropriateness of Injunctive Relief. Where monetary sanctions are ineffective in deterring vexatious filings, injunctions are appropriate. The court's power to enter such orders flows not only from various statutes and rules relating to sanctions, but from the inherent power of the court to protect its jurisdiction and its judgments and to control its docket. *Ferguson*, 808 F.2d 358, 359 (confirming that this inherent power also resides with bankruptcy courts for bad faith conduct occurring in proceedings before them). To determine whether injunctive relief is appropriate, a court considers the party's history of litigation, whether or not it has a good faith basis for pursuing the litigation, the extent of the burden on the court and other parties resulting from the party's filings, and the adequacy of alternative sanctions. *Baum v. Blue Moon Ventures, L.L.C.*, 513 F.3d 181, 189 (5th Cir. 2008).

Commentary

The decision in *Jones* is significant because, instead of simply penalizing a national mortgage company for its actions as creditor in the hope that future improper behavior will be deterred, the bankruptcy court went out of its way to establish its authority and to order the creditor to change how its business practices.

The Bankruptcy Court Could Consider the Adequacy of Alternative Remedies. Although the parties raised several tangential issues, the first real question before the bankruptcy court was whether an adequate, alternative legal remedy to injunctive relief existed. On remand, if the bankruptcy court concluded that alternative forms of relief were both available and adequate, then imposing the Accounting Procedures would be unwarranted. Additionally, the bankruptcy court was confronted with the issue of how to handle the substantial change in Wells Fargo's position since trial. According to the bankruptcy court, it had declined to award monetary punitive damages because of Wells Fargo's statements at the hearing that it would voluntarily change its practices. Once the Amended Judgment was entered, however, Wells Fargo changed its position with the possible result of avoiding monetary punitive damages.

Because of the possibility that Wells Fargo could avoid sanction, the bankruptcy court quickly dismissed Wells Fargo's argument that the imposition of alternative forms of relief were either beyond the scope of remand or barred by Jones's failure to seek them on appeal. According to the bankruptcy court, this result would be especially untenable given that Wells Fargo offered to implement the Accounting Procedures and consented to their inclusion in a court order in an effort to avoid punitive damages and other sanctions. Although the district court had allowed Wells Fargo another day in court on the issue because of this change of position, the bankruptcy court could not believe that the district court intended to foreclose all relief against Wells Fargo. As a result, the bankruptcy court concluded that the scope of the remand included considering the adequacy of alternative remedies and, if available, the imposition of those remedies.

The Bankruptcy Court Has Authority to Grant Injunctive Relief. The bankruptcy court also summarily rejected Wells Fargo's assertion that the bankruptcy court did not have "inherent authority" to issue an injunction. In fact, the bankruptcy court felt that Fifth Circuit precedent was so clear on this issue that it described the argument as a "blatant misstatement of the law." 2009 Bankr. LEXIS 3317, at *13 n.26; see also *Franklin v Elliott*, 15 F.3d 179 (5th Cir. 1994) (characterizing argument that bankruptcy courts lack inherent power to sanction as "totally without merit").

The Required Accounting Procedures Do Not Exceed the Bankruptcy Court's Authority.

Wells Fargo further argued that individual debtors, not the bankruptcy court itself, should enforce their rights by filing separate actions to challenge the proofs of claim or motions for relief filed by Wells Fargo. To the bankruptcy court, this argument might have had some merit under normal circumstances, but several factors weighed against Wells Fargo in this regard:

- (i) Wells Fargo had refused to audit its filings for errors and to voluntarily correct its errors despite the fact that it admitted that it regularly committed such errors;
- (ii) Wells Fargo insisted on limiting any change in its conduct prospectively, even as it continued to seek to collect on loans in other cases for amounts owed in error.

To the bankruptcy court, Wells Fargo's refusal to rectify its errors was particularly egregious because of the heavy burden it put on debtors to enforce their rights. "Naïve borrowers/debtors, trustees, and creditors rightly assume that Wells Fargo is complying with the plain meaning of its notes, mortgages, court orders, and confirmed plans. Why would anyone assume otherwise?" 2009 Bankr. LEXIS 3317, at *25.

In fact, Wells Fargo's refusal to verify and correct existing proofs of claim and pleadings put the bankruptcy court in the position of enforcing pleadings that it suspected were incorrect. For that reason, the bankruptcy court found that the injunctive relief was grounded in the bankruptcy court's inherent authority to control its proceedings and the integrity of the judicial system. At its core, the relief was needed as a means to ensure that the pleadings filed by Wells Fargo would be accurate or immediately corrected.

Adequacy of Alternative Remedies/ Punitive Damages. The parties agreed that a legal remedy to address stay violations already existed under Code section 362(k)(1), which provides that "an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in

appropriate circumstances, may recover punitive damages." *See also In re Fisher*, 144 B.R. 237 n.1 (Bankr. D.RI 1992) (noting that the compensatory and punitive damages provided for a willful stay violation under section 362 is a legal remedy). According to Wells Fargo, this meant that, because Debtor had been reimbursed for his actual damages, *i.e.*, his attorney's fees, he had received an adequate legal remedy. Taking this argument to its logical conclusion, Wells Fargo maintained that punitive damages were not warranted and the Accounting Procedures were unnecessary. In contrast, the Debtor did not oppose the Accounting Procedures but argued that Wells Fargo's conduct warranted the imposition of substantial punitive damages.

The purpose of punitive damages is to punish and deter. Restatement (Second) of Torts § 908(1) (1977). While the bankruptcy court believed that punitive damages could be imposed, it did not believe that punitive damages would either deter or punish Wells Fargo sufficiently to change its behavior. This conclusion was based on Wells Fargo's conduct in the case of *Slick v. Norwest Mortgage, Inc.*, 2002 Bankr. LEXIS 772 (Bankr. S.D. Ala. 2002), in which Wells Fargo was assessed \$2 million in punitive damages for charging postpetition attorney's fees to debtors' accounts without disclosing the fees to anyone. Four years after the ruling in *Slick*, Wells Fargo continued to charge undisclosed postpetition fees despite the punitive damages. To the bankruptcy court, this conduct, as well Wells Fargo's behavior during the *Jones* case itself, constituted such an "arrogant defiance of federal law" that the bankruptcy court did not believe that Wells Fargo would change unless ordered to do so. 2009 Bankr. LEXIS 3317, at *32. By concluding that punitive damages alone would be insufficient to stop Wells Fargo's improper business practices, there could be no other adequate alternative legal remedy to force Wells Fargo's compliance with the Bankruptcy Code. Accordingly, the bankruptcy court concluded that it was acting with proper authority in imposing the injunctive relief of the Accounting Procedures. n2

Conclusion

The decision in *Jones v. Wells Fargo Home Mortgage, Inc. (In re Jones)*, 418 B.R. 687, 2009 Bankr. LEXIS 3317 (Bankr. E.D. La. Oct. 1, 2009), is important in that the bankruptcy court found that punitive damages would not make Wells Fargo change its behavior. With no other remedies available to it, the court was forced to use its authority under 11 U.S.C. § 105(a), and its inherent authority, to order the implementation of the Accounting Procedures and regulate how a national mortgage company operates its business.

[Return to Text](#)

n1 Wells Fargo also asserted as one of its assignments of error on appeal, and continued to assert in subsequent proceedings, that it never agreed to implement the Accounting Procedures ordered by the Amended Judgment. Addressing this contention, the district court found that Wells Fargo was "disingenuous." *Wells Fargo Bank N.A. v. Jones (Jones III)*, 391 B.R. 577, 611 (E.D. La. 2008).

n2 Debtor urged the Bankruptcy Court to impose both punitive damages and the Accounting Procedures, arguing that the remedies are not exclusive. But the bankruptcy court disagreed on the grounds that if punitive damages would deter Wells Fargo's conduct, then the Accounting Procedures would be both unwarranted and unnecessary. Because the bankruptcy court found that punitive damages would not be adequate to curb Wells

Fargo's behavior, any additional award of punitive damages would be inconsistent with this position.

RELATED LINKS: For discussion of Bankruptcy Code section 105, see Collier on Bankruptcy, ch. 105.

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17 of 197 DOCUMENTS

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Braucher on 9th Circuit's Interpretation of Inherent Power to Sanction Attorneys

2010 Emerging Issues 4877

Anne Braucher on the Ninth Circuit's Interpretation of a Bankruptcy Court's Inherent Power to Sanction Attorneys

By Ms. Anne Braucher

February 22, 2010

SUMMARY: Bankruptcy courts have broad authority to discipline attorneys pursuant to their inherent sanction power. In the recent *Price v. Lehtinen* (*In re Lehtinen*) decision, the Ninth Circuit stated that bankruptcy courts can exercise their inherent power to sanction attorneys in any way that is not punitive and that is based upon a finding of bad faith or willful misconduct. This commentary discusses the import of this significant decision.

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ARTICLE: A Bankruptcy Court's Inherent Power Allows it to Suspend Attorneys Who Engage in Bad Faith or Willful Misconduct

The United States Court of Appeals for the Ninth Circuit has upheld a bankruptcy court's decision to suspend an attorney for bad faith or willful misconduct during representation of a debtor in a Chapter 13 case. The decision, *Price v. Lehtinen* (*In re Lehtinen*), 564 F.3d 1052 (9th Cir. 2009), demonstrates that bankruptcy courts do not have to rely on statutory authority or rules of professional conduct in order to sanction attorneys for misconduct. The Circuit Court held that suspending the attorney from practicing before the bankruptcy court was a proper exercise of inherent authority because attorney suspension is not a punitive sanction. Further, the attorney's due process rights were properly protected because he received sufficient notice of the several instances of misconduct upon which his three-month suspension was based.

Background

Bankruptcy courts have the power to sanction attorneys pursuant to the civil contempt authority established in section 105(a) of the Bankruptcy Code or the inherent authority established by case law. See *Chambers v. NASCO, Inc.*, 501 U.S. 32 (1991); *Caldwell v. Unified Capital Corp. (In re Rainbow Magazine, Inc.)*, 77 F.3d 278 (9th Cir. 1996). The two sources of sanctioning power differ in their reach and application. Civil contempt authority is limited to remedying violations of specific orders. With inherent authority, bankruptcy courts can sanction attorneys for a broad range of misconduct, even without express statutory authority to do so. Before exercising inherent authority, however, bankruptcy courts must make a finding of bad faith or willful misconduct. "[B]ad faith or willful misconduct consists of

something more egregious than mere negligence or recklessness." *In re Lehtinen*, 564 F.3d at 1058 (quoting *Fink v. Gomez*, 239 F.3d 989, 993-94 (9th Cir. 2001)). Civil contempt authority does not require such a finding. According to the Supreme Court, inherent authority must be exercised with "restraint and discretion" because it is so much more potent than civil contempt authority. *Chambers*, 501 U.S. at 44. This means that courts exercising inherent authority cannot impose significant punitive sanctions. Such punitive sanctions would require due process protections that are usually available only to criminal defendants.

The debtor, Patricia Lehtinen, retained attorney Jim Price to represent her in her Chapter 13 case. After filing her petition, Price did not attend Lehtinen's § 341 meeting of creditors, but sent a contract attorney in his place. Price had not told Lehtinen that he would not be attending her creditor meeting. Price also referred Lehtinen to a lender who agreed to help her finance home improvements, but only if she retained Price as a broker for the later sale of her home. Then, Lehtinen appeared at her confirmation hearing alone, and her plan was confirmed. Price missed the hearing because he had agreed to appear in another court for another client, even though he knew it conflicted with Lehtinen's hearing. The next day, Price sent Lehtinen a letter telling her that her case had been dismissed, when it had not, and offering to help her file another case or sell her house. Price assumed that her case would be dismissed because he did not attend her confirmation hearing and she was behind on her payments to the trustee.

The United States Bankruptcy Court for the Northern District of California then issued its first order to show cause why Price should not disgorge all or part of his \$1,500 fee for failure to appear at the § 341 meeting and the confirmation hearing. Following the hearing, the court entered an order requiring Price to disgorge \$300 of his fee. After the hearing, but before the court entered its order, Lehtinen sent a letter to the court outlining several instances of Price's misconduct and attaching the letter in which Price erroneously stated that her case had been dismissed. Based upon her letter, the bankruptcy court issued a second order to show cause why Price should not be suspended or disbarred for bad faith misconduct. The court identified four instances of Price's misconduct: (1) his failure to attend and inform Lehtinen of her confirmation hearing; (2) pressuring the debtor to list her house with his brokerage firm; (3) referring her to a lender who conditioned a home improvement loan on Lehtinen's retaining Price as a broker for the sale of her home; and (4) his letter falsely stating that her case had been dismissed. Following hearing, the court ordered Price to disgorge the rest of his \$1,500 fee and suspended him from practicing in the bankruptcy court for three months. The Bankruptcy Appellate Panel ("BAP") for the Ninth Circuit held that the bankruptcy court was within its power to sanction Price, but it vacated the suspension and remanded to the bankruptcy court for consideration of the American Bar Association standards in disciplining Price. Price appealed to the Ninth Circuit.

The Decision

Following a hearing, the Ninth Circuit determined that Price's suspension was proper. *In re Lehtinen*, 564 F.3d at 1062. In reaching its decision, the court engaged in a three-part analysis, including: (1) whether the bankruptcy court possessed inherent authority to suspend Price; (2) whether Price was accorded due process; and (3) whether the BAP should have referred the matter to a standing committee pursuant to a Northern District of California local rule. *See id.* at 1058.

The court first held that the bankruptcy court possessed inherent authority to suspend Price. Attorney discipline proceedings are neither civil nor criminal, but "an investigation into the conduct of the attorney-respondent." *Id.* at 1059 (quoting *Cantanella v. California*, 404 F.3d 1106, 1110 (9th Cir. 2005)). They are not, like criminal proceedings, undertaken for the purpose of punishment, but rather to "maintain the integrity of the courts and the profession." *Id.* (quoting *Patterson v. Standing Comm. Of Discipline of Bar of the U.S. Dist. Court of Or. (In re Patterson)*, 176 F.2d 966, 968 n.1 (9th Cir. 1949)). Because attorney suspensions are not punitive in nature, it is within the inherent sanction authority of bankruptcy courts to impose them.

The court then held that Price was accorded due process by the bankruptcy court. According to the Ninth Circuit, "due process is accorded as long as the sanctionee is 'provided with sufficient, advance notice of exactly which conduct was alleged to be sanctionable, and [was] furthermore aware that [he] stood accused of having acted in bad faith.'" *Id.* at

1060 (quoting *Miller v. Cardinale (In re DeVille)*, 361 F.3d 539, 549 (9th Cir. 2004)). The bankruptcy court protected Price's due process rights by giving him notice of the particular alleged misconduct - the four instances cited in the second order to show cause. *See id.* The bankruptcy court's failure to notify Price of any other alleged misconduct was harmless, especially given the egregious nature of the four instances cited in the second order to show cause. *See id.* at 1060-1. Further, the bankruptcy court's failure to cite specific rules on which it based its decision to suspend Price was not fatal. Invoking the court's inherent sanction power was sufficient to protect Price's due process rights. *See id.* at 1061. The bankruptcy court also made an implied finding of bad faith or willful conduct by Price that was sufficient grounds for the suspension. *See id.*

Finally, the court held that the BAP was not required to refer Price's suspension proceeding to a standing committee. On close reading, the Northern District of California local rule regarding discipline states that its procedures are discretionary and not mandatory. *See id.* at 1062.

The Effect of the Decision: Bankruptcy Courts Have Broad Authority to Discipline Attorneys.

The *In re Lehtinen* decision means that bankruptcy courts have extremely broad authority to discipline attorneys who engage in misconduct. Federal courts already have authority under *section 105(a) of the Bankruptcy Code* to impose sanctions on attorneys who defy specific court orders. Now, the Ninth Circuit has stated that inherent sanction authority includes the power to suspend attorneys from practicing in bankruptcy courts.

Because inherent authority is not codified but rather established by case law, it is difficult to determine the boundaries of this power to discipline attorneys. In *Lehtinen*, the court said only that sanctions imposed pursuant to inherent authority must not be punitive and must be based on a finding of bad faith or willful misconduct. The court also stated that attorney suspensions are, by definition, not punitive. Accordingly, there appears to be no real limit at all to the inherent authority of courts to suspend attorneys. The *Lehtinen* court also stated that "[a]lthough the bankruptcy court did not explicitly state that Price's conduct was performed in 'bad faith' or was 'willful,' it impliedly did so by finding that the 'conduct in this case was outrageously improper, unprofessional and unethical under any reading of California's ethical standards for attorneys.'" *Id.* at 1061. This means that it is not, in fact, necessary for a court to make an explicit finding of bad faith or willful misconduct. A court can exercise its inherent authority to suspend an attorney based on something less - a finding that the attorney acted unethically.

For the bankruptcy practitioner, the *Lehtinen* case is a cautionary tale. Bankruptcy attorneys, like all attorneys, need to ensure that they maintain regular communication with their clients. Given the volume of cases that debtors' attorneys often manage, maintaining this communication may be particularly difficult but also particularly important. Failure to timely inform debtors of hearings and deadlines may cost an attorney the privilege of practicing in a particular bankruptcy court. Bankruptcy attorneys also need to maintain a reliable calendaring system. Failure to attend hearings in person may, again, be grounds for suspension.

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18 of 197 DOCUMENTS

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Mears, Gregg and Winge on the Saab Reorganization in Sweden

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Patrick E. Mears, John T. Gregg and Mathias Winge on the Saab Reorganization in Sweden: The Expedited and Successful Restructuring and Sale of a Global Automobile Manufacturer

By Patrick E. Mears, John T. Gregg and Mathias Winge

January 22, 2010

SUMMARY: In 2009, two of the three primary American auto assemblers sought relief under Chapter 11 of the United States Bankruptcy Code, a European subsidiary of General Motors and its British sister company were sold to a multinational joint venture, although at the date of this writing the sale has yet to close, and Saab Automobile AG, another foreign subsidiary of General Motors, filed for reorganization under Sweden's Reorganization of Business Act.

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ARTICLE: Calendar year 2009 was a watershed time for reorganizing automobile manufacturers globally. Two of the three primary American auto assemblers, Chrysler LLC and General Motors Corporation, sought relief under Chapter 11 of the United States Bankruptcy Code in the first six months of the year. General Motors' European subsidiary, Adam Opel GmbH, and its British sister company, Vauxhall Motors, Ltd., have been sold to a joint venture involving Magna International, an Austrian-Canadian auto supplier, and Sberbank Rossii OAO, a Russian commercial bank with ties to GAZ Group, a Russian automobile manufacturer, although at the date of this writing the sale has yet to close. Finally, Saab Automobile AG, another foreign subsidiary of General Motors, filed for reorganization in Sweden in February of 2009 under Sweden's Reorganization of Business Act. In these court proceedings, the administrator of Saab successfully restructured its debt and sold its assets to a consortium headed by Koenigsegg Automotive AB, a specialty automobile manufacturer. The goal of the Saab reorganization proceedings, i.e., the sale of Saab on a going concern basis, was accomplished in less than a year, and these proceedings were terminated in August 2009. This success story and an analysis of Sweden's Reorganization of Business Act follow.

I. History of Saab Automobiles

A. The Founding and Growth of Saab

Saab automobiles were first manufactured in 1947 by the automobile division of the Swedish Aeroplane Company, Svenska Aeroplan AB n1, that was established in the city of Trollhaettan, Vaestra Gotaland County, in the southwest of Sweden. That year, Saab produced its first vehicle, the Saab 92, with a two-cylinder engine that realized the lowest drag

coefficient of any automobile produced that year. In 1969, during the expansion of the worldwide market for Saab vehicles, Saab merged with Scania AB, a Swedish manufacturer of heavy trucks, buses and diesel engines; this merger was uncoupled in 1995, and the two companies went their separate ways. n2

Saab gained an allure in the late 1970s and early 1980s as the maker of stylish, high-end and high-performance vehicles that generated significant consumer demand throughout the world, especially in the United States where the Saab 900 Turbo became one of the cars of choice of the "yuppie" generation. n3 In 1978, Saab entered into an agreement with Fiat S.p.a. to develop jointly a new car platform that resulted in the Alfa Romeo 164, Fiat Croma, Lancia Thema and the Saab 9000.

In December, 1989, General Motors purchased 50% of Saab's automotive division and, as a result, created Saab Automobile AB. General Motors was granted at the same time an option to purchase the remaining shares of Saab within a 10-year period. In 2000, General Motors exercised this option, and Saab became another one of its wholly-owned, European subsidiaries along with Adam Opel GmbH and Vauxhall Motors, Ltd. n4

B. The Global Recession of 2008-2009 and its Effect on Saab

The global recession of 2008-2009 and the accompanying worldwide credit crisis severely impacted sales of Saab vehicles, with Saab sharing the pain with its parent company and its other subsidiaries. In 2008, only 93,295 Saab vehicles were sold worldwide, 21,383 of them in the United States. n5 As of the end of 2008, Saab had production facilities in (i) Trollhaettan, Sweden, (ii) Graz, Austria, (iii) Moraine, Ohio (USA), and (iv) Uusikaupunki, Finland (a joint venture with Valmet Automotive, Inc., a Finnish manufacturer of specialty cars). Saab produced only 90,281 vehicles in 2008, a drop of approximately 35,000 from the previous year. n6 Saab was the worst selling General Motors brand during 2008.

During the fall of 2008, the chief executives of Chrysler and General Motors appeared at public hearings before the United States Congress and pressed for governmental financial assistance for their respective enterprises on account of the dismal state of the American economy and the North American automotive sector. At roughly the same time, Saab appealed to the Swedish government for similar state aid; Saab had experienced losses of approximately \$3 billion Swedish Kronor ("SEK"), which translated at the then current exchange rates as \$343 million (U.S.). General Motors requested a loan of 5 billion SEK or \$565 million (U.S.) from the Swedish government in order to continue operations at Saab until the beginning of 2010, but this request was rejected. n7 Swedish Industry Minister Maud Olofsson was quoted as saying that Saab's survival was General Motors' responsibility and that GM's business plan for Saab was not "realistic." She continued by declaiming that the "Swedish state and taxpayers in Sweden will not own car factories. Sometimes you get the impression that this is a small, small company, but it is the world's biggest automaker, so we have a right to make demands." n8

Shortly after this request for state aid was turned down, Saab commenced a voluntary proceeding on February 10, 2009, under the Swedish Reorganization Act in the district court in Vanersborg, a city near Saab's manufacturing facilities in Trollhaettan. n9 After Saab filed its application for reorganization, Saab's Managing Director, Jan-Ake Jonsson, remarked that Saab would "continue to explore all available options for funding and/or selling Saab" and that Saab's board of directors had determined that "a formal reorganization would be the best way to create a truly independent entity that is ready for investment." n10 General Motors' Group Vice President for Purchasing, Bo Andersson, who began his career at Saab, contended that GM was "fully committed to maintaining a viable and successful local and global supplier base during the Saab reorganization." n11

II. Swedish Business Reorganization Law and the Saab Proceedings

A. Description and Analysis of Sweden's Reorganization of Business Act

1. Commencement of the Reorganization Proceedings

The Reorganization of Business Act (Sw: "foertagsrekonstruktion") adopted in Sweden in 1996 establishes special procedures for the reorganization of financially troubled businesses. These procedures are separate from those prescribed by the Swedish Bankruptcy Act that provide for the liquidation of insolvent corporations. A reorganization proceeding is commenced by the filing of an application by the business debtor with a Swedish district court, which filing must be approved by a resolution of the debtor's board of directors. The application need not contain proof of insolvency but must describe the debtor's economy, difficulties in paying its debts as they become due and facts indicating a reasonable possibility of a successful reorganization. n12 Upon the filing of the application, the district court may enter an order formally opening the reorganization case, appointing an administrator to examine the debtor's affairs with the power to negotiate with creditors the terms of a reorganization plan. n13 Upon being appointed, the administrator must promptly notify all known creditors of the debtor that the reorganization proceedings are pending and must provide the creditors with certain financial information concerning the debtor. n14 If the court determines that there is no valid reason to believe that the business can be reorganized, the court may decline to open the proceedings. n15 The length of these proceedings is three months, although the court may decide to extend the proceedings at three-month intervals upon the request of the debtor. n16

2. Pre-Plan Administrative Issues in Swedish Reorganization Proceedings

(i) Stays of Creditor Action

Upon the commencement of reorganization proceedings, unsecured creditors are prohibited from commencing actions to collect pre-filing debts and executing on the debtor's assets. However, litigation by creditors pending against the debtor as of the date the proceedings were opened is not stayed. Secured creditors holding a pledge of the debtor's property are also not stayed from realizing on their collateral although these creditors must follow a specific statutory procedure in doing so. n17

(ii) Operation of the Debtor's Business

Upon the opening of proceedings, the debtor will continue in possession and control of its assets but must consult with the administrator concerning their proposed use and disposition. The debtor, nonetheless, must conduct its business operations in a manner to protect against further deterioration of its financial condition. During this period, the debtor may not pay nonpreferential, pre-filing claims of creditors without the consent of the administrator. n18

(iii) Treatment of Executory Contracts

The Swedish reorganization statute establishes certain rules concerning contracts that are in existence as of the date the proceedings are opened. These rules permit the debtor, with the administrator's consent, to demand performance by all parties to each contract. If the contract was breached by the debtor before the proceedings were commenced but was not then terminated, the nondebtor party is prohibited from terminating after the filing. n19 However, unlike Chapter 11 of the United States Bankruptcy Code, Swedish reorganization law does not permit the debtor to reject executory contracts.

(iv) Post-Filing Loans

The debtor may, with the administrator's consent, obtain new loans during the proceedings that must be paid in full or receive a preferential status in future bankruptcy cases. n20

(v) Appointment of Creditors Committees

Upon the request of a creditor, the district court will appoint a creditor's committee consisting of three members. The administrator has the duty to consult with the committee on significant issues arising during the proceedings unless there is no opportunity to do so given the circumstances, e.g., in the case of an emergency requiring immediate action by the administrator. n21

3. Reorganization Plans

The administrator, in consultation with the debtor, will normally prepare a proposed reorganization plan describing how the debtor's financial and business problems will be addressed and resolved and then transmit that plan to the court and the creditors. n22 If the plan is accepted, then the plan will be implemented by the debtor, and when the reorganization has reached its goal, the administrator will be discharged and the reorganization proceedings will be terminated by the district court. n23 If no consensual plan is accepted by the creditors, then the debtor may file with the district court an application for a public (compulsory) composition proceeding wherein a "cram down" plan may be proposed and approved by the court that will pay less than 100% of the claims of nonpreferential creditors. The composition proceeding requires voting on the plan by the creditors. If the dividend will be less than 50% of claims, which is common, the composition must be approved by at least 75% of the voting creditors, and their claims must amount to at least the same percentage of the total amount of claims entitled to vote. n24 Alternatively, if the aim of the reorganization cannot be achieved, the process will be ended by the Court, and as a consequence, the debtor may then commence a liquidation proceeding. n25

B. Saab's Reorganization Proceedings and their Successful Conclusion

1. Appointment of Administrator

Upon the commencement of the Saab reorganization proceedings in the Vanersborg district court, that court appointed Guy Lofalk, an experienced insolvency lawyer with the Stockholm law firm of Lofalk Advokatbyrå, as the administrator of Saab. Also, Alix Partners, a global restructuring firm, was made available to Saab during the restructuring process. n26

2. Funding of Operations During Proceedings

In order to finance the operations of Saab during the reorganization proceedings, General Motors loaned \$150 million (U.S.) to Saab shortly after the filing. General Motors has since declared that it will forgive this unpaid indebtedness even though it is classified as a preferential claim in the proceedings entitled to full payment. n27 Part of Saab's funding of the operations also has been made by the Swedish state-owned Wage Guarantee Fund that, in certain circumstances, will pay salaries to a company's employees during a reorganization. This state funding is capped at approximately 171,000 SEK per employee and reorganization proceeding. n28

3. Court-Ordered Extension of Three-Month Periods of Administration

On May 20, 2009, Saab requested from the district court of Vanersborg an extension of the time to accomplish the reorganization for an additional three months to August 20, 2009. The reason for the request was that Saab needed more time to implement its reorganization plan and to finalize the reorganization with respect to Saab's operative and financial divisions that had not been finished at the time of the application. The request was approved by the district court of Vanersborg on 29 May, 2009. n29

4. Marketing of Saab Assets for Sale as a Going Concern

General Motors and its adviser, Deutsche Bank, have since the beginning of Saab's reorganization searched for a new owner. A short information memorandum of Saab, a so-called "teaser", was transmitted to a selection of possible interested parties. n30 The selling-process began with 27 interested parties, of which 20 signed a confidentiality agreement. Of these 20, approximately 10 potential bidders were invited to Saab's plant in Trollhaettan. n31 Afterward, three candidates were selected to continue the negotiations for the acquisition of Saab, which finally concluded with the sale to the Koenigsegg Group.

5. Sale of Assets to Koenigsegg Group

On June 15, 2009, General Motors agreed to sell the Saab assets to a newly formed consortium led by Koenigsegg Automotive AB, a Swedish manufacturer of custom-made, luxury automobiles. This consortium, named "Koenigsegg Group", and General Motors executed a memorandum of understanding for the sale of Saab's assets, including the brand. n32 The investors in this new entity are (i) Koenigsegg Automotive AB, holding a 23.4% interest, (ii) Alprazz AB, another Swedish corporation controlled by the founder of Koenigsegg, with a 42.6% stake, (iii) Eker Group, a Norwegian holding company with an 11.8% share, and (iv) an American, Mark Bishop, who owns the remaining equity (22.2%). n33 Koenigsegg Automotive had been established in 1994 by Christian von Koenigsegg, the company's current CEO, who has been described as a "Swedish sports car fanatic and entrepreneur." n34 This company has historically manufactured and sold only 12 to 15 custom-made automobiles per year, employs only forty-five (45) workers and maintains its manufacturing facilities at a former Swedish air force base near Angelholm in southern Sweden. The prices of a Koenigsegg automobile are not advertised but are believed to range between 8 million and 18 million SEK, which translates to between \$1 million and \$2.3 million (U.S.). n35 The media reported when this sale was announced that General Motors would, after the closing of the sale, provide new Saab with automotive components and technology and that production of the new Saab 9-5 model would remain at the Trollhaettan plant and not be shifted to the Opel plant in Ruesselsheim, Germany. n36

6. Proposal of Reorganization Plan and its Approval

Saab's reorganization plan was presented to its creditors at the creditors meeting on April 6, 2009. The plan consisted of several measures designed to return Saab to profitability. Organic changes were proposed to make Saab independent of General Motors, to streamline the production and development of several new models, all of which are hoped to make Saab profitable at a lower yearly sales volume. n37 The financial reorganization included a composition agreement providing for the forgiveness of 75% of the pre-reorganization debts, new financing through a loan of approximately \$600 million (U.S.) from the European Investment Bank and contributions on \$400 million (U.S.), consisting of both forgiveness of debt and delivery of tools to manufacture new car models by General Motors. n38 The plan also included as a decisive factor a change of ownership through a sale of Saab to a new entity.

Saab's creditors thereafter overwhelmingly approved the composition, which involved writing off debts of approximately 8.3 billion SEK; only one creditor out of 473 voting creditors rejected the plan. n39 One explanation for this vote is that General Motors during the reorganization proceedings has repaid many of Saab's suppliers and thus was assigned these suppliers' claims and votes on the plan against Saab. n40 Of Saab's total debt of approximately 10.6 billion SEK, General Motors holds 9.7 billion SEK; the next largest creditor is the Government of Sweden with 347 million SEK. n41 The one creditor voting against the composition was the Swedish Tax Authorities. Sweden, through the Swedish Tax Authorities, is planning to demand payment of 75 million SEK for earlier payments from the state-owned Wage Guarantee Fund which the Tax Authorities do not consider to be part of the composition. However, Saab has argued that the composition includes this amount. n42 The dividend from the composition shall, according to Saab's managing director Jan Ake Jonsson, be paid from Saab's own cash. n43

7. Termination of Proceedings

On August 19, 2009, the administrator filed with the district court a notice that he would not seek another three-month extension of the Saab reorganization proceedings. This notice had the effect of terminating those proceedings. n44 At the same time, Augie Fabela, the American chairman of the Koenigsegg Group, announced to the media that, in order to close this asset purchase, 3 billion SEK (\$413 million) in financing would be needed in addition to an anticipated loan of \$593 million to be made by the European Investment Bank and guaranteed by the government of Sweden. n45 The Koenigsegg Group had previously applied to the government for a loan to close the sale transaction, but that request was denied. Frederik Reinfeldt, the Swedish prime minister, said at that time that he was "not prepared to mortgage Sweden or act as a venture capitalist for the well-to-do." n46

8. Anticipated Closing of Saab Asset Sale

On September 9, 2009, the Koenigsegg Group announced that a slice of its equity would be sold to Beijing Automotive Industry Holding, an automobile manufacturer owned by the Peoples Republic of China, in order to raise equity for the purchase of Saab from General Motors. At that time, a General Motors spokesman stated that the closing of the Saab sale was expected by the end of October, 2009. n47

III. Conclusion

Whether viewed up close or at a distance, the Saab reorganization proceedings under Sweden's Reorganization of Business Act were successful and were accomplished without stretching and bending that statute in order to achieve a socially desirable result. As noted above, Saab filed its application for reorganization in February, 2009, continued to operate smoothly with post-filing funding provided by its parent, General Motors. In June, 2009, a mere four months after the proceedings commenced, General Motors and Koenigsegg Group signed a memorandum of understanding for the sale of Saab's assets. The administrator, Guy Lofalk, with Saab's concurrence, proposed a reorganization plan in April 6, 2009, which was thereafter accepted by creditors, and on August 19, 2009, the district court terminated these proceedings upon the administrator's request. All that remains to be done is for the Koenigsegg Group to close this sale and acquire the Saab assets. Existing Swedish law provided the framework for the prompt reorganization of Saab. Throughout the course of these proceedings, there was little drama and no significant twists and turns of fortune, so unlike a thriller by Stieg Larsson or Henning Mankell.

The Chapter 11 cases of Chrysler LLC and General Motors, commenced only months apart in the United States Bankruptcy Court for the Southern District of New York n48, provide both a point and counterpoint to the Saab proceedings. These cases resulted in the prompt reorganization of these two American auto assemblers. The Chrysler reorganization was completed on June 1, 2009, with its acquisition by Fiat, and the General Motors bootstrap restructuring was finished on July 5, 2009. However, in order to accomplish these restructurings in the form desired by the debtors and the United States Government, the two bankruptcy judges assigned to these cases were required to stretch and perhaps violate the existing law governing distributions in Chapter 11 cases. In distributing equity in these reorganized auto companies to groups of creditors, the courts allowed certain of these groups, in particular, the union employees, to receive a larger share of this equity than they would otherwise be entitled to receive to the prejudice of the unsecured bondholders of each debtor. n49 This questionable result was achieved under public pressure by the Obama Administration to reorganize the debtors in this fashion.

At the other end of the reorganization spectrum lies the case of Adam Opel, GmbH, the German subsidiary of General Motors and its British sister company, Vauxhall Motors, Ltd. Opel and Vauxhall are in the process of being restructured by means of a sale of 55% of their stock to a consortium consisting of Magna International, Inc. and Sperbank Rossii OAO. Under the agreement arrived at by GM, this joint venture and the European automobile workers' unions, General Motors will retain 35% of its equity interest in Opel/Vauxhall and the employees will receive the remaining 10% upon the closing of this restructuring. n50 The distribution of equity to the unions is in return for their consent to projected reductions in the workforce and the anticipated closing of at least one Opel plant, probably the Antwerp plant. This sale will be accomplished by the payment by Magna/Sperbank of 500 billion Euros and 4.5 billion Euros in loan guaranties by the German government. n51 This sale, which was long in the making and has not yet closed, did not happen without incident, however. The governments of Spain and Belgium have protested to the European Commission over what they characterized as the disproportionate impact on the plants and workforce in their countries of the projected costs reductions in contrast to the relatively light reductions affecting Opel's German plants and workforce. n52 Spain and Belgium argue that Angela Merkel's promise of German state aid in the form of these loan guaranties violates European Union antitrust law. n53

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n12 Swedish Reorganization of Business Act at chapter 2, paragraph 3.

n13 Swedish Reorganization of Business Act at chapter 2, paragraph 10.

n14 Swedish Reorganization of Business Act at chapter 2, paragraph 13.

n15 Swedish Reorganization of Business Act at chapter 2, paragraph 6.

n16 Swedish Reorganization of Business Act at chapter 4, paragraph 8.

n17 Swedish Reorganization of Business Act at chapter 2, paragraph 17.

n18 Swedish Reorganization of Business Act at chapter 2, paragraph 15.

n19 Swedish Reorganization of Business Act at chapter 2, paragraph 20.

n20 "Restructuring and Insolvency 2009 Section for Sweden" by Odd Swarting, Setterwalls Advokatbyrå.

n21 Swedish Reorganization of Business Act at chapter 2, paragraph 16.

n22 Swedish Reorganization of Business Act at chapter 2, paragraph 12.

n23 Swedish Reorganization of Business Act at chapter 4, paragraph 7.

n24 Swedish Reorganization of Business Act at chapter 3, paragraph 4.

n25 Swedish Reorganization of Business Act at chapter 4, paragraph 7.

n26 The formal document of the application for reorganization for Saab Automobile AB.

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n29 The formal document of the request for extension of the time for the reorganization procedure and the district court of Vanersborg's decision.

n30 The formal document of the preliminary reorganization plan for Saab Automobile AB.

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19 of 197 DOCUMENTS

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Swartz on New Revenue Procedure 2009-37 & Cancellation Under I.R.C. Sec. 108(i)

2009 Emerging Issues 4761

Linda Z. Swartz on New Revenue Procedure 2009-37 and the Cancellation of Indebtedness Income Deferral Under I.R.C. Section 108(i)

By Linda Z. Swartz

December 28, 2009

SUMMARY: In 2009 Congress enacted I.R.C. Section 108(i), which permits a taxpayer to defer recognition of COD income when the taxpayer or a related person "reacquires" an "applicable debt instrument" in 2009 or 2010 pursuant to the American Recovery and Reinvestment Act. The IRS issued *Revenue Procedure 2009-37* (2009 TNT 157-4) to provide rules and procedures for making an election under new section 108(i).

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ARTICLE: Two temporary provisions were enacted recently in 2009 to provide relief from Cancellation of Indebtedness (COD) income recognition to certain taxpayers. First and foremost, Congress enacted *I.R.C. Section 108(i)*, which permits a taxpayer to defer recognition of COD income when the taxpayer or a related person "reacquires" an "applicable debt instrument" in 2009 or 2010 pursuant to the American Recovery and Reinvestment Act, effective February 17, 2009. n1 At the taxpayer's election, the COD income may be deferred until 2014 and then included ratably over a period of five years. n2 Once made, the election is irrevocable. n3 Generally, a taxpayer that elects to defer COD income through section 108(i) may not benefit from any other COD exclusions, including the title 11 and insolvency exclusions, with respect to the same debt instrument, or portion thereof, to which the election applies, for the tax year in which the election is made or any subsequent tax year. n4

Section 108(i) defines an applicable debt instrument as a debt instrument issued by a C corporation or by any other person in connection with the conduct of a trade or business by that person. n5 An applicable debt instrument is "reacquired" if the debtor, or a related person to the debtor, "acquires" the debt, which is defined to include an acquisition (i) for cash, (ii) in exchange for another debt instrument (including an exchange resulting from a modification of the debt instrument), (iii) in exchange for corporate stock or a partnership interest, and (iv) as a contribution to capital. A debt instrument is also treated as acquired if it is completely forgiven by the holder. n6

On August 18, 2009, the IRS issued *Revenue Procedure 2009-37* (2009 TNT 157-4) to provide rules and procedures for making an election under new section 108(i). As discussed below, *Revenue Procedure 2009-37* provides both additional guidance on theoretical questions the statute did not address and procedures for making the election. n7

More specifically, an election is generally made on an instrument-by-instrument basis, and a taxpayer may make a partial election for only a portion of COD income realized with respect to one or more instruments. n8 *Revenue Procedure 2009-37* confirms that a taxpayer that makes a partial section 108(i) election and defers only a portion of COD income realized with respect to a debt instrument may exclude from income the remaining portion of COD income under another applicable COD exclusion, such as the insolvency exception. n9 In addition, if a taxpayer elects to defer COD income under section 108(i), original issue discount (OID) deductions in respect of the debt instrument issued to reacquire an applicable debt instrument n10 will be deferred until the five-year period during which the taxpayer takes the COD income into account, and then be included ratably during that five-year period. n11

An election under section 108(i) to defer COD income is made by including with the taxpayer's income tax return for the tax year in which the debt instrument is acquired a statement that provides (i) the name and any applicable taxpayer identification numbers of the issuer(s) of the debt instrument; (ii) a general description of the debt instrument; (iii) a general description and the date of the reacquisition transaction(s) generating the COD income; (iv) the amount of COD income resulting from the reacquisition and the amount of COD income the taxpayer is electing to defer; (v) in the case of a partnership or S corporation, a list of partners or shareholders, respectively, that have a deferred amount, their identifying information, and each partner's or shareholder's deferred amount or share of the deferred amount; (vi) in cases in which a new debt instrument is issued or deemed issued in exchange for the debt instrument, the issuer's name, taxpayer identification number, a general description of the new debt instrument and whether the new debt instrument has OID, a schedule of the OID that the issuer expects to accrue each taxable year on the instrument and the amount of OID that the issuer expects to defer each taxable year; and (vii) any other information required by the IRS. n12 A taxpayer that makes a section 108(i) election must also provide an information statement with its income tax returns beginning with the taxable year following the taxable year in which the taxpayer makes the election. n13 Partnerships, S corporations, and certain foreign corporations making a section 108(i) election are subject to additional reporting requirements. n14

Any COD income deferred by a partnership must be allocated among (and subsequently recognized by) the partners holding partnership interests immediately before the debt is discharged in the same manner as those amounts would have been included in the partners' income under section 704 if the COD income were immediately recognized. n15 *Revenue Procedure 2009-37* provides that a partnership that makes a partial section 108(i) election may specify whether deferred or currently realized COD income is to be allocated to each partner. n16 Any decrease in the partner's share of partnership liabilities resulting from the debt discharge is only taken into account at that time to the extent it would not cause the partner to recognize gain under section 731; any excess amount subsequently taken into account by the partner at the same time, and to the extent remaining, in the same amount, as the deferred COD income is recognized. n17 Practitioners have voiced concern that the rules for allocated deferred COD income, particularly in a partnership situation, are somewhat ambiguous. For example, it remains unclear how section 108(i) applies to tiered partnerships, how partial transfers or redemptions of interest will be treated, and whether any amounts of deferred COD allocated to the partners in a partnership should be reflected in the partners' capital accounts. n18

Any COD income that is deferred under section 108(i) will be accelerated if the taxpayer (i) dies, (ii) liquidates or sells substantially all of its assets, or (iii) ceases to do business, or similar circumstances occur, to the taxable year in which the event occurs or in the case of a title 11 proceeding, the day before the petition is filed. n19 In the case of a pass-through entity, including a partnership, the COD income is also accelerated if there is a sale, exchange, or redemption of an interest in the pass-through entity by the person holding the ownership interest in the entity. n20

Congress also enacted an exception to the taxation of COD income arising from a taxpayer restructuring the debt on its principal residence or upon a foreclosure of its principal residence. n21 This exception excludes from COD income recognition "qualified principal residence indebtedness" discharged in calendar years 2007 through 2012 as a result of a decline in the value of the residence or the financial condition of the taxpayer. n22 "Qualified principal residence indebtedness" is up to \$2 million of acquisition indebtedness with respect to the taxpayer's principal residence. n23 Any excluded qualified principal residence indebtedness will reduce the taxpayer's basis in its principal residence, although not below zero. n24

[Return to Text](#)

n1 American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2009); *I.R.C. § 108(i)(1)*.

A related person is a person that would be related to the taxpayer under section 108(e)(4). *I.R.C. § 108(i)(5)(A)*.

n2 *I.R.C. § 108(i)(1)*; *I.R.C. § 108(i)(3)(A)*.

n3 *I.R.C. § 108(i)(5)(B)(ii)*.

n4 *I.R.C. § 108(i)(5)(C)*.

n5 *I.R.C. § 108(i)(3)(A)*. A debt instrument is defined to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of section 1275(a)(1). *I.R.C. § 108(i)(3)(B)*.

n6 *I.R.C. § 108(i)(4)(A)*, (B).

n7 *Rev. Proc. 2009-37, 2009-36 I.R.B. 309*.

n8 *I.R.C. § 108(i)(5)(B)(ii)*; *Rev. Proc. 2009-37, 2009-36 I.R.B. 309*.

n9 *Rev. Proc. 2009-37, 2009-36 I.R.B. 309*.

n10 If the proceeds of a debt instrument are used directly or indirectly by the issuer to reacquire an

applicable debt instrument of the issuer, the debt instrument will be treated as issued for the applicable debt instrument. If only a portion of the proceeds are used, the original issue discount (OID) deferral rule will only apply to that portion of the debt instrument. *I.R.C. § 108(i)(2)*.

n11 If the OID accruals during the five-year deferral period exceed the deferred COD income, the OID deductions are disallowed in the order the OID is accrued. *I.R.C. § 108(i)(2)*.

n12 *I.R.C. § 108(i)(5)(B)(i)(II); Rev. Proc. 2009-37, 2009-36 I.R.B. 309.*

n13 See *Rev. Proc. 2009-37, 2009-36 I.R.B. 309* (providing a description of, and the time and manner for reporting, the additional information).

n14 See *Rev. Proc. 2009-37, 2009-36 I.R.B. 309.*

n15 *I.R.C. § 108(i)(6)*.

n16 *Rev. Proc. 2009-37, 2009-36 I.R.B. 309.*

n17 *I.R.C. § 108(i)(6)*.

n18 See Jenks et al., Expert Commentary on the New COD Deferral Election, Collier on Bankruptcy Taxation, 2009 Supplement.

n19 *I.R.C. § 108(i)(5)(D)(i)*.

n20 *I.R.C. § 108(i)(5)(D)(ii)*.

n21 *I.R.C. § 108(a)(1)(E)*; H.R. Rep. No. 110-356, at 56 (2007).

n22 The exception does not apply to debt discharged on account of services performed for the lender or any other factor not directly related to the decline in the value of the residence or the financial condition of the taxpayer. *I.R.C. § 108(a)(1)(E)*, as amended by the Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142 (2007), and extended by the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008); *I.R.C. § 108(h)(3)*.

If a portion of a discharged loan is not qualified principal residence indebtedness, section 108(a)(1)(E) applies only to the extent that the amount discharged exceeds the non-qualifying portion of the loan (as determined immediately prior to the discharge). *I.R.C. § 108(h)(4)*.

n23 *I.R.C. § 108(h)(2)*. Acquisition indebtedness includes any debt incurred to acquire, construct or substantially improve the taxpayer's principal residence if the debt is secured by the residence, as well as any refinancing of that debt to the extent of the prior debt. *I.R.C. § 163(h)(3)(B)*.

Principal residence has the same meaning as when used in section 121. *I.R.C. § 163(h)(5)*.

n24 *I.R.C. § 108(h)(1)*.

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20 of 197 DOCUMENTS

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Lawniczak on Ogle v. Fidelity & Deposit Co.

2009 Emerging Issues 4744

James M. Lawniczak on *Ogle v. Fidelity & Deposit Co. of Maryland*, 586 F.3d 143 (2d Cir. 2009)

By James Lawniczak

December 21, 2009

SUMMARY: In this Emerging Issues Analysis, James Lawniczak considers the Second Circuit's holding that an unsecured creditor has a valid claim under a prepetition indemnity agreement for the expenditure of postpetition attorneys' fees related to the litigation of issues under the underlying contract. The decision is consistent with the SNTL decision of the Ninth Circuit and correctly applies the rationale of the Supreme Court *Travelers* case.

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ARTICLE: The Second Circuit Holds That a Creditor Has an Unsecured Prepetition Claim for Attorneys' Fees Incurred Postpetition to Enforce Rights Under an Indemnity Contract

In *Ogle v. Fidelity & Deposit Co. of Maryland*, 586 F.3d 143, 145 (2d Cir. 2009), the U.S. Court of Appeals for the Second Circuit considered an issue as to which "[c]ourts are closely divided." The court held that an unsecured creditor has a valid claim under a prepetition indemnity agreement for the expenditure of postpetition attorneys' fees related to the litigation of issues under the underlying contract.

The Facts

Fidelity & Deposit Company of Maryland ("Fidelity") provided surety bonds to various insurers of Agway, Inc., which ended up in chapter 11 bankruptcy proceedings. Agway had agreed to indemnify Fidelity for any attorneys' fees it incurred to enforce its rights against Agway. After Agway filed its chapter 11 petition, Fidelity incurred attorneys' fees of approximately \$884,000 enforcing its state law contractual indemnity rights against Agway. In its opinion, the court did not identify exactly what rights Fidelity had been enforcing or in which court it was acting.

Eventually, a liquidating trust was established to handle the liquidation of Agway's assets. D. Clark Ogle was appointed trustee, and he challenged Fidelity's claim for postpetition attorneys' fees. Ogle admitted that Fidelity would

be entitled to a claim for the fees under state law, but contended that the claim could not be allowed under federal bankruptcy law.

Review of the Applicable Statutory Provisions

The key statutory provision in the court's decision was 11 U.S.C. § 502, which deals with the allowance of claims against a debtor. Section 502(b) provides that, once an objection to a claim is filed, the court "shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition." There are then nine subsections of section 502(b), which list various types of claims against debtors that should not be allowed, *e.g.*, subsection (2), which disallows claims for "unmatured interest," or that should only be allowed in part.

The term "claim" is very broadly defined in *section 101(5)(A) of the Bankruptcy Code* as any "right to payment," including rights that are unliquidated, contingent, unmatured or disputed. A "contingent" claim is one where the obligations may become due on the happening of a future event that was within the contemplation of the parties when the original relationship was created. *Olin Corp. v. Riverwood Int'l Corp. (In re Manville Forest Prods. Corp.)*, 209 F.3d 125, 128-29 (2d Cir. 2000).

The other statutory provision that the court of appeals considered in its decision in the *Ogle* case was section 506(b). That section is part of the description of secured claims and provides that if an allowed secured claim is secured by collateral with a value greater than the amount of the secured claim, then the secured creditor is entitled to interest on its claim, as well as any reasonable fees, costs or charges provided for in the agreement or by state statute.

The Supreme Court Case of *Travelers Casualty & Surety Co. of America*

In *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443, 127 S. Ct. 1199, 167 L. Ed.2d 178, 57 C.B.C.2d 314 (2007), the Supreme Court considered an issue very similar to the issue in the *Ogle* case. In *Travelers*, the creditor who had issued a surety bond and who had an indemnity covering attorneys' fees incurred such fees in connection with bankruptcy issues in the bankruptcy proceeding -- negotiating and then litigating appropriate language in the debtor's plan and disclosure statement. The creditor sought an unsecured claim for those postpetition attorneys' fees, and the debtor objected. The Court of Appeals for the Ninth Circuit affirmed the disallowance of those postpetition fees on the basis that postpetition attorneys' fees are not appropriately awarded when the fees are incurred in connection with issues peculiar to bankruptcy law, as opposed to basic contract enforcement.

The Supreme Court reversed and allowed the claim. The Court first noted that bankruptcy courts should enforce contracts allocating attorneys' fees among the parties, "except where the Bankruptcy Code provides otherwise," citing to 4 *Collier on Bankruptcy*, 506.04[3][a] (15th ed. rev. 2006). 549 U.S. at 448-49, 127 S. Ct. at 1203-04. The Court then went on to consider whether the Bankruptcy Code disallowed the claim and concluded that it did not.

The *Travelers* Court relied heavily on the nine exceptions to allowable claims in *section 502(b) of the Bankruptcy Code*, noting that none of the last eight exceptions applied to eliminate or reduce claims for postpetition attorneys' fees, except section 502(b)(4), which applied only to attorneys for the debtor. 549 U.S. at 449-50, 127 S. Ct. at 1204. Thus, the claim could be disallowed only if it were encompassed in the broad language of the first exception of section 502(b)(1), which disallows claims that are unenforceable against the debtor "under any agreement . . . for a reason other than because such claim is contingent or unmatured." The Court noted that this subsection made the claim allowable to the extent it was a valid claim under applicable state law, which it indeed was. 549 U.S. at 450-51, 127 S. Ct. at 1204-05.

The *Travelers* Court refused to consider whether section 506(b) would prevent the allowance of the claim, because

the issue was not properly raised below. The Court also noted that it had only considered the issue whether there could be a categorical disallowance of claims for attorneys' fees for litigating bankruptcy issues, thus leaving open the issue of whether claims for litigating nonbankruptcy matters would or would not be allowable. 549 U.S. at 455-56, 127 S. Ct. at 1207-08.

Legal Analysis of the *Ogle* Court on the Issue of Whether the Creditor Had an Unsecured Claim for Postpetition Attorneys' Fees

The *Ogle* court's decision began where the Supreme Court's *Travelers* case ended, with the issue left open by the Supreme Court as to the allowance of postpetition attorneys' fees for litigating nonbankruptcy issues. The *Ogle* court's legal analysis paralleled that of the Supreme Court. Essentially, the *Ogle* court held that there was no specific provision in the Bankruptcy Code that disallowed claims for postpetition attorneys' fees, so that the claim was valid. 586 F.3d at 147-48.

The *Ogle* court then went on to consider the issue that the *Travelers* Court had not reached -- whether section 506(b) should be applied to disallow the claim. It is difficult to see how section 506(b) is applicable, for it describes circumstances where a secured creditor can add either interest or fees to its secured claim, and the claim in the case before the Second Circuit was an unsecured claim, not discussed in section 506(b). Indeed, the *Ogle* court noted that it was section 502(b)(2), disallowing claims for unmatured interest, that would disallow the first component of the two items discussed in section 506(b), but that there was no comparable provision to disallow an unsecured claim for fees. 586 F.3d at 148. Therefore, the claim for attorneys' fees that was valid under state law was not disallowed by the Bankruptcy Code.

Lastly, the court referred to a Bankruptcy Act of 1898 case in the Second Circuit, *United Merchants & Manufacturers, Inc. v. Equitable Life Assurance Society of the United States (In re United Merchants & Manufacturers, Inc.)*, 674 F.2d 134, 139 (2d Cir. 1982), which held that postpetition attorneys' fees under contractual loan agreements that are valid under state law are allowable claims in a bankruptcy proceeding. The *Ogle* court found nothing in the current Bankruptcy Code that would change the result reached by the *United Merchants court*. 586 F.3d at 149. Therefore, the court allowed the unsecured claim for postpetition attorneys' fees.

Legal Position Taken by Other Courts on the Issue of Allowance of Postpetition Attorneys' Fees for Litigating Nonbankruptcy Matters

As the *Ogle* court noted, its opinion was consistent with the decisions of the Court of Appeals for the Ninth Circuit in *SNTL Corp. v. Centre Ins. Co. (In re SNTL Corp.)*, 571 F.3d 826, 839-45 (9th Cir. 2009), decided after *Travelers*, and the Court of Appeals for the Sixth Circuit in *Martin v. Bank of Germantown (In re Martin)*, 761 F.2d 1163, 1168 (6th Cir. 1985), decided before *Travelers*. Following the *Travelers* decision, lower bankruptcy courts have split on the issue. Compare *Qmect, Inc. v. Burlingame Capital Partners II (In re Qmect, Inc.)*, 368 B.R. 882, 884-85 (Bankr. N.D. Cal. 2007) (unsecured creditor could include contract-based attorneys' fees as part of unsecured claim), with *In re Electric Machinery Enterprises, Inc.*, 371 B.R. 549, 551 (Bankr. M.D. Fla. 2007) (disallowing unsecured creditor's claim for postpetition attorneys' fees, noting the general rule that "the time for determining the amount of a claim is 'as it existed as of the time of the filing of the case'").

There were also cases before the *Travelers* case that held that postpetition attorneys' fees could not be part of an unsecured claim. See, e.g., *Adams v. Zimmerman*, 73 F.3d 1164, 1177 (1st Cir. 1996) (fees incurred prior to insolvency are allowable; those incurred thereafter are not). It is unclear whether those courts would change their opinion based on the reasoning of the *Travelers* case.

Although the Second Circuit *Ogle* decision (586 F.3d at 146) cited *Waterman v. Ditto (In re Waterman)*, 248 B.R. 567, 573 (B.A.P. 8th Cir. 2000), for the proposition that postpetition attorneys' fees are not allowable as part of a prepetition claim, the actual result in the *Wasserman* case was the allowance of claim for postpetition attorneys' fees

under section 506(b) because Ditto was an oversecured creditor. The *Wasserman* court did note that as a general rule, "a creditor's claim is determined as of the date of the filing of the bankruptcy petition," and that "amounts incurred post-petition are not usually permitted as part of the claim," but this *dictum* describing a very general rule should not be taken as an indicator of the position that the *Wasserman* court might have taken on the issue before the Second Circuit in *Ogle*.

Conclusion

The decision of the Second Circuit Court of Appeals in *Ogle*, consistent with the decision of the Ninth Circuit in *SNTL Corp.*, applies the rationale of the Supreme Court *Travelers* case to allow unsecured claims for postpetition attorneys' fees for litigating issues under the indemnity contracts themselves. This is the correct result, properly interpreting the various sections of the Bankruptcy Code.

RELATED LINKS: For discussion of Code section 502(b), see Collier on Bankruptcy, ¶ P 502.03.

For discussion of Code section 506(b), see Collier on Bankruptcy, ¶ P 506.04.

For analysis of other decisions relating to creditors and claims, click [here](#).

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21 of 197 DOCUMENTS

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Bachman, Barnett, Loveland, Manzer & Shuster on Recent Treatment of "Stub Rent"

2009 Emerging Issues 4742

Katharine E. Bachman, Keith R. Barnett, Benjamin W. Loveland, Nancy L. Manzer, and George W. Shuster, Jr. on the Treatment of "Stub Rent" in the Goody's and Stone Barn Retail Apparel Bankruptcies

By Katherine E. Bachman, Keith R. Barnett, Benjamin W. Loveland, Nancy L. Manzer & George W. Shuster and Jr.

December 20, 2009

SUMMARY: Two recent decisions in retail apparel bankruptcy cases, in Delaware and New York, highlight the ongoing uncertainty regarding "stub rent". While the ultimate financial outcomes for the landlords in the two cases are similar, the different approaches taken by the courts leave open questions regarding when and to what extent those claims will be paid.

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ARTICLE: The two cases-*Goody's* n1 and *Stone Barn/Steve & Barry's* n2-involved nearly identical facts, yet the courts adopted different approaches for the mechanisms available for landlords to collect "stub rent" from tenants in bankruptcy.

When "Stub Rent" Claims Arise

A landlord's claim against a bankrupt tenant for "stub rent" arises when the lease calls for payment of rent in advance, *i.e.* the first of the month. If the tenant files its bankruptcy case later in the month without having paid that month's rent, the bankruptcy filing can be said to divide the monthly rent into two portions-first, the portion allocable to the days of the month before the bankruptcy filing, and second, the portion allocable to the days of the month remaining after the bankruptcy filing. The term "stub rent" refers to the amount of rent due under the lease for the second, or stub, period. When a tenant files for bankruptcy, landlords may assert a claim under *Section 365(d)(3) of the Bankruptcy Code* n3 for immediate payment of the "stub rent".

Two Approaches to Addressing "Stub Rent" Claims Under Section 365(d)(3)

The decisions in *Goody's* and *Stone Barn* illustrate the two main approaches courts have adopted for dealing with "stub rent" under Section 365(d)(3): n4

"Billing Date" Approach. The "billing date" approach, often preferred by tenants, n5 focuses on when the rent is

due, usually prior to the petition date. Under the "billing date" approach, if the rent is due on the first of the month and the tenant files bankruptcy later in the month, none of the rent is considered a post-petition obligation subject to payment under Section 365(d)(3). Thus, under the "billing date" approach, there is no Section 365(d)(3) claim for "stub rent." n6

"Proration" Approach. The "proration" approach, often preferred by landlords, provides that the obligation to pay the month's rent should be allocated on a per diem basis to each day within the month, such that a bankruptcy filing on the fifteenth day of the month would create a "stub rent" claim for the second half of the month. Under the "proration" approach, there is a Section 365(d)(3) claim for immediate payment of rent allocable to the stub period.

"Back-up" Claims for "Stub Rent" under Section 503(b)(1)

When a court applies the "billing date" approach for purposes of Section 365(d)(3), the decision in *Goody's* instructs that landlords may nevertheless be entitled to payment of rent for the stub period under Section 503(b)(1). Section 503(b)(1) provides an administrative expense claim for "the actual, necessary costs and expenses of preserving the estate." n7 Administrative expenses ordinarily must be paid in a successful Chapter 11 bankruptcy case, but are generally not required to be paid until a Chapter 11 plan is confirmed and effective; by contrast, Section 365(d)(3) expressly requires "stub rent" to be paid on a "timely" basis, which is usually interpreted to mean immediately as it becomes due. As such, a Section 503(b)(1) claim may serve as a "back-up" for a landlord in the event that a Section 365(d)(3) claim is denied, although Section 503(b)(1) may pose additional hurdles to a landlord (discussed further below) and will result in later and perhaps more uncertain payment if a Chapter 11 plan of reorganization is delayed or at risk of failure.

The Recent Decisions in *Goody's* and *Stone Barn*

The pertinent facts in *Goody's* and *Stone Barn* are nearly identical. The tenants in each case, apparel retailers, filed voluntary Chapter 11 petitions on the ninth day of the applicable months. At the time of filing, none of the debtors had paid the rent due on the first of the month under their retail location leases, yet they continued to occupy the leased space to conduct retail sales.

In re Goody's Family Clothing, Inc.

The March 31, 2009 decision in *Goody's* by the United States District Court for the District of Delaware resulted from an appeal of a decision from the Delaware Bankruptcy Court. The Bankruptcy Court, relying on precedent from the United States Court of Appeals for the Third Circuit in the *Montgomery Ward* n8 case, summarily disposed of the landlords' argument for adoption of the "proration" approach. Instead, the Delaware Bankruptcy Court held that the plain meaning of Section 365(d)(3) commanded use of the "billing date" approach for "stub rent." The court interpreted the term "obligations" as used in Section 365(d)(3) to mean "something that one is legally required to perform under the terms of the lease." n9 The court went on to conclude that an obligation only arises when a party becomes legally obligated to perform it. Because the debtors' obligations to pay rent under the leases were due on the first of the month (about a week before the petition date), they could not be said to have arisen "after the order for relief" and, therefore, the landlords were not entitled to payment of "stub rent" under Section 365(d)(3).

The Delaware Bankruptcy Court rejected, however, the debtors' argument that Section 365(d)(3) renders Section 503(b)(1) inapplicable, holding that (1) the debtors' occupancy of the premises alone was sufficient to establish that payment for such occupancy was an actual and necessary expense of preserving the debtors' estates, and (2) absent evidence to the contrary, the fair market value of occupying the premises was the lease rate. The court did not, however, order immediate payment of the administrative expense claim, a ruling emphasizing that a Section 503(b)(1) claim may be only a second-best result for landlords.

The debtors appealed the Bankruptcy Court's holding that Section 503(b)(1) was available to landlords seeking "stub rent" after the enactment of Section 365(d)(3), as well as the Bankruptcy Court's holding that the debtors' mere

presence in the property was sufficient to satisfy the landlords' burden under Section 503(b)(1). n10 The landlords did not cross-appeal.

Because the parties to the appeal did not dispute the Delaware Bankruptcy Court's application of the "billing date" approach, the Delaware District Court declined to revisit the lower court's ruling on that issue. The Delaware District Court went to substantial lengths, however, to explain that if it had reached the issue, it might have read *Montgomery Ward* more narrowly than did the Delaware Bankruptcy Court. The District Court, in an extended footnote, explained its basis for why a Section 365(d)(3) "proration" approach might apply to "stub rent" notwithstanding the Third Circuit Court of Appeals precedent adopting the "billing date" approach for tax claims. Given that the purpose of Section 365(d)(3) was to free landlords from having to comply with the administrative expense procedure, the District Court found it "a perverse result that debtor-tenants could use § 365(d)(3) offensively to avoid timely rent payments." n11 Moreover, the District Court found problematic the idea that the impact of Section 365(d)(3) would depend on a landlord's lease-drafting choices, *i.e.* under the "billing date" approach, a lease requiring that rent be due in full on the first day of the month deprives Section 365(d)(3) of any practical effect, whereas a lease requiring that rent be due each day would presumably lead to payment for the stub period under Section 365(d)(3).

The Delaware District Court proposed three ways of reconciling the Third Circuit's apparent rejection of the "proration" approach for tax claims in *Montgomery Ward* with the legislative intent for rent claims underlying Section 365(d)(3). First, the District Court noted that rent could be viewed as an obligation that "arises" in full each day of a tenant's occupancy. The result would be that a tenant who files for bankruptcy after the first of the month still owes rent for the full month (not a prorated portion) under Section 365(d)(3). However, the District Court did not explain how this would provide a basis for distinguishing the treatment of rent claims from the treatment of tax claims. Second, the District Court reasoned that if a lease provides a grace period for payment that expires post-petition, it could be argued that the payment obligation has arisen post-petition under Section 365(d)(3). Of course, this might only shift the timing of a debtor's bankruptcy filing to several days later in the month, after any applicable grace period expires, rather than result in a dramatic change in treatment of "stub rent." n12 Third, if a lease provides for a default penalty that accrues during the post-petition/pre-rejection period, "one might interpret the lease as creating a new obligation to which § 365(d)(3) would apply, namely, payment of the complete delinquent rent plus the penalty." n13

After a lengthy analysis, the Delaware District Court affirmed the Bankruptcy Court's conclusion that Section 365(d)(3) does not render Section 503(b)(1) inapplicable, holding that "[n]othing within the text of § 365, the legislative history, or other canons of interpretation, bars the collection of post-petition rent through the administrative expense procedure of § 503(b)(1)." n14 Applying Section 503(b)(1), the Delaware District Court held that the debtors' use of the premises to conduct normal business and rental of the premises to a liquidator to conduct profitable store closing sales was sufficient to establish the necessity of the debtors' use of the premises. The court noted that although there was no ambiguity in this case as to whether the debtors genuinely occupied and used the premises, "[h]ad the [debtors] vacated, or merely left idle the premises—a 'lights out' lease-[the landlords] would be faced with a more difficult claim." n15

In re Stone Barn Manhattan LLC

The court in *Stone Barn* did not require the landlords to follow as circuitous a path as the *Goody's* court to pursue "stub rent". The United States Bankruptcy Court for the Southern District of New York concluded that holding the debtor immediately responsible for "stub rent", measured on a daily basis as it accrued after the date of the order for relief until the end of that month, was the proper construction of Section 365(d)(3). The court reasoned that the "proration" approach is faithful to the purpose of Section 365(d)(3) because it "afford[s] landlords an enhanced right to timely performance under a commercial lease during [the post-petition, pre-rejection period]" and is faithful to the "purpose of the bankruptcy laws as a whole." n16

The court noted that although a number of bankruptcy courts have eschewed the "proration" method, "very few of these courts have been willing to draw the obvious conclusion that rent for the first month is a pre-petition claim only, based on the "billing date" approach, and that the debtor has the right to use the leased property during the stub period

without further liability." n17 Instead, these courts fill the gap by allowing landlords an administrative claim for rent under Section 503(b). Indeed, that was the result in *Goody's*. Thus, the New York Bankruptcy Court implied that the "proration" approach under Section 365(d)(3) is a more straightforward mechanism of reaching a result that would likely be the same under Section 503(b)(1).

The court emphasized that Congress intended Section 365(d)(3) to nullify the requirement that a creditor prove benefit to the estate before it can obtain administrative expense status for a post-petition rent claim. Under the "billing date" approach, the landlords would have to prove, in order to prevail on a Section 503(b)(1) claim, that a debtor's use and occupancy was necessary and beneficial to the estate during the stub period. Therefore, the court reasoned that the "billing date" approach contradicts the plain purpose of Section 365(d)(3)-to give landlords an irrefutable right to rent at the contract rate during the bankruptcy. Still, the New York Bankruptcy Court noted that this is an issue on which different courts have come to different conclusions, and that its decision therefore may be an appropriate candidate for appeal to higher courts in the Second Circuit.

The Bottom Line

The contrast of *Goody's* and *Stone Barn* demonstrates the different approaches that courts may take to the stub rent issue under Section 365(d)(3). However, these different approaches are not polar opposites. Rather, the Delaware District Court's decision indicates a possible movement in the Third Circuit, which is a traditionally "billing date" jurisdiction, toward the "proration" approach used in New York. Moreover, the Delaware District Court's relatively brief treatment of the "actual" and "necessary" elements of the landlords' Section 503(b)(1) claims makes the Section 503(b)(1) process in Delaware appear very similar to the Section 365(d)(3) process in New York. Even assuming the Third Circuit retains the "billing date" approach for "stub rent," the primary disadvantage of that approach for landlords may be the timing and certainty of payment in a case where a Chapter 11 plan or reorganization is delayed or at risk of administrative insolvency.

[Return to Text](#)

n1 The U.S. District Court for the District of Delaware, in *In re Goody's Family Clothing, Inc.*, No. 08-585 (D. Del. March 31, 2009), recently affirmed, in a lengthy opinion, the Bankruptcy Court's ruling in that case, 392 B.R. 604 (*Bankr. D. Del. 2008*).

n2 *In re Stone Barn Manhattan LLC*, 398 B.R. 359 (*Bankr. S.D.N.Y. 2008*). "Stone Barn" is often referred to by the trade name "Steve & Barry's."

n3 11 U.S.C. § 365(d)(3). Section 365(d)(3) provides, in relevant part, that "the trustee shall timely perform all obligations of the debtor...arising from and after the order for relief under any expired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title." 11 U.S.C. § 365(d)(3).

n4 Courts have disagreed on which approach to adopt with respect to the treatment of a debtor's post-petition lease obligations under Section 365(d)(3). Compare *In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998), *In re Furr's Supermarkets, Inc.*, 283 B.R. 60 (B.A.P. 10th Cir. 2002), and *In re All For a Dollar, Inc.*, 174 B.R. 358 (Bankr. D. Mass. 1994) (applying "proration" approach), with *Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986 (6th Cir. 2000), and *HA-LO Industries v. CenterPoint Properties Trust*, 342 F.3d 794 (7th Cir. 2003) (applying "billing date" approach).

n5 There are instances where a landlord may benefit from the billing date approach, for example, in the context of annual taxes that become due in arrears under a lease following the bankruptcy filing date. *See infra* note 8.

n6 The "billing date" approach is alternatively labeled the "performance" approach.

n7 11 U.S.C. § 503(b)(1).

n8 *In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001). The Third Circuit in *Montgomery Ward* held that where a lease obligates a debtor to pay a tax bill upon receipt and the bill is received post-petition for taxes allocable to both pre-petition and post-petition periods, the entirety of the tax payment must be made in a timely manner under Section 365(d)(3). Significantly, as described below, in footnote 8 of its *Goody's* decision the Delaware District Court indicated that *Montgomery Ward's* ruling on tax claims may not be binding precedent with respect to "stub rent" claims, reviving the possibility of a "proration" approach to "stub rent" claims in Delaware and elsewhere in the Third Circuit.

n9 *In re Goody's Family Clothing, Inc.*, 392 B.R. 604, 609 (Bankr. D. Del. 2008).

n10 The debtors appealed multiple Bankruptcy Court orders granting landlords administrative claims for "stub rent". While some of the appeals were consolidated and dealt with by the Delaware District Court's opinion, others remain pending. In addition, the debtors have indicated in filings with the Bankruptcy Court their intention to appeal future orders granting landlords' administrative claims under Section 503(b)(1). The legal issues raised in the pending and possible future appeals will likely be disposed of, under the doctrine of collateral estoppel, by reference to the District Court's recent decision. The factual issues of whether the debtors' occupancy was necessary to the preservation of the estate, however, may need to be decided on a case-by-case basis. The need for such fact specific inquiry under Section 503(b)(1) highlights the consequence to landlords of the court's declining to adopt the "proration" approach.

n11 *Goody's*, No. 08-585, slip. op. at 12 n.8.

n12 Nevertheless, a landlord may be able to take other actions to structure lease obligations in a way that mitigates the effect of the "billing date" approach. For example, a landlord could require monthly payment in advance toward annual taxes due at year end.

n13 *Id.* (emphasis in original).

n14 *Id.* at 25.

n15 *Id.* at 33. Not only must a landlord satisfy the burdens of proof imposed by Section 503(b)(1), but a landlord asserting a Section 503(b)(1) administrative claim may be denied the benefit of its lease bargain if prevailing rental rates change so that the fair market rental value of the premises drops below the originally bargained-for rent-not an uncommon occurrence in a declining real estate market. *In re Ames Dept. Stores, Inc.*, 306 B.R. 43, 68 (Bankr. S.D.N.Y. 2004). Although not as common, the converse is also possible where a landlord can establish that the fair market rental value of the premises is greater than the lease rate. *See In re Xonics, Inc.*, 65 B.R. 69, 74 (Bankr. N.D. Ill. 1986). While the Delaware District Court in the *Goody's* case did not press the landlords to prove the "actual" and "necessary" elements of their Section 503(b)(1) claims (indeed, the District Court declined to remand to the Bankruptcy Court for further consideration of those elements), relying on the debtors' use of the leased premises as prima facie evidence of those elements, other courts or other facts may require further proof of those elements.

n16 *Stone Barn*, 398 B.R. at 365-66.

n17 *Id.* at 366.

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22 of 197 DOCUMENTS

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Terminal Valuation: 7th Cir. on Valuation of United Airlines Bond Collateral

2009 Emerging Issues 4743

Philip D. Anker, Craig Goldblatt, George W. Shuster, Jr. and John D. Sigel on Terminal Valuation: Will the Seventh Circuit Decision on Valuation of United Airlines Bond Collateral Bring Closure to Recharacterization Litigation?

By Philip D. Anker, Craig Goldblatt, George W. Shuster Jr. and John D. Sigel

December 20, 2009

SUMMARY: The Seventh Circuit's decision to reverse a ruling on valuation made by the Northern District of Illinois District Court regarding collateral for United Airlines bonds is an interesting one in its own right, for its approach to valuing collateral in bankruptcy. It is also an important development in nearly a decade of municipal conduit finance recharacterization litigation in the United Airlines, Delta, and Northwest bankruptcy cases.

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ARTICLE: In its recent *United Airlines* decision, the Seventh Circuit held that the District Court had undervalued the collateral for bonds issued by the Los Angeles airport authority to finance improvements at facilities leased by United Airlines in Los Angeles International Airport (LAX) terminals. The Seventh Circuit increased the collateral value for the \$60 million in bond claims from \$35 million to over \$60 million, dramatically increasing the recovery on the bonds. The Seventh Circuit found that the District Court had improperly tied its valuation methodology to the value of unimproved airport terminal space under constrained market conditions, rather than improved space like that comprising the bond collateral on an open market. In addition, the Seventh Circuit criticized the District Court's selection of a discount rate for the collateral value-the District Court had averaged the discount rates proposed by United Airlines and the representatives for the bonds, rather than choosing the legally correct discount rate.

Background Financing

The United Airlines litigation is grounded in the structure of the bond financing at issue. The bonds were issued not by United Airlines, as would be the case for ordinary corporate bonds, but rather by the Regional Airports Improvement Corporation (RAIC), a governmental entity created for the purpose of issuing such bonds and using the proceeds to finance airport improvements. However, United Airlines was the sole source of payment on the bonds, through payments made by United Airlines to RAIC under a lease for the LAX terminals, between United Airlines as lessee and the City of Los Angeles as lessor (who assigned its right to payment as lessor to RAIC). The reason for this "conduit finance" structure was to qualify the interest on the bonds for tax exemption as municipal bond interest.

Recharacterization Litigation

When United Airlines (and other airlines) filed bankruptcy cases, they challenged the status of the terminal leases providing the revenue stream for the bonds. The airlines argued that the leases were not "true leases" for the terminal space, subject to assumption or rejection in bankruptcy, but rather components of a financing transaction for terminal improvements. As a corollary, the airlines took the position that the terminal improvements were owned by the airlines, rather than owned by the airport authorities and leased to the airlines. The airlines argued-successfully in the case of United Airlines at LAX-that the bond claims were not lease claims but rather should be "recharacterized" as loan claims. n1 If the United Airlines bond claims were loan claims, RAIC would not own the lease improvements but would, at best, be able to argue that the loan claims should be secured loan claims and that the court should impose a retroactive lien to make the lease improvements collateral for the bond claims.

A key premise of United Airlines' recharacterization strategy was its need to maintain operations at the LAX terminals for business reasons. Had United Airlines been willing to vacate the leased terminals, it could have sought to treat the terminal leases as "true leases" and reject those leases under *Section 365 of the Bankruptcy Code*-leaving the bondholders with a general unsecured claim for rejection damages. But, since United Airlines needed to maintain the leased terminal space, "true lease" treatment would have required assumption of the leases and payment of the bonds in full under Section 365. Recharacterization was a potential means for United Airlines "to have its cake and eat it too" by remaining in the premises and reducing the amount payable on the bonds.

After the recharacterization was upheld by a separate decision of the Seventh Circuit, n2 the case was remanded to the Bankruptcy Court to determine the scope of the collateral for the deemed "secured loan" and to value that collateral. Each of these issues was both controversial and crucial to the bondholders' recovery. If the collateral were broadly defined and valued highly enough, the bonds would be fully secured and eventually paid in full. If the collateral were narrowly defined or valued low enough, the bonds would be undersecured and paid only a portion of their face amount.

The scope of the collateral was in dispute because no collateral was ever expressly granted to secure the loans, given that the claims were not structured as secured loans (or as loans at all)-they were simply "recharacterized." Thus, the court, in imposing a lien after the fact, was required to approximate what might have been the collateral had the lease structure been a loan structure-that is, what a lender might have required for collateral if the transaction had been initially structured as a secured financing. This approximation was not an easy task because while United Airlines was a tenant of LAX with respect to a large area of improved terminal space, only certain terminal improvements were financed with the proceeds of the bonds.

The Bankruptcy Court defined the scope of the collateral to include a portion of the United Airlines terminal space at LAX and valued the collateral at only \$33 million, meaning that the remaining \$27 million of the bond claims were unsecured. n3 Because United Airlines' right to the collateral was that of a tenant, the Bankruptcy Court valued the collateral by judging the cost of a replacement rental (\$17 per square foot) and applying a discount rate to the term for which the collateral would be rented (11.64%). The District Court affirmed the Bankruptcy Court's decision. n4 The determination of the scope of the collateral was not appealed to the Seventh Circuit-only the determination of the rental rate and discount rate remained in dispute. n5

The Seventh Circuit focused first on the rental rate. The bond representatives argued that a rate of \$17 per square foot was not the correct basis for the bond collateral valuation because the \$17 rental rate did not reflect the fair market value of improved terminal space at the airport. The bondholders' collateral, however, included the improvements that United Airlines had made to the terminal space, which would necessarily increase the rental rate. Moreover, the \$17 per square foot rate was the product of constrained market conditions. While the Seventh Circuit did not adopt a specific higher rate, it explained that the \$17 rental rate was far too low and stated that the rate should be at least \$30-a rate that would make the bond claims fully secured even at the discount rate selected by the lower courts. The Seventh Circuit also criticized the District Court's analysis in selecting a discount rate. The District Court selected a rate that simply split the difference between the competing experts, rather than seeking to determine the correct discount rate. The Seventh

Circuit, in a more empirical analysis, determined the correct discount rate could not exceed 8% (the airport's actual cost of unsecured borrowing)-meaning even a rental rate of \$23 per square foot would make the bond claims fully secured. Overall, the Seventh Circuit increased the value of the collateral by more than 100% as compared to the lower courts.

The Bottom Line

The Seventh Circuit decision in *United Airlines* is only the most recent event in a long saga of airline conduit finance recharacterization litigation. In a sense, it brings the initial litigation issues full-circle by ordering payment in full of the bond claims at issue in that case, a result that may have also occurred had the recharacterization litigation never been commenced. However, because of the years of recharacterization litigation leading up to the recent Seventh Circuit decision and the complicated facts that were components of each court decision along the way, the Seventh Circuit decision does not resolve all aspects of recharacterization. Instead, the Seventh Circuit's reliance on specific facts in determining the components of valuation-the rental rate and discount rate-emphasizes the importance of rigorous valuation analysis in bankruptcy litigation of this type.

[Return to Text](#)

n1 The results in the various recharacterization cases were not always the same as between different airlines or even as between different airports in which a single airline operated. The results varied on the basis, among others, of the details of the conduit finance structure and documentation.

n2 *United Airlines, Inc. v. U.S. Bank National Association, Inc., City of Los Angeles*, 447 F.3d 504 (7th Cir. 2006). This decision reversed a District Court decision to the contrary (finding no recharacterization), which in turn reversed a Bankruptcy Court decision (finding recharacterization).

n3 *United Airlines, Inc. v. UMB Bank, N.A.*, 374 B.R. 625 (Bankr. N.D. Ill., August 24, 2007).

n4 *UMB Bank, N.A. v. United Air Lines, Inc.*, 2008 U.S. Dist. LEXIS 46553 (N.D. Ill. June 13, 2008).

n5 Under different circumstances, the scope of the collateral might have been determined to be narrower (e.g., only the lease improvements themselves, such as fixtures, and not the leased space) or broader (e.g., all of the leased terminal space and improvements occupied by United Airlines at LAX).

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23 of 197 DOCUMENTS

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Jurs on Smith v. Pritchett (In re Smith)

2009 Emerging Issues 4734

S. Andrew Jurs on Smith v. Pritchett (In re Smith), 2009 U.S. App. LEXIS 24439 (1st Cir. Nov. 6, 2009)

By S. Andrew Jurs

December 17, 2009

SUMMARY: This Emerging Issues Analysis looks at the First Circuit's ruling that a late-payment penalty provided for in a separation agreement was not a "domestic support obligation" as that term is defined in the Bankruptcy Code. Although fact specific, the decision does provide some of the first circuit-court guidance as to what factors might cause a claim to qualify as a domestic support obligation and thus be nondischargeable.

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ARTICLE: The First Circuit Determined That a Late-Payment Penalty Was Not a Domestic Support Obligation and Thus Was Dischargeable in Bankruptcy

In *Smith v. Pritchett (In re Smith)*, 2009 U.S. App. LEXIS 24439 (1st Cir. Nov. 6, 2009), the Court of Appeals for the First Circuit considered whether a separation agreement that provided for a \$50 per day late payment fee was intended as support to the ex-wife, such that it would not be dischargeable in the debtor's bankruptcy, or instead was intended as a punitive measure to deter the debtor from late payment and as such would be dischargeable. According to the appeals court, the late fee only encouraged payment of alimony and was not itself alimony. Of particular importance was the fact that the fee was contingent on tardy payment and was a fixed charge unconnected to the amount of actual alimony owed to the ex-wife. Additionally, under the agreement, the debtor's alimony payments decreased every year, but the late payment fee never changed. Accordingly, the ex-wife's claim was a general unsecured claim not entitled to priority status and could be discharged under 11 U.S.C.S. §§ 523(a)(15), 1328(a)(2).

Facts and Procedural History

On April 20, 1986, Nelson J. Smith ("Smith" or "Debtor") and Rita M. Pritchett ("Pritchett") were married. Just over nine years later, without having had any children, the parties filed for divorce. On October 26, 1995, the state court approved a joint Separation Agreement ("Agreement") and, in its order approving the Agreement, further provided that the Agreement survived as an independent contract.

The Agreement stated that it resolved all issues between the parties and that the parties' respective financial circumstances had been taken into account. Additionally, the Agreement provided for alimony payments from Smith to Pritchett beginning at \$2,300 per month and decreasing to \$1,600 per month on a set schedule ending after approximately five years. If Pritchett remarried, the alimony payments would decrease to \$1,000 per month but still continue through the five-year period. The Agreement also included a provision requiring Smith to purchase and transfer to Pritchett a term life insurance policy on his life for the five-year term of the alimony payments to ensure that the alimony payments would survive Smith's death. The Agreement also stated that:

All alimony payments shall be due in funds available to the Wife on or before the first of each month, and shall be subject to a late payment penalty in the amount of \$50.00 for each day after the first of each month upon which they are received by or become available to the Wife.

The Agreement further provided that "payments made by the Husband . . . shall be deductible for the Husband and taxable to the Wife for income tax purposes."

With one unrelated exception, Smith was responsible for the parties' marital debts. Under the Agreement, Smith also agreed to pay Pritchett \$150 per month to maintain a health plan for her benefit. Finally, either party would be entitled to reasonable attorney's fees in the event of a breach of the Agreement.

Smith fell into arrears almost immediately, and, after several years of consistently late payments, Pritchett filed a Complaint for Contempt in the probate court seeking accrued late-payment penalties from Smith. The probate court found that although Smith was current on his alimony payments, and had only one remaining payment due, his payments had been constantly late. As a result, on September 16, 2005, the probate court entered judgment against Smith in the amount of \$75,010, which represented just the late-payment penalties that had accumulated since a 1998 modification (the "Judgment").

In 2006, Pritchett commenced an action in the New Hampshire Superior Court to enforce the Judgment and obtained an *ex parte* attachment of Smith's homestead in New Hampshire. On March 2, 2007, the New Hampshire court approved a stipulation by the parties for a judgment of \$75,010 plus applicable statutory interest and costs.

On October 5, 2007, Smith filed a voluntary petition under chapter 13 of the Bankruptcy Code. Smith's bankruptcy schedules listed Pritchett's claim to late-payment penalties in Schedule D, "Creditors Holding Secured Claims." Smith filed a proposed chapter 13 plan on October 11, 2007, disclosing his intent to file a motion to avoid Pritchett's lien pursuant to 11 U.S.C. § 522(f), on the grounds that it impaired his homestead exemption under N.H. Rev. Stat. Ann. § 480:1. On November 29, 2007, Pritchett filed a proof of claim in the amount of \$81,932.04. Pritchett also filed an objection to confirmation of Smith's proposed chapter 13 plan asserting that her claim was (1) secured and (2) that it was a domestic support obligation entitled to priority under 11 U.S.C. § 507(a)(1)(A). *See also* 11 U.S.C. § 1328(a)(2) (excepting domestic support obligations from discharge). On December 6, 2007, Smith filed an objection to Pritchett's proof of claim, and a motion to avoid Pritchett's lien.

The bankruptcy court conducted a non-evidentiary hearing on the motions and held that Pritchett's claim was a domestic support obligation and, accordingly, denied Smith's motion to avoid Pritchett's lien. Conceding it was a "close call," the bankruptcy court concluded that the \$50 fee "looks, smells, and feels too much like attorneys' fees collecting alimony and support payments, which have historically . . . been treated as in the same nature" as alimony. Smith appealed to the First Circuit Bankruptcy Appellate Panel, which reversed the bankruptcy court on both counts, holding that the obligation at issue was not in the nature of support; therefore, the lien on Smith's home was avoidable and the claim was a general unsecured claim not entitled to priority status. *See In re Smith*, 398 B.R. 715 (B.A.P. 1st Cir. 2008). Subsequent to the appellate panel's decision, a lien holder senior to Pritchett foreclosed on Smith's residence, rendering the lien avoidance issue moot.

Legal Analysis

In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act created a new group of preferred creditors: creditors with claims arising from domestic support obligations. Such creditors receive special treatment, such as priority over most other creditors, *see* 11 U.S.C. §§ 507(a)(1)(A), (B), and the domestic support obligation claims are also nondischargeable under chapters 7 and 13. *See* 11 U.S.C. §§ 727(b), 1328(a)(2). A new concept in bankruptcy, a "domestic support obligation" is defined in 11 U.S.C. § 101(14A) as

a debt that accrues before, on, or after the date of the order for relief in a case under this title, including interest that accrues on that debt as provided under applicable nonbankruptcy law [owed to] a former spouse [and that is] in the nature of alimony, maintenance, or support . . . without regard to whether such debt is expressly so designated.

Consequently, for an obligation to a former spouse to be considered a domestic support obligation, it must actually be in the nature of support. A party seeking to have a debt determined to be a domestic support obligation, and thus nondischargeable, bears the burden of proving that the obligation is in the nature of support. *In re Werthen*, 329 F.3d 269, 271-72 (1st Cir. 2003) (stating that moving party "bore the burden of showing that the debts were nondischargeable") (citing *Grogan v. Garner*, 498 U.S. 279, 287-88, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991)). The issue is one of federal bankruptcy law, and not state law. 329 F.3d 269, 272-73.

Commentary

The First Circuit's holding in *Smith v. Pritchett* is noteworthy in that it is one of the first circuit-court opinions to address the standards needed to determine which creditors will qualify for the preferred treatment given to domestic support obligation claims.

As an initial matter, the appeals court noted that the label applied to the obligation by the court or the parties is not necessarily controlling for Bankruptcy Code purposes. Instead, the principal issue is "whether the divorce court judge 'intended' a particular award to be for support or for something else." 2009 U.S. App. LEXIS 24439, at *9 (quoting *Werthen*, 329 F.3d at 273). To discern the intent behind the obligation, "courts look to a range of factors, including the language used by the divorce court and whether the award seems designed to assuage need, as discerned from the structure of the award and the financial circumstances of the recipients." *Id.* There is not, however, a universally accepted multi-factor test to discern intent when determining whether an obligation is in the nature of support. *See In re Soforenko*, 203 B.R. 853, 859 (Bankr. D. Mass. 1997) (describing the multitude of multi-factor tests used in the First Circuit).

In *Smith v. Pritchett*, the First Circuit declined to adopt such a universal test, and instead agreed with the appellate panel that "[a]s in all fact intensive inquiries, the critical factors depend on the totality of circumstances of a particular case." *In re Smith*, 398 B.R. at 722. The First Circuit noted that, to determine the parties' intent, a trial court ordinarily may look beyond the separation agreement to discern the parties' relative financial circumstances at the time of the divorce. *See, e.g., Werthen*, 329 F.3d at 273-74. In *Smith v. Pritchett*, however, the parties did not dispute the bankruptcy court's finding that supplementing the record with additional information was unnecessary, because the issues relating to the parties' relative economic status were rendered moot by the fact that they had agreed to a court-approved fixed schedule of alimony payments.

The next step in the analysis, therefore, was to determine whether, given the language of the Agreement, the \$50 per day late-payment fee provision was intended as support to Pritchett or, alternatively, was intended as a punitive measure to deter Smith from paying late. Pritchett argued that the Agreement's language supported her position that the \$50 fee was intended to serve as alimony, maintenance, or support in that the fee provision was included in an Exhibit entitled "ALIMONY." The Agreement also did not distinguish between the alimony schedule and the \$50 late fee; thus, any payments made by Smith under the "ALIMONY" Exhibit were to be treated the same way alimony is normally treated for income tax purposes, *i.e.*, the payments were deductible as alimony to him and taxable to her.

For several reasons, the First Circuit rejected these arguments. As an initial point, the court noted that the labels

parties give to obligations are not controlling. 2009 U.S. App. LEXIS 24439, at *12; see also *Werthen*, 329 F.3d at 273 ("federal courts have been unwilling to treat the label applied by the divorce court as controlling for Bankruptcy Code purposes"). Accordingly, although the provision was located in the Agreement under a heading called "ALIMONY," the provision itself referred to it as a "late payment penalty." Furthermore, while the tax treatment of the provision constituted a factor favoring Pritchett, the appeals court was persuaded that, despite this treatment, the late fee was intended to encourage payment of alimony and was not itself alimony.

Of primary importance to the First Circuit was the fact that the fee was contingent on Smith's tardiness to pay. Because Pritchett had no expectation of this payment unless and until Smith was late, the only way this contingent payment could be considered alimony was if it was meant to compensate Pritchett for the time during which she was waiting for her alimony payment. This argument was unavailing, however, because the \$50 fee was a fixed charge that had no connection to the amount of actual alimony owed to Pritchett. Whether Smith was late by a single dollar or by the entire alimony payment, he would still owe Pritchett the same \$50.

Further evidence to the First Circuit that the parties did not intend the \$50 fee to be alimony was the fact that the Agreement called for Smith's monthly alimony payments to decrease every year, from \$2,300 to \$1,600, and to go as low as \$1,000 if Pritchett remarried. In contrast, the fee for a late payment was fixed throughout the term of the Agreement. "A \$ 50 per day fee completely disconnected from any amount that Smith owed Pritchett cannot have been expected to be directly related to her recouping those costs." 2009 U.S. App. LEXIS 24439, at *13-14. The appeals court hypothesized in *dictum*, however, that the scales might have tipped in Pritchett's direction if the parties had provided for an interest-based fee, contingent on the amount of alimony outstanding.

The substantial provisions for Pritchett's support outlined in the Agreement also weighed against any finding that the late-payment fee was intended to provide for Pritchett's support. In the First Circuit's opinion, the Agreement was relatively sophisticated, as could be seen in the fact that: (a) alimony continued even in the event of Pritchett's remarriage, (b) the Agreement provided for contributions toward her medical insurance premiums, and (c) the Agreement mandated that the support would outlive Smith's death. Additionally, attorney's fees incurred in enforcing the agreement, "a provision not always contemplated in such contracts," were clearly provided for in this instance. *Id.* at *14. Pritchett also received the only real estate owned by the parties that was not in foreclosure, and Smith was solely responsible for the parties' debts incurred prior to the divorce. According to the First Circuit, this sophistication meant that the obligation to pay a \$50 fee per day that Smith was late in alimony payments was not itself intended to assuage Pritchett's needs, and was thus not alimony. Accordingly, the appeals court concluded that Pritchett's claim was a general unsecured claim not entitled to priority status and that the claim could be discharged in Smith's bankruptcy pursuant to 11 U.S.C. §§ 523(a)(15), 1328(a)(2).

Conclusion

The decision in *Smith v. Pritchett* is significant because, although the court noted that each case is fact-dependent and that there is not a specific, multi-factor test, the decision provides some of the first circuit-court guidance as to what factors might cause a claim to qualify as a domestic support obligation such that it would receive preferential treatment, including priority of distribution and nondischargeability.

RELATED LINKS: For discussion of the definition of "domestic support obligation," see Collier on Bankruptcy, ¶ 101.14A.

For discussion of the discharge exception for domestic support obligations, see Collier on Bankruptcy, ¶ 523.11.

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24 of 197 DOCUMENTS

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Limits on Discharge of Claims by One Debtor Against Another

2009 Emerging Issues 4736

John D. Sigel and George W. Shuster, Jr. on Debtor Against Debtor: Limits on the Discharge of Claims by One Bankruptcy Estate Against Another

By John D. Sigel and George W. Shuster Jr.

December 17, 2009

SUMMARY: As corporate bankruptcy filings increase, one debtor corporation is more likely to find that it has claims against another unaffiliated debtor corporation. The US Bankruptcy Code is generally not drafted with this situation in mind, and questions may arise regarding the effect of one debtor's bankruptcy on another's.

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ARTICLE: Recently, the Southern District of New York Bankruptcy Court considered whether the avoidance actions pursued in the bankruptcy of OneStar under *Sections 547 and 549 of the Bankruptcy Code* n1 could be maintained against WorldCom, which had confirmed in its own bankruptcy a Chapter 11 Plan of Reorganization discharging all claims against it under *Section 1141 of the Bankruptcy Code*. n2 The Bankruptcy Court held that the OneStar avoidance actions could be pursued against WorldCom, notwithstanding WorldCom's discharge, because the discharge is binding only on WorldCom's creditors and their successors, not on the bankruptcy estate represented by OneStar's bankruptcy trustee. n3

One Bankruptcy After Another

WorldCom filed its Chapter 11 cases in July 2002. During its Chapter 11 cases, WorldCom received payments from OneStar for telecommunications services purchased from WorldCom by OneStar. In October 2003, WorldCom confirmed its Chapter 11 Plan of Reorganization, which contained an extensive provision discharging all claims against WorldCom. Before that Chapter 11 Plan became effective, OneStar filed its own Chapter 11 case in December 2003. The WorldCom Chapter 11 plan became effective in April 2004, and the OneStar Chapter 11 reorganization was converted to a Chapter 7 liquidation in January 2005. In August 2005, the OneStar Chapter 7 Trustee sued WorldCom to avoid and recover under Section 547 payments made to WorldCom from October through December 2003, the 90-day "preference period" preceding OneStar's bankruptcy filing. n4

Whether Avoidance Actions Are Claims

The Chapter 7 Trustee for OneStar first argued that WorldCom's discharge did not apply to the OneStar avoidance actions because those actions were not "claims" that were subject to the discharge. The Bankruptcy Court ruled against the OneStar Trustee on this issue. The Bankruptcy Court held that the avoidance actions were "claims" of the type that could be subject to the WorldCom discharge under its Chapter 11 Plan and *Section 1141 of the Bankruptcy Code* authorizing that discharge. The Bankruptcy Court reached this conclusion notwithstanding the fact that the payments to WorldCom were made-and indeed OneStar's bankruptcy giving rise to the avoidance actions was filed-only after WorldCom filed its bankruptcy filing and after its Chapter 11 Plan was confirmed. This ruling has significance beyond the "debtor against debtor" context, as it confirms the principle that a Chapter 11 Plan can discharge claims arising both before and after a bankruptcy filing, and, in some circumstances, claims arising up until the date a Chapter 11 Plan becomes effective.

Whether the OneStar Trustee is Bound by the Discharge

The Chapter 7 Trustee for OneStar next argued that WorldCom's discharge was not binding on the OneStar Trustee because the OneStar Trustee brought the avoidance actions on behalf of OneStar's bankruptcy estate and not as a successor to OneStar itself. The Bankruptcy Court ruled that the OneStar Trustee was the successor in interest to OneStar, and was bound by the WorldCom discharge in that capacity. But the Bankruptcy Court ruled that the OneStar Trustee also acted in a separate capacity-as representative of OneStar's bankruptcy estate and the creditors of OneStar with an interest in that estate. In this separate capacity the OneStar Trustee was not a successor in interest to OneStar and was not bound by the WorldCom discharge. Because the OneStar Trustee brought the avoidance actions in its capacity as representative of OneStar's bankruptcy estate and not in its capacity as successor to OneStar, the OneStar Trustee's pursuit of the avoidance actions was not barred by the WorldCom discharge. This result followed from the Bankruptcy Court's holding that the avoidance actions only arose upon the filing of OneStar's bankruptcy and that those actions became a part of OneStar's bankruptcy estate "at their inception." At no time did OneStar hold the avoidance actions in its own right, and therefore at no time could the OneStar Trustee be a successor to OneStar in pursuing those actions. n5

The Bottom Line

In the current economic climate, the otherwise rare instance of one bankruptcy estate asserting claims against another bankruptcy estate may become more common. The WorldCom-OneStar decision demonstrates how the status of a claimant as a representative of a bankruptcy estate may allow it to assert claims against another bankruptcy estate without regard to a discharge, and how being a representative of a bankruptcy estate may change the litigation battlefield. Bankruptcy discharge is a powerful weapon with a broad reach-but some claims of a bankruptcy trustee or debtor in possession may be outside its range.

[Return to Text](#)

n1 11 U.S.C. §§ 547 and 549.

n2 11 U.S.C. § 1141.

n3 *In re WorldCom, Inc.*, 401 B.R. 637 (Bankr. S.D.N.Y. 2009).

n4 The OneStar Chapter 7 Trustee also sought to avoid and recover under Section 549 a smaller amount paid to WorldCom after OneStar's bankruptcy filing.

n5 Although the actions were pursued by the OneStar Trustee after conversion of the OneStar bankruptcy to a Chapter 7 liquidation, based on the Bankruptcy Court's reasoning, the result may have been the same if OneStar had pursued the actions as debtor-in-possession during its Chapter 11 reorganization.

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25 of 197 DOCUMENTS

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Lawniczak on In re Smart World Technologies, LLC

2009 Emerging Issues 4738

James M. Lawniczak on Riker, Danzig, Scherer, Hyland & Perretti v. Official Committee of Unsecured Creditors (In re Smart World Technologies, LLC), 552 F.3d 228 (2d Cir. 2009)

By James M. Lawniczak

December 17, 2009

SUMMARY: In this Emerging Issues Analysis, James Lawniczak considers the Second Circuit's holding that an unsecured creditor has a valid claim under a prepetition indemnity agreement for the expenditure of postpetition attorneys' fees related to the litigation of issues under the underlying contract. The decision is consistent with the SNTL decision of the Ninth Circuit and correctly applies the rationale of the Supreme Court Travelers case.

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ARTICLE: The Second Circuit Holds That Whether a Method of Payment of a Professional Has Been Pre-Approved Depends on the Totality of the Circumstances and Does Not in All Cases Require a Specific Reference to Section 328

In *Riker, Danzig, Scherer, Hyland & Perretti v. Official Committee of Unsecured Creditors (In re Smart World Technologies, LLC)*, 552 F.3d 228 (2d Cir. 2009), the U.S. Court of Appeals for the Second Circuit considered what must happen before a professional retained in a bankruptcy case can rely on a bankruptcy court's pre-approval of the nature and measure of professional compensation. Noting that the question was one of "first impression" in the *Second Circuit*, 552 F.3d at 229, the court posed the question as follows: "How does a court determine whether a bankruptcy court has 'pre-approved' a debtor's retention of a professional pursuant to 11 U.S.C. § 328(a)?" *Id.* The court held that the "totality of the circumstances" must be considered to answer the question.

The Facts

A related group of "Smart World" entities filed chapter 11 petitions in 2000. The debtors' subscriber lists were the most valuable assets in the case, and those lists were sold to Juno Online Services, Inc. ("Juno") for an amount of compensation that varied depending upon the number of subscribers obtained. A dispute developed between debtors and Juno as to how much was owed under the asset purchase agreement. The law firm of Riker, Danzig, Scherer, Hyland &

Perretti, LLP ("Riker Firm") was retained as special counsel to pursue litigation against Juno.

The Riker Firm's proposed compensation—a contingency fee with a sliding compensation scale that varied depending upon both the amount recovered and the time taken to obtain recovery—was presented to the bankruptcy court as part of the application to approve the Riker Firm's retention. The application indicated that the Riker Firm was being retained pursuant to *sections 327 and 328 of the Bankruptcy Code (11 U.S.C. §§ 327, 328)*. The proposal was approved by the bankruptcy court, although the court order did not specifically refer to section 328, and the order indicated that all compensation would be fixed only after further application to the court in accordance with the original retention application and the proposal letter. Thereafter, the Riker Firm began its work.

After considerable time, Juno reached a settlement with Smart World's creditors to pay \$5.5 million, which was approved by the bankruptcy court over the debtors' objection. The Riker Firm took an appeal on behalf of Smart World, and the settlement was reversed by the Second Circuit, which held that it was inappropriate to approve it over the debtors' objection. *See Smart World Techs., LLC v. Juno Online Services, Inc. (In re Smart World Techs., LLC)*, 423 F.3d 166 (2d Cir. 2005). On remand, the creditors proposed a plan of reorganization that included a \$6.5 million settlement with Juno, which was approved.

Thereafter, the Riker Firm applied for a final fee award in accordance with the formula in the approved contingency fee agreement, in the amount of \$2,320,959.02, plus expenses. The bankruptcy court held that the original retention order was indeed a pre-approval of the contingency fee arrangement but went on to determine that four events, including the unusually prolonged litigation, had occurred that triggered the court's authority under section 328(a) to reduce the professional fee, because it had proved to be "improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions." As a result, the bankruptcy court ordered a fee award of only approximately \$1.2 million.

On appeal, the district court agreed that the contingency fee agreement was properly approved under section 328. However, the court disagreed with the bankruptcy court's position that developments had occurred that were incapable of being anticipated. Consequently, the district court awarded almost all of the fees requested, reducing them to approximately \$2.1 million. *Riker, Danzig, Scherer, Hyland & Perretti v. Official Committee of Unsecured Creditors (In re Smart World Techs., LLC)*, 383 B.R. 869 (S.D.N.Y. 2008). The debtors appealed, and the Riker Firm did not cross-appeal from the small percentage reduction in its fee award.

Review of the Applicable Statutory Provisions

Section 327(a) of the Bankruptcy Code authorizes a trustee, which includes the debtor in possession in a chapter 11 case, to retain, with bankruptcy court approval, professionals who will represent or assist the trustee in carrying out the trustee's duties under the Code. Sections 328 and 330 of the Code provide for the compensation of professionals retained under section 327(a). Section 328(a) allows the court to pre-approve the reasonable terms and conditions of the professionals' employment, on any reasonable basis, including "on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis." Section 328(a) goes on to provide that once a professional has been retained on specific enumerated terms and conditions under that section, the compensation finally awarded may only differ from the pre-approved method "if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions."

Where the terms and methods of professional compensation are not pre-approved in the retention order, then section 330(a)(1) of the Code governs. That section provides that the bankruptcy court awards reasonable compensation by reviewing what the professional did after the fact. Section 330(a)(3) lists six facts that a court should consider in awarding compensation under section 330. However, in general, courts use a "lodestar method" to award compensation under section 330(a), determining a reasonable number of hours spent on the matter and then multiplying that by a reasonable rate. *See, e.g., 3 Collier on Bankruptcy*, 330.04[3][c] (15th ed. rev. 2007).

The Two Methods of Retaining and Paying Professionals

In the *Smart World* case, the Second Circuit pointed out that the statutory scheme created two, mutually exclusive methods of compensating professionals in bankruptcy cases. Either a professional is retained under the pre-approval methodology of section 328(a) or the professional is only generally retained, with reasonable compensation to be determined later pursuant to section 330. See, e.g., *Smart World*, 552 F.3d at 232-33; *Peele v. Cunningham (In re Texas Sec., Inc.)*, 218 F.3d 443, 445 (5th Cir. 2000) ("[s]ection 328 applies when the bankruptcy court approves a particular rate or means of payment, and § 330 applies when the court does not do so"). The section 330 review process is inappropriate if the court has already pre-approved the methodology of payment under section 328(a); *Friedman Enterprises v. B.U.M. Int'l, Inc. (In re B.U.M. Int'l, Inc.)*, 229 F.3d 824, 829 (9th Cir. 2000).

Even if a retention is under section 328(a), the professional still needs to file a final fee application as provided in section 330(a) and attach as detailed a statement as is appropriate under the circumstances consistent with the retention order and *Fed. R. Bankr. P. 2016(a)*. See *In re Westbrooks*, 202 B.R. 520, 522 (*Bankr. N.D. Ala.* 1996). It is through the final fee application process that any developments incapable of being anticipated will come to light.

Legal Analysis of the Court on the Issue of Whether the Retention Was Appropriately Made Under Section 328(a)

In concluding that the retention of the Riker Firm in the *Smart World* case was of the first type of retention discussed above, pre-approval under section 328(a), the court looked to the "totality of the circumstances." 552 F.3d 228, 233. Because section 328(a) does not contain any specific requirements that must be met in order to invoke its provisions, there is nothing that absolutely has to be done for a retention order to constitute a pre-approval of fees. On the other hand, pre-approval cannot be lightly granted; instead there must be an indication that "the court evaluated the propriety of the fee arrangement before granting final, and not merely preliminary, approval." 552 F.3d at 233.

Under the facts of the *Smart World* case, the retention order was a section 328(a) pre-approval, even though the order itself did not specifically reference that subsection. The Riker Firm's application for retention referenced 328(a). The order authorized payment in accordance with the contingency fee agreement. At the hearing, the bankruptcy judge made several comments about the reasonableness of the contingency fee and that section 330 was inapplicable. Therefore, the Second Circuit affirmed the decision of the lower courts that the original retention of the Riker Firm was an appropriate section 328(a) retention.

Approaches of the Other Circuits

The Second Circuit's adoption of a "totality of the circumstances" test was consistent with the decision of the Sixth Circuit in *Nischwitz v. Miskovic (In re Airspect Air, Inc.)*, 385 F.3d 915 (6th Cir. 2004). In that case, the court noted that the most important elements to consider were the application for compensation and the court order approving compensation, and that the focus should be on whether (1) the application specifically requested the pre-approval, (2) the court order assessed the reasonableness of the fee methodology and (3) the application or order specifically referred to section 328. 385 F.3d at 922. In the *Airspect Air* case, the court held that there was no section 328 pre-approval where neither the application nor the order referred to section 328 and where there was no discussion of the reasonableness of the fee arrangement.

In *Donaldson Lufkin & Jenrette Securities Corp. v. National Gypsum Co. (In re National Gypsum Co.)*, 123 F.3d 861, 862-63 (5th Cir. 1997), the court held that a bankruptcy court's approval of a detailed letter setting forth a particular method of compensation was a pre-approved retention entitled to the protection of section 328, even though section 328(a) was not specifically mentioned and the retention order reserved to the bankruptcy court the "right to consider and approve the reasonableness and amount" of the fees. The court viewed this reservation as simply allowing reconsideration in the event of subsequent and unanticipated circumstances described in section 328(a). The rationale of the *National Gypsum* court was that if the most competent professionals are to accept bankruptcy case matters, courts

must protect their agreements and expectations. 123 F.3d at 863.

The approach of the Second, Fifth and Sixth Circuits is inconsistent with the approach of the Ninth Circuit. In *Circle K Corp. v. Houlihan, Lokey, Howard & Zukin, Inc. (In re Circle K Corp.)*, 279 F.3d 669, 671 (9th Cir. 2001), the court held that there can be no section 328(a) retention with pre-approval of the fee methodology "unless a professional's retention application unambiguously specifies that it seeks approval under § 328." The court went on to state that as a matter of good practice, the retention order should do likewise, although that is not absolutely determinative. Thus, where the application requested authority to enter into a retention agreement with a fixed fee of \$100,000 per month without reference to section 328(a), the professional was not appropriately retained under section 328(a) and subsequent fees were subject to the reasonableness test of section 330. 279 F.3d at 672.

An intermediate approach was taken by the Court of Appeals for the Third Circuit in *Zolfo, Cooper & Co. v. Sunbeam-Oster Co., Inc.*, 50 F.3d 253 (3d Cir. 1995). There, the court stated that the burden was on the professional to ensure that the bankruptcy court notes "explicitly the terms and conditions" if the professional intends to rely upon the section 328(a) protections. Because the retention order merely established the nature and range of services, without more specifics, it could not bind the court to particular terms and conditions of retention. 50 F.3d at 262.

Analysis of the Second Circuit on Whether the Subsequent Developments Were Incapable of Being Anticipated at the Time of the Retention

The second issue before the Second Circuit in *Smart World* was whether the bankruptcy court correctly concluded that the fee could be adjusted under section 328(a) because of subsequent developments that were incapable of anticipation at the time of the retention. The court explained that the test was not whether the subsequent developments themselves were actually considered at the time of retention but whether they were capable of being considered. 552 F.3d at 234-35. In the court's estimation, this is a "high hurdle to clear" in order to reconsider the pre-approved fee methodology.

In *Smart Word*, the bankruptcy judge had relied on four factors to reconsider the fees, and the court of appeals rejected each of them as having been capable of being anticipated, even if not actually anticipated. Divergent positions taken in litigation and the fact that there might be benefits to equity holders rather than creditors could have been anticipated as some degree of antagonism between parties can be expected in any bankruptcy proceeding. 552 F.3d at 235. The fact that the proceedings were unusually prolonged and that the Riker Firm was an obstacle to the settlement were both also not determinative. The prospect of prolonged litigation always exists. Indeed, the Riker Firm's appeal of the initial settlement showed that they were not an obstacle but a benefactor-obtaining another million dollars.

It will indeed be the rare case where something happens that could not have been anticipated at the time of the retention. Thus, where the contingent fee lawyer recovered a substantial judgment, which was promptly paid with relative ease, these factors were capable of anticipation at the time of the retention and thus the fee could not be reduced. *Daniels v. Barron (In re Barron)*, 325 F.3d 690 (5th Cir. 2003). Indeed, in *In re Merry-Go-Round Enterprises, Inc.*, 244 B.R. 327 (Bankr. D. Md. 2000), the court approved a \$71.2 million contingency fee, estimated at nearly 20 times the attorneys' hourly rates, because a high settlement, though viewed as highly unlikely at the time the retention was approved, was not wholly unanticipated.

On the other hand, in *Gibbs & Bruns LLP v. Coho Energy Inc. (In re Coho Energy Inc.)*, 395 F.3d 198, 205 (5th Cir. 2004), the court approved the reduction of a section 328(a) contingent fee where the attorney was subsequently fired for cause, one of several factors that could not have been anticipated at the time of the retention.

The fee agreement can be limiting on the professional as well. It has been held that a professional retained under section 328(a) was not entitled to an enhanced fee without reference to "any unforeseen events necessitating an increase in pay." *Smith v. Lounsbury (In re Amberjack Interests, Inc.)*, 326 B.R. 379, 387 (Bankr. S.D. Tex. 2005).

Practice Pointers

Notwithstanding the fact that most courts of appeals do not follow the strict approach of the Ninth Circuit, best practice is that all professionals being retained under anything but an hourly rate should be careful to ensure that both the application to the court and the retention order specifically reference section 328(a). The professional should also strive to be certain that the application and order discuss the reasonableness of the proposal with as much specificity as possible, including using broad language as to the payment of the fees on the conclusion of the engagement. It would be helpful to reference examples of what is being anticipated in the application as well, such as in connection with a contingency fee, that the parties recognize that there might be a quick, large recovery which would lead to a very large hourly rate for the professional.

Conclusion

There are two, mutually exclusive methods of compensating professionals. Retentions governed by Code section 328(a) are pre-approved methodologies of paying professional fees on the basis agreed to at the time of the retention. Retentions governed by section 330 require the court to determine the reasonableness of the professional fee at the end of the matter. The Court of Appeals for the Second Circuit joined with the Sixth Circuit in holding that a "totality of the circumstances" test should be applied to determine which is which in any given case.

RELATED LINKS: For discussion of retention of counsel under Code section 328(a), see *Collier on Bankruptcy*,
 ■ P 328.02.

For discussion of a reasonable compensation under Code section 330, see *Collier on Bankruptcy*,
 ■ ch. 330.

For analysis of decisions relating to case administration, click
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26 of 197 DOCUMENTS

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Lender Liability Claims Brought by Unsecured Creditors Committees

2009 Emerging Issues 4732

Commentary on the Effectiveness of Lender Liability Claims Brought by Unsecured Creditors Committees

By Leslie Treff

December 16, 2009

SUMMARY: Recently, unsecured creditors committees have found themselves spending less time negotiating with lenders and more time in litigation challenging secured creditors' claims. Success in bringing lender liability claims against secured creditors, however, is far from guaranteed. This commentary reviews the most commonly alleged lender liability claims and evaluates their effectiveness.

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ARTICLE: Over the last ten years, changing economic conditions have required unsecured creditors committees to refocus their recovery efforts. Such committees have often found themselves spending less time negotiating with lenders and more time in litigation challenging the secured creditors' claims. Several types of lender liability claims are commonly alleged, however, it has been extremely hard to recover as the result of such claims.

Unsecured creditors committees most often seek equitable subordination and recharacterization of the lenders' claims. Additionally, common allegations are that the secured creditors aided and abetted an insider's breach of fiduciary duty, deepening a borrower's insolvency, and improvident lending.

Standing

Prior to a court even addressing an unsecured creditors committee's lender liability claims, such committee must have standing to initiate an adversary proceeding. Such committees have a qualified right to bring a derivative suit, in a very narrow set of situations. First, the trustee or the debtor-in-possession must either unreasonably fail to bring suit, or the trustee or debtor-in-possession consents to such an action. In addition, no adversary proceeding may be commenced without permission of the court, which will hinge upon on a judicial determination that such claims benefit the estate, rather than just an individual creditor. *See In re Commodore Intern. Ltd.*, 262 F.3d 96, 46 C.B.C. 2d 1120 (2nd Cir. 2001); *Official Committee of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3rd Cir. 2003); *In re Automotive Professionals, Inc.*, 59 C.B.C.2d 1611, 389 B.R. 630 (Bankr. N.D. Ill. 2008).

In an attempt to circumvent the requirement of court permission, committees have sought to use *Bankruptcy Code*

section 510(c) to classify their equitable subordination claim as "direct," rather than "derivative." Thus far, however, such attempts have been unsuccessful and no courts have allowed direct standing. However, every circuit but one, has allowed an individual creditor to bring a direct action under Code section 510(c) because that individual asserts a particular harm, a creditors committee's interest is closer to that of the debtor-in-possession and, therefore, does not assert a particular harm. See *In re Applied Theory Corp.*, 493 F.3d 82, 58 C.B.C.2d 351 (2nd Cir. 2007); *In re Andrews*, 2009 Bankr. LEXIS 1052 (Bankr. S.D. Tex. 2009); *In re Franklin Indus. Complex, Inc.*, 2007 Bankr. LEXIS 3004 (Bankr. N.D.N.Y. 2007).

Therefore, unsecured creditors committees must seek court permission prior to alleging lender liability claims.

Equitable Subordination

One of the most widely sought lender liability claims is equitable subordination. An attempt to offset an inequality of claim position, equitable subordination is codified in Code section 510(c). See *Collier on Bankruptcy*, 510.05[1] (Matthew Bender). The doctrine allows for reordering of claims, but does not provide a vehicle for disallowance. Applicable mostly to insiders, those with a fiduciary duty to the debtor, and those in control of the debtor, equitable subordination is remedial, not penal, and is used only sparingly by the court. See *Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims*, 323 F.3d 228 (3rd Cir. 2003), cert. denied, 540 U.S. 825, 124 S. Ct. 178, 157 L. Ed.2d 46.

Courts look for three conditions to order equitable subordination. See *In Matter of Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977); *In re Lazar*, 83 F.3d 306, 35 C.B.C.2d 1259 (9th Cir.1996). The secured creditor first must have been involved in "inequitable conduct," which has been held to include deceptive undercapitalization, as well as other "suspicious inequitable behavior." See *Matter of Lifschultz Fast Freight*, 132 F.3d 339, 32 C.B.C.2d 97 (7th Cir. 1997). As respects insiders, actual misconduct is not required, but for general creditors, the standard is much higher. Some courts have held that gross misconduct and egregious behavior must be shown, which includes fraud, misrepresentation, over-reaching, and/or spoliation. See *In re Hedged-Investments Associates, Inc.*, 380 F.3d 1292 (10th Cir. 2004).

But others have embraced a more expanded definition of "inequitable conduct," requiring only that the creditor breach "an existing, legally recognized duty arising under contract, tort or other area of law." In commercial cases, that has meant a showing of "a substantial breach of contract and advantage-taking by the creditor." If there is no contract, however, the creditors committee need only show that there was conduct similar to fraud that justifies the intervention of equity. This can include pursuing one's legal rights in such a manner that the tactics harm the estate by causing it to incur excessive fees, or where one claimant's conduct may have been the direct or indirect cause for the other [creditors] having changed their positions. See *In re Giorgio*, 862 F.2d 933 (1st Cir. 1988); *Matter of Cajun Elec. Power Co-op., Inc.*, 119 F.3d 349 (5th Cir. 1997); *In re Racing Services, Inc.*, 571 F.3d 729 (8th Cir. 2009); *In re First Alliance Mortg. Co.*, 471 F.3d 977 (9th Cir. 2006); *In re Winstar Communications, Inc.*, 554 F.3d 382 (3rd Cir. 2009); *In re 80 Nassau Associates*, 31 C.B.C.2d 620, 169 B.R. 832 (Bankr. S.D.N.Y. 1994).

In addition to "inequitable conduct," that misconduct "must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant." Therefore, courts have held that equitable subordination is limited by the extent of the injury. See *In re SI Restructuring, Inc.*, 532 F.3d 355, 59 C.B.C.2d 1723 (5th Cir. 2008); *In re Kreisler*, 546 F.3d 863 (7th Cir. 2008); *In re Marketxt Holdings Corp.*, 361 B.R. 369 (Bankr. S.D.N.Y. 2007). In other words, a claim is only to be subordinated up to the amount of harm the inequitable conduct has done to the debtor or other creditors. Such harm must exist as the result of the secured creditors' misconduct, not because of the lender's status. Finally, the equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.

This is a very high standard for unsecured creditors committees to meet, and although it is always possible that a court will order a secured claim subordinated, absent egregious behavior, very few courts have allowed recovery under

such claims.

Recharacterization

Unlike equitable subordination, where claims are adjusted because of the behavior of the parties involved in the claim, a bankruptcy court considering recharacterization examines the substance of the transaction. In recharacterization, a court recognizes the existence of a relationship between the debtor and the claimant, but, based upon the transaction between the parties, determines that the relationship is one between equity owners rather than that of a debtor and creditor. *See In re Official Committee of Unsecured For Dornier Aviation (North America), Inc.*, 453 F.3d 225 (4th Cir. 2006). The court's inquiry seeks to discern whether the claim is truly a loan or is instead a capital contribution.

Many courts have looked to the "necessary or appropriate" clause of Code Section 105(a) for their authority to recharacterize claims. The courts that recognize recharacterization see it as necessary for the application of Code Section 726's system of prioritization of claims, where contributions to capital receive a lower priority than loans. At least one other court has held, however, that held Code Section 510's framework for equitable subordination already exists and that any attempt to use Code Section 105(a) to recharacterize a claim is an attempt to circumvent that framework. *See In re Airadigm Communications, Inc.*, 376 B.R. 903 (Bankr. W.D. Wis. 2007), *aff'd*, 392 B.R. 392 (W.D. Wis. 2008); *In re Pacific Exp., Inc.*, 69 B.R. 112, 16 C.B.C.2d 286 (B.A.P. 9th Cir. 1986).

If a creditors committee can get past the authority issue, courts then look at a list of factors to determine whether or not a claim should be recharacterized. Every transaction is looked at separately and in context, and a multi-factored test is applied to determine whether the parties "called an instrument one thing when in fact they intended it as something else." The factors are used to determine the intent of the parties at the time of the transaction. If it is clear that the transaction is a loan, both on the face of the loan documents and in the fact that the debtor was repaying it, attempts at recharacterization will not succeed. *See In re SubMicron Systems Corp.*, 432 F.3d 448, 55 C.B.C.2d 1077 (3rd Cir. 2006); *In re Hedged-Inv. Assocs., Inc.*, 380 F.3d 1292 (10th Cir. 2004); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001); *In re N & D Prop., Inc.*, 799 F.2d 726 (11th Cir. 1986).

Breach of Fiduciary Duty and Aiding and Abetting

Committee claims of breach of fiduciary duty or aiding and abetting an insider to breach their fiduciary duty seek monetary damages for interference with the affairs of the corporation prior to the bankruptcy filing. Courts hearing them rely on state law definitions to determine whether such allegations will be successful.

Ordinarily, lenders are not fiduciaries of borrowers. However, if the lender exerts substantial control over the borrower, a fiduciary duty may arise. *See In re Fedders North America, Inc.*, 405 B.R. 527 (Bankr. D. Del. 2009); *In re Adelphia Communications Corp.*, 365 B.R. 24 (Bankr. S.D.N.Y. 2007). Such control can be demonstrated when a lender was involved in the actual day-to-day management and operations of the borrower, or had the ability to compel the borrower to engage in unusual transactions. A creditors committee is well served to look to the state law at issue prior to making this claim and tailoring the allegations to the applicable state law. Questions have arisen as to whether there is a fiduciary duty on the part of a lender who knows that the borrower is near bankruptcy. Several cases have rejected this theory, and it is likely that such claims will be successful for creditor's committees outside those jurisdictions that have already ruled on this issue. *See RSL Communs. PLC v. Bildirici*, 2009 U.S. Dist. LEXIS 72691 (S.D.N.Y. 2009); *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. Sup. Ct. 2007).

Although successful prosecution of fiduciary duty claims is rare, in some states, alleging that the secured lender aided and abetted an insider breach their fiduciary duty has been more fruitful. Some states do not recognize such a cause of action, but in those that do, the creditors committee must show that a fiduciary relationship existed and that the fiduciary duty was breached. *See Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145 (11th Cir. 2006). In addition, the committee must show that the lender, who was not a fiduciary, knowingly participated

in a breach, and that damages to the unsecured creditors resulted from the concerted action of the fiduciary and the secured creditor. See *In re Fedders North America, Inc.*, 405 B.R. 527 (Bankr. D. Del. 2009); *In re Norvergence, Inc.*, 405 B.R. 709 (Bankr. D. N.J. 2009); *In re The Brown Schools*, 386 B.R. 37 (Bankr. D. Del. 2008).

Secured lenders have attempted to defend against aiding and abetting claims by asserting that recovery in such instances would violate the doctrine of in pari dilecto, in that the creditors committee, standing in the shoes of the debtor, is at equal fault, and of unclean hands. However, the doctrine, used to bar claims by plaintiffs who participate in the conduct giving rise to the claim, has generally not been applied to aiding and abetting claims where fiduciaries are found to have been acting outside the scope of their employment or to have been engaged in self-dealing. In such instances, the misconduct of a corporation's fiduciaries will not be imputed to the corporation as such fiduciaries have an interest adverse to the corporation. See *Pinter v. Dahl*, 486 U.S. 622, 636, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988); *Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. Price Waterhouse Coopers, LP*, 2007 U.S. Dist. LEXIS 3331 (W.D. Pa. 2007); *In re James River Coal Co.*, 360 B.R. 139 (Bankr. E.D. Va. 2007); *In re Verestar, Inc.*, 343 B.R. 444 (Bankr. S.D.N.Y. 2006); but see *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3rd Cir. 2001).

Deepening Insolvency and Improvident Lending

Claims for deepening insolvency and improvident lending rely on state law, and both of these types of claims have been increasingly rejected by the courts. See *In re CitX Corp.*, 448 F.3d 672 (3d Cir. 2006); *In re SI Restructuring, Inc.*, 532 F.3d 355, 59 C.B.C. 2d 1723 (5th Cir. Jun 20, 2008); *In re Fedders North America, Inc.*, 405 B.R. 527 (Bankr. D. Del. 2009); *In re Propex Inc.*, 2009 Bankr. LEXIS 629 (Bankr. E.D. Tenn. 2009); *In Liquidating Trustee of the Amcast Unsecured Creditor Liquidating Trust v. Baker (In re Amcast Indus. Corp.)*, 365 B.R. 91 (Bankr. S.D. Ohio 2007); *Limo v. Buerger (In re Del-Met Corp.)*, 322 B.R. 781, 813 (Bankr. M.D. Tenn. 2005). But, at least one court has held that improvident lending would be acceptable in cases where there is a duty of care in lending, and the lender had knowledge of the inadequacy of consideration received by the Debtor. Although not likely to be effective, it would behoove creditors committees to investigate the viability of these claim in the appropriate jurisdiction. See *In re OODC, LLC*, 321 B.R. 128 (Bankr. D. Del. 2005).

Conclusion

While many other possible lender liability claims exist, this review of the major claims indicates the difficulty committees face when attempting to maximum recovery for unsecured creditors. Most claims put forth by such creditors' committees are increasingly unsuccessful, unless the secured creditors have engaged in egregious behaviors or the transaction itself was put together in such a way as to present a fairly obvious conclusion that it was an equity contribution rather than a loan. Courts will continue to clarify the situations in which such claims will be allowed over the next few years, but if the trend continues, committees will not be very successful in pursuing recovery in this manner.

RELATED LINKS: For further discussion of injunctions under Bankruptcy Code section 510(c), see Collier on Bankruptcy,
 ■ " 510.05

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27 of 197 DOCUMENTS

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Braucher on Schubert v. Lucent Techs. (In re Winstar Communications, Inc.)

2009 Emerging Issues 4691

Anne Braucher on Schubert v. Lucent Techs. (In re Winstar Communications, Inc.), 554 F.3d 382 (3rd Cir. 2009): A Corporate Creditor is a Non-statutory Insider Subject to the One-year Preference Reach Back Period

By Anne Braucher

December 7, 2009

SUMMARY: Common sense dictates that a transaction is not at arms length when one of the transacting parties is coerced into purchasing inventory it does not need, does not have the cash to finance the purchase, and is forced out compliance with financial covenants by the purchase. So the Third Circuit held in the recent Winstar decision. This commentary discusses the import of this important decision.

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ARTICLE: The United States Court of Appeals for the Third Circuit has ruled that a corporate creditor is a non-statutory insider for purposes of a preference determination because the creditor engaged in coercive practices and forced one-sided transactions that were not in the best interests of the debtor. The decision, *Schubert v. Lucent Techs. (In re Winstar Communications, Inc.)*, 554 F.3d 382 (3rd Cir. 2009), confirms that a corporate entity need not have actual managerial control over a debtor in order to be considered an insider subject to the longer reach back period under 11 U.S.C. § 547(b). Instead, a non-statutory insider exerts control over a debtor by forcing transactions with the debtor that are not at arm's length.

Background

Section 547 of the Bankruptcy Code provides that a trustee can avoid a preferential transfer made to a creditor between ninety days and one year before a petition was filed if the creditor was, at the time of the transfer, an insider. See 11 U.S.C. § 547(b). The Code further provides that "the term insider" includes . . . [a] (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer or person in control of the debtor." 11 U.S.C. § 101(31)(B). Because section 101 contains a non-exhaustive list of insiders, courts have identified an additional category called "non-statutory insiders." Non-statutory insiders include individuals and entities whose close relationships with the debtor require closer scrutiny than those who deal with the debtor at arm's length. Alan M.

Resnick & Henry J. Sommer, 2-101 *Collier on Bankruptcy* P 101.31 (2009).

Winstar, a provider of local and long-distance telecommunications services, and Lucent, a designer of telecommunications services and products, entered into a strategic partnership in October 1998. As a result of the partnership, Lucent funded construction of Winstar's network and Winstar became a major customer for Lucent's products and services. In May 2000, Winstar obtained a \$1.15 billion revolving credit and term loan from a consortium of banks (the "Bank Facility"). Winstar used the Bank Facility proceeds to pay off its existing obligations to Lucent. At the same time, Winstar executed a new agreement with Lucent through which it received a \$2 billion line of credit (the "Second Credit Agreement"). In November 2000, Siemens joined the Bank Facility and loaned Winstar \$200 million (the "Siemens Loan"). Winstar used the Siemens Loan proceeds to pay \$188.2 million that it owed to Lucent under the terms of the Second Credit Agreement. Winstar and its subsidiary filed chapter 11 reorganization cases on April 18, 2001.

After the cases were converted to chapter 7, the trustee attempted to recover the \$188.2 million payment as a preference. Because Winstar made the payment more than ninety days prior to the date it filed its petition, the trustee had to show that Lucent was an insider in order to satisfy § 547(b). Following a long trial, the United States Bankruptcy Court for the District of Delaware found that Lucent was an insider and held that the \$188.2 million transfer was indeed an avoidable preference. The United States District Court for the District of Delaware upheld the bankruptcy court's decision, and Lucent appealed.

The Decision

The Court of Appeals for the Third Circuit upheld the lower courts' rulings. The court agreed with Lucent that a person or entity must have actual control of a creditor in order to be considered a "person in control" insider under 11 U.S.C. § 101(31). The court held, however, that an entity need not have actual control in order to be considered a non-statutory insider for two reasons. First, "[t]o hold otherwise would render meaningless Congress's decision to provide a non-exhaustive list of insiders in 11 U.S.C. § 101(31)(B) because the person in control' category would function as a determinative test." 554 F.3d at 396. Second, not all of the categories of insiders enumerated in 11 U.S.C. § 101(31) have actual control of debtors. Neither a relative of a general partner, director, officer, or person in control of the debtor nor a partnership in which the debtor is a general partner will have actual control of the debtor at issue. The court therefore stated that "[i]n light of these enumerated categories, we hold that it is not necessary that a non-statutory insider have actual control; rather, the question is whether there is a close relationship [between the debtor and creditor] and . . . anything other than closeness to suggest that any transactions were not conducted at arm's length." 554 F.3d at 396-7 (quoting *Anstine v. Carl Zeiss Meditec AG (In re U.S. Med.)*, 531 F.3d 1272, 1277 (10th Cir. 2008)).

Applying this arm's length standard to the facts, the court held that Lucent was an insider because it was able to coerce Winstar into many transactions that were not in Winstar's best interests. In 2000, for example, Lucent pressured Winstar to purchase \$135 million of Lucent software when less than \$20 million of the software was of any value to Winstar, Winstar paid the list price rather than a lower price it was entitled to by contract, and Lucent had to fund the purchase because Winstar did not have sufficient cash. The software purchase also forced Winstar out of compliance with its financial covenants under the Second Credit Agreement and made it necessary for Winstar to obtain the Siemens Loan. In other transactions, Lucent "'forced the purchase' of its goods well before the equipment was needed and in many instances . . . never needed at all;" treated Winstar as a captive buyer for Lucent's goods;" and used Winstar as a means for Lucent to inflate its own revenue." 554 F.3d at 397. The court stated that "[s]uch one-sided transactions refute any suggestion of arm's-length dealings." *Id.* at 399.

The Effect of the Decision: Creditors that exert too much influence over Debtors with whom they are strategic partners may be considered non-statutory insiders and subject to preference investigations.

In the current economic climate, strategic partnerships may be appealing because entities' complementary strengths and weaknesses make the combination greater than its parts. The Third Circuit's *Winstar* decision should, however, be a

cautionary tale for potential strategic partners. Bankruptcy courts will not accept form over substance in defining control by an insider. Even if one partner does not have actual, managerial control of the other partner, failure to execute transactions at arm's length will render one a non-statutory insider.

While it may not be possible or even desirable to create a strategic partnership of equals, it is important that each entity maintain sufficient autonomy. When structuring a strategic partnership, corporate practitioners should attempt to put measures in place so that one partner does not exert too much influence over the other. Decision-making processes should be independent and, if possible, potential transactions should comport with whatever course of dealing existed before the strategic partnership was formed.

In the *Winstar* case, the record was filled with evidence of coercive tactics by executives, unusual courses of dealing, accounting irregularities, and completed transactions that severely impaired the financial condition of one strategic partner and greatly improved the condition of the other. A bankruptcy practitioner concerned about his creditor client's exposure to non-statutory insider preference claims should therefore carefully examine the relationship between his client and a strategic partner debtor. Did the creditor's executives exert undue influence over the debtor's decisions? Did the creditor's course of dealing with the debtor differ greatly than it would have with another entity? Were there allegations or investigations of irregular accounting practices by the creditor? Did each strategic partner benefit from transactions executed by the pair? Failure to ask these questions may leave the creditor client surprised by a preference claim that benefits from the year-long reach back period of section 547(b).

RELATED LINKS: For more information on section 547(b) of the Bankruptcy Code, see Collier on Bankruptcy
 ■ 547.03.

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28 of 197 DOCUMENTS

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Jurs on Sternberg v. Johnston

2009 Emerging Issues 4661

S. Andrew Jurs on Sternberg v. Johnston, 582 F.3d 1114 (9th Cir. Oct. 1, 2009)

By S. Andrew Jurs

December 1, 2009

SUMMARY: In this Emerging Issues Analysis, the author looks at a decision from the Ninth Circuit that effectively creates a circuit split on the issue of whether attorney's fees are available not only for remedying a stay violation but also for the efforts in collecting damages for the violation. The Ninth Circuit concluded that once the stay has been remedied, the debtor is responsible for fees to continue the prosecution of the violating party.

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ARTICLE: The Ninth Circuit Creates a Split of Authority Among the Circuits by Ruling That a Debtor Enforcing the Automatic Stay Can Recover as Actual Damages Only Those Attorney's Fees Related to Enforcing the Stay, Not the Fees Incurred in the Adversary Proceeding to Collect Damages.

In *Sternberg v. Johnston*, 582 F.3d 1114, 2009 U.S. App. LEXIS 21532 (9th Cir. Oct. 1, 2009), the Court of Appeals for the Ninth Circuit was faced with two issues arising from an attorney's alleged violation of the bankruptcy automatic stay under 11 U.S.C. § 362 by pursuing a state court action on behalf of his client. The Ninth Circuit first considered whether an attorney has an affirmative duty to educate a state court on the extent of the bankruptcy stay, even if it is to the detriment of his client. Second, the court had to determine the quantum of damages for such a violation and decide whether such damages could include the attorney's fees incurred in prosecuting the action against the violating party.

Facts and Procedural History

In 1996, Logan Johnston ("Debtor") divorced Paula Parker and agreed to pay spousal maintenance, which obligation was incorporated in a state court order. Almost five years later, in 2001, Parker, through her attorney, Melvin Sternberg, returned to the state court seeking an order finding the Debtor in contempt for nonpayment of spousal support. Although the Debtor was himself an attorney, he obtained legal counsel for purposes of filing bankruptcy to contest the payment of this support.

On May 14, 2001, the Debtor filed a chapter 11 bankruptcy petition, but his bankruptcy counsel did not file a notice of bankruptcy in the state court support proceeding until May 17. That same day, the state court conducted a previously

scheduled hearing on Parker's motion for contempt. The Debtor represented himself at that hearing, during which he advised the state court of the bankruptcy filing. Citing statements from his bankruptcy counsel, the Debtor told the state court that his bankruptcy stayed anything regarding the property settlement, attorney's fees, and sanctions. While objecting "in the abstract to anything that would contravene the bankruptcy laws," the Debtor agreed that the state court could establish the amount of the Debtor's arrears.

Sternberg did not know if the bankruptcy filing stayed the proceedings, but he believed that the stay would not be violated if the court moved forward on the arrears, attorney's fees, and contempt determination. The state court proceeded on the issue of contempt but declined to issue sanctions until it could research its jurisdiction to do so. On July 13, 2001, the state court filed a minute order ("State Court Order") finding the Debtor in violation of the divorce decree and granting judgment for Parker in the amount of \$87,525.60. Additionally, the State Court Order set a deadline of August 1, 2001, for the Debtor to pay the full amount or be jailed. The extent of the State Court Order surprised all of the parties; Sternberg and Parker had expected that the state court would conduct further proceedings before ordering the Debtor to pay a sum certain.

The Debtor quickly filed in the state court a motion to stay the judgment, but the hearing date on that motion was set for the day after the August 1 deadline to pay or be jailed. The Debtor also sent Sternberg a letter alleging that Sternberg was violating the stay and asking Sternberg to cure the violation. Furthermore, the Debtor filed a petition with the Arizona court of appeals to stay and vacate the State Court Order. Sternberg took no action in response to the Debtor's letter, and in fact had a lawyer from his firm file a brief with the Arizona court of appeals against the Debtor's petition.

Contemporaneous with his efforts in the state courts, the Debtor also filed in the bankruptcy court (1) a motion to set aside the State Court Order and (2) an adversary proceeding against Parker and Sternberg for violating the automatic stay. One day before the Debtor's deadline, the bankruptcy court conducted a hearing on the Debtor's motion and concluded that the stay had been violated. In its order vacating the State Court Order, the bankruptcy court noted that the state court could have avoided violating the stay if it had qualified the State Court Order to reflect only the amount of arrearages or had been informed of what constituted non-estate property so that the arrearages would be collected only from that property.

At a later date, the adversary proceeding against Parker and Sternberg went to trial. After the Debtor's presentation of evidence, the bankruptcy court granted directed verdict to Parker and Sternberg after concluding that neither of them committed a separate violation of the stay other than obtaining the State Court Order. The Debtor appealed, and the district court reversed the bankruptcy court on the basis that Sternberg and Parker had an obligation to remedy the violation. Before the adversary proceeding went to trial again, Parker settled with the Debtor, leaving only Sternberg to defend against the Debtor's allegations.

In March 2006, the bankruptcy court filed its decision after retrying the adversary proceeding. According to the bankruptcy court, the district court's conclusion that "Sternberg willfully violated the automatic stay" limited the issues at trial. The final result was a determination that the Debtor had been injured to the extent of \$2,883.20 in lost work, \$20,000 for emotional distress, and attorney's fees of \$69,986.

On appeal, the district court upheld the bankruptcy court, at which point Sternberg timely filed his appeal with the Court of Appeals for the Ninth Circuit.

Legal Background

Immediately on the filing of a bankruptcy petition, *11 U.S.C. § 362(a)* provides an automatic stay that protects against, among other things, "the commencement or continuation . . . of a judicial, administrative, or other action or proceeding against the debtor . . . ; the enforcement . . . of a judgment . . . ; any act to obtain possession of property of the estate . . . ; [and] any act to create, perfect, or enforce any lien." There is a limited exception, however, to the automatic

stay; it does not prevent civil actions "for the establishment or modification of an order for domestic support obligations" or "the collection of a domestic support obligation from property that is not property of the estate." 11 U.S.C. § 362(b)(2)(A)-(B).

Under Ninth Circuit precedents, the automatic stay imposes on nondebtors an affirmative duty of compliance. See *California Employment Development Dep't v. Taxel (In re Del Mission Ltd.)*, 98 F.3d 1147, 36 C.B.C.2d 1658 (9th Cir. 1996) (holding that the state's knowing retention of disputed taxes violated the automatic stay when the burden to return estate property is placed upon the possessor and not the debtor); *Knupfer v. Lindblade (In re Dyer)*, 322 F.3d 1178 (9th Cir. 2003) (finding that postpetition recording of a deed of trust violated the stay because the creditor had an affirmative duty to remedy the violation by attempting to undo the recording process). In *Eskanos & Alder, P.C. v. Leetien*, 309 F.3d 1210 (9th Cir. 2002), the Ninth Circuit affirmed a bankruptcy court decision that a law firm's failure to dismiss a collection action for 23 days after learning of the bankruptcy violated the stay.

Commentary

The Ninth Circuit's holding in *Sternberg* is noteworthy in that it addresses two important questions for lawyers dealing with the automatic stay:

(1) To what extent can a lawyer be liable for violating the stay while pursuing matters on behalf of his client?

(2) What damages can be assessed for such a violation. In fact, in determining the standard for damages, the Ninth Circuit disagreed with the Fifth Circuit and created a split between the circuits on that issue?

Violating the Automatic Stay. In light of the affirmative duty that a creditor has to remedy any possible violation of the automatic stay, the Ninth Circuit did not struggle much with the question of whether Sternberg's conduct constituted a violation of section 362. While the appeals court did not fault Sternberg for his conduct at the first hearing or for the issuance of the over-broad state court order, "Within a reasonable time . . . , however, the law required Sternberg to take correction action." 2009 U.S. App. LEXIS 21532, at *13. Instead of complying with this affirmative duty, though, Sternberg filed a brief with the Arizona court of appeals defending the entire state court order: "Sternberg's defense of the order was absolute. He did not try to parse the valid from the invalid, but instead defended the order in its entirety ." In fact, Sternberg recognized the faults with the state court order but said nothing to the appellate court because "he did not think it was his duty to practice law on [the Debtor's] behalf." *Id.* at *15.

The Ninth Circuit disagreed, however, and noted that Sternberg's affirmative duty to remedy the violation trumped the normal operation of the adversarial process. "At a minimum, he had a obligation to alert the state appellate court to the conflicts between the order and the automatic stay." *Id.* The court also rejected Sternberg's arguments that he could not be liable for willfully violating the stay because the Debtor had not specifically requested that Sternberg modify the order and that Sternberg did not try to collect on the order. According to the Ninth Circuit, the Debtor "was not required to ask Sternberg to modify the order for Sternberg's violation to be willful." *Id.* at *17. All that was required for liability was that Sternberg "knew of the automatic stay and [his] actions in violation of the stay were intentional." *Id.* at *18 (quoting *Eskanos & Alder, P.C. v. Leetien*, 309 F.3d 1210, 1215 (9th Cir. 2002)).

Damages for Violating the Automatic Stay. The other issue facing the Ninth Circuit was the computation of the Debtor's damages to be awarded against Sternberg. On that issue, the Ninth Circuit agreed with Sternberg and reversed the award of damages to the extent that it awarded attorney's fees for both the work associated with remedying the stay violation and the adversary proceeding in which the Debtor sought to collect damages for the stay violation.

The applicable statute, 11 U.S.C. § 362(k)(1), provides that "an individual injured by any willful violation of a stay shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." This language clearly allows recovery of attorney's fees for acts necessary to prevent a stay violation. See *California Employment Development Dep't v. Taxel (In re Del Mission Ltd.)*, 98 F.3d 1147, 1152, 36 C.B.C.2d 1658 (9th Cir. 1996) (noting that section 362(k)(1) "mandates the award of actual damages to an individual

injury by any willful violation of a stay"). According to the Ninth Circuit, however, the phrase "actual damages" is ambiguous. 2009 U.S. App. LEXIS 21532, at *22; see also *Dawson v. Washington Mut. Bank (In re Dawson)*, 390 F.3d 1139, 1146 (finding that "the text of the statute" does not define "actual damages").

Some courts have resolved this ambiguity by creating a rule that "actual damages" requires an award that returns the debtor to his previolation status. For example, in *Havelock v. Taxel (In re Pace)*, 30 C.B.C.2d 48, 159 B.R. 890, 900 (B.A.P. 9th Cir. 1993), vacated in part on other grounds by 67 F.3d 187 (9th Cir. 1995), the court stated that "it is well established that the attorneys' fees and costs incurred in prosecuting an adversary proceeding seeking damages arising from a violation of the automatic stay is recoverable." Similarly, the Fifth Circuit has held that "it is proper to award attorney's fees that were incurred prosecuting a section 362(k) claim." *Young v. Repine (In re Repine)*, 536 F.3d 512, 522 (5th Cir. 2008).

The Ninth Circuit, however, goes the opposite direction by relying on the standard definition of "actual damages" as "an amount awarded to compensate for a proven injury or loss; damages that repay actual losses." Blacks' Law Dictionary 416 (8th ed. 2004). According to the appeals court, "the proven injury is the injury resulting from the stay violation itself," and that once the violation is ended, any fees incurred thereafter by a debtor would not compensate for "actual damages." 2009 U.S. App. LEXIS 21532, at *22. Therefore, under the American Rule that each party bears its own fees in the absence of a fee-shifting statute, awarding fees for a subsequent adversary proceeding would be improper even if it could be argued that he will not be made whole. *Id.* In further support of this position, the Ninth Circuit analogizes the stay violation to several different types of lawsuits, each of which requires a plaintiff to bear his own attorney's fees to remedy the wrong, such as torts, legal malpractice suits, bad faith actions against an insurer, and abuse of process suits.

The Ninth Circuit further states that its interpretation of the phrase "actual damages" is more consistent with several of the goals of the automatic stay. First, the stay is meant to help the debtor deal with his creditors, but is not meant as a tool for the debtor to pursue his creditors, even when they violate the stay. "The stay is a shield, not a sword." *Id.* at *24. Second, limiting damages in this manner has the potential for reducing stay litigation. *Id.* at *24-25.

Conclusion

The decision in *Sternberg* is significant for two reasons. First, it provides further guidance as to counsel's responsibility when confronted by the automatic stay to act affirmatively to avoid violations of the stay and to correct violations of the stay. It is not a debtor's responsibility to seek the remedy, even if it means that plaintiff's counsel must act, in a sense, as the debtor's lawyer and point out the effect of the stay to state courts that may not be familiar with the stay's broad scope. Second, the decision in *Sternberg* creates a split between the circuits on the question of whether a debtor is entitled to recover attorney's fees expended to collect on a violation of the stay. According to the Ninth Circuit, once the stay has been remedied, the debtor is responsible for his fees to continue the prosecution of the violating party, even if it means that the debtor will not necessarily be "whole" despite receiving a judgment in his favor.

RELATED LINKS: For further discussion related to remedies for violation of the automatic stay, see generally Collier on Bankruptcy, § 362.11.

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29 of 197 DOCUMENTS

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Baldwin on New Pleading Standards for Avoidance Actions in Bankruptcy Courts

2009 Emerging Issues 4649

Gerald L. Baldwin on New Pleading Standards for Avoidance Actions in Bankruptcy Courts

By Gerald Baldwin

November 30, 2009

SUMMARY: Pleading standards in bankruptcy avoidance actions have historically been set extremely low. The standards were so low that practitioners seldom saw a motion to dismiss under Rule 12(b)(6). The rules have just changed. Gerald L. Baldwin, of Frost Brown Todd LLC, in Cincinnati, discusses the new pleading standards for avoidance actions in bankruptcy courts.

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ARTICLE: Introduction. Pleading standards in bankruptcy avoidance actions have historically been set extremely low. The standards were so low that practitioners seldom saw a motion to dismiss under Rule 12(b)(6). The rules have just changed.

Sue First; Ask Questions Later. For decades, standard operating procedure has dictated that a bankruptcy trustee sue everyone whom the debtor has paid in the ninety (90) days preceding the bankruptcy filing. The cause of action? Preference. Those defendants always ask their counsel "What did I do wrong?" The answer, for the most part, is "Nothing."

Trustees have justified such blanket suits by invoking the time-honored rationale that there undoubtedly were preferences in the days or months before the filing and it simply costs the bankruptcy estate too much to thoroughly investigate and make an informed decision on which payments by the debtor should be recovered. After all, trustees have little or no idea when goods and services were received by the debtor, relative to when the payments were made. Making that investigation can be time consuming and expensive. Their approach has been to print out a list of all checks issued by the debtor for ninety (90) days and sue everyone on that list. Let the defendants prove that they have defenses.

As unfair as that position may seem to payees, the law has tended to support the trustees' approach. Typical defenses to a preference action, like contemporaneous exchange, have been characterized as affirmative defenses so trustees need not concern themselves with pleading around them. *See, e.g., K-Mart Corp. v. Uniden American Corp.*, 318 B.R. 409 (Bankr. N.D. Ill. 2004). *See also, U.S. v. Northern Trust Co.*, 372 F.3d 886 (7th Cir. 2004).

Historic Liberal Pleading Standards. Traditional pleading standards imposed few impediments on counsel for the trustees. In 1957, the Supreme Court ruled that unless "it appears without a doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief," a complaint was not to be dismissed under Rule 12 of the Rules of Federal Procedure for failure to state a claim. *Conley v. Gibson*, 355 U.S. 41 (1957). The *Conley* standard meant that all a trustee had to plead was that the defendant had received a transfer from the debtor within the period of time applicable to a particular form of avoidance claim. The defendant then was forced to either repay the money to the trustee or retain counsel to examine the transaction, determine whether the claim was legitimate and then contest or settle the claim.

Settlement has always been the name of the game for trustees. If 50% of the defendants settled for 50% of the payment they had received, for little or no effort by the trustee, the estate received a cash fund equal to 25% of the total of all payments made to all vendors in the ninety (90) days prior to bankruptcy. What better way to fund important bankruptcy expenses like trustee's fees and counsel fees?

Changes In Non-Bankruptcy Standards. The tide has now turned in favor of the defendants. In 2007, the Supreme Court issued its opinion in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), holding in an antitrust case that a pleading merely stating "a formulaic recitation of the elements of a cause of action will not do." *Id.* at 555. Under the *Twombly* standard, the plaintiff must plead "factual allegations [sufficient] to raise a right to relief above the speculative level on the assumption that all of the complaint's allegations are true." *Id.* In 2009, the Supreme Court made it clear that the *Twombly* holding extended beyond the antitrust field. *Ashcroft v. Iqbal*, 2009 U.S. LEXIS 3472.

Specific Facts Now Must Be Plead. Following *Ashcroft*, at least one Bankruptcy Judge has applied the higher *Twombly* standard to lawsuits to recover avoidable transfers. *In re Care America, Inc.*, Case No. 06-02913-8-JRL (Bankr. E.D.N.C. July 23, 2009). The trustee filed several complaints to recover both preferential transfers pursuant to § 547 and fraudulent conveyances pursuant to 11 U.S.C. § 548. Basically, the trustee merely quoted the applicable provision of the code and alleged that various transfers took place on certain dates and that they were voidable because the debtor had been insolvent when the transfers occurred. The judge held that these pleadings failed to meet the minimum requirements to survive the defendants' motions to dismiss because the trustee had not pleaded adequate.

Applies To Both §§ 547 and 548. With respect to the preference claims brought under § 547, the court found the pleadings to be defective in several respects. First, because the trustee had failed to plead the nature of the debtor's interest in the funds allegedly transferred, the pleadings failed the new standards. The funds of the debtor appear to have been held in various accounts in several names and the transfers appear to have been indirect. Next, and more importantly, the pleadings failed to allege specific facts concerning the nature and amount of the antecedent debt to the recipients. Simply pleading the conclusory statement that the transfer had been made on account of an antecedent debt was held to be insufficient. This may be the most important holding in the opinion because investigation of the age and nature of the debt paid is precisely the type of work the typical trustee strives to avoid, placing that burden on the defendants. Finally, some of the defendants were described by the pleadings as "insiders" thereby extending the look-back period from ninety days to one year. The court held that merely labeling defendants as insiders was inadequate without pleading the facts that made the defendants "insiders" under the statutory definition.

In dismissing the § 548 fraudulent transfer claims, the court followed similar logic. Because § 548 permits recovery if the debtor "received less than reasonably equivalent value," the trustee must allege precisely what consideration was transferred between the parties and why that exchange constituted something other than equivalent value. Where cash is involved, there is no valuation problem. However, fraudulent transfers often involve property other than cash and valuation of non-cash property would now seem to be a prerequisite to the assertion of a fraudulent transfer claim.

Best Practices Today. The practice point is clear. A trustee bringing avoidance claims is now required to conduct sufficient factual investigation to enable him/her to plead facts that support the statutory basis for the avoidance claims. Pleading legal conclusions alone is inadequate. The burden is on the trustee as plaintiff to determine which pre-petition transfers are actually vulnerable under the code. Trustees no longer can require recipients of legitimate payments to

establish the background facts in order to avoid the expense of defending the payments they have received.

RELATED LINKS: For further discussion of Bankruptcy Code sections 547 and 548, see Collier on Bankruptcy,

- 547.01;
- 548.01

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30 of 197 DOCUMENTS

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Strochak and Yates on United States v. Apex Oil Co., Inc.

2009 Emerging Issues 4637

Adam Strochak and Erin Yates on United States v. Apex Oil Co., Inc.: Seventh Circuit Holds that Reorganized Debtors Must Comply with a RCRA Cleanup Order Because the Mandatory Cleanup Injunction Is Not a "Claim" Discharged in a Prior Chapter 11 Bankruptcy

By Adam Strochak and Erin Yates

November 25, 2009

SUMMARY: A RCRA cleanup order is not dischargeable in bankruptcy because the government cannot demand payment of cleanup costs in lieu of compliance with the order, says the Seventh Circuit in *Apex Oil*. In so holding, the court rejected the "expenditure test," explaining that discharge must be limited to claims that give rise to a right to payment because the equitable decree cannot be executed. This commentary discusses this important decision.

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ARTICLE: Seventh Circuit Holds that Reorganized Debtors Must Comply with a RCRA Cleanup Order Because the Mandatory Cleanup Injunction Is Not a "Claim" Discharged in a Prior Chapter 11 Bankruptcy

The United States Court of Appeals for the Seventh Circuit has provided some clarification on an issue at the intersection of environmental and bankruptcy law, holding that the obligation to comply with a Resource Conservation and Recovery Act ("RCRA") cleanup order was not a "claim" discharged in a prior chapter 11 bankruptcy. The decision, *United States v. Apex Oil Co., Inc.* 579 F.3d 734 (7th Cir. 2009), effectively required Apex Oil Company ("Apex Oil"), the successor to the reorganized debtor, to pay a contractor to perform the cleanup, at an estimated cost of \$150 million, of contamination caused by the predecessor. The Seventh Circuit grappled with the difficult question of whether a mandatory cleanup injunction falls within the broad definition of "claim" in the bankruptcy laws. Under the Bankruptcy Code, only obligations that are "claims" are subject to payment and discharge when a plan of reorganization is confirmed by the bankruptcy court. *See 11 U.S.C. § 1141(d)*. Non-claim obligations pass through the bankruptcy unaffected and continue to be retained as liabilities of the reorganized debtor. Finding that RCRA provides no cause of action for recovery of cleanup costs or payment of damages, only a right of injunctive relief, the Seventh Circuit held that the obligation under the cleanup order was not a "claim" for bankruptcy purposes and therefore passed through the prior bankruptcy.

Background. The *Apex Oil* case involves an action by the federal government against an oil refining company that reorganized under chapter 11 in the late 1980s. Fifteen years after the company's plan of reorganization was confirmed,

the United States sued Apex Oil, seeking an injunction under section 7003(a) of RCRA, 42 U.S.C. § 6973(a), to compel Apex Oil to cleanup groundwater contamination resulting from the prepetition operations of Apex Oil's corporate predecessors at a site in Hartford, Illinois. In 2008, the United States District Court for the Southern District of Illinois held that Apex Oil was liable for the hydrocarbon plume at the Hartford site and ordered the company to abate the contamination and all conditions associated with it. See *United States v. Apex Oil Co., Inc.*, 2008 U.S. Dist. LEXIS 59973 (S.D. Ill. July 28, 2008). Apex Oil appealed to the Seventh Circuit, arguing that the government's claim had been discharged in the bankruptcy 15 years earlier.

The Seventh Circuit's Analysis. The Court of Appeals rejected Apex Oil's argument and held that the obligation to perform a mandatory cleanup injunction under RCRA was not a "claim" discharged in Apex Oil's bankruptcy, even though the reorganized debtor could comply only by hiring a contractor to perform the cleanup at an estimated cost of \$150 million. The Seventh Circuit reasoned that, because section 7003(a) of RCRA only provided the government with a right to injunctive relief, and not a right to cost recovery, the government's right to an injunction under the statute was not convertible into a right to payment. 579 F.3d at 736. Judge Posner, writing for the court, explained that the definition of a "claim" in section 101(5)(B) of the Bankruptcy Code, 11 U.S.C. § 101(5)(B) includes "a right to an equitable remedy for breach of performance" only if the breach "gives rise to a right to payment." According to the court, only two types of injunctions give rise to an alternate right of payment: (1) injunctions that are no longer capable of performance, such as an injunction to do something that is no longer possible and (2) injunctions that actually call for the payment of money, such as restitution orders. *Id.* at 735-36. Because the cleanup was capable of being performed, and because there is no authority under RCRA to require the payment of money in lieu of performance of a cleanup injunction, breach of the cleanup injunction did not give rise to a "right of payment" and therefore was not a "claim" discharged in the prior bankruptcy. The court rejected Apex Oil's argument that it could comply only by spending money, and therefore the injunction did give rise to a right of payment, reasoning that "virtually all equitable decrees" impose costs of the defendant. *Id.* at 738.

A Split Among the Circuits. By rejecting the argument that an injunction is a dischargeable "claim" if the debtor must spend money to comply, the Seventh Circuit split from the Sixth Circuit Court of Appeals' decision in *United States v. Whizco, Inc.* that an injunction directing a mine operator to reclaim surface mines, which required the operator to purchase equipment in order to comply, was a dischargeable "claim." Compare 579 F.3d at 737-38 with *United States v. Whizco, Inc.*, 841 F.2d 147, 150-51 (6th Cir. 1988). With its ruling in *Apex Oil*, however, the Seventh Circuit joined the Third Circuit Court of Appeals in holding that injunctions which require the expenditure of money to comply are not automatically dischargeable claims in bankruptcy. In *In re Torwico Electronics, Inc.*, 8 F.3d 146 (3d Cir. 1993), the Third Circuit Court of Appeals held that an administrative order issued pursuant to New Jersey's Industrial Site Recovery Act, which required the debtor to clean up releases of hazardous substances from a former manufacturing facility, was not a dischargeable "claim" under the Bankruptcy Code, even though the debtor did not own the property in question and had ceased operations at the site four years prior to filing for bankruptcy.

Although the Seventh Circuit reached a similar conclusion to the Third Circuit Court of Appeals in *Torwico*, the court reached its decision by a different analytical approach. The *Torwico* court reasoned that the New Jersey's cleanup order was neither seeking money nor asserting a right to payment, but merely requiring the debtor to comply with the state's environmental laws. Hence, the court concluded that the state's cleanup order did not amount to a dischargeable "claim" in bankruptcy. The *Torwico* court also distinguished the United States Supreme Court's holding in *Ohio v. Kovacs*, 469 U.S. 274 (1985)—that a debtor's obligation under a prepetition court order to cleanup a hazardous waste disposal site was a "claim" in a chapter 7 bankruptcy case—on the basis that it applies only to situations where the state itself is seeking money directly from the debtor. See 8 F.3d at 150. Consequently, there continues to be uncertainty in the federal courts as to when mandatory injunctions create dischargeable claims in bankruptcy and the outcome of any particular case is highly dependent on both the specific environmental statute at issue and the federal judicial circuit in

which the case is heard.

Unanswered Questions After *Apex Oil*. One issue that the *Apex Oil* court left unanswered is how are injunctions treated if they arise under a statute that provides the government with an alternative right to cost recovery, like the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 U.S.C. §§ 9601-9675. The analysis in *Apex Oil* relies, in part, on the fact that the Supreme Court previously had concluded that RCRA does create a cause of action for recovery of cleanup costs. Therefore, the *Apex Oil* decision suggests that CERCLA injunctions may be treated as "claims" and subject to discharge in bankruptcy because that statute expressly gives the government or private parties the right to sue for recovery of cleanup costs. The Seventh Circuit, however, also based its decision on the determination that the definition of "claim" only includes those equitable remedies which give "rise to a right to payment because the equitable decree cannot be executed." *See 579 F.3d at 738*. Contrary to the first part of the court's analysis, this suggests that a CERCLA injunction would not be treated as a "claim" if it is capable of execution. While *Apex Oil* provides some clarity on the narrow issue of whether a RCRA cleanup injunction may be discharged in bankruptcy, the law remains murky with respect to obligations under other environmental laws

Effect of the Decision. The bankruptcy treatment of environmental cleanup obligations will be an increasingly important issue as the bankruptcy cases spawned by the 2008-09 financial crisis and recession work their way through courts. Dozens of manufacturing companies, real estate assets and other businesses with significant environmental cleanup liabilities currently are in bankruptcy. If federal courts follow *Apex Oil*, cleanup orders under RCRA will survive chapter 11 reorganization and debtors may find themselves emerging from chapter 11 with substantial environmental liabilities for historic operations unaffected by the bankruptcy. Environmental regulators and private parties seeking to impose environmental liabilities on debtors at least those in the Seventh Circuit may find that asserting only a RCRA claim for injunctive relief will maximize the likelihood of avoiding the discharge of their rights in bankruptcy, effectively obtaining a priority over the claims of competing creditors for limited assets. The *Apex Oil* decision thus may prompt the government to exercise its authority under section 7003 of RCRA more frequently than it has in the past and also may encourage private parties to assert rights under section 7002 of RCRA. As a practical matter, however, the *Apex Oil* decision is not likely to result in a large-scale change in government enforcement efforts. While proceeding under RCRA may provide some advantages in the bankruptcy context, other statutes like CERCLA provide more robust enforcement mechanisms. In cases where the government targets scores or hundreds of potentially responsible parties, as happens in many large-scale hazardous substance cleanups, the institutional preference of state and federal environmental authorities to proceed under CERCLA is not likely to change.

RELATED LINKS: For more discussion on the treatment of judicial and administrative cleanup orders in bankruptcy, see

- Collier Monograph: Environmental Issues in Bankruptcy Cases, § 6.

For information on environmental issues in bankruptcy, see

- Environmental Law in Real Estate and Business Transactions (Matthew Bender).

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31 of 197 DOCUMENTS

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Weisz on Eligibility Requirements for High Income Earners in Bankruptcy

2009 Emerging Issues 4638

Richard L. Weisz on Eligibility Requirements for High Income Earners in Bankruptcy Under 11 U.S.C. § 109: When High Earners Go Bust

By Richard Weisz

November 25, 2009

SUMMARY: In this Emerging Issues Analysis, Richard L. Weisz, a partner with Hodgson Russ LLP, examines the bankruptcy choices for high income earners and how these choices have been significantly impacted by the adoption of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

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ARTICLE: When a high income earner, or recently high income earner, runs into financial problems, their eligibility to file in bankruptcy, and their choices of what kind of bankruptcy to file, have been significantly impacted by the adoption of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). Contained within BAPCPA is the so-called means test (*11 U.S.C. §707(b)(2)*). If the debtor's Current Monthly Income (CMI) is higher than a detailed statutory formula, which is measured by income over the six (6) months prior to the last date of the calendar month preceding the filing of the bankruptcy petition (*11 U.S.C. §101(10)(A)*), the debtor is not eligible for a chapter 7 liquidation bankruptcy. This generally bars high income earners from filing in chapter 7 unless they are a family farmer, which, as defined, limits their aggregate debt to \$3,544,525.00 and requires that not less than 50% of the debt arises out of farming operations (*See U.S.C. §101(18)(A)*).

The high income earner therefore is usually left with a choice of chapter 13, adjustment of debt of income of individuals, or chapter 11, the basic business reorganization procedures available to individuals (subject to narrow exceptions). In either event, they must take a credit counseling course within six (6) months of the bankruptcy filing and file the certificate with their bankruptcy petition like all consumer debtors (*See 11 U.S.C. §109(h)*). Generally, then, the high income debtor is left struggling to fit into the more consumer-friendly chapter 13 proceeding as opposed to being required to meet the considerable requirements of the business-oriented chapter 11 proceeding.

The eligibility to file in chapter 13 is determined by debt ceilings that adjust from time to time to reflect inflation. Under current *11 U.S.C. §109(3)*

"Only an individual with regular income that owes, on the date of the filing of the petition, non-contingent,

liquidated unsecured debt of less than \$336,900.00 and non-contingent, liquidated secured debt of less than \$1,010,650.00 n1, or an individual with regular income and such individual's spouse, except a stockbroker or commodity broker"

For purposes of the eligibility requirements, the terms "liquidated," "contingent," and "disputed" have distinctive meanings. Unfortunately, the legislative history of the origins of chapter 13 eligibility is silent as to the phrase "non-contingent, liquidated." See *In re Crescenzi*, 53 B.R. 374 (Bankr. S.D.N.Y. 1985). Courts have therefore approached eligibility with some inconsistent results.

A debt is defined as a liability on a claim (11 U.S.C. §101(12)), a definition that the United States Supreme Court found sufficient to treat debt and claims as equivalent. See *Pennsylvania Dept. of Welfare v. Davenport*, 495 U.S. 552, 558, 110 S. Ct. 2126 (1990). Under contract law, an unmatured or contingent claim refers to obligations that will become due upon the happening of a future event that was within the actual or presumed contemplation of the parties at the time the original relationship was created. See *In re Water Valley Finishing, Inc.*, 139 F.3d 325 (2nd Cir. 1998); *In re Chateaugay*, 944 F.2d 997 at 1004 (2nd Cir. 1991). Whether a debt is liquidated depends upon whether it is subject to a ready determination and precision in calculating the amount due. *In re Reader*, 274 B.R. 893 (Bankr. D. Co. 2002) and cases cited therein. A debt is non-contingent when all events giving rise to liability occurred prior to the debtor's filing for bankruptcy. *In re Mazzeo*, 131 F.3d 295, 303 (2nd Cir. 1997).

Secured debt has been treated as the face amount of any debt which is secured, to any extent, by collateral. *In re Belknap*, supra; *In re Gorman*, 58 B.R. 372 (Bankr. E.D.N.Y. 1985). However, it has also more specifically held that "secured debts" as referenced in § 109(e) refer only to those debts secured by property of the estate and, therefore, guaranties of secured debt are unsecured debt. See, for example, *Fuson*, 404 B.R. 872 (Bankr. S.D. Ohio 2008).

Merely because the debtor disputes a debt does not render the debt contingent or unliquidated. See, for example, *In re Murphy*, 374 B.R. 73 (Bankr. W.D.N.Y. 2007); *In re Crescenzi*, 69 B.R. 64, 65 (S.D.N.Y. 1986). Filing bankruptcy before judgments can be entered on a money claim does not by itself make the claim contingent or unliquidated, even if the debtor disputes the claim. *In re Jordan*, 166 B.R. 201 (Bankr. D. Me. 1994).

Tort claims not reduced to judgment and where liability has not been conceded by the debtor prepetition or in the schedules do not count in determining eligibility. See *In re Star*, 2008 W.L. 324125 (Bankr. E.D. Pa. 2008); But see *In re Pearson*, 773 F.2d 751 (6th Cir. 1985), which indicates eligibility should be determined based on schedules if completed in good faith, and *In re Nowakowski*, 404 B.R. 789 (Bankr. M.D. Pa. 2009), and references therein. Therefore, if the debtor lists a liability arising from the tort without indicating that it is contingent or unmatured, eligibility in chapter 13 may be denied.

A guaranty is a secondary liability usually thought of as contingent. Yet it has been held in New York that when the true state of affairs indicates that the guarantor will ultimately be responsible for the debt, the amount of the guaranty liability can be used to bar eligibility in chapter 13. See, for example, *In re Belknap*, 174 B.R. 182 (Bankr. W.D.N.Y. 1994). However, under New York State foreclosure law, the liability of any guarantor cannot be determined until the time of the foreclosure sale (See RPAPL 1371). Therefore, if a foreclosure has been started, the debtor may be able to file in chapter 13 if other debts do not make him or her ineligible.

It is now incumbent on both debtor's and creditor's attorneys to closely examine individual bankruptcy filings for eligibility requirements under 11 U.S.C. § 109 since the ultimate selection of the chapter under which the bankruptcy is filed in will determine the process and standard under which the debts may be discharged and the debtor allowed to keep assets.

n1 These limits will remain in effect until April 1, 2010 when new amounts will be determined [11 U.S.C. §104(a)].

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32 of 197 DOCUMENTS

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Jurs on In re Shankman, 2009 Bankr. LEXIS 2600 (Bankr. S.D. Tex. 2009)

2009 Emerging Issues 4525

S. Andrew Jurs on *Cage v. Shankman (In re Shankman)*, 2009 Bankr. LEXIS 2600 (Bankr. S.D. Tex. Sept. 1, 2009)

By S. Andrew Jurs

November 1, 2009

SUMMARY: This Emerging Issues Analysis looks at a court's decision to allow a ch. 7 trustee to amend his complaint objecting to discharge to allege additional grounds for the denial, grounds that occurred after the 60-day deadline for objection. In doing so, the court adopted an "extended version" of the approach of the Second and Ninth Circuits. The decision is noteworthy precisely because the court did not leap immediately to an equitable solution.

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ARTICLE: Chapter 7 Trustee Allowed to Amend Complaint Objecting to Discharge in Order to Allege Additional Grounds That Occurred after the Deadline for Filing the Complaint

In *Cage v. Shankman (In re Shankman)*, 2009 Bankr. LEXIS 2600 (Bankr. S.D. Tex. Sept. 1, 2009), the bankruptcy court was called upon to determine whether a chapter 7 trustee could amend a complaint objecting to the debtor's discharge to include allegations regarding conduct that occurred after the deadline to file an objection to discharge had passed.

Facts and Procedural History

Because the issue confronting the court was a purely procedural matter, the underlying facts of the debtor's chapter 7 case need little elaboration. It is undisputed that the chapter 7 trustee (the "trustee") timely filed an adversary proceeding (the "Discharge Proceeding") in which the trustee objected to debtor's discharge pursuant to 11 U.S.C. § 727(a). In the Discharge Proceeding, the trustee alleged that the debtor:

- (1) failed to turn over documents relating to investments in closely-held enterprises that constituted assets of the estate;
- (2) failed to provide tax returns;
- (3) failed to provide documentation relating to his recent divorce;

(4) failed to disclose significant assets;

(5) failed to turn over other assets to the trustee; and

(6) attempted to sell estate property or to give estate assets to creditors in satisfaction of debt.

The trustee subsequently filed a motion seeking leave from the bankruptcy to amend the Discharge Proceeding to add two additional grounds for objection to debtor's discharge:

(7) that debtor did not comply with a bankruptcy court order to provide certain information such that his discharge should be denied pursuant to section 727(a)(6); and

(8) that, after the deadline to object to debtor's discharge had passed, the debtor received \$14,000 cash that was property of the estate and failed to turn it over to the trustee, such that his discharge should be denied pursuant to section 727(a)(2).

Debtor objected to the trustee's motion to amend on the grounds that the amendments were untimely.

Legal Analysis

The deadline to file an objection to a chapter 7 debtor's discharge under section 727(a) is set forth in *Rule 4004(a) of the Federal Rules of Bankruptcy Procedure*. Under Rule 4004(a), a party has 60 days after the first date set for the meeting of creditors to file an objection. The purpose of this deadline is to set an early and definitive date by which parties have to lay out the bases for their objections to discharge. To achieve this goal, Rule 4004(b) provides that the deadline for filing an objection to discharge cannot be extended unless a motion to extend the deadline is filed before the deadline has run. Additionally, there is substantial precedent that if an objection to discharge is filed, it cannot be amended after the deadline to substitute a successor party plaintiff or to add new bases for denial of the discharge. See *Collier on Bankruptcy*, 4004.02.

Under Rule 4004(c), if no objection is filed in a timely manner, the bankruptcy court is required to issue the discharge "forthwith." The entry of discharge is delayed until the conclusion of the adversary proceeding, however, if a complaint is timely filed. See Advisory Committee Notes to *Fed. R. Bankr. P. 4004*. If the discharge has already been entered, it will be revoked upon the request of a trustee, creditor, or United States trustee if:

(1) The debtor obtained the discharge through fraud and the party requesting the revocation of discharge did not know of the fraud until after issuance;

(2) The debtor acquired property that is property of the estate and knowingly and fraudulently failed to report the acquisition or to deliver the property to the trustee; [or]

(3) The debtor has refused to obey a bankruptcy court order.

11 U.S.C. § 727(d). Section 727(e) further provides that such a complaint must be filed within one year after the discharge was granted if the complaint is based on fraud; for a complaint alleging other grounds, the deadline is the later of one year after the granting of the discharge or the date that the case was closed.

Commentary

The bankruptcy court's holding in *Shankman* is noteworthy in that it provides a framework for analyzing cases that fall between the cracks in the process created in section 727. Although Rule 4004(c)(1) requires that a discharge issue "forthwith" after the passing of the 60-day objection period, there are several exceptions that could create a gap ("Gap") between the deadline for filing objections to discharge and the entry of the discharge. In fact, the length of such a Gap may be substantial when the adversary proceeding to prove the allegations of the objection moves at the same slow pace

as other complex federal litigation, with extensive discovery, pretrial preparation, and clogged dockets.

The bankruptcy court in *Shankman* identified two problems that may arise during the Gap: (1) fraud discovered during the Gap, and (2) misconduct occurring during the Gap. Each of these issues needed to be addressed in the case at hand.

Fraud Discovered During the Gap. In this situation, a party entitled to object to discharge discovers debtor fraud during the Gap. Although the discharge has not been entered, the deadline to objecting to the discharge has passed. This means that revocation of the discharge is not possible because the objecting party learns of the conduct before entry of the discharge. This creates a perverse incentive for the debtor to obtain immunity from revocation of the discharge by disclosing fraudulent conduct during the Gap. According to the plain language of the statutes and rules, the bankruptcy court would know that a discharge should not be entered but would be forced to issue the discharge because the deadline for objecting had run.

Circuit courts have gone in two directions in deciding how to deal with this situation. The Seventh Circuit affirmed the lower courts' dismissal of a complaint objecting both to discharge under section 523(a) and, concurrently, seeking revocation of discharge under section 727(d). *Zedan v. Habash*, 529 F.3d 398 (7th Cir. 2008). The Second and Ninth Circuits, however, have created a legal fiction that the discharge has been entered "forthwith" as required by Rule 4004(c), meaning that a complaint to revoke the discharge was permissible even though a discharge had not yet actually been entered. *In re Emery*, 132 F.3d 892 (2d Cir. 1998); *In re Dietz*, 914 F.2d 161 (9th Cir. 1990).ⁿ¹ To resolve the split, the Rules Committee has proposed an amendment to Rule 4004 that would permit the bankruptcy court to extend the deadline for filing objections to discharge if the discharge has not been entered and if the objection to discharge would be a basis for revocation of a discharge if a discharge had been entered.

Misconduct Occurring During the Gap. The bankruptcy court in *Shankman* notes, however, that the proposed amendment to Rule 4004 still does not address how to handle situations where the conduct for which a discharge might be denied occurs after the deadline for objecting to discharge. Additionally, the proposed rule ignores the fact that the reasons for denial of discharge under section 727(a) are broader than the bases for revocation of discharge under section 727(d). For example, the elements that an objecting party must prove to revoke a discharge are more limited than the elements to deny discharge.

Application to the Case. To the bankruptcy court, resolution of these two dilemmas boils down to a simple question:

Very simply, why should a debtor, post-deadline, be immunized by the Federal Rules of Bankruptcy Procedure from the statutory consequences of mutilating property of the estate or from the statutory consequences of "permitting" the removal of property of the state with intent to hinder or delay the trustee or creditors?

2009 Bankr. LEXIS 2600, at *11. The self-evident answer to this question, according to the bankruptcy court, was that "Setting a deadline that effectively eliminates the ability to assert a statutory right renders a rule invalid." *Id.* at *12. In the event, though, that Rule 4004's time limitations cannot be invalidated, the bankruptcy court adopts an "extended version" of the Second and Ninth Circuits' "legal fiction" analysis. According to this "extended version":

When a discharge is not entered "forthwith" after the expiration of the Rule 4004(a) period and until a discharge is actually entered, although a complaint objecting to discharge under section 727(a) would be untimely, a party may properly file a complaint under section 727(d) to "revoke" a discharge for

1) Conduct occurring prior to the expiration of the Rule 4004(a) period of which the party did not have knowledge in time to file a timely complaint under section 727(a) due to the fraud of the debtor or

2) Conduct occurring after the expiration of the Rule 4004(a) period.

Id. at *12-13 (quoting *In re Stevens*, 107 B.R. 702, 705 (B.A.P. 9th Cir. 1989)).

In light of this analysis, the bankruptcy court had two options: (1) deny the amendment to the pleadings, hold a trial on the original allegations of the trustee's complaint, and then, if the trustee loses, allow the trustee to bring an action to revoke the discharge; or (2) adopt the solutions posited by the Second and Ninth Circuits and allow the trustee to seek to revoke a discharge that had not yet been entered. In the interests of efficiency, the bankruptcy court decided to allow amendment of the complaint to the extent that (1) the alleged misconduct could be a basis for revocation of discharge under section 727(d), or (2) the improper conduct occurred during the Gap.

It is interesting to note that, the above analysis notwithstanding, the bankruptcy court was always going to allow the claims against the debtor to proceed. Although statutes of limitation and deadlines are generally enforced in a strict manner, see *Taylor v. Freeland v. Kronz*, 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed. 2d 280 (1992), they are still subject to equitable modification by the courts. First, the bankruptcy court identified that the deadline for objections to discharge is not jurisdictional. *Kontrick v. Ryan*, 540 U.S. 443, 124 S. Ct. 906, 157 L. Ed. 2d 867 (2004). Following on that point, the bankruptcy court stated: "To the extent that interpretation of Rule 4004(a) would deny a creditor, the trustee, or the United States trustee a right established by statute, an equitable exception is appropriate and the Court will recognize it." 2009 LEXIS 2600, at *14-15.

Because the bankruptcy court recognized that other courts have handled similar matters differently, however, it hedged on its directions to the trustee. The bankruptcy court required the trustee to plead its new claims both as objections to discharge and as requests to revoke the discharge.

Conclusion

The decision in *Shankman* is noteworthy precisely because the bankruptcy court did not leap immediately to the equitable solution to its dilemma and, instead, sought to create a logical, statutorily justifiable basis for allowing the trustee to pursue his new claims. The bankruptcy court identified problems that could arise during the Gap and proposed a workable answer that would also set the table for appellate review on all issues.

[Return to Text](#)

ⁿ¹ According to the bankruptcy court in *Shankman*, this legal fiction works only if no objection to discharge was filed. In the event an objection had been filed, *Fed. R. Bankr. P. 4004(c)(1)(B)* would prohibit entry of the discharge, thereby voiding the fiction. 2009 *Bankr. LEXIS* 2600, at *8-9 n.12.

RELATED LINKS: For discussion of Federal Rule of Bankruptcy 4004, see Collier on Bankruptcy, [■](#) ch. 4004.

For analysis of other decisions relating to bankruptcy litigation and procedure, click [■](#) here.

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Bernhardt on In re Solutia

2009 Emerging Issues 4515

Professor Roger Bernhardt on In re Solutia Inc., 379 B.R. 473 (Bankr. S.D.N.Y. 2007)

By Mr. Roger Bernhardt

October 29, 2009

SUMMARY: *Get Emerging Issues Analysis on In re Solutia, Inc., 379 B.R. 473 (Bankr. S.D.N.Y. 2007), where bankruptcy debtors proposed a Ch. 11 reorganization that provided for payment of secured noteholders in full and for significant change in control; the debtors and a committee of unsecured creditors moved for partial summary judgment with regard to the amount of the noteholders' claim which included interest, which was granted.*

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ARTICLE: This decision conveys two ominous warnings to lenders regarding acceleration clauses.

First, it warns a lender that its attempt to draft an acceleration clause that appears both automatic and elective will not easily survive hostile judicial scrutiny. This loan agreement provided for acceleration of the loan automatically "without any declaration or other act" by the lender on the filing of a bankruptcy reorganization. (Since all other defaults lead to acceleration only after notice, this feature was clearly designed to avoid the effect of a bankruptcy stay.) However, since the lender also apparently desired to be able to de-accelerate if it so chose, the loan documents also included the following provision (much excerpted):

"Provided the Notes are not then due and payable by reason of a declaration of acceleration, the Holders may waive the any past Default with respect to such notes and its consequences by providing written notice thereof, except a default in the payment of interest or on the principle of any Note ..."

While these words do appear to permit an acceleration that has occurred automatically (rather than by declaration) to be undone by a written notice (although the unpaid amounts would not be waived), the bankruptcy court instead characterized the language of the section as "simply difficult to parse" and construed it otherwise. While the inclusion of far too many other clauses in that provision perhaps justified that judicial reaction, its fate should warn drafters how difficult it may be to employ language that judges will accept when it seems unfair to the borrower.

Second, the court's holding that the notice of the de-acceleration was void as in violation of the bankruptcy stay means that even more effective language would probably not help. A lender is therefore put to a hard choice: if the loan

documents make acceleration optional on default, a timely filing for bankruptcy may prohibit it from being able to thereafter declare an acceleration. On the other hand, if they make acceleration automatic, that bankruptcy filing can prohibit it from de-accelerating, entailing costly effects such as those that fell on this lender.

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34 of 197 DOCUMENTS

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Bernhardt on Clear Channel Outdoor, Inc. v. Knupfer

2009 Emerging Issues 4517

Professor Roger Bernhardt on *Clear Channel Outdoor, Inc. v. Knupfer* (In re PW, LLC), 391 B.R. 25 (B.A.P. 9th Cir. 2008)

By Mr. Roger Bernhardt

October 29, 2009

SUMMARY: Get Emerging Issues Analysis on *Clear Channel Outdoor, Inc. v. Knupfer*, a case from the bankruptcy appellate panel for the Ninth Circuit that found that outside a plan of reorganization, 11 U.S.C. § 363(f) does not permit a secured creditor to credit bid its debt and purchase estate property, taking title free and clear of valid, nonconsenting junior liens.

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ARTICLE: This case was remanded by the Bankruptcy Appellate Panel for the Ninth Circuit "to allow the parties to identify a qualifying proceeding under nonbankruptcy law (if one exists) that would enable them to strip Clear Channel's lien and make the sale of PW's property to DB free and clear under § 363(f)(5)." As such, the matter is not over.

However, is there any nonbankruptcy law that would permit the senior lienor or the debtor to strip away the junior's lien? Lien stripping is a function of bankruptcy law, not state law, which is not what 11 U.S.C. § 363(f)(5) demands. California's fair value provisions (*Code Civ. Proc.* §§ 726 and 580a) do reduce debts but perform their function only in the context of a foreclosure proceeding, which did not happen here. (And any foreclosure sale here would probably be conducted by the senior, which would make PW a sold out junior, not subject to fair value unless it became the high bidder at the senior sale).

If there is no identifiable proceeding to justify stripping away the junior's lien, that would make a free and clear sale improper. But one was already held. Thus, some questions arise:

- Should the bankruptcy court order it unwound and restore DB to its former status as lienor?
- Should it do the same for the \$800,000 paid to the trustee?
- Or can it leave title in DB, as purchaser at the sale, but merely restore PW's lien to the property that DB now holds?
- If DB does now hold title subject again to PW's lien, what are its remedies? And can it now foreclose on PW, demanding that PW exercise its right of redemption and pay DB the \$41 million that it was owed (or that it paid for the transfer)?

The alternative (if redemption is not made) is no longer likely to be a sale since DB may be both owner and creditor as a result of the improper free and clear sale. More likely, the foreclosure would be "strict," merely wiping out PW's redemption rights if they are not exercised, as is done in the case of a senior foreclosure action that fails to include the junior creditor as a party.

Assuming that the next highest bid for the property of only \$25 million says something about the value of the property, it does not seem likely that the junior will get any benefit from its victory before the BAP.

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35 of 197 DOCUMENTS

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Jurs on Ransom v. MBNA, America Bank, N.A. (In re Ransom)

2009 Emerging Issues 4507

S. Andrew Jurs on Ransom v. MBNA, America Bank, N.A. (In re Ransom), 577 F.3d 1026, 2009 U.S. App. LEXIS 18179 (9th Cir. 2009)

By S. Andrew Jurs

October 26, 2009

SUMMARY: S. Andrew Jurs looks at the Ninth Circuit's decision in *In re Ransom*, where the court considered whether an above-median-income chapter 13 debtor is allowed to deduct from projected disposable income the vehicle "ownership cost" even though the vehicle is owned free and clear. The decision has created a circuit split, with both sides claiming that their positions are supported by the "plain language" of Code section 707.

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ARTICLE: The Ninth Circuit Denied a Chapter 13 Debtor's Plan to Take an Ownership Deduction for a Car Owned Free and Clear of All Liens

In *Ransom v. MBNA, America Bank, N.A. (In re Ransom)*, 577 F.3d 1026, 2009 U.S. App. LEXIS 18179 (9th Cir. 2009), the Court of Appeals for the Ninth Circuit was faced with a split between various courts regarding how to read the purportedly plain language of the Bankruptcy Code and the possible incorporation in the Bankruptcy Code of interpretative provisions of the Internal Revenue Manual (the "Manual"). In denying a chapter 13 debtor's plan to take an ownership deduction for a car owned free and clear, the court not only declined to utilize the Manual's interpretations of the IRS deduction rules, but rejected other courts' "plain language approach" in favor of its own purported plain reading of the statutory language.

Facts and Procedural History. The parties agreed on the underlying facts. On the petition date, the Debtor owned a 2004 Toyota Camry free and clear of all liens. On his official Statement of Current Monthly Income Form B22C, the Debtor, whose income was above-median, claimed an ownership expense deduction for the Toyota in the amount of \$471.00. The Debtor's resulting monthly income was \$210.55 after this deduction, but he proposed paying \$500.00 per month for 60 months to give unsecured creditors a 25 percent distribution for general unsecured claims.

An unsecured creditor, MBNA America Bank ("MBNA"), objected to plan confirmation on the grounds that the Debtor was not allowed to claim an ownership expense deduction on a vehicle owned free and clear. If the allegedly improper ownership expense deduction was backed out, the Debtor would pay \$680.55 per month.

The bankruptcy court upheld MBNA's objection and held that the Debtor was entitled to an ownership expense deduction only if he was making loan or lease payments on the Toyota. The bankruptcy court denied confirmation of the Debtor's chapter 13 plan, and the Debtor appealed the decision to the Ninth Circuit Bankruptcy Appellate Panel ("BAP"). The BAP affirmed the bankruptcy court but certified the decision to the Ninth Circuit for possible interlocutory appeal. *Ransom v. MBNA Am. Bank, N.A. (In re Ransom)*, 380 B.R. 799 (B.A.P. 9th Cir. 2007). The Ninth Circuit subsequently granted leave for the interlocutory appeal to go forward.

Legal Analysis. Courts may not approve a proposed chapter 13 plan if an unsecured creditor objects and (a) the plan does not pay the claim in full or (b) does not provide for payment of "all of the debtor's projected disposable income to be received" during the plan period. 11 U.S.C. §1325(b)(1)(A)-(B). The Bankruptcy Code, however, does not define "projected disposable income." Instead, the closest analogous term is "disposable income," which, under section 1325(b)(2), is calculated for above-median debtors as "current monthly income" *minus the standardized deductions*.

The standardized deductions consist of reasonably necessary expenses for, among other things, maintenance or support of a debtor and the debtor's dependents. 11 U.S.C. §1325(b)(2). Additionally, according to section 1325(b)(3), for above-median debtors section 707(b)(2)(A) of the Code governs the determination of such expenses, and it provides:

The debtor's monthly expenses shall be the debtor's *applicable* monthly expense amounts specified under the National Standards and Local Standards, and the debtor's *actual* monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtors resides. (Emphasis added.)

Determining transportation expenses is further complicated by the fact that the Local Standard has three components: (1) a single national allowance for public transportation costs available to everyone, even without proof of using public transportation; (2) a single national ownership cost allowance for one or two cars; and (3) an operating cost allowance for one or two cars that varies by place of residence.

The Debtor and MBNA disputed whether the second component, the ownership expense deduction, was a proper "applicable monthly expense amount" under section 707(b)(2)(A). According to the Debtor, the only factors to consider when determining "applicable monthly expense amounts" involve the Debtor's date of filing, family size, geographic location and number of vehicles. In contrast, MBNA argued that the Debtor was only allowed an automobile ownership interest deduction if he actually owed money on the vehicle as of the petition date.

Commentary. The Ninth Circuit's holding in *Ransom* is noteworthy in that it not only rejects the two most recent circuit court opinions on the issue, but posits a contradictory "plain language" interpretation of section 707. The end result was that the Ninth Circuit became the first circuit court to hold that an above-median income chapter 13 debtor does not get to deduct from his projected disposable income the vehicle "ownership cost" when he owns the vehicle free and clear of all liens.

As a preliminary matter, the Ninth Circuit acknowledges the "significant split in authority" on the issue identified by the BAP. *Ransom*, 380 B.R. at 803-06. In fact, the appeals court noted that it was in the "uncomfortable position" of disagreeing with the Fifth and Seventh Circuits and their readings of the statute. 2009 U.S. App. LEXIS 18179, at *7, referring to *Tate v. Bolen (In re Tate)*, 571 F.3d 423 (5th Cir. 2009); *Ross-Tousey v. Neary (In re Ross-Tousey)*, 549 F.3d 1148 (7th Cir. 2008).

According to the Seventh Circuit in *Ross-Tousey*, the appropriate analysis involved a "plain language approach" of statutory interpretation, which led the appeals court to conclude that a vehicle not encumbered by a debt or lease still qualified for the "ownership cost" deduction. *Ross-Tousey*, 549 F.3d at 1157-58. This conclusion was based on the fact that section 707(b)(2)(A)(ii)(I) uses the word "applicable," and not "actual," to describe the "ownership cost" deduction. To the Seventh Circuit, "applicable" refers

to the selection of an expense amount corresponding to the appropriate geographic region and number of vehicles owned by the debtor. . . . In other words, under [this] approach, the Local Standard vehicle ownership deduction applies'

to the debtor by virtue of his geographic region and number of cars, regardless of whether that deduction is an actual expense.

Id. This "plain language approach" was sufficiently convincing that the Fifth Circuit described it as the "best reading of § 707(b)(2)(A)(ii)(I)," and accordingly adopted it. *Tate*, 571 F.3d at 427.

To counter this "plain language approach," the Ninth Circuit instead decided the issue on the "statutory language, plainly read," 2009 U.S. App. LEXIS 18179, at *11 (citing *Ransom*, 380 B.R. at 806 n.18). n1 According to the appeals court, "[a]n ownership cost' is not an expense--either actual or applicable--if it does not exist, period." *Id.* (Emphasis added.) In support of this interpretation, it adopted the "cogent reasoning" of the BAP that the "statute is only concerned about protecting the debtor's ability to continue owning a car, and if the debtor already owns the car the debtor is adequately protected. . . . When the debtor has no monthly ownership expenses, it makes no sense to deduct an ownership expense to shield it from creditors." *Id.* at *12. Furthermore, according to the BAP, the adjective "applicable" modifies "monthly expense amounts" to indicate that the deduction for the expense "becomes relevant to the debtor (i.e., appropriate or applicable to the debtor) when he or she in fact has such an expense." *Id.* at *12-13. To the BAP and the Ninth Circuit, this reading of the word "applicable" is consistent with its ordinary sense of meaning "capable of or suitable for being applied." *Id.* at *13 (citing Merriam-Webster's Collegiate Dictionary 60 (11th ed. 2005)). According to these courts, it is inconceivable that the vehicle ownership expense allowance can be "*capable of being applied to the debtor if he does not make any lease or loan payments on the vehicle []*." *Id.* Any other interpretation, in these courts' opinion, would read "applicable" out of the Bankruptcy Code.

Yet neither the Ninth Circuit nor its BAP addresses the question of why Congress used the word "applicable" to modify "monthly expense amounts specified under the National Standards and Local Standards," and the word "actual" to modify "monthly expenses for the categories specified as Other Necessary Expenses." Applying the same analysis as these courts, it seems that "applicable" runs the risk of being "read out of the Bankruptcy Code" by being replaced by "actual."

In the final part of its decision, the Ninth Circuit rejected the Debtor's argument that, on equitable grounds, he should be entitled to the vehicle ownership expense deduction. According to the Debtor, the age of the car, the likelihood of major repairs, and the costs of such repairs, will increase, but the allowable operating costs under the Local Standards do not cover these costs. The Ninth Circuit refuted this position, however, with the fact that section 707 already has safeguards to protect debtors with old or high mileage cars, including an extra \$200 per month operating expense and possible additional expenses based on "special circumstances." 2009 U.S. App. LEXIS 18179, at *14 (citing 11 U.S.C. § 707(b)(2)(B)). In the appeals court's opinion, equity does require it to provide any additional protections to the Debtor.

Conclusion. The final result, therefore, is that the decision in *Ransom* creates a split between the circuits on the question of whether an above-median income chapter 13 debtor gets to deduct from projected disposable income the vehicle "ownership cost" when the debtor actually has no such costs. Both sides argue that their positions are supported by "plain language" readings of section 707 and the ordinary meanings of "applicable" and "actual." As the Ninth Circuit recognized at the end of its opinion: "The correct' answer to the question before us, which the courts have been struggling with for years--at the unnecessary cost of thousands of hours of valuable judicial time--depends ultimately not upon our interpretation of statute, but upon what Congress wants the answer to be." *Id.* at *15. For that reason, it pleaded for "legislation clearly answering [this] straightforward policy question," and took the unusual step directing its Clerk of Courts to forward copies of the opinion to the Senate and House Judiciary Committees.

n1 Going this route, the Ninth Circuit was able to avoid engaging in analysis of what it called the "IRM approach," which relies on the IRS's interpretation of "applicable" contained in the Internal Revenue Manual. See *In re Talmadge*, 371 B.R. 96, 100-01 (Bankr. M.D. Pa. 2007); *In re Slusher*, 359 B.R. 290, 308-09 (Bankr. D. Nev. 2007). Other courts have found it inappropriate to consider the Manual in interpreting these provisions. See *In re Moorman*, 376 B.R. 694, 697-98 (Bankr. C.D. Ill. 2007); *In re Sawdy*, 362 B.R. 898, 912-13 (Bankr. E.D. Wis. 2007); *In re Barrett*, 371 B.R. 855, 858-59 (Bankr. S.D. Ill. 2007); *In re Chamberlain*, 369 B.R. 519, 525 (Bankr. D. Ariz. 2007); *In re Swan*, 368 B.R. 12, 18 (Bankr. N.D. Cal. 2007).

RELATED LINKS: For further discussion related to the determination of applicable deductions under Bankruptcy Code section 707(b)(2)(A), see Collier on Bankruptcy, ¶ 707.05.

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36 of 197 DOCUMENTS

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Mears on Long Term Supply Contracts in Auto Supplier Bankruptcies

2009 Emerging Issues 4491

Patrick Mears on Long Term Supply Contracts in Auto Supplier Bankruptcies

By Patrick Mears

October 20, 2009

SUMMARY: In this LexisNexis Emerging Issues Analysis, author Patrick Mears examines long term supply contracts in auto supplier bankruptcies, posing the question: may the nondebtor seller change payment terms for postpetition sales to the chapter 11 debtor? [Note: This EIA was recently available as a free download on the Bankruptcy Law Center, <http://law.lexisnexis.com/practiceareas/BankruptcyLawCenter>]

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ARTICLE: In virtually all Chapter 11 cases of auto suppliers, particularly higher-tiered suppliers n1 such as Delphi Corporation and Lear Corporation, and original equipment manufacturers like Chrysler Corporation and General Motors Corporation, a clash of interests will occur between the Chapter 11 debtor-supplier, on the one hand, and the nondebtor, lower-tiered supplier, on the other hand. The Chapter 11 debtor will attempt to move mountains in order to keep its operations functioning at prebankruptcy levels so as to stabilize, maintain and increase its cash flow. One strategy employed by Chapter 11 debtors to achieve this goal involves insisting that the debtor's suppliers continue to supply goods n2 under the terms of their prepetition supply contracts. These contracts normally contain extended payment terms. The nonbankruptcy seller, however, is often reluctant to bet on the debtor's survival and may push for abbreviated payment terms including, in many cases, cash on delivery or cash in advance. How these competing interests are accommodated in Chapter 11 cases may make the difference between the debtor's successful reorganization or its uncontrolled liquidation.

A. The Economic Matrix: Long Term Supply Contracts and the Auto Industry

The prevalent type of supplier contract in the American automotive industry is the long term requirements contract. Under these contracts, manufacturers of discrete parts and assemblies agree in writing to sell those goods to higher-tiered suppliers or to OEMs normally on unsecured credit terms. Often, these contracts are "requirements" contracts n3 where Tier II Supplier sells to Tier I Supplier all of its requirements of certain goods for an extended time period which in most cases will be the anticipated life-span of the particular vehicle model assembled by an OEM. The normal term of these contracts is therefore 5 or 6 years. Many, if not most, of these sellers are "sole source suppliers," meaning that the buyer of the components will contract only with one seller. The universe of suppliers to OEMs for the

production of a particular model is but a fraction of their number 60 to 80 years ago in the heady days of Alfred P. Sloan, Henry Ford and Walter Chrysler.

The combination of sole source suppliers for automotive parts with "just in time" inventory systemsⁿ⁴ creates an unstable brew in normal economic times. However, in a recessionary economic environment such as we have today, this admixture becomes explosive. The "resourcing" of parts manufacturing from a financially troubled, sole source supplier to an economically healthy one cannot be achieved overnight. Rather, this process may take six months or more because the parts to be fabricated by the replacement supplier must be approved by the purchaser through a procedure known as the "Production Part Approval Process" or "PPAP." In order for a part made by a new supplier to be "PPAPed," the parts must satisfy all of the specifications and tolerances demanded by the ultimate customer, the OEM.ⁿ⁵ In circumstances where production of a part is being resourced to a new supplier but where PPAP of the part has not occurred, there will be the constant threat of a line shutdown if (i) the financially troubled supplier is unable or unwilling to continue production pending resourcing; and (ii) an inadequate supply of parts, referred to as an "inventory bank," is not available to supply the OEM's production needs during the process of resourcing. A line shutdown is likely to cause the OEM to incur consequential damages of millions of dollars per day, the liability for which losses the OEM will attempt to assign to other members of the supply chain.ⁿ⁶

In this atmosphere, the commencement of a Chapter 11 case by a Tier I supplier has the potential of multiplying the potential for Armageddon on the assembly line. A Chapter 11 debtor will have an immediate and often overwhelming need for cash to pay its employees, lenders, suppliers, utilities, landlords and other entities that become creditors of the debtor in possession during the Chapter 11 case. In order to satisfy this critical need for cash, a Chapter 11 debtor will attempt to secure "debtor in possession financing" ("DIP financing")ⁿ⁷ from its existing secured lenders or new lenders and to negotiate with its existing secured creditors for its continued use of "cash collateral."ⁿ⁸ Once this postpetition financing is secured and use of cash collateral is permitted, the Chapter 11 debtor should be able to stabilize its business and negotiate a plan of reorganization with its creditors and other parties in interest. Without this stabilization, the debtor in possession will be hard pressed to convince its creditors that the debtor will survive long enough to negotiate and obtain confirmation of a Chapter 11 plan.

B. The Legal Matrix: The Treatment of Executory Contracts in Chapter 11 Cases

The Federal Bankruptcy Code contains an entire section defining the rights and obligations of Chapter 11 debtors and nondebtor counterparties under a class of contracts referred to as "executory contracts." This term is not defined in the Bankruptcy Code but was intended by the Code's drafters as those contracts which the parties thereto have duties of performance thereunder to some extent. Long-term auto supplier contracts that have not been terminated as of the date the debtor's Chapter 11 case was commenced fall within this category: the nondebtor party has the obligation to manufacture, sell and deliver goods to the debtor and the debtor has the duty to pay the contract price for these goods.ⁿ⁹

The overwhelming weight of reported case law prohibits the nondebtor counterparty from unilaterally terminating an executory supply contract once the debtor's case is commenced and, moreover, requires the nondebtor party to continue to perform its obligations under the contract until the debtor rejects the contract or the bankruptcy court enters an order authorizing the nondebtor to suspend or cease performance during the "limbo period."ⁿ¹⁰ A debtor in possession has the option of either assuming or rejecting an executory contract and may delay making this decision until the bankruptcy court confirms a Chapter 11 plan.ⁿ¹¹ However, the nondebtor party may file a motion with the bankruptcy court requesting it to fix an earlier date by which the debtor must either assume or reject the contract.ⁿ¹²

If a Chapter 11 debtor desires to assume an executory contract, it must file a motion with the bankruptcy court and serve the motion upon the other parties to the contract.ⁿ¹³ If the court grants this relief, the debtor will be bound to perform all of its contractual obligations thereafter and, if the debtor thereafter breaches the assumed contract prior to confirmation of a plan, the nondebtor's damages caused by the breach will be treated in the Chapter 11 case as administrative expenses.ⁿ¹⁴ Upon a Chapter 11 debtor's rejection of an executory contract, the contract will be

deemed to have been breached as of the date the bankruptcy case was commenced and all damages arising from the rejection will be treated as prepetition unsecured claims. n15 However, any claims for unpaid goods sold and delivered to the debtor postpetition will be treated as postpetition administrative expenses entitled to priority under **11 USCS § 507(a)(2)**. n16

C. The Supplier's Dilemma: To Ship or Not to Ship in the Limbo Period

As previously noted, a nondebtor supplier under an executory supply contract containing extended payment terms may determine shortly after the debtor's Chapter 11 case is commenced that it does not wish to risk nonpayment for goods sold postbankruptcy to a financially shaky debtor. This nondebtor's insecurity will be heightened if the nondebtor holds a large claim for unpaid goods sold prior to bankruptcy. Nevertheless, if the nondebtor refuses to ship goods to the debtor postpetition altogether or insists upon the imposition of cash on delivery or cash in advance terms as a precondition to postpetition shipments, the debtor will likely claim that this action violates the automatic stay and the case law requiring nondebtors to perform their contractual obligations during the limbo between the bankruptcy petition date and the date on which the contract is assumed or rejected.

One "traditional" remedy available to suppliers in this situation is to file a motion with the bankruptcy court requesting it to fix a date by which the Chapter 11 debtor must assume or reject the supply contract. n17 If an early date is fixed in response to this motion and the lease is assumed, the supplier will be assured that the debtor is obligated to perform under the contract. If the contract is rejected, the nondebtor supplier will no longer be required to manufacture and ship goods to the debtor. However, Chapter 11 debtors and creditors committees will normally oppose these motions, especially when they are filed in the early stages of the case. Debtors and committees will argue that if they assume a contract and it is later determined that it was economically improvident to do so, any subsequent breaches by the debtor will result in damages being treated as administrative expenses. If the debtor improvidently rejects the executory contract at an early date, the debtor will have forfeited under creditor pressure a valuable asset. It is for these reasons that bankruptcy courts are often loath to fix an early date by which a debtor must assume or reject executory contracts. Creditors filing these motions at the outset of the Chapter 11 case often find themselves in the position of the Light Brigade charging the Russian cannon at Balaklava with virtually no chance of success.

D. A New Supplier Strategy: Requesting Adequate Assurance of Future Performance Under U.C.C. § 2-609

Recent auto supplier Chapter 11 cases have seen instances where nondebtor suppliers to a Tier I Chapter 11 debtor have adopted a different strategy in the early stages of these bankruptcy cases based upon provisions of Article 2 of the Uniform Commercial Code. These suppliers have filed motions early in these cases under U.C.C. § 2-609 asserting that they have reasonable grounds for insecurity concerning the debtor's ability to perform under the terms of the long-term supply contracts (especially under the extended payment terms of the contracts) and, therefore, these suppliers are entitled to receive from these debtors adequate assurance of future performance of their contract obligations. In addition, some of these suppliers have argued that, because their debtors are "insolvent," the suppliers are entitled to unilaterally impose COD or CIA payment terms in lieu of credit terms as explicitly permitted by U.C.C. § 2-702(1).

Applied frequently in situations prior to any bankruptcy filing, U.C.C. § 2-609 (the "UCC") authorizes a party, upon reasonable grounds for insecurity, to demand adequate assurances of due performance and until it receives such performance, . . . if commercially reasonable, to suspend any performance for which he has not already received the agreed return. However, the UCC does not require a party to request assurances as a condition precedent to recovery. The purpose of a demand under U.C.C. § 2-609 is to permit a party likely to be injured by the other party's nonperformance to take steps to protect itself without worrying that its own nonperformance will later be construed as a repudiation.

Whether a supplier has reasonable grounds for insecurity is generally a question of fact. Because the reasonableness of a supplier's insecurity is determined by commercial standards, an objective factual basis must exist for the supplier's insecurity, as opposed to a purely subjective fear that the customer will not perform.

A buyer who has recently filed for Chapter 11 bankruptcy is likely to insist that its suppliers continue to ship goods and seek to compel performance by filing a motion to enforce the automatic stay and the underlying contract. n18 Debtors are increasingly seeking to enforce prepetition credit terms without any assurances of post-petition payment to suppliers. However, suppliers are not without recourse and legal argument, as illustrated by a recent motion filed by a supplier in *In re Visteon Corp.*, Case No. 09-11786 (Bankr. D. Del.).

In the *Visteon* bankruptcy cases, Visteon suggested that suppliers were not entitled to cash on delivery or cash in advance, despite the fact that the debtors were insolvent and had no debtor in possession financing. In support of its position, Visteon sent letter to its allegedly recalcitrant suppliers stating:

Under *section 362 of the Bankruptcy Code*, an automatic stay has been imposed to prevent third parties from taking actions against the assets of the Debtors (including the Debtors' contracts) without prior approval of the Bankruptcy Court. [Supplier's] actions to unilaterally modify and interfere with the Debtors rights under the Debtors' contract[s] with [Supplier] . . . would violate the automatic stay.

Prior to Visteon's bankruptcy filing, one of Visteon's suppliers sent a demand for adequate assurance of future performance under U.C.C. § 2-609. The supplier subsequently received acceptable adequate assurance, but nonetheless was owed approximately \$2.5 million, of which \$179,000 was past due.

When Visteon filed for bankruptcy, the supplier informed Visteon that it was prepared to continue to ship post-petition, but only in the event that Visteon provided payment on cash in advance basis. Visteon, however, refused to agree to cash in advance terms and reiterated that such a demand was a violation of the automatic stay. The supplier aggressively disputed the debtors' position by filing a motion requesting, among other things, adequate assurance under U.C.C. § 2-609 on a post-petition basis.

The supplier argued that shipping post-petition on prepetition credit terms would unfairly expose it to significant economic harm, especially in light of the fact that Visteon (i) admitted it was administratively insolvent, (ii) had no debtor in possession financing or other long term source of working capital, and (iii) had a limited right to use cash collateral. The supplier further argued that if forced to adhere to prepetition credit terms, it would in essence be forced to finance Visteon's bankruptcy and suffer from the risk of an administratively insolvent estate. n19

The supplier's motion emphasized that Visteon's use of cash collateral alone was insufficient to assure the supplier that Visteon would continue to satisfy its obligations to the supplier post-petition by noting, among other things:

- (i) Visteon's lack of a post-petition working capital facility;
- (ii) Visteon's admitted insolvency;
- (iii) cash collateral financing could be terminated as a result of an event of default with no notice to the supplier;
- (iv) a cash collateral budget that failed to contain a line item for payment to the supplier and only a generic line item entitled "operating disbursements;"
- (v) no carveout from the secured lenders' post-petition liens for the payment of goods delivered by the supplier to Visteon prior to the occurrence of an event of default but unpaid as of the date of the default; and
- (vi) a cash collateral order structured to provide maximum protection for a particular OEM and creditors who supply parts for that OEM, when the supplier's parts are not used for that OEM.

The supplier also attempted to refute any claim of Visteon that it would be adequately assured of future performance as a result of the supplier's administrative expense under section 503(b) by stressing that Visteon has not demonstrated that it is not administratively insolvent or is not at risk of administrative insolvency. Finally, the supplier

emphasized that its refusal to ship absent cash in advance or other forms of security was supported not only by U.C.C. § 2-609, but also U.C.C. § 2-702(1), U.C.C. § 2-703 and U.C.C. § 2-610(c). n20

Ultimately, Visteon and the supplier appear to have resolved the dispute before the bankruptcy court considered the supplier's motion. However, Visteon's assertion that a supplier cannot demand cash in advance or some other form of adequate assurance for post-petition shipments is likely to occur with a great deal of frequency in the future. In such instances, suppliers should take note of the aggressive posture assumed by Visteon's supplier in this particular instance and not hesitate to file a similar motion to protect against potential post-petition losses.

[Return to Text](#)

n1 The author wishes to thank his colleague, John T. Gregg, for his assistance in preparing this piece.

[1] In automotive industry parlance, an assembler of automobiles such as General Motors Corporation is referred to as an "original equipment manufacturer" or "OEM." Immediate suppliers of parts or modules to an OEM are called "Tier I Suppliers." Tier I Suppliers often purchase components from "Tier II Suppliers" for incorporation into systems that Tier I Suppliers sell to OEMs. Lower tiered suppliers may include parts manufacturers and tool and die fabricators. These relationships are commonly collectively referred to as the "automotive supply chain."

n2 Because these contracts involve the sale of "goods," these agreements, at least insofar as they are between American entities, will be governed by Article 2 of the Uniform Commercial Code ("UCC"). U.C.C. § 2-102. Article 2 has been adopted in all 50 states.

n3 U.C.C. § 2-306(1) addresses requirements contracts for the sale of goods. See also *Metal One America Inc. v. Center Manufacturing Inc.*, 2005 U.S. Dist. LEXIS 40304 (W.D. Mich. July 14, 2005).

n4 In the 1990s, American OEMs adopted the Japanese lean manufacturing practice of "just in time" inventory supply, which required suppliers to deliver just enough inventory to OEMs in order to maintain uninterrupted vehicle assembly without building up an expensive "inventory bank."

n5 See generally, John T. Gregg, *An Introduction to Tooling Liens in the Automotive Industry*, American Bankruptcy Institute Journal, Vol. XXVIII, No. 6 (July/August 2009).

n6 See, e.g., *In re Autostyle Plastics, Inc.*, 216 B.R. 784, 788 (Bankr. W.D. Mich. 1997).

n7 Financing of a Chapter 11 debtor involves the extension of new credit facilities, such as a revolving line of credit, after the commencement of the Chapter 11 case. This financing can be either on a secured or unsecured basis and must be approved by an order of the bankruptcy court. *Section 364 of the Federal Bankruptcy Code* governs this practice.

n8 The term "cash collateral" is defined in 11 U.S.C. § 363(a) and means cash or cash equivalents subject to a prepetition security interest that will normally be held by the Chapter 11 debtor's prebankruptcy secured lender. A Chapter 11 debtor may use "cash collateral" during the reorganization case on if the secured creditor consents to such use or if the lender's security interests in this collateral is adequately protected. 11 U.S.C. § 363(e).

n9 See generally *In re Dana Corporation*, 379 B.R. 449 (Bankr. S.D.N.Y. 2007).

n10 See, e.g., *In re National Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004). But see *In re Lucre, Inc.*, 339 B.R. 648 (Bankr. W.D. Mich. 2006).

n11 11 U.S.C. § 365(d)(2).

n12 See, e.g., *Adelphia Communications Corp.*, 291 B.R. 283, 293 (Bankr. S.D.N.Y. 2003).

n13 **USCS Bankruptcy R 6006.**

n14 See, e.g., *In re Parmenter*, 527 F.3d 606 (2009).

n15 11 U.S.C. § 365(q)(1), 11 U.S.C. § 502(g).

n16 See, e.g., *In re Collins & Aikman Corp.*, 384 B.R. 751 (Bankr. E.D. Mich. 2008).

n17 See *Adelphia Communications Corp.*, 291 B.R. 283, 293 (Bankr. S.D.N.Y. 2003).

n18 The Bankruptcy Code itself is silent on the rights and obligations of the parties of an executory contract during the period between the filing of the petition and the time of assumption or rejection. *In re National Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004). However, it is widely accepted that an executory contract generally remains in effect pending assumption or rejection by a debtor. See, e.g., *Pub. Serv. Co. of N.H.*, 884 F.2d 11, 14 (1st Cir. 1989).

n19 The supplier's contract with Visteon established payment terms of "Net 30th, Prox 10th, 20th Subsequent. These terms mean:

Net 30th: payments for goods received on the 1st through the 10th day of the month are due on the 30th day of the following month;

Prox 10th: payments for goods received on the 11th through the 20th day of month one are due on the 10th day of month three; and

20th Subsequent: payments for goods received on the 21st through the 30th/31st day of month one are due on the 20th day of month three.

n20 U.C.C. § 2-702(1) provides that a seller may refuse delivery except for cash when it discovers the buyer to be insolvent. U.C.C. § 2-703 provides that where a buyer refuses to make payment due on or before delivery, then with respect to any goods directly affected, the aggrieved seller may withhold delivery of goods. U.C.C. § 2-610 provides that when either party repudiates the contract with respect to performance not yet due, the loss of which will substantially impair the value of the contract to the other, the aggrieved party may suspend his own performance.

RELATED LINKS: For further discussion of Bankruptcy Code sections 362, 363, 364, 365, 502 and 507, see Collier on Bankruptcy

- 362.01;
- 363.01;
- 364.01;
- 365.01;
- 502.01;

■ 507.01

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37 of 197 DOCUMENTS

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Hedayat on Emotional Distress Damages for Violations of the Automatic Stay

2009 Emerging Issues 4495

Mazyar M. Hedayat on Emotional Distress Damages for Violations of the Automatic Stay

By Mazyar Hedayat Esq.

October 20, 2009

SUMMARY: In this LexisNexis Emerging Issues Analysis, Mazy Hedayat examines the issue of emotional distress damages for violations of the automatic stay, as well as the burdens of proof and persuasion to be met by any who wish to seek such damages.

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ARTICLE: The signature feature of bankruptcy is the *automatic stay* -- an automatic, universal, self-executing injunction against all actions to collect, enforce, commemorate, or advance claims against property of the bankruptcy estate. *11 U.S.C. § 362(a)* ("Automatic Stay" or "Stay"). The Stay serves the dual purposes of safeguarding debtor peace of mind and maximizing value for unsecured creditors. How does it manage to do both? By forcing a quiet period on all creditors while the Trustee examines and evaluates property of the bankruptcy estate ("Estate").

Once the Stay is in effect all attempts to secure claims against property of the Estate are forbidden: thereafter the onus is on the creditor to show that it has not acted in defiance of the Stay. Even the creation, perfection, or enforcement of a lien on property of the Estate is a violation of the Stay.

This article will examine the recovery of emotional distress damages for violations of the Automatic Stay, as well as the burdens of proof and persuasion to be met by any who wish to seek such damages.

Establishing Automatic Stay Violations

The elements of a cause of action for violation of the Automatic Stay are modest. To establish a violation the party must show the following by a **preponderance of evidence**: (a) that a petition was filed; (b) that a creditor attempted to exercise dominion or control over property; and (c) that said property belonged to the bankruptcy estate at the time. Intent to violate the Stay is **not** an element and need not be shown in order to establish that the Stay was violated. Awards in such circumstances are limited to damage to the Estate: generally, disgorgement of Estate property.

Establishing Intentional Violations

Intent need to be shown to allow for the Estate to recover from violator since the Stay must often be used to dramatic effect (stopping foreclosure, curtailing the sale of a home or car), such delay would render it useless. However, where a violation is shown to have been intentional, the Debtor may also recover damages. These damages are aimed at discouraging further violations by creditors such as the one at bar and include expenses incurred by the Debtor and punitive damages.

Step One: Establishing Willful Violation

Debtors who establish by **clear and convincing evidence** that they have been injured due to a *willful violation* of the Automatic Stay may recover actual damages. 11 U.S.C. 362(k). An obvious example is the creditor that receives actual notice of a bankruptcy filing but takes steps to collect anyway. Of course such flagrant violation is not always necessary, and *specific intent* to violate the Automatic Stay is not required at all for an action to be willful. Merely having the general intent to commit the complained of act (making a phone call, issuing a demand letter) justifies these damages. Whether or not the creditor knew that the offending action violated the Automatic Stay is irrelevant. Thus, creditors identified on a mailing matrix were deemed to have constructive notice of the case and their actions constituted *willful* violations of the Stay. See, *Fleet Mortgage Group v. Kaneb*, 196 F.3d 265, 268-69 (1st Cir. 1999); see also, *Giochman v. Bloom (In re Bloom)*, 875 F.2d 224 (9th Cir. 1989) (when creditor has actual notice of the Stay, court presumes the violation was deliberate).

Step Two: Distinguishing Actual Damages

The first courts that considered damages for intentional violations of the Automatic Stay had to grapple with the fact that the Bankruptcy Code did not define "actual damages" at all. Relying instead on the definition of the term "actual" those courts concluded that: (a) individuals can sustain emotional injuries; (b) the Code therefore treats such damages as "actual" ones; and (c) there was no limitation in the Code on what, or how much, "actual damages" could be recovered. *Holden v. IRS (In re Holden)*, 226 B.R. 809 (Bankr. D. Vt. 1998), and *In re Carrigan*, 109 B.R. 167 (W.D.N.C. 1989).

Soon after the issue began to be explored, the First Circuit concluded that emotional distress constituted a form of actual damages. *Fleet Mortgage Group v. Kaneb*, 196 F.3d 265 (1st Cir. 1999). A few years later the Ninth Circuit agreed in *Dawson v. Washington Mutual Bank*, 390 F.3d 1139 (9th Cir. 2004). The court first concluded that emotional distress damages were allowed as recovery under 363(k) was limited to individuals, who could suffer emotional damages, as distinct from corporations. The court then pointed out that the Automatic Stay traditionally had two aims. The first was to maximize the value of the estate (financial), and the second was to provide a quiet period for the debtor (non-financial). Damages for emotional distress were therefore among the actual damages that arose from violating the "non-financial" aim of the Stay. Hence, emotional distress damages could be granted in and of themselves -- not necessarily in combination with other forms of damages. The Seventh Circuit Court of Appeals disagreed.

In *Aiello v. Providian Financial*, the Seventh Circuit concluded that emotional injuries *were* actual damages but relied on the legislative history of 11 U.S.C. 362(k) and the traditional hesitancy of Bankruptcy Courts to entertain claims of emotional injury to conclude that such damages could only be granted as part of a broader scheme, including non-emotional damages. *Aiello*, 239 F.3d 876 (7th Cir. 2001). In that case the Seventh Circuit pointed out that emotional distress was a tort cause of action and rightfully belonged in state court -- not being ruled upon by a bankruptcy court. *Id.*

Step Three: Proving Emotional Distress

While consensus has developed on the recoverability of damages for emotional distress, there has been disagreement on the subject of how best to establish the existence of genuine distress. Is a doctor's opinion needed? How about a non-MD psychologist? Could other disciplines be called upon to answer the question? While a majority of

courts still require medical testimony to establish distress, since 1999, several courts of appeal have started to reconsider the issue. *See generally, In re Brockington*, 129 B.R. 68 (Bankr. D.S.C. 1991), *see also, In re Diviney*, 211 B.R. 951 (Bankr. N.D. Okla 1997), *In re Skeen*, 248 B.R. 312 (Bankr. E.D. Tenn. 2000), *In re Mercer*, 48 B.R. 562 (Bankr. D. Minn. 1985), *In re Jacobs*, 100 B.R. 357 (Bankr. S.D. Ohio 1989); *but see In re Putnam*, 167 B.R. 737 (Bankr. D.N.H. 1994).

The First Circuit took up the question determining emotional distress damages in *Fleet Mortgage Group v. Kaneb*, 196 F.3d 265 (1st Cir. 1999). In that case the debtor had filed a chapter 13 petition and converted his case to one under chapter 7. A mortgage lender with respect to one of the debtor's homes instituted foreclosure proceedings without first modifying the Automatic Stay. Although the foreclosure action was withdrawn 6 weeks later, the debtor sought damages for emotional distress. The court found in favor of the debtor and assessed emotional distress damages of \$25,000 based solely on the debtor's testimony. In drawing its conclusion, the court observed that emotional distress damages were "actual" ones and that testimony regarding the decline in the debtor's social life and changes in his eating and sleeping habits since the foreclosure was sufficient proof. No further showing or expert testimony was needed.

The Seventh Circuit considered the issue and came to the same conclusions -- albeit with a different outcome -- in *Aiello v. Providian Financial*. There the debtor had filed a petition under chapter 7 and her creditor sent a letter requesting that she sign a reaffirmation agreement or face fraud charges. The court wrote that the debtor could not recover damages for emotional distress because she had not also alleged financial damages. However, the court pointed out that if the debtor had shown financial damages she might be able to recover emotional distress damages as well under the "clean-up" doctrine of equity. *Aiello*, 239 F.3d 876 (7th Cir. 2001).

The next circuit to consider the issue was the Ninth Circuit. There, in *Dawson v. Washington Mutual Bank*, the court found that emotional distress damages are actual damages and therefore recoverable, but in order to do so the debtor must clearly show that he or she suffered significant harm and demonstrate a causal connection between that harm and the complained-of violation of the Stay. *Dawson*, 390 F.3d 1139 (9th Cir. 2004). In addition, that distress would have to be distinct from the anxiety inherent in the bankruptcy process.

Finally, the Fifth Circuit considered the issue in a case involving a debtor's ex-wife's divorce attorney refusing to agree to an order releasing him from prison, after the debtor had filed a petition under chapter 13, until the attorney's fees were paid by the debtor. *Young v. Repine*, No. 06-20807 (5th Cir. 2008). The court agreed with the other circuits in finding that emotional distress damages were actual damages and recoverable. The court articulated the evidentiary standard that the debtor must present "specific information concerning the damages caused by the emotional distress rather than relying only on generalized assertions." *Id.*

Securing Damages Due to Emotional Distress

All circuit courts that have considered the issue have determined that damages for emotional distress are proper where there are violations of the automatic stay. For practitioners, the questions remains: what evidence must be present to justify a finding of those damages?

First, the question is: can emotional damages can be recovered without a showing of financial damages? The only circuit to consider the issue directly on point was the Seventh Circuit, who rejected the idea, stating the reasons for the automatic stay were financial and not for peace of mind. It is likely that the other courts would allow for emotional damages without a showing of financial damages, although the findings for emotional distress have generally been low. As a practical matter, without a showing of financial loss, it is unlikely that a finding of emotional distress alone would compensate a debtor for the costs of the litigation.

Second, what must an attorney present as evidence of the emotional distress to recover damages? The courts have rejected the requirements that a debtor, or other plaintiff, show medial evidence of a physical manifestation of emotional distress. Therefore, a debtor need not present medical testimony or other evidence regarding the extent of the

distress. However, the debtor must present specific evidence of the distress. This evidence includes descriptions of changes in the debtor's social life, belief of those around them, or changes in the debtor's other habits. This evidence has been accepted by the courts as specific enough to justify awarding damages for emotional distress. The other option, instead of showing specific effects of the emotional distress, a debtor could show that the actions by the creditor were so extreme that there must have been emotional distress on the part of the debtor. Instances where this argument was accepted by the court include forcing the debtor to cancel her eight year-old's birthday party, reposing the debtor's car during the section 341 meeting, or coming to the debtor's home and banging on the door for several minutes to repossess property inside. Obviously, these situations are extreme and hopefully rare, but if a debtor has experienced similar action, the specific evidence related to the distress is likely not required for a finding of damages.

Conclusions

Section 362 provides that the Automatic Stay goes into effect immediately when a petition in bankruptcy is filed, remains in force during the case, and is replaced by a permanent injunction following discharge. Creditors that violate the Stay can be ordered to disgorge property of the estate, pay actual damages such as lost wages, attorneys' fees, and court costs, and even pay punitive damages. Debtors have even been able to secure *damages for emotional distress* following a Stay violation.

Almost all courts to consider this issue have found that emotional distress damages are recoverable for violations of the automatic stay. They have found that these damages are actual damages as required in the statute and that Congress intended that language to have a broad meaning. Even the courts that did not find emotional damages to be recoverable as actual damages have found that they can likely be awarded by a court in connection with other damages, notably financial damages. Courts also require detailed evidence as to the emotional distress suffered by the debtor. While most courts no longer require medical evidence, they do require specific testimony as to the changes that they emotional damage caused in the lives of the debtors. However, once the evidentiary standard has been met, courts have been willing to grant emotional distress damages for violations of the automatic stay as part of the award to debtors.

RELATED LINKS: For further discussion of Bankruptcy Code sections 341, 362, and 363, see Collier on Bankruptcy

- 341.01;
- 362.01;
- 363.01

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38 of 197 DOCUMENTS

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Piazza on In re R. Ring Enterprises, Inc.

2009 Emerging Issues 4478

Deborah J. Piazza on In re R. Ring Enterprises, Inc., 2009 Bankr. LEXIS 685 (Bankr. N.D. Cal. Feb. 18, 2009): Can a debtor's time to assume or reject unexpired leases of nonresidential real property be indefinitely extended?

By Deborah Piazza

October 14, 2009

SUMMARY: In this LexisNexis Emerging Issues Analysis, Deborah J. Piazza examines *In re R. Ring Enterprises, Inc., 2009 Bankr. LEXIS 685* (Bankr. N.D. Cal. Feb. 18, 2009), in which the issue was whether a debtor could indefinitely extend the time to assume or reject its nonresidential real property leases under 11 U.S.C. § 365(d)(4) if it filed, but did not confirm, a plan which included the assumption of such leases.

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ARTICLE: Can a debtor indefinitely extend the time to assume or reject its nonresidential real property leases under 11 U.S.C. § 365(d)(4) if it files, but does not confirm, a plan which includes the assumption of such leases? According to the Bankruptcy Court in the Northern District of California, the answer may be yes!

BAPCPA

Since the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), there has been extensive analysis and discussion regarding a debtor's time to assume or reject nonresidential real property leases under section 365(d)(4) of title 11 (the "Bankruptcy Code"). Prior to BAPCPA, a debtor would routinely request, and often be granted, several extensions of time to assume or reject its unexpired nonresidential real property leases. This was typical of a chapter 11 debtor, especially in large retail cases where a debtor's leasehold interests were often the most valuable asset in the bankruptcy estate. BAPCPA has changed that strategy for debtors.

Under BAPCPA, section 365(d)(4) of the Bankruptcy Code was revised to provide that a debtor must assume or reject its nonresidential real property leases within 210 days (120 days, plus a 90 day extension for cause). The debtor may only receive a further extension if the landlord consents to such extension. In today's depressed real estate market, it may not be a problem to receive the landlord's consent to an extension of time. However, once the market turns, will landlords be willing to allow debtors to continue to extend their time to assume or reject leases and maintain control over the landlord's property? While many debtors and debtors' attorneys have had much anxiety over such time restrictions, the Bankruptcy Court in *In re R. Ring Enterprises, Inc., 2009 Bankr. LEXIS 685* (Bankr. N.D. Cal. Feb. 18,

2009) may have offered everyone a solution.

In re R. Ring Enterprises, Inc.

In *In re R. Ring Enterprises, Inc.*, the court made clear that for a debtor to assume or reject a nonresidential real property lease in a timely manner the *debtor* need only act within the time limitations set forth in the Bankruptcy Code, not the Court. Hence, as long as the debtor has filed a motion or plan which provides for the assumption or rejection of its leases prior to the expiration of the time as set forth in the Bankruptcy Code, the debtor will have effectively extended its time to assume or reject its leases. The quandary will then arise where, as in *In re R. Ring Enterprises, Inc.*, the debtor has not obtained an order prior to the expiration of the applicable time period. Can a debtor be permitted to adjourn such motion or plan confirmation in perpetuity, thereby allowing for an unlimited extension of time? According to the court in *In re R. Ring Enterprises, Inc.*, the answer is yes.

The Bankruptcy Court in relying upon *In re Victoria Station, Inc.*, 840 F. 2d 682 (9th Cir. 1988), which addressed the issue in a pre-BAPCPA case, found that while BAPCPA did amend the rules regarding an extension of time to assume or reject leases to provide that the debtor must now have an order entered prior to the expiration of such time period, an order to assume a lease is not required prior to the expiration of such time. Other courts have followed *In re R. Ring Enterprises, Inc.* with support. See e.g., *In re Amerlink, Ltd.*, 2009 Bankr. LEXIS 2349 (Bankr. E.D.N.C. Aug. 12, 2009).

High Risk Strategy

However, before relying upon such a strategy, one must proceed with caution. If a debtor were to file a motion or plan which provides for the assumption or rejection of leases without being certain of the ultimate disposition of the leases, the court could refuse any adjournments and require the debtor to go forward on its motion or plan confirmation. At that time, if the disposition of the debtor's leasehold interests is still unresolved and the debtor withdraws the motion or plan to avoid assumption, its leases could be deemed rejected and the debtor could lose potentially valuable assets of the estate. Further, whether the rejection is effective as of the date of the withdrawal of the plan or motion, the date the plan or motion were filed, or the date the time to assume or reject originally expired could also have a significant impact on the value of the debtor's estate. While the courts in both *In re R. Ring Enterprises, Inc.* and *In re Victoria Station, Inc.* dealt with the assumption of leases, the same analysis could apply to a lease rejection so that a debtor seeking to reject its leases through a motion or plan could subsequently amend its motion or plan to provide for assumption of its leases prior to its approval.

Lenders' Growing Trend of Seeking Immediate Liquidation Sales

Further, in *In re R. Ring Enterprises, Inc.*, it was the landlord which sought an order compelling the rejection of the leases. However, in this economic market, it may well be the debtor's lenders who are more concerned with the debtor's treatment of its leasehold interests than the landlord. While there is no specific time period set forth in the Bankruptcy Code by which a debtor must sell its assets, many lenders today are requiring that the debtors sell their assets by a date certain or risk losing their debtor in possession financing. Because lenders are demanding immediate liquidation sales in many cases, debtors now have a limited ability to formulate a restructuring plan within the time constraints set by the lender. Consequently, if the time constraints of the lender are more stringent than those set forth in the Bankruptcy Code, a debtor may have very few options in its chapter 11 case. The court in *R. Ring Enterprises, Inc.* may have broadened such options for a debtor.

Burden of Proof to Show Debtor's Motives Improper

Assuming a debtor files a motion or plan providing for the assumption of leases before it was certain of the disposition of its leases to allow for additional time to market and analyze the value, would a party be able to prove the debtor's motives were improper? How would one prove such motivations? While it may be very difficult to prove the debtor did not intend to assume or reject its leases as it proposes in its plan or motion, debtors and debtors' attorneys

should still be cautioned that such practice could result in costly litigation.

Conclusion

Of course, none of the above analysis applies if the debtor is simply seeking an extension of time to assume or reject nonresidential real property leases in the traditional matter under *section 365(d)(4) of the Bankruptcy Code*. Since the enactment of BAPCPA, a debtor must now obtain an order of the court granting the extension of time **prior** to the expiration of the applicable time period. While filing a motion or plan which provides for the assumption or rejection of leases and perpetually adjourning the disposition of such motion or plan may seem attractive as a strategy if you are representing a debtor who wishes to extend its time to assume or reject leases, it is always prudent to obtain an order of the bankruptcy court granting the extension of time as opposed to taking a risk. While the debtor may need to address some objections, such actions will less likely result in the forfeiture of your client's leasehold interests.

RELATED LINKS: For further discussion of injunctions under Bankruptcy Code section 365(d), see Collier on Bankruptcy,

- 365.04 (Matthew Bender).

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39 of 197 DOCUMENTS

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Klee on Travelers Indemnity Co. v. Bailey

2009 Emerging Issues 4472

Professor Kenneth N. Klee on the Supreme Court's holding in *Travelers Indemnity Co. v. Bailey*, 2009 U.S. LEXIS 4537, 129 S. Ct. 2195 (2009)

By Kenneth Klee

October 13, 2009

SUMMARY: In this LexisNexis Emerging Issues Analysis, Professor Kenneth N. Klee discusses the holding in *Travelers Indemnity Co. v. Bailey*, 2009 U.S. LEXIS 4537, 129 S. Ct. 2195 (2009), the most recent in a long line of five other Supreme Court cases consistently precluding collateral attack on final bankruptcy court judgments, even where the scope of the judgments arguably exceed the subject matter jurisdiction of the bankruptcy court.

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ARTICLE: The Lesson To Be Learned: Parties challenging a bankruptcy court's final order almost always must take a direct appeal or be forever barred from collateral attack.

In *Travelers Indemnity Co. v. Bailey*, 2009 U.S. LEXIS 4537, 129 S. Ct. 2195 (2009), the Supreme Court granted certiorari to review the decision of the Second Circuit in *In re Johns-Manville*, 517 F.3d 52 (2d Cir. 2008), interpreting the 1986 confirmation order and injunction in the Manville chapter 11 plan. As provided in the plan, Bankruptcy Judge Burt Lifland approved a settlement providing that Manville's insurers, including petitioner The Travelers Indemnity Company, would contribute \$770 million to the corpus of an asbestos claimants' trust in exchange for a release from any "Policy Claims" channeled to the trust. Some asbestos claimants, however, filed direct or independent action claims against Travelers based on Travelers' alleged wrongdoing, independent of any wrongdoing of Manville. Travelers asked Bankruptcy Judge Lifland to enjoin the direct action claims based on the 1986 confirmation order and injunction. In settlement of this matter, Travelers agreed to pay the direct action claimants \$445 million for a 2004 bankruptcy court order "clarifying" that the direct or independent actions are, and always have been, permanently barred by the 1986 confirmation order and injunction. In issuing its 2004 order, Judge Lifland found that the direct action claims were inextricably intertwined with Travelers' long relationship as Manville's insurer. As such, they were barred by the 1986 confirmation order and injunction.

Some individual asbestos claimants and Chubb Indemnity Insurance Company objected to the 2004 settlement and appealed. The district court affirmed, but the Second Circuit reversed, holding that the direct actions were not enjoined by the 1986 order or injunction and that the 2004 clarifying order was beyond the subject matter jurisdiction of the bankruptcy court. The Court granted certiorari, 129 S. Ct. 1606, to consider whether the bankruptcy court had subject

matter jurisdiction to authorize the inclusion in a chapter 11 confirmation order of a release of non-debtor claims and to enjoin their prosecution against a non-debtor, if the claim asserted does not seek a recovery from the debtor estate or give rise to a claim for indemnity or contribution from the debtor estate, even though the released entity contributed major funding necessary to confirm the chapter 11 plan.

The Court ducked the issue of jurisdiction over third party releases and decided the case narrowly based on the finality of the 1986 Confirmation order. Under the Court's precedent in *Local Loan v. Hunt*, 292 U.S. 234, 239 (1934), the bankruptcy court clearly had jurisdiction to enforce its prior order. The Second Circuit erred in holding that the order could be collaterally attacked.

Travelers Indemnity Co. v. Bailey is the most recent in a long line of five other Supreme Court bankruptcy and insolvency cases consistently precluding collateral attack on final bankruptcy court judgments, even where the scope of the judgments arguably exceed the subject matter jurisdiction of the bankruptcy court. As explained more fully in my recent book *Bankruptcy and the Supreme Court* (LexisNexis 2008), if a court renders a final judgment in a contested action, *res judicata* precludes the parties from litigating the question of the court's subject matter jurisdiction in a subsequent litigation, unless the subject matter of the action was so plainly beyond the court's jurisdiction that its entertaining the action was a manifest abuse of authority. Beginning in *Oriel v. Russell*, 278 U.S. 358, 363 (U.S. 1929), the Court held that a turnover order issued under the Bankruptcy Act could not be collaterally attacked in a later contempt proceeding. About a decade later, in *Stoll v. Gottlieb*, 305 U.S. 165, 171 (U.S. 1938), 305 U.S. 165 (1938) the Court precluded collateral attack on a reorganization plan which eliminated a creditor's right to proceed against a third party guarantor. Even if the bankruptcy court lacked jurisdiction to issue such an order, the creditor's sole remedy was to object to plan confirmation and take a direct appeal rather than engage in a collateral attack. Likewise, in *Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371, 375 (U.S. 1940), the Court held that a bondholder could not collaterally attack an order confirming a municipal readjustment plan, even when the statute on which the plan was based was later declared unconstitutional. The Court reasoned that the district court that confirmed the plan had jurisdiction to determine its own jurisdiction, and if the bondholder wanted to challenge the jurisdiction, it was required to do so in the bankruptcy case or in a direct appeal, not in a collateral attack. In a similar vein, the Court has held that when creditors fail to appeal a sale order, they may not later ask for return of property transferred under the order. See *New Haven Inclusion Cases*, 399 U.S. 392, 481 (U.S. 1970) "[W]e agree with Penn Central that the Committee's request for the return of the stock is foreclosed by *res judicata*. For the Committee-as well as all the other bondholders-took no appeal from the order of the reorganization court directing the transfer of the New Haven assets subject to a later determination of value." (footnote omitted). More recently, in *Celotex Corp. v. Edwards*, 514 U.S. 300, 307 (U.S. 1995), 514 U.S. 300 (1995) the Court upheld as within the bankruptcy court's "related to" jurisdiction, the bankruptcy court's issuance of an injunction in a Bankruptcy Code case against a judgment creditor proceeding to execute on a surety bond posted by the debtor. In so holding, however, the Court noted in *dictum* that if the creditor contended the power to issue the injunction was beyond the jurisdiction of the court, its recourse was to object to the injunction in the court that issued it and challenge it on direct appeal rather than through a collateral attack. See *id.* at 306-307, 313.

Based on this long line of precedent, the Court had little trouble deciding *Travelers Indemnity Co. v. Bailey*. Justice Souter, writing the opinion of the Court for a seven judge majority, held squarely that Bankruptcy Judge Burt Lifland's 2004 order clarifying his previous 1986 final confirmation order did not open the original confirmation order to collateral attack. 129 S. Ct. at 2203, 2205. Thus, the Second Circuit could not properly consider whether the bankruptcy court had jurisdiction and authority to enter the injunction in 1986. Nor could the Second Circuit preclude the bankruptcy court from interpreting and enforcing its 1986 confirmation order and injunction. See *id.* at 2205.

Justice Stevens authored a dissent, which Justice Ginsburg joined, noting that the bankruptcy court's 2004 order expanded the 1986 injunction rather than clarifying it. This is why Travelers paid \$445 million in 2004 in exchange for the order. Plainly the 1986 injunction which enjoined actions arising out of Manville's insurance policies did not preclude actions against insurers for their own misconduct. See *id.* at 2207-09. Thus, the Second Circuit had jurisdiction to consider the 2004 "clarifying" order and concluded correctly that the bankruptcy court lacked jurisdiction to enjoin state-law claims against insurers for their own wrongdoing.

Advocacy Tip: As in so many cases, the majority and dissent disagree about the plain meaning of a phrase and whether the Court should look behind the four corners of the court's order to determine its meaning. Like it or not, familiarity with the Court's plain-meaning jurisprudence is a staple of modern practice. For an in depth discussion of "plain meaning" and other maxims, see *Bankruptcy and the Supreme Court* at 14-36.

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- Bankruptcy and the Supreme Court at 14-36.

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Kenneth N. Klee is a nationally recognized expert on bankruptcy law. He is a tenured professor at the UCLA School of Law and a founding partner of Klee, Tuchin, Bogdanoff & Stern LLP, specializing in corporate reorganization, insolvency, and bankruptcy law. From 1974 to 1977, Professor Klee served as associate counsel to the Committee on the Judiciary, U.S. House of Representatives, where he was one of the principal drafters of the 1978 Bankruptcy Code. He served as a consultant on bankruptcy legislation to the U.S. Department of Justice in 1983-1984. From 1992-2000, he served as a member of the Advisory Committee on Bankruptcy Rules to the Judicial Conference of the United States. From 2000-2003, and previously from 1988-1990, Professor Klee served as a lawyer delegate to the Ninth Circuit Judicial Conference. From 2005 to 2008 he served as member of the executive committee of the National Bankruptcy Conference, a capacity in which he previously served from 1985 to 1988, and 1992-1999. He also served as chair of the NBC's legislation committee from 1992 to 1999. Professor Klee is a past president and member of the board of governors of the Financial Lawyers Conference. From 2003-2008 he was named by the Daily Journal as one of California's Top 100 Lawyers. In the February 2004, 2005, 2006, 2007, and 2008 editions of Los Angeles Magazine, he was named one of the Top 10 Super Lawyers for Los Angeles County. *Law Dragon* has included him among the top 500 lawyers in the United States in 2005, 2007, and 2008. In March 2005, he was named by the Century City Bar as Bankruptcy Lawyer of the Year. In November 2006, the Central District of California Consumer Bankruptcy Attorneys Association bestowed on him the Calvin Ashland Award as consumer bankruptcy attorney of the year. In October, 2007 he received the Excellence in Education Award from the Endowment for Education of the National Conference of Bankruptcy Judges. Professor Klee has recently authored *Bankruptcy and the Supreme Court* (2009). He also has co-authored *Business Reorganization in Bankruptcy* (with Scarberry, 1995, 2d ed. 2001, 3d ed. 2006) and *Fundamentals of Bankruptcy Law* (4th ed., with Treister, 1996), and has authored or co-authored numerous articles on bankruptcy law. Professor Klee's *Bankruptcy and the Supreme Court* was published in 2008 by LexisNexis.

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40 of 197 DOCUMENTS

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S. Andrew Jurs on Wirum v. Warren (In re Warren)

2009 Emerging Issues 4188

S. Andrew Jurs on Wirum v. Warren (In re Warren), 568 F.3d 1113 (9th Cir. 2009)

By S. Andrew Jurs

August 28, 2009

SUMMARY: The Ninth Circuit in *Wirum v. Warren (In re Warren)* considered whether the 45-day filing requirement of Code section 521(i)(1) is a hard and fast deadline that the bankruptcy court may not extend. Going against numerous lower court decisions, the Ninth Circuit held that the automatic dismissal of section 521(i)(1) is not quite automatic if the bankruptcy court decides to waive the section 521(a)(1) filing requirements and retain the case.

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ARTICLE: Following the "Minority" Approach, the Ninth Circuit Holds That the 45-Day Filing Requirement of Code Section 521(i)(1) Is Subject to Extension by the Bankruptcy Court

Section 521(i)(1) of the Bankruptcy Code requires a debtor to file a list of creditors and financial information within 45 days of filing the petition or face dismissal of the bankruptcy case. In *Wirum v. Warren (In re Warren)*, 568 F.3d 1113, 2009 U.S. App. LEXIS 13062 (9th Cir. June 18, 2009), the Court of Appeals for the Ninth Circuit was asked to determine, in a matter of first impression in the circuit, whether this requirement constitutes a hard and fast deadline depriving the bankruptcy court of its power to extend the deadline.

Facts and Procedural History

In September 2006, the State of California froze the bank accounts of Steven Jay Warren (the "Debtor") in an attempt to obtain over \$93,330.46 owed by the Debtor in overdue child support payments. Shortly thereafter, on October 11, 2006, the Debtor filed bankruptcy under chapter 7 of the Bankruptcy Code. According to the Ninth Circuit, this filing was "an apparent attempt to avoid his child support obligations." Attached to Debtor's chapter 7 petition was a list of creditors, but he did not include any of the other financial information required by 11 U.S.C. § 521(a)(1).

The next day, the bankruptcy court issued its standard order notifying the Debtor that his case might be dismissed if he did not submit the required financial information within fifteen days. The Debtor did not respond to this order, nor did he file any additional financial information. Accordingly, the bankruptcy court issued an order setting for hearing on November 17, 2006, the determination of whether to dismiss the Debtor's case and whether to sanction the Debtor

and/or his counsel for failure to file the required information in a timely manner.

Two days before the scheduled hearing, Andrea Wirum, the chapter 7 trustee (the "Trustee"), filed a response to the bankruptcy court's show cause order and requested that the bankruptcy court not dismiss the case. In her response, the Trustee asserted that she needed additional time to investigate the circumstances surrounding the filing of the Debtor's petition and whether assets existed for distribution to creditors. When the Debtor did not appear at the hearing, the bankruptcy court granted the Trustee's request and did not dismiss the case.

Almost four months later, on March 6, 2007, the Debtor filed a motion to dismiss his bankruptcy case on the grounds that he failed to obtain prepetition credit counseling or apply for a waiver of this requirement, such that he failed to qualify as a "debtor" under 11 U.S.C. § 109(h). Subsequently, before the bankruptcy court even had a chance to rule, the Debtor moved again to dismiss his case due to his failure to file the required financial information of 11 U.S.C. § 521(a)(1) within 45 days of filing his petition as required by 11 U.S.C. § 521(i).

On April 9, 2007, the bankruptcy court denied both of the Debtor's motions to dismiss. Four days later, the bankruptcy court issued an order waiving the requirement that Debtor file the financial information required by section 521(a)(1). This order was issued by the bankruptcy court *nunc pro tunc* to November 15, 2006.

Debtor timely filed a notice of appeal to the district court, which reversed the bankruptcy court's decision and remanded with instructions to dismiss the Debtor's case. According to the district court, the bankruptcy court did not have discretion to waive the requirements of section 521(a)(1) after the 45-day deadline of section 521(i)(1) had passed; therefore, dismissal was mandatory. The Trustee timely appealed the district court's decision to the Ninth Circuit.

Legal Analysis

When Congress enacted the 2005 Act, it revised section 521 and increased a debtor's duties of financial disclosure. Section 521(a) requires a debtor to:

- (1) file
 - (A) a list of creditors; and
 - (B) unless the court orders otherwise
 - (i) a schedule of assets and liabilities;
 - (ii) a schedule of current income and current expenditures;
 - (iii) a statement of the debtor's financial affairs and, if section 342(b) applies, a certificate . . .;
 - (iv) copies of all payment advices or other evidence of payment received within 60 days before the date of the filing of the petition, by the debtor from any employer of the debtor;
 - (v) a statement of the amount of monthly net income itemized to show how the amount is calculated; and
 - (vi) a statement disclosing any reasonably anticipated increase in income or expenditures over the 12-month period following the date of the filing of the petition. . .

The enforcement mechanism for these requirements is section 521(i)(1), which provides that, if a debtor fails to file the required financial information within 45 days after filing his petition, the case will be "automatically dismissed effective on the 46th day after the date of the filing of the petition." The issue, therefore, is whether a bankruptcy court has the authority, after the passing of the 45-day filing deadline of section 521(i)(1), to extend or to waive the section 521(a)(1) filing requirements.

The majority of bankruptcy courts and district courts considering the matter have concluded that the language of section 521(i)(1) makes dismissal of a debtor's bankruptcy case mandatory if the requirements of section 521(a)(1) have not been waived within the 45-day period. *See, e.g., In re Bonner*, 374 B.R. 62, 64-65 (Bankr. W.D. N.Y. 2007) (holding that dismissal is automatic under section 521(i) such that an order waiving the section 521(a)(1) filing requirements must be filed before the 45-day period expires); *In re Calhoun*, 359 B.R. 738, 740-41 (Bankr. E.D. Mo. 2007); *In re Lovato*, 343 B.R. 268, 270 (Bankr. D. N.M. 2006); *In re Ott*, 343 B.R. 264, 268 (Bankr. D. Colo. 2006); *In re Fawson*, 338 B.R. 505, 514 (Bankr. D. Utah 2006). In contrast, one circuit court has held that a bankruptcy court has discretion to waive the section 521(a)(1) filing requirement even after the filing deadline of section 521(i)(1) has passed. *See Segarra-Miranda v. Acosta-Rivera (In re Acosta-Rivera)*, 557 F.3d 8, 9 (1st Cir. 2009).

Commentary

Warren is significant in that it is another example of circuit courts, who do not handle bankruptcy cases on a regular basis, differing from the majority of bankruptcy courts in interpreting the 2005 Act and its confusing provisions. In one sense, the decision in *Warren* seems results-driven, as if the circuit court was going to make sure that this debtor did not "escape" from bankruptcy court scrutiny. Another reading, however, could be that bankruptcy courts had issued decisions with unpalatable results as a way of emphasizing the defects of the 2005 Act and that circuit courts went the opposite direction as a way of bringing some reasonableness and practicality to the legislation.

In either case, the appeals court first had to circumvent the explicit directive of section 521(i)(1) that a debtor's case will be "automatically dismissed effective on the 46th day." To do so, the court first had to find an ambiguity that would allow other sources, such as congressional intent, to influence the statutory interpretation. According to the Ninth Circuit, this ambiguity arises from a conflict between the mandatory language of section 521(i)(1) and section 521(a)(1)'s statement that bankruptcy courts have the power to "order[] otherwise," without a statutory deadline to enter such an order. 568 F.3d 1113, 1117. "Nor does any other subsection of § 521 state that there is a time limit within which a court may order[] otherwise." *Id.* In fact, the court found that the filing requirement of section 521(i)(1) is directed only at debtors, not at bankruptcy courts, thus making them not subject to such limitations on their power. *Id.* Because of the potential that section 521(i)(1)'s 45-day filing deadline does not limit the bankruptcy court's authority to "order[] otherwise" and waive the section 521(a)(1) filing requirements, the circuit court found that a statutory ambiguity exists.

With the ambiguity established, the Ninth Circuit could engage in an examination of the alternative interpretations, in light of the purpose of section 521, *id.* at 1117-18 (citing *Burns v. Stone Forest Indus., Inc.*, 147 F.3d 1182, 1184 (9th Cir. 1998)), to determine Congress's reasonable purpose. The first factor that the court identified as bearing on Congress's intent was the fact that the 2005 amendments did not change section 521's grant of power to bankruptcy courts to "order[] otherwise." *Id.* at 1118. According to the appeals court, Congress's silence in this regard constituted an affirmative decision not to include a hard deadline for issuing such an order and that it would, in fact, be improper to imply that the 45-day deadline of the new section 521(i)(1) applied to and limited the bankruptcy court's existing authority. *Id.*

In the Ninth Circuit's opinion, this reading is consistent with Congress's intent to limit abusive bankruptcy filings. *Id.* According to the appeals court, not allowing bankruptcy courts to retain the authority to waive financial filing requirements, when the putative filing deadline has passed, will invite frivolous filings because inaction on the debtor's part will be sufficient to guarantee dismissal of the case. "[W]e are reluctant to read into the statute by implication a new limit on judicial discretion that would encourage rather than discourage bankruptcy abuse. It is safe to say that Congress, in acting BAPCPA, was not bent on placing additional weapons in the hands of abusive debtors." *Id.* (quoting *Segarra-Miranda v. Acosta-Rivera (In re Acosta-Rivera)*, 557 F.3d 8, 13 (1st Cir. 2009)).

Given its interpretation of Congress's intent, the Ninth Circuit rejected the "majority approach" under which lower courts have found that the language of section 521(i)(1) should be applied, as written, to *both* debtors and bankruptcy courts. According to the *Warren* court, the bankruptcy and district courts overreached by implying that section 521(i)(1) applied to section 521(a)(1) in such a way as to limit the bankruptcy court's power to combat abusive bankruptcy filings.

The Ninth Circuit held that in this case the bankruptcy court acted within its discretion when it issued the order waiving the section 521(a)(1) filing requirements notwithstanding the passage of the 45-day filing period of section 521(i)(1).

Conclusion

In sum, whatever the Ninth Circuit's motivation, the decision in *Warren* is important in that it and the First Circuit's decision in *Acosta-Rivera* have become the majority rule among those courts of appeals considering the issue. Despite the numerous bankruptcy and district court cases to the contrary, the rule now appears to be that the "automatic dismissal" of section 521(i)(1) is not quite automatic if, at any point in time, the bankruptcy court decides to waive the section 521(a)(1) filing requirements and retain the case.

[Return to Text](#)

n1 Bankruptcy Abuse and Consumer Protection Act, Pub. L. No. 109-8 (2005).

n2 Although it has no bearing on the final decision, the appeals court's discussion of the appropriate use of *nunc pro tunc* orders also is worthwhile reading on its own. According to the Ninth Circuit, a court's inherent power to rectify the record through the use of *nunc pro tunc* "is a limited one, and may be used only where necessary to correct a clear mistake and prevent injustice." 568 F.3d 1113, 1116 n.1 (quoting *United States v. Sumner*, 226 F.3d 1005, 1009-10 (9th Cir. 2000)). That power, however, does not allow a court to change what occurred, or to backdate an order to serve some other purpose. 568 F.3d 1113, 1116 n.1. Instead, *nunc pro tunc* is only appropriate where the court is making the record reflect what was actually intended. *Id.* Because there is nothing indicating that the bankruptcy court intended to waive the section 521(a)(1) filing requirements at any point in time prior to its rulings in April 2007 on the motions to dismiss, the Ninth Circuit felt that the bankruptcy court improperly used its *nunc pro tunc* power to backdate the order in an attempt to fall within the 45-day period. *Id.* at 1116. In other words, the bankruptcy court was wrongly trying to "alter the substance of that which actually transpired." *Id.* (quoting *Sumner*, 226 F.3d 1005, 1010).

RELATED LINKS: For discussion of Code section 521(a)(1), see

- Collier on Bankruptcy, 521.04.

For discussion of Code section 521(i), see

- Collier on Bankruptcy, 521.24.

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41 of 197 DOCUMENTS

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Paul H. Zumbro on In re Chrysler LLC

2009 Emerging Issues 4189

Paul H. Zumbro on In re Chrysler LLC, 2009 U.S. App. LEXIS 17441 (2d Cir. Aug. 5, 2009)

By Paul Zumbro

August 28, 2009

SUMMARY: Paul H. Zumbro, of Cravath, Swaine & Moore LLP, analyzes the Second Circuit's Chrysler decision, in which the court held that a dissenting minority lender could not object to a "free-and-clear" sale in circumstances where the loan documents authorized the agent to act on behalf of the secured lenders and a majority in interest of the lenders consented.

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ARTICLE: Agent May Consent to a "Free-and-Clear" Sale or Credit Bid under Section 363 of the Bankruptcy Code over Objection of Dissenting Minority Secured Lenders

It has become increasingly popular for a debtor to utilize *section 363 of the Bankruptcy Code* to sell all or substantially all of its assets. Given the highly leveraged capital structure of many debtors, the agent for the secured lenders is often playing a primary role in the section 363 sale process by acting at the direction of the secured lenders to consent to a sale free and clear of interests or to use the secured lenders' claims as currency to buy the debtor's assets in a "credit bid." n1 A recent decision from the United States Court of Appeals for the Second Circuit, *In re Chrysler LLC*, 2008 U.S. App. LEXIS 17411 (2d Cir. Aug. 5, 2009), held that a dissenting minority lender could not object to a "free-and-clear" sale in circumstances where the loan documents authorized the agent to act on behalf of the secured lenders and a majority in interest of the lenders consented.

Background

Section 363(f) of the Bankruptcy Code permits a debtor to sell assets out of the ordinary course of business free and clear of any lien or other interest in such property under specified circumstances. In the case of the sale of Chrysler's assets, the debtors relied in part on *section 363(f)(2) of the Bankruptcy Code*, which permits a sale free and clear of an entity's interest if the entity consents to the sale. In *In re Chrysler LLC*, the court considered whether the consent requirement of section 363(f)(2) could be satisfied without the unanimous consent of the secured lenders.

The secured parties' relationship in *Chrysler* was governed by three related agreements: (1) a credit agreement, (2) a collateral trust agreement, under which the collateral securing Chrysler's obligations under the credit agreement was held by a designated trustee (the collateral trustee) for the benefit of the secured lenders and (3) a security agreement, under which Chrysler and the other obligors granted to the administrative agent a security interest in substantially all of their assets.

Upon the commencement of Chrysler's chapter 11 cases, Chrysler moved to sell substantially all of its assets free and clear of interests under section 363. Chrysler argued that *section 363(f)(2) of the Bankruptcy Code* had been satisfied because secured lenders holding 92.5 percent of the outstanding principal amount of the loans under the credit agreement had directed the administrative agent, who, in turn, directed the collateral trustee, to consent to the sale of the debtors' assets. Three Indiana state funds holding less than 1 percent of the indebtedness (the "Indiana Funds") objected to Chrysler's sale motion. The Indiana Funds argued that the elements of section 363(f)(2) were not satisfied because the credit agreement required the unanimous consent of the secured lenders in order to "release all or substantially all of the Collateral," including in connection with a section 363 sale of the debtors' assets.

The Decision

The bankruptcy court dismissed the Indiana Funds' objection because the collateral trustee had the authority to act on behalf of the secured lenders in accordance with the loan documents, even though the secured lenders under the credit agreement did not unanimously consent to the sale. The United States Court of Appeals for the Second Circuit affirmed the bankruptcy court's decision on similar grounds. n2

The courts concluded that, through a series of agreements, the collateral trustee had been empowered to take any action necessary to realize upon the collateral, including consenting to a sale of the collateral free and clear of all interests under *section 363 of the Bankruptcy Code* at the direction of the administrative agent. By the terms of the credit agreement, the administrative agent was authorized to act, including to direct the collateral trustee, at the request of lenders holding a majority of the indebtedness. The courts found that each of these elements had been satisfied in accordance with the terms of the loan documents in connection with the collateral trustee's consent to the sale. Accordingly, having agreed to the framework created by the credit agreement and related security documents, the Indiana Funds were bound by the decision of the majority of the lender group to consent to the sale of the debtors' assets under section 363. n3

The courts rejected the Indiana Funds' argument that the amendment and waiver provision of the credit agreement required that the administrative agent receive the consent of all lenders before it could authorize the collateral trustee to release all or substantially all of the collateral. Rather, the transfer of the debtors' assets to New Chrysler pursuant to *section 363 of the Bankruptcy Code* was simply a "collective action to enforce rights as authorized under the agreed-upon specific provisions of the parties' loan agreements," n4 which did not require any amendment, supplement or modification of the loan documents. The Second Circuit stated that "[b]ecause the Sale required no amendment to loan documents, Chrysler was not required to seek, let alone receive, the [dissenting lenders'] written consent." n5 Moreover, the consent to the sale was not a "release" of collateral because the secured lenders' lien would attach to the proceeds of the sale, which remained as collateral to secure the loan made by the lenders. n6

Effect of the Decision

Although the decision in *Chrysler* was based on specific provisions in the applicable loan documents, the language relied upon by the court of appeals and the bankruptcy court is fairly customary in U.S. syndicated credit facilities, in which collateral enforcement actions taken by the agent may typically be authorized by the majority in interest of the lenders. The courts appear to be saying that this contract-based "majority rule" approach overrides what could be argued to be individual statutory rights under the Bankruptcy Code.

Other recent bankruptcy court decisions are consistent with this approach. For example, a recent Delaware

bankruptcy court decision reached a similar conclusion in the credit bid context, holding that the administrative agent had the authority to enter a credit bid on behalf of the secured lenders pursuant to *section 363(k) of the Bankruptcy Code*, over the objection of some of the secured lenders. n7 The court in *GWLS* concluded that credit bidding by the collateral agent, acting at the direction of the secured lenders holding a majority of the indebtedness in accordance with the loan documents, fell within the collateral agent's delegated powers to "dispose of or deliver the Collateral" on behalf of the secured parties pursuant to any applicable law, which the court determined included the Bankruptcy Code. Accordingly, the dissenting lender was forced to have its claim included in the credit bid along with the rest of the syndicate. The bankruptcy court in the Southern District of New York relied on *Chrysler* and *GWLS* in reaching a similar conclusion in approving a credit bid made by the agent for substantially all of the assets of Metaldyne Corporation over the objection of a dissenting lender. n8

These recent decisions suggest that when secured lenders broadly delegate to an agent or trustee the power to take collateral enforcement actions or to exercise any other remedies against the collateral, an objecting secured creditor will likely be bound by the decision of lenders holding a majority of the indebtedness. When a secured lender enters into syndicated loan agreement containing provisions like the ones examined in *Chrysler* and *GWLS*, it is agreeing to a collective arrangement under which the agent or trustee may be authorized to exercise remedies under *section 363 of the Bankruptcy Code*, including to consent to the sale of all or substantially all of a debtor's assets free and clear of any liens or interests or to credit bid for a debtor's assets, without receiving the unanimous consent of the secured lenders.

Return to Text

n1 *Section 363(k) of the Bankruptcy Code* allows a secured creditor to offset an allowed secured claim against the "purchase price of property" in a section 363 sale, referred to as "credit bidding."

n2 In certain circumstances, an appeal may be taken directly to the court of appeals (bypassing the district court) if the court of appeals authorizes the direct appeal. 28 U.S.C. § 158(d)(2). The Court of Appeals for the Second Circuit granted a motion for direct appeal in *Chrysler*.

n3 *In re Chrysler*, 405 B.R. 84, 101-03 (Bankr. S.D.N.Y. 2009), *aff'd*, *Chrysler*, 2008 U.S. App. LEXIS 17411.

n4 405 B.R. 101, 103.

n5 2008 U.S. App. LEXIS 17411, at *31.

n6 405 B.R. 101, 103.

n7 *In re GWLS Holdings, Inc.*, 2009 Bankr. LEXIS 378 (Bankr. D. Del. Feb. 23, 2009) (appeal pending).

n8 *In re Metaldyne*, No. 09-13412 (Bankr. S.D.N.Y. Aug. 12, 2009) (unpublished opinion).

RELATED LINKS: For discussion in Collier on Bankruptcy on sales free of liens or interests, click [here](#).

For discussion in Collier on Bankruptcy on section 363(b) sales, click [here](#).

For discussion in Collier on Bankruptcy on section 363(c) sales, click [here](#).

For the American College of Bankruptcys Circuit Review of Asset Sales, click [here](#).

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42 of 197 DOCUMENTS

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Adam P. Storchak on the Automatic Stay and Environmental Claims

2009 Emerging Issues 4024

Adam P. Storchak on Application of the Automatic Stay Against Environmental Claims

By Adam P. Storchak

July 16, 2009

SUMMARY: Adam P. Storchak, of Weil, Gotshal & Manges LLP, considers the extent to which an environmental action is precluded by application of the Bankruptcy Code section 362 automatic stay or the bankruptcy court's discretionary power under Code section 105. This analysis is an excerpt from *Collier Monograph: Environmental Issues in Bankruptcy Cases* (LexisNexis Matthew Bender 2009).

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ARTICLE: Adam P. Storchak on Application of the Automatic Stay Against Environmental Claims n1

Adam P. Storchak, of Weil, Gotshal & Manges LLP, considers the extent to which an environmental action is precluded by application of the 362 automatic stay or the bankruptcy court's discretionary power under Code section 105. This analysis is an excerpt from *Collier Monograph: Environmental Issues in Bankruptcy Cases* (LexisNexis Matthew Bender 2009).

Under section 362(a) of the Bankruptcy Code, a bankruptcy petition imposes an automatic stay of all judicial, administrative or other actions or proceedings against the debtor or the enforcement of any judgment obtained before the filing of the petition. n2 Certain governmental proceedings are exempt from the automatic stay under the police or regulatory power exception. n3 Actions brought for the enforcement of monetary judgments, however, are not subject to the police powers exception and are therefore barred by the automatic stay. n4 Where environmental claims are not subject to the automatic stay, a debtor may under certain circumstances petition the bankruptcy court for a discretionary stay of governmental enforcement proceedings and injunctions pursuant to section 105(a).

Certain Environmental Actions Are Subject to the Automatic Stay

Section 362(b)(4) provides that the filing of a bankruptcy petition does not operate as a stay of any action by a governmental unit "to enforce such governmental unit's . . . police and regulatory power, including the enforcement of a judgment *other than a money judgment*, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's . . . police or regulatory power." n5 Thus, even an action subject to the police power exception to

the automatic stay must cease before execution of any resulting "money judgment." n6

An important controversial issue is what type of environmental proceedings, and what stage in the proceeding, constitutes the "enforcement of a money judgment." Notwithstanding debtors' arguments that CERCLA section 107 costs recovery actions and actions to impose fines are merely attempts to collect on prepetition debts and are therefore actions for "enforcement of a money judgment," courts generally have held that the government may pursue the litigation to judgment, but is barred by the automatic stay from enforcing that judgment. n7

The courts have reached conflicting results over whether the automatic stay prevents the government from enforcing a judgment for injunctive relief if that injunction would require the debtor to spend money to clean up environmental contamination. The issue is similar to the dispute over whether a mandatory injunction constitutes a "claim." In *Penn Terra*, the Court of Appeals for the Third Circuit held that an injunction requiring cleanup was not a money judgment, even if compliance requires the debtor to spend money. n8 The court interpreted the phrase "money judgment" narrowly to mean an order that identifies the parties against whom judgment is being entered and specifies the amount such parties owe. n9 Because CERCLA injunctions or administrative orders under section 106 require the defendants or respondents to perform the work prescribed in the order, without specifying the amount to be spent, CERCLA actions do not meet the *Penn Terra* "money judgment" test. The Third Circuit also held that an injunction aimed at protecting against potential harm, rather than at compensation of past wrongful acts, was not a "money judgment." n10 This appears to be the majority view. n11

Other courts have held that a cleanup injunction is a "money judgment" if it requires the debtor to spend money to comply. n12 Accordingly, these courts have enjoined the enforcement of cleanup injunctions.

Police or Regulatory Power Exception

Generally, courts have treated environmental enforcement actions and other governmental claims under the environmental laws as invoking the government's police or regulatory powers, thus exempting the action from the automatic stay. n13 Section 362(b)(4) allows the government to pursue such actions against a debtor, determine the debtor's liabilities and fix the penalties, damages or costs.

To fall under the police or regulatory power exception, an action brought to enforce an environmental law must address a present threat to public health, safety or welfare. In *In re W.R. Grace & Co.*, an action brought against the debtor by the New Jersey Department of Environmental Protection (NJDEP) was found not to fall within the police or regulatory power exception to the automatic stay, because it did not address any "risk to public health, safety or welfare" where the contaminated site already had been cleaned up. n14 The court cited the holding in *Penn Terra* that "police/regulatory power is a limited exception to the automatic stay designed solely to protect public health and safety." n15 In the *W.R. Grace* case, the EPA had already cleaned up the site, so no risk to public health or safety continued to exist, and the court found that the sole purpose of the NJDEP action was to "liquidate its monetary claim for penalties." n16 As such, the action did not fall under the section 362(b)(4) exception to the automatic stay and was "null and void." n17

The "police or regulatory" exception does not apply to actions by nongovernmental claimants, such as citizen suit actions or private cost recovery actions against the debtor. n18

Discretionary Stays under Section 105

Given that the police power exception to the automatic stay generally permits governmental authorities to prosecute environmental claims and to obtain cleanup injunctions against the debtor that may be enforced outside of the bankruptcy case, and may not be dischargeable, environmental enforcement has the potential to impede a debtor's ability to reorganize. Under appropriate circumstances, the debtor may seek to limit these risks by petitioning the bankruptcy court for a discretionary stay of government enforcement proceedings and injunctions pursuant to section 105(a).

Court's Equitable Powers under Section 105. Under section 105(a) of the Bankruptcy Code, the court is empowered to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." This provision has been interpreted as granting the court in a bankruptcy case broad equity powers. n19 These powers include the ability to enjoin other judicial or administrative proceedings when they threaten the assets of the estate or unduly interfere with the bankruptcy case. n20 Thus, under section 105 the court has the discretionary power to stay actions or proceedings that otherwise would be exempt from the automatic stay, including environmental enforcement actions. n21

Some courts have even used their equitable powers under section 105 in certain circumstances to extend an automatic stay to nondebtor third parties, given the potential interference with the debtor's reorganization that a suit against the third party might cause. In *In re W.R. Grace & Co.*, the court employed the "unusual circumstances" test to extend the protection of an automatic stay to a nondebtor party. n22 The test considers "(1) whether the non-debtor and debtor share an identity of interest such that action against the non-debtor is essentially an action against the debtor, and (2) whether the third party action will have an adverse impact on the debtor's ability to accomplish reorganization." n23 The third party, BNSF, faced potential liability in asbestos-related personal injury actions connected to the debtor's former mining operations in Montana. The debtor, W.R. Grace, had contractual indemnification obligations to BNSF for any such liability, and was precluded from seeking contribution in the event of a damages award, so any damages awarded against BNSF would in turn be borne by W.R. Grace. The court found that suits against BNSF would have "an adverse impact on the debtor's ability to accomplish reorganization," and consequently extended the automatic stay to the suits against BNSF. n24

Standard for Granting Stay of Government Proceedings under Section 105. The test a debtor must meet in order to obtain a section 105 injunction is similar to that imposed on parties seeking a preliminary injunction: n25 (1) irreparable harm; (2) undue interference with the bankruptcy case (in lieu of the likelihood of success on the merits requirement in a nonbankruptcy action); (3) a balance of equities favoring the debtor; and (4) a lack of adverse effect on the public interest.

Courts are generally reluctant, however, to enjoin pending environmental enforcement proceedings pursuant to section 105, and some have pointed to the obligation of a debtor to comply with law under 28 U.S.C. § 959(b) as a direct requirement that the bankruptcy court has no authority to contravene by using its equitable powers under section 105 of the Bankruptcy Code. n26

In fact, at least one court simply refused to use the equitable powers granted in section 105 to stay a state air permit proceeding that resulted in the denial of the debtor's permit and the closure of the debtor's entire plant. n27

In the most well-reasoned opinion on this issue; the court in *In re Security Gas & Oil, Inc.* n28 acknowledged that the state's interest in protecting the public from serious environmental risk needed to be balanced against the policies of the Bankruptcy Code. The court recognized that permitting a state to enforce an environmental cleanup order or injunction based upon prepetition contamination could deny the debtor the "breathing space" needed to successfully accomplish a reorganization, and interfere with the priorities established for creditors' claims under the Bankruptcy Code. n29 At the same time, the court must weigh against these considerations the "immediacy, severity and certainty of danger to the public," as well as the state's interest in seeing its laws obeyed. n30

Nine Factors Recognized for a Ruling on a Motion for Stay of Environmental Enforcement. In view of the balance that must be struck between bankruptcy and environmental law principles, the court in *In re Security Gas & Oil, Inc.* identified nine factors to be considered in ruling on a motion for a stay of environmental enforcement activities under section 105:

- the immediacy, severity and certainty of the danger posed by the potential hazard;
- the extent to which the debtor is uniquely able to effect the cleanup (e.g., is the Superfund available to fund the

cleanup);

- the extent to which enforcement would distort creditor priorities;
- the effect of enforcement on the likelihood of successful reorganization;
- the length of time the bankruptcy case has remained open;
- the length of time the government has delayed enforcement of the law or regulation;
- the extent to which the debtor continues to operate a similar business;
- the extent to which a compromise other than full prohibition of cleanup orders can better accommodate safety concerns with bankruptcy law policies; and
- any other factors relevant to whether injunctive relief should be granted, including the good or bad faith of the parties.

Return to Text

n1 This material is excerpted from *Collier Monograph: Environmental Issues in Bankruptcy Cases*, by Adam P. Storchak, Jennifer L. Wine and Erin K. Yates, and available at the LexisNexis online store: <http://www.lexisnexis.com/store/us/>.

n2 11 U.S.C. § 362(b)(4); see Collier on Bankruptcy, 362.05[5].

n3 11 U.S.C. § 362(b)(4); see also *Penn Terra Ltd. v. Department of Env'tl. Resources*, 733 F.2d 267, 272 (3d Cir. 1984); see Collier on Bankruptcy, 362.05[5][b][ii].

n4 11 U.S.C. § 362(b)(4) (emphasis added).

n5 See *Penn Terra Ltd. v. Department of Env'tl. Resources*, 733 F.2d 267, 272 (3d Cir. 1984) (noting that section 362(b)(5) created an " 'exception to the exception,' [from the automatic stay] in that actions to enforce money judgments are affected by the automatic stay even if they otherwise were in furtherance" of police and regulatory powers). Section 362(b)(5) was repealed on October 21, 1998, and the language regarding money judgment was added to section 362(b)(4).

n6 *City of New York v. Exxon*, 932 F.2d 1020, 1026 (2d Cir. 1991); *United States v. Nicolet, Inc.*, 857 F.2d 202, 209 (3d Cir. 1988); *In re Commerce Oil Co.*, 847 F.2d 291, 295 (6th Cir. 1988); *United States v. Mattiace Indus, Inc.*, 73 Bankr. 816 (E.D.N.Y. 1987).

n7 *Penn Terra Ltd. v. Dep't of Env'tl. Resources*, 733 F.2d 267, 275 (3d Cir. 1984).

n8 733 F.2d 267, 275.

n9 733 F.2d 267, 277.

n10 *Accord United States v. F.E. Gregory & Sons, Inc.*, 58 B.R. 590, 591-92 (W.D. Pa. 1986); *United States v. Ilco, Inc.*, 48 B.R. 1016, 1023 (N.D. Ala. 1985); *In re Security Gas & Oil, Inc.*, 70 B.R. 786, 790 (Bankr. N.D. Cal. 1987); *In re Williston Oil Corp.*, 54 B.R. 10, 11-12 (Bankr. D.N.J. 1984).

n11 *See, e.g., Johns-Manville Sales Corp.*, 13 *Env'tl. L. Rep.* 20310 (D.N.H. 1982); *In re Thomas Solvent Co.*, 44 B.R. 83 (Bankr. W.D. Mich. 1984).

n12 *See, e.g., City of New York v. Exxon*, 932 F.2d 1020 (2d Cir. 1991) (holding City's claim under section 107(a)(4)(B) of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) for reimbursement of cleanup costs is not stayed by section 362(a) because the City is a governmental unit which is merely attempting to fix liability and damages in the district court action, and not attempting to execute or enforce a money judgment; also, affirming injunction against California bankruptcy court proceeding on same claim under "first filed" rule); *United States v. Nicolet, Inc.*, 857 F.2d 202 (3d Cir. 1988); *In re Commerce Oil Co.*, 847 F.2d 291 (6th Cir. 1988); *Penn Terra, Ltd. v. Dep't of Env'tl. Resources*, 733 F.2d 267 (3d Cir. 1984) (lifting the automatic stay and allowing enforcement of an injunction sought by Pennsylvania governmental authorities requiring compliance with state environmental laws governing strip mining activities); *In re Wilner Wood Prods. Co. v. Maine Dep't of Env'tl. Protection*, 128 B.R. 1, 3 (D. Me. 1991) (section 362 does not authorize court to stay proceeding by state environmental agency to grant or deny any emissions permits for debtor's facility); *In re Commonwealth Oil Refining Co.*, 23 *Env't Rep. Cas. (BNA)* 1069 (W.D. Tex. 1983) (automatic stay under section 362(a) held inapplicable to a Resource Conservation and Recovery Act (RCRA) compliance suit against and interim status facility); *United States v. Ilco, Inc.*, 48 B.R. 1016 (N.D. Ala. 1985) (RCRA section 7003 and CERCLA section 106 claims are excepted from stay under section 362(a)(4) and (5) as actions to enforce police or regulatory powers). *But see United States v. Johns-Manville Sales Corp.*, 13 *Env'tl. L. Rep. (Env'tl. L. Inst.)* 20310 (D.N.H. 1982) (holding that an injunction action to undertake an asbestos cleanup was stayed because the government's remedy would require the debtor to spend money).

n13 *In re W.R. Grace & Co.*, 384 B.R. 678, 682 (Bankr. D. Del. 2008).

n14 384 B.R. 678, 681.

n15 384 B.R. 678, 682.

n16 384 B.R. 678, 682; see also *Penn Terra Ltd. v. Department of Environmental Resources*, 733 F.2d 267 (3d Cir. 1984).

n17 *City of New York v. Exxon*, 932 F.2d 1020, 1026 (2d Cir. 1991) (application of the section 362(b)(4) exception "requires that [CERCLA] suits be brought by governmental units, not private persons."); *In re Revere Copper & Brass, Inc.* 32 B.R. 725 (S.D.N.Y. 1983).

n18 See, e.g., *In re Ranch House of Orange-Brevard*, 773 F.2d 1166, 1169 (11th Cir. 1985); *Missouri v. United States Bankr. Court*, 674 F.2d 761, 776-777 (8th Cir.), cert. denied, 454 U.S. 1162 (1981); see also Collier on Bankruptcy, ch. 105.

n19 *In re Sec. Gas & Oil, Inc.*, 70 B.R. 786 (Bankr. N.D. Cal. 1987); *In re Tuscon Yellow Cab Co.*, 8 C.B. C.2d 261, 27 B.R. 621 (B.A.P. 9th Cir. 1983).

n20 *In re Baldwin-United Corp. Litig.*, 765 F.2d 343, 348 (2d Cir. 1985); *NLRB v. Superior Forwarding, Inc.*, 762 F.2d 695, 698 (8th Cir. 1985); *In re Bel Air Chateau Hosp., Inc.*, 611 F.2d 1248, 1251 (9th Cir. 1979); see *Penn Terra, Ltd. v. Dep't of Env'tl. Res.*, 733 F.2d 267, 274-279 (3d Cir. 1984). But see *In re Big Muddy Oil Processors, Inc.*, No. 82-00293 (D. Wyo. Jan. 15, 1986).

n21 *In re W.R. Grace & Co.*, 386 B.R. 17 (Bankr. D. Del. 2008).

n22 386 B.R. 17, 30.

n23 386 B.R. 17, 31; see also *In re Combustion Engineering*, 391 F.3d 190 (3d Cir. 2004); *In re Zale Corp.*,

62 F.3d 746 (5th Cir. 1995); *A.H. Robins Co. v. Piccinin*, 788 F.2d 994 (4th Cir. 1986).

n24 *In re Sec. Gas & Oil, Inc.*, 70 B.R. 786, 793 n.3 (Bankr. N.D. Cal. 1987); *In re Commonwealth Oil Ref. Co.*, 805 F.2d 1189 (5th Cir. 1986); *In re Norwesco Dev. Corp.*, 68 B.R. 123 (Bankr. W.D. Pa. 1986); *In re Beker Indus. Corp.*, 57 B.R. 611 (Bankr. S.D.N.Y. 1986)

n25 *In re Environmental Waste Control, Inc.*, 125 B.R. 546 (N.D. Ind. 1991) (denying injunction to halt EPA's enforcement of RCRA cleanup order, despite debtor's lack of funds to comply in full, because 28 U.S.C. § 959(b) mandates compliance with law regardless of debtor's finances and because of imminent threat to environment); *In re Beker Indus. Corp.*, 57 B.R. 611, 624 (Bankr. S.D.N.Y. 1986) (holding that section 105 does not excuse compliance with law as required by section 959(b)).

n26 *Wilner Wood Prods. Co. v. Maine Dep't of Env'tl. Prot.*, 128 B.R. 1, 3 (D. Me. 1991) (holding that 28 U.S.C. § 959(b) is a clear mandate to comply with state laws that cannot be overridden by section 105).

n27 70 B.R. 786, 795-96 (Bankr. N.D. Cal. 1987).

n28 70 B.R. 786, 795-96.

n29 70 B.R. 786, 796. *Accord In re Env'tl. Waste Control, Inc.*, 125 B.R. 546 (N.D. Ind. 1991) (section 105 injunction denied in part based upon imminent danger to environment).

n30 70 B.R. 786, 796-97.

RELATED LINKS: For the complete Collier monograph on environmental issues in bankruptcy cases, click [here](#).

For discussion of Code section 362, see Collier on Bankruptcy, [ch. 362](#).

For discussion of Code section 105, see Collier on Bankruptcy, [ch. 105](#).

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43 of 197 DOCUMENTS

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Environmental Obligations and the Code's Definition of "Claims"

2009 Emerging Issues 4026

Adam P. Stochak on Determining When Environmental Obligations Constitute "Claims" Within the Meaning of Section 101(5) of the Bankruptcy Code

By Adam P. Stochak

July 16, 2009

SUMMARY: Whether an environmental obligation constitutes a "claim" as that term is defined by the Bankruptcy Code is a significant issue because only a "claim" is potentially subject to discharge. Here, Adam P. Stochak, of Weil, Gotshal & Manges LLP, examines cleanup costs, administrative and judicial cleanup orders, and fines and penalties. This analysis is an excerpt from the Collier monograph on environmental Issues in bankruptcy cases.

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ARTICLE: In enacting the Bankruptcy Code in 1978, Congress took a broad view of what constitutes a "claim" to ensure that "all legal obligations of the debtor, no matter how remote or contingent will be able to be dealt with in the bankruptcy case." n1 Thus, "claim" is broadly defined to include any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." n2 Courts accordingly have given an expansive reading of the term "claim." n3

Cleanup Costs

Obligations to pay cleanup costs under federal and state environmental programs may constitute "claims" against the bankruptcy estate within the meaning of section 101(5) of the Bankruptcy Code. EPA, state governments and private citizens can seek reimbursement for incurring cleanup costs from certain categories of responsible parties under environmental statutes, such as CERCLA and RCRA. Debtors' monetary obligations to governmental units and private parties that arise under these statutes can constitute dischargeable prepetition claims. For example, the Court of Appeals for the Second Circuit concluded in *In re Chateaugay Corp.* that an obligation to pay the EPA for cleanup costs under CERCLA is a dischargeable "claim" in bankruptcy, whenever the obligation is based on prepetition conduct resulting in the release or threatened release of hazardous substances. n4

Administrative and Judicial Cleanup Orders-Injunctions

The Bankruptcy Code's broad definition of a "claim" also reaches certain types of debtors' obligations under administrative and judicial cleanup orders. Federal and state governments may enforce environmental laws not only by punishing offenders, but by ordering compliance through the issuance of direct administrative orders or by seeking injunctive relief in court. n5 Section 101(5)(B) of the Bankruptcy Code specifies that a "claim" includes a "right to an equitable remedy for breach of performance if such breach also gives rise to a right to payment." n6 For purposes of determining whether an injunctive remedy under environmental cleanup statutes constitutes a "claim" within the meaning of section 101(5), courts generally distinguish between those that prohibit a polluting activity and those that create a "right to payment." If an environmental injunction is not a "claim," either the debtor will be required to comply or the obligation passes through to the reorganized entity. n7

Prohibitory injunctions that require the debtor simply to cease and desist from some polluting activity and do not give rise to a right to payment (e.g., an injunction against further discharges of waste water into a river) clearly fall outside the scope of a "claim." Therefore, prohibitory injunctions may be enforced against the debtor in possession to the extent the debtor is in control of the prohibited activity. n8

The more complex question, however, is whether a mandatory injunction, such as a court order under state or federal law directing the debtor in possession to clean up its property, constitutes a "claim." The majority of courts have applied a simple test, looking at whether the order required the debtor to spend money to comply. In *Ohio v. Kovacs*, n9 the U.S. Supreme Court held that a state injunction ordering the individual owner of a site to clean up hazardous waste was converted to a right to payment when the state obtained the appointment of a receiver for the site, thus dispossessing the owner and preventing him from performing the mandated cleanup work himself. Since the individual would be forced to spend money to comply, the cleanup injunction was therefore a dischargeable "claim" in bankruptcy. n10

Applying the same "expenditure" test in *United States v. Whizco, Inc.*, n11 the Court of Appeals for the Sixth Circuit held that an injunction directing a mine operator to reclaim surface mines required the operator to purchase equipment in order to comply and therefore was a dischargeable "claim." In an important test case involving the LTV Steel bankruptcy, however, the Court of Appeals for the Second Circuit held in *In re Chateaugay Corp.* that neither a prohibitory injunction nor a mandatory injunction directing the debtor to remediate contamination currently existing on or emanating from property held by the debtor is a "claim" for purposes of bankruptcy and, therefore, the debtor's obligation to comply with such injunctions at its own property passes through to the reorganized company without being discharged. n12

According to the *Chateaugay* court, an injunction is a "claim" only if it "does no more than impose an obligation entirely as an alternative to a payment right," such as an order to remove drums from the debtor's property that are not leaking, provided the EPA could have incurred the costs itself and sued for reimbursement. n13 On the other hand, a "non-claim" injunction is "any order that to any extent ends, or ameliorates current pollution." n14 Unfortunately, the court provides no guidance as to what constitutes "current pollution," except to say that most injunctions will fall under the non-claim side of the line. n15

Many environmental statutes allow private litigants to seek injunctions to compel a cleanup or prohibit a polluting activity. Like government injunctions, private claims for injunctive relief may be dischargeable in bankruptcy where they in fact do nothing more than require the debtor to spend money for a cleanup. For example, in *In re Cottonwood Canyon Land Co.*, n16 the debtor sold contaminated property to the claimant. The claimant brought an action under the citizen suit provision of RCRA, seeking a mandatory injunction requiring the debtor-seller to come onto the property and clean it up. The court held that the suit was a "claim" for purposes of bankruptcy law because the debtor could do nothing more than pay someone to clean up the site if the claimant was successful. n17 Accordingly, the debtor's

liability was discharged by confirmation of the reorganization plan and the claimant was barred from seeking injunctive relief against the reorganized company.

There is still, however, considerable confusion in the federal courts as to when mandatory injunctions create dischargeable claims for purposes of CERCLA liability. In *Ohio v. Kovacs*,ⁿ¹⁸ the U.S. Supreme Court held that the debtor's obligation under a prepetition state court order to clean up a hazardous waste disposal site created a claim that can be discharged in chapter 7 bankruptcy case. But in *In re Torwico Electronics, Inc.*ⁿ¹⁹ the Court of Appeals for the Third Circuit held that an administrative order from a state environmental agency requiring the debtor to clean up releases of hazardous substances from a former manufacturing facility did not constitute a "claim" under section 101(5).

In *Torwico*, the New Jersey Department of Environmental Protection and Energy (NJDEPE) ordered Torwico, already under chapter 11 protection, to clean up property Torwico had ceased leasing five years earlier. Relying on *Kovacs*,ⁿ²⁰ Torwico contended that its obligations under NJDEP's order amounted to a "claim" because the company could comply with the order only by spending money and it was no longer in possession of the polluted site. New Jersey opposed, arguing that the debtor's obligation to clean up its former property under the state's Environmental Cleanup Responsibility Act (ECRA) constituted an ongoing regulatory obligation rather than a claim for the payment of money. The bankruptcy court agreed with Torwico, holding that NJDEP's order should be treated as an unsecured claim.ⁿ²¹ On appeal, the district court reversed, relying on *Chateaugay* for the proposition that "[a] cleanup order that accomplishes the dual objectives of removing accumulated wastes and stopping or ameliorating on-going pollution emanating from such wastes is not a dischargeable claim."ⁿ²² Under the district court's reasoning, NJDEP's order, even though framed as a mandatory order to clean up pollution already released to the environment, did not amount to a "claim" because it was intended to halt ongoing pollution.

The Court of Appeals for the Third Circuit affirmed on these grounds, seemingly departing from the Supreme Court's decision in *Kovacs*. The *Torwico* court reasoned that the fact the debtor could comply with the state's cleanup order only by paying money did not make the order a "claim" under *Kovacs*.ⁿ²³ Rather, the court limited *Kovacs*, reasoning that it applied only to situations where the state itself was seeking money directly from the debtor. "What the state cannot do is force the debtor to pay money to the state; at that point the state is no longer acting in its role as regulator, it is acting as a creditor."ⁿ²⁴ Because the Third Circuit accepted New Jersey's argument that it was neither seeking money nor asserting a right of payment but, rather, merely requiring the debtor to comply with the state's environmental laws, the court concluded NJDEP's order did not amount to a "claim."ⁿ²⁵

Although the Third Circuit's decision in *Torwico* is an apparent conflict with the Supreme Court's own holding in *Kovacs* and with the decision of the Sixth Circuit in *United States v. Whizco, Inc.*,ⁿ²⁶ the Supreme Court denied a petition for *certiorari* in the case in April 1994. Accordingly, *Torwico* is the law in the Third Circuit (New Jersey, Pennsylvania and Delaware). In light of this decision, debtors facing cleanup obligations on previously owned or leased property are virtually certain to see state environmental regulators issue administrative orders requiring the debtor to conduct the cleanup, rather than spend the money themselves and seek reimbursement. Although the two remedies would appear to be different sides of the same coin, the Third Circuit has created a *de facto* bankruptcy priority for the former over the latter.

Fines and Penalties

Courts have had little difficulty finding that actions brought by environmental agencies or private parties against the debtor seeking reimbursement of costs incurred to clean up a site, or civil penalties, constitute "claims."ⁿ²⁷ The Bankruptcy Code explicitly recognizes civil penalties as a category of claims that are not dischargeable against an individual, but are dischargeable against a reorganized corporate debtor.ⁿ²⁸ When environmental fines and penalties fit within the exception for "a fine, penalty or forfeiture payable to and for the benefit of a governmental unit" and not in compensation for actual pecuniary loss under section 523(a)(7), they are not dischargeable in a case of an individual debtor.ⁿ²⁹

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n1 H.R. Rep. No. 595, 95th Cong., 1st Sess. 309; *see* Collier on Bankruptcy, ch. 101.

n2 11 U.S.C. § 101(5) (emphasis added).

n3 *See Ohio v. Kovacs*, 469 U.S. 274, 279, 105 S. Ct. 705, 83 L. Ed. 2d 649 (1985).

n4 944 F.2d 997 (2d Cir. 1991).

n5 *Compare* 42 U.S.C. § 9607(a) (authorizing cost recovery), *with* 42 U.S.C. § 9606 (authorizing administrative orders or injunctions).

n6 11 U.S.C. § 101(5)(B).

n7 11 U.S.C. § 1141(d)(1). Generally speaking, if an injunction is not a "claim," it will also be exempt from the automatic stay.

n8 11 U.S.C. § 101(5)(B); *see also Industrial Salvage, Inc. v. Illinois*, 1996 Bankr. LEXIS 643 (S.D. Ill. June 6, 1996) (two debtors' obligations under a state administrative order to close three landfills and mitigate associated environmental damage is not a "claim" under section 101(5) of the Bankruptcy Code because it did not involve money damages, and thus was not discharged by confirmation of the debtors' reorganization plan).

n9 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649 (1985).

n10 *Ohio v. Kovacs*, 469 U.S. 274, 282-83, 105 S. Ct. 705, 83 L. Ed. 2d 649 (1985).

n11 841 F.2d 147, 150-51 (6th Cir. 1988); see also *In re Robinson*, 46 B.R. 136, 138 (Bankr. M.D. Fla. 1985) rev'd. on other grounds, 55 B.R. 355 (M.D. Fla. 1985) (injunctive obligation to restore wetlands discharged because restoration would require expenditure of money).

n12 944 F.2d 997, 1006-09 (2d Cir. 1991).

n13 *In re Chateaugay Corp.*, 944 F.2d 997, 1008 (2d Cir. 1991).

n14 *Id.*

n15 944 F.2d 997, 1007.

n16 146 B.R. 992 (Bankr. D. Colo. 1992)

n17 *In re Cottonwood Canyon Land Co.*, 146 B.R. 992, 999 (Bankr. D. Colo. 1992).

n18 *Ohio v. Kovacs*, 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649 (1985).

n19 8 F.3d 146 (3d Cir. 1993), cert. denied, 511 U.S. 1046 (1994).

n20 *Ohio v. Kovacs*, 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649 (1985).

n21 *In re Torwico Electronics, Inc.*, 131 B.R. 561, 567 (Bankr. D.N.J. 1991), vacated in part on other

grounds, 153 B.R. 24 (Bankr. D.N.J. 1992).

n22 *Torwico Electronics, Inc. v. New Jersey Dep't of Env'tl. Prot. & Energy*, 153 B.R. 24, 26 (D.N.J. 1992) (quoting *In re Chateaugay Corp.*, 944 F.2d 997, 1008 (2d Cir. 1991)).

n23 *In re Torwico Electronics, Inc.*, 8 F.3d 146, 150 (3d Cir. 1993).

n24 8 F.3d 146, 150.

n25 8 F.3d 146, 151.

n26 841 F.2d 147 (6th Cir. 1988).

n27 See, e.g., *In re Chateaugay Corp.*, 944 F.2d 997 (2d Cir. 1991) (federal government's right to recover hazardous waste cleanup costs under CERCLA was a "claim" within the meaning of Bankruptcy Code section 101(4)); *Worcester R.R. v. Penn Central Corp.*, 30 Env't Rep. Cas. (BNA) 1309 (E.D. Pa. 1989) (private cost recovery action under CERCLA § 107 for prepetition conduct of debtor constituted a "claim" against the debtor).

n28 11 U.S.C. §§ 523(a)(7), 1141(d)(1)-(2).

n29 *Ohio v. Kovacs*, 469 U.S. 274 (1985); *In re Tinkham*, 59 B.R. 209 (Bankr. D.N.H. 1986).

RELATED LINKS: For additional discussion of the definition of "claim," see Collier on Bankruptcy, ■ 2-101 Collier on Bankruptcy P 101.05.

For discussion of when a claim is subject to discharge, see Collier Monograph: Environmental Issues in Bankruptcy Cases,

■ SP3-Monograph3 Collier on Environmental Law and Bankruptcy Section 6[2].

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In chapter 11 cases, Mr. Strochak has represented debtors from diverse industries, including telecommunications, steel, healthcare, building products and retail sales. Major debtor representations include WorldCom, Inc., Silicon Graphics, Inc., Genesis Health Ventures, Inc., Sun Healthcare Group, Inc., Enron Corporation, G-I Holdings Inc. (former known as GAF Corporation), Eagle-Picher Industries, Inc., Republic Technologies International, LLC, Brothers' Gourmet Coffee and Metallurg Inc. Mr. Strochak also regularly represents creditors in both out-of-court workouts and court-supervised restructurings. Creditor representations include the Official Committee of Asbestos Property Damage Claimants in the Federal-Mogul bankruptcy, the Senior Lenders of Owens Corning, General Electric Capital Corporation in the Kmart Corporation Chapter 11 case, GE Capital Aviation Services, Inc. in the Fairchild Dornier Corporation bankruptcy, and ChevronTexaco Corporation in the American Western Refining bankruptcy.

Mr. Strochak is a co-author, with David R. Berz and Stanley M. Spracker, of the three-volume treatise *Environmental Law in Real Estate and Business Transactions* (Matthew Bender), which focuses on the implications of environmental law in transactional and restructuring matters. He also has written for a variety of publications on current topics in restructuring, environmental law and insurance coverage.

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44 of 197 DOCUMENTS

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Lawniczak on In re Airadigm Communications, Inc.

2009 Emerging Issues 4019

James M. Lawniczak on *Airadigm Communications, Inc. v. F.C.C. (In re Airadigm Communications, Inc.)*, 519 F.3d 640 (7th Cir. 2008)

By James M. Lawniczak

July 14, 2009

SUMMARY: James M. Lawniczak comments on *In re Airadigm Communications, Inc.*, where the Seventh Circuit considered whether a chapter 11 bankruptcy plan can provide for releases of nondebtor parties, regardless of a lack of consent of the creditors and other parties in interest that are bound by the releases. This was an issue of "first impression in this circuit," as well as an issue that has split the circuits, resulting in a "variety of approaches."

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ARTICLE: The Seventh Circuit Holds That a Chapter 11 Plan Can Include Nonconsensual Nondebtor Releases If Appropriate for the Reorganization

In *Airadigm Communications, Inc. v. F.C.C. (In re Airadigm Communications, Inc.)*, 519 F.3d 640, 2008 U.S. App. LEXIS 5260 (7th Cir. Mar. 12, 2008), the U.S. Court of Appeals for the Seventh Circuit considered whether a chapter 11 bankruptcy plan can provide for releases of nondebtor parties, regardless of a lack of consent of the creditors and other parties in interest that are bound by the releases. The court noted that this was an issue of "first impression in this circuit," as well as an issue that has split the circuits, resulting in a "variety of approaches." 519 F.3d at 655.

Facts. The chapter 11 debtor, Airadigm Communications, Inc. ("Airadigm"), went into business as a cellular-service provider. Its second chapter 11 proceeding involved a variety of disputes with the Federal Communications Commission. A plan of reorganization was proposed and confirmed in that proceeding, which provided for certain treatment of the FCC's claims. It also provided that a third party, Telephone and Data Systems ("TDS"), would finance the reorganization and in return would receive a release from liability for "any act or omission arising out of or in connection with the . . . confirmation of this Plan . . . except for willful misconduct." 519 F.3d at 647.

The bankruptcy court held that the release was "reasonable given both TDS's centrality to the reorganization and the potential for liability should TDS engage in 'willful misconduct.'" *Id.* Both the FCC and Airadigm appealed the bankruptcy court's determinations to the district court, which affirmed, and a further appeal was taken to the Seventh

Circuit.

Legal Analysis of the Seventh Circuit. After it first addressed several issues related to the disputes between Airadigm and the FCC, the court turned to the issue of the third-party release. The court first determined that 11 U.S.C. § 524(e) does not preclude third-party releases because it does not contain any limit on the bankruptcy court's power. 519 F.3d at 656. The court then considered whether a bankruptcy court had the affirmative power to grant third-party releases without consent, finding that the court's equity powers were sufficient. 519 F.3d at 657.

Having reached the conclusion that third-party releases were possible, the court next considered under what circumstances they would be allowed. The court noted that whether a release is appropriate "is fact intensive and depends on the nature of the reorganization." *Id.* The court focused on whether the release "was necessary for the reorganization and appropriately tailored." *Id.* The court pointed out that the release was narrowly tailored—it applied to claims arising out of or in connection with the reorganization and excluded willful misconduct. That, coupled with the fact that the reorganization could not have occurred without TDS's involvement, made this release appropriate. *Id.*

Expansion of Releases to Cover Claims of Non-Creditors. Following *Airadigm*, in *In re Ingersoll, Inc.*, 562 F.3d 856, 865 (7th Cir. 2009), the court indicated that under appropriate circumstances, where a release is "narrowly tailored and critical to the plan as a whole," the release could even cover claims of entities that were not creditors of the debtor, so long as the affected party received appropriate notice and an opportunity to be heard. The court cautioned, however, that because third party releases are limited to unusual circumstances, in most cases, compelled releases against non-creditors will not pass muster.

Consensual Releases. The *Airadigm* court noted that the Seventh Circuit had previously approved consensual releases as part of a chapter 11 plan. In *In re Specialty Equipment Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993), creditors who rejected the plan or who abstained from voting were not obligated under the releases. The *Specialty Equipment* court held that 11 U.S.C. § 524(e) does not apply to prevent consensual releases because it does not directly prohibit third-party releases in chapter 11 plans, rather it only provides that a bankruptcy discharge does not affect the liability of third parties. *Id.*; accord *Food Lion, Inc. v. S.L. Nusbaum Ins. Agency, Inc.*, 202 F.3d 223, 228 (4th Cir. 2000) (section 524(e) does not preclude the consensual settlement of claims; a voluntary, consensual release is not a discharge in bankruptcy).

In a quote that suggested the outcome in the instant *Airadigm* case, the *Specialty Equipment* court stated: "While a third-party release, like the one in Union Carbide releasing a co-debtor from liability, may be unwarranted in some circumstances, a [per] se rule disfavoring all releases in a reorganization plan would be similarly unwarranted, if not a misreading of the statute." *Id.*

Even in circuits and courts that hold that a bankruptcy court does not have the power to provide for a third-party release, a consensual release is likely to be binding on the consenting party. See, e.g., *In re Arrowmill Dev. Corp.*, 211 B.R. 497, 506-07 (Bankr. D.N.J. 1997) (although holding that third-party releases were improper under section 524(e), a creditor can nonetheless consent to the release). The consenting creditor will likely be bound by *res judicata* principles in any event. See *Trulis v. Barton*, 107 F.3d 685, 691 (9th Cir. 1995) (confirmation order is *res judicata* as to the third-party releases; indicating that creditors who do not wish to be bound must object, even though the Ninth Circuit line of cases holding that third-party releases are not permitted in bankruptcy cases predated this case by a number of years); *Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1054 (5th Cir. 1987) (*res judicata* operated to bar action against the third-party guarantor, but pointing out that the plan release of the third party was "beyond the statutory grant of the Code").

Approaches of the Other Circuits

No Power to Grant Release. Two courts of appeals, the Ninth and the Tenth Circuits, have held that section 524(e) precludes bankruptcy courts from granting releases to nondebtors. *Resorts Int'l, Inc. v. Lowenschuss (In re*

Lowenschuss), 67 F.3d 1394, 1401 (9th Cir. 1995), cert. denied, 517 U.S. 1243, 116 S. Ct. 2497, 135 L. Ed. 2d 189 (1996); *American Hardwoods, Inc. v. Deutsche Credit Corp.*, 885 F.2d 621 (9th Cir. 1989); *Landsing Diversified Properties-II v. First Nat'l Bank & Trust Co. of Tulsa (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600 (10th Cir. 1990).

In a case decided about a year and a half after the *Airadigm Communications* case, the Fifth Circuit Court of Appeals essentially adopted the no third-party release concept. *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229, 252-53 (5th Cir. 2009). The court noted that the fresh start that Bankruptcy Code section 524(e) provides debtors was not intended to absolve parties who are not jointly liable with the debtor from "any negligent conduct that occurred during the course of the bankruptcy." The court did allow releases for creditors' committee members which contained an exception for willfulness and gross negligence. 584 F.3d at 253. On an interesting related point, the court determined that the appeal taken from the grant of the third-party releases was not equitably moot due to the consummation of the plan and the fact that the parties being released had already provided the consideration they were to provide under the plan. The court stated: "the goal of finality sought in equitable mootness analysis does not outweigh a court's duty to protect the integrity of the process." 584 F.3d at 252. Two prior Fifth Circuit cases strongly suggested that the rule in the Fifth Circuit is that third-party releases are inappropriate. See *Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987), discussed in the Consensual Release section above and *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746 (5th Cir. 1995), discussed in the Bankruptcy Settlement section below.

Releases Appropriate Under Unusual, Narrow Circumstances. The Second and Sixth Circuits have approved third-party releases, but have cautioned that they require "extraordinary cases" or "unusual circumstances"; this standard may not be as liberal in favor of the releases as the one set forth in the *Airadigm* case. The Second Circuit held in *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 142-43 (2d Cir. 2005), that third-party releases were allowable if "important" to the reorganization, but went on to point out that such releases should be limited to "rare cases" where "truly unusual circumstances render the release terms important to success of the plan."

On the other hand, the factors referred to in the Second Circuit *Metromedia* case suggest that there may not be that great a difference between the Seventh Circuit's approach in *Airadigm* and the Second Circuit's approach. The *Metromedia* court looked to substantial financial contributions, which are themselves important to the plan. *Id.* A Delaware Bankruptcy Court case discussed the requirement of substantial financial contribution in more detail in *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 607 (Bankr. D. Del. 2001) ("The question of necessity requires demonstration that the success of the debtor's reorganization bears a relationship to the release of the non-consensual parties, and that the releasees have provided a critical financial contribution to the debtor's plan that is necessary to make the plan feasible in exchange for receiving a release of liability.").

In *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002) ("unusual circumstances"), the court noted that a release would be appropriate when all seven of the following factors were present: (1) an identity of interests between the debtor and the third party, usually an indemnity relationship so that actions against the third party are closely related to actions against the debtor; (2) the third party's contribution of substantial assets to the reorganization; (3) the releases are essential to the reorganization; (4) the impacted class or classes have overwhelmingly voted for the plan; (5) all or substantially all of the claims of the affected creditors will be paid; (6) there is an opportunity for those claimants who choose not to settle to recover in full; and (7) the bankruptcy court has made a record of specific factual findings in support of the release. Those extensive seven factors go well beyond the standard set by the Seventh Circuit in *Airadigm*.

In *In re AOV Industries, Inc.*, 792 F.2d 1140, 1152 (D.C. Cir. 1986), the D.C. Circuit court found that a third-party release was appropriate, although the court did not consider the section 524(e) issue. There, the court indicated that the third-parties "could not have been expected to commit millions of dollars to a reorganization plan and still remain liable to individual creditors for the full amount of their claims."

The Fourth Circuit approved nonconsensual releases in *Menard-Sanford v. Mabey (In re A.H. Robins Co., Inc.)*, 880 F.2d 694, 701-02 (4th Cir. 1989). Although the court held that section 524(e) did not prohibit the injunction, it did so in a context where the plan was overwhelmingly approved, where the reorganization hinged on the debtor's freedom from indirect claims and where the affected creditors were being paid in full. Thus, the court did not determine the circumstances under which such injunctions would be proper.

Issue Remains Open in the Third Circuit. Although the *Airadigm* opinion included the Third Circuit with the circuits that have approved third-party releases under various circumstances, 519 F.3d at 657, a careful reading of the referenced Third Circuit case, *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 213-14 (3d Cir. 2000), reveals that the court did not actually decide the issue. After a thorough analysis of the current state of the law, the court there noted that the releases provided for in the case before it could not stand under "even the most flexible tests for the validity of non-debtor releases." 203 F.3d at 214. Therefore, the court indicated that "we do not establish our own rule regarding the conditions under which non-debtor releases and permanent injunctions are appropriate or permissible." *Id.* However, if third-party releases are allowed in the Third Circuit, then at a minimum there must be the "hallmarks of permissible non-consensual releases-fairness, necessity to the reorganization, and specific factual findings to support those conclusions. *Id.*; see *United Artists Theatre Co. v. Walton*, 315 F.3d 217, 227 (3d Cir. 2003).

In a case subsequent to *Continental Airlines*, the U.S. Bankruptcy Court for the District of Delaware noted a five-factor test to determine when third-party releases would be appropriate: (1) identity of interest between debtor and nondebtor so that a suit against the nondebtor will deplete the estate; (2) substantial contribution to the plan by the nondebtor; (3) necessity of the release to the reorganization; (4) overwhelming acceptance of the plan and release by creditors; and (5) payment of all or substantially all of the claims of the creditors. *In re Coram Healthcare Group*, 315 B.R. 321, 335 (Bankr. D. Del. 2004).

Bankruptcy Settlements That Result in Third-Party Releases. Two courts of appeals, the Fifth and the Eleventh, that have not weighed in on the issue of third-party releases in plans have addressed third-party releases in the context of settlement agreements. The Fifth Circuit refused to approve the releases, while the Eleventh Circuit approved them.

In *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 754-55, 760 (5th Cir. 1995), the court considered the bankruptcy court's approval of a settlement that enjoined third-parties, including appellants, from pursuing claims related to the settlement against the insurance company that was contributing to the settlement. The court reversed the approval of the settlement, holding that the bankruptcy court lacked both jurisdiction and power to grant the requested third-party injunction. The court stated: "[W]e must overturn a § 105 injunction if it effectively discharges a nondebtor." 62 F.3d at 760 (citing section 524(e)). Thus, based on the *Zale* case, it is likely that the Fifth Circuit would join the Ninth and Tenth Circuits in rejecting nonconsensual third-party releases in plans of reorganization, if that issue were to come before it.

On the other hand, in *Munford v. Munford, Inc. (In re Munford, Inc.)*, 97 F.3d 449, 455 (11th Cir. 1996), the court affirmed the approval of a settlement that released a third party from contribution and indemnity claims by co-defendants. The court did not discuss section 524(e) in ruling that bar orders are appropriate "where such orders are integral to settlement in an adversary proceeding."

What Happens When the Third Party Seeks to Enforce the Release or Injunction? In *Travelers Indemnity Co. v. Bailey*, 129 S. Ct. 2195, 174 L. Ed. 2d 99, 2009 U.S. LEXIS 4537 (2009), the Supreme Court held that a plan injunction issued in 1986 barring third party suits against the debtor's insurance companies was effective to prevent asbestos claimants from bringing actions against those insurance companies, even though the allegations in the lawsuit raised direct, independent causes of action against the insurance companies. The Court found that the language of the 1986 plan injunction applied, and that the plan was *res judicata* as to the issue of whether the suits were barred. The Court pointed out that there was no longer any issue before it or any other court as to whether the bankruptcy court

appropriately entered the injunction back in 1986, as the confirmation order had become final, so that the Court's decision provides no guidance on whether or when third party releases are appropriate. See *In re Ingersoll, Inc.*, 562 F.3d 856 (7th Cir. 2009) (holding that non-debtor individuals with equity interests in the debtors were entitled to enforce releases contained in the corporation's plan of reorganization against an attorney who was seeking to collect attorney fees, even though the attorney was not a creditor in the corporation's bankruptcy case).

In general, the parties that have been released would prefer to litigate the enforcement of the release in the bankruptcy court that approved the plan, rather than in the subsequent action that is brought against it, which could be in a state court. In fact, if the action against the third party is brought in state court and the defendant cannot involve the bankruptcy court in the process, the only way for the beneficiary of the bankruptcy release to obtain a federal court's interpretation of the release is through appeal to the Supreme Court after losing the case before the highest court of the state, which is an unlikely prospect.

So long as a bankruptcy case is open, the bankruptcy court would be a proper place to seek to enforce the release of the injunction. Thus, the Supreme Court in the *Travelers Indemnity Co.* case noted that "the Bankruptcy Court plainly had jurisdiction to interpret and enforce its own prior orders." 174 L. Ed.2d at 110, 2009 U.S. Lexis 4537 at *26; see *In re Spiegel Inc.*, 2006 Bankr. LEXIS 2158 at *19 (Bankr. S.D.N.Y. Aug. 16, 2006), *aff'd on other grounds*, 2007 U.S. Dist. LEXIS 19633 (S.D.N.Y. Feb. 26, 2007), *aff'd still on other grounds*, 2008 U.S. App. LEXIS 5339 (2d Cir. Mar. 13, 2008) (finding jurisdiction over determination whether claims were or were not released and denying motion of proposed plaintiffs for declaratory judgment that they can bring claims).

However, once the bankruptcy case has been closed, it is problematic whether it can be reopened to assert a claim that an injunction or a release has been violated. See, e.g., *Zerand-Bernal Group, Inc. v. Cox*, 23 F.3d 159 (7th Cir. 1994) (the bankruptcy court had no jurisdiction to enforce its injunction in favor of the purchaser of assets in sale order after the completion of the bankruptcy proceeding). But see *Thomas & Betts Corp. v. Myers Power Products, Inc.*, 2006 U.S. Dist. LEXIS 3492 (D.N.J. Jan. 27, 2006).

Releases in Asbestos Trusts. Third-party releases are appropriate in asbestos trusts under the specific provisions in 11 U.S.C. § 524(g)(4)(A)(ii). This provision was added by the 1994 amendments to the Bankruptcy Code. For a discussion on asbestos trusts, see Collier on Bankruptcy, 524.07 (Matthew Bender).

Practice Pointers

Based on the approaches in those circuits that allow third-party releases, a third party seeking a release in a plan of reorganization must make an important, perhaps even vital, contribution to the reorganization. In addition, the release cannot be overbroad: it must be narrowly tailored and probably limited to matters related to the reorganization. Excluding "willful misconduct" from the release will be important. Finally, based particularly on the *Johns-Manville* case, the third party receiving the release should carefully consider the circumstances under which it will be able to enforce the release going forward.

Consensual third-party releases are generally allowed. However, as a matter of due process, they should be highlighted in the materials, probably in the ballot itself right next to the vote, and certainly in the initial executive summary of the plan in the disclosure statement. If the information on the release is buried on page 88 of the plan and page 156 of the disclosure statement, a creditor might have a due process argument with which to collaterally attack the release.

Conclusion

The Seventh Circuit has joined the majority of circuits holding that third-party releases can be included in a chapter 11 plan of reorganization under appropriate circumstances. At the same time, it is the only case to approve a third-party nonconsensual release without noting that such releases should only be given in extraordinary, rare circumstances. The Seventh Circuit only required that the release be necessary for the reorganization and appropriately

tailored for the situation.

RELATED LINKS: For further discussion of Bankruptcy Code section 524, see

■ *Collier on Bankruptcy*, ch. 524.

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45 of 197 DOCUMENTS

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Chrysler Bankruptcy

2009 Emerging Issues 3781

Chrysler Bankruptcy

By Publisher's Editorial Staff 2009

June 16, 2009

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John J. Gallagher and Todd C. Duffield on In re City of Vallejo

2009 Emerging Issues 3624

John J. Gallagher and Todd C. Duffield on In re City of Vallejo, 403 B.R. 72; 2009 Bankr. LEXIS 705 (Bankr. E.D. Cal. Mar. 13, 2009)

By John J. Gallagher and Todd C. Duffield

May 14, 2009

SUMMARY: John Gallagher & Todd Duffield, of Paul, Hastings, Janofsky & Walker LLP, consider the ruling by a California bankruptcy court that a chapter 9 debtor is not bound by the requirements of Code section 1113 or any state law in rejecting a collective bargaining agreement. The decision, however, leaves some important issues unresolved, including whether a municipal debtor can unilaterally reject a CBA and subsequently seek bankruptcy court approval.

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ARTICLE: Municipal Bankruptcies: The Battle Rages on Between State Sovereignty and Federal Bankruptcy Law

In *In re City of Vallejo*, 403 B.R. 72, 2009 Bankr. LEXIS 705 (Bankr. E.D. Cal. Mar. 13, 2009), the Bankruptcy Court for the Eastern District of California ruled that a municipal debtor in chapter 9 reorganization proceedings is not required to comply with section 1113 of the Bankruptcy Code in order to reject a collective bargaining agreement. The decision leaves uncertain whether a municipal debtor can unilaterally reject such an agreement without prior judicial approval or without compliance with state law.

In deference to state sovereignty, when Congress extended the federal bankruptcy law to municipalities, ⁿ¹ it deferred to the states the right to decide whether to allow their municipalities to take advantage of the federal law. ⁿ² This ongoing role for state law has led to uncertainty about the interplay of state law with other provisions of the Bankruptcy Code. The recent *City of Vallejo* decision illustrates this uncertainty, disagreeing with a prior decision and finding state law completely preempted.

Congress enacted section 1113 in 1984, in response to a Supreme Court decision holding that (1) a collective bargaining agreement is an executory contract subject to rejection by a chapter 11 debtor under section 365 of the Bankruptcy Code and (2) the debtor does not commit an unfair labor practice when it unilaterally modifies or terminates the agreement after filing for bankruptcy but before the court approves rejection of it. ⁿ³ Section 1113 creates certain procedural and substantive requirements which a chapter 11 debtor must satisfy prior to making unilateral changes to or

rejecting a collective bargaining agreement. Congress, however, did not make section 1113 applicable to chapter 9.

While the courts have uniformly agreed that section 1113 is inapplicable in chapter 9 cases, they have taken different views with regard to the consequences of the *Bildisco* decision in chapter 9 proceedings. The first case to consider the consequences issue, *In re County of Orange*, 179 B.R. 177, 184 (Bankr. C.D. Cal. 1995), held that while *Bildisco* permits rejection of a collective bargaining agreement by a municipal debtor, the debtor must still comply with state labor law requirements for adjustment of collective bargaining agreements. *In re City of Vallejo* now takes a very different approach, holding that section 365 provides the exclusive authority for a municipal debtor in chapter 9 to reject a collective bargaining agreement and preempts any otherwise applicable state law requirements.

As a result of these rulings, it remains uncertain (1) whether a municipal debtor can unilaterally reject a collective bargaining agreement, as was done in *Bildisco*; (2) whether a union can strike in response to the municipal debtor's unilateral action; and (3) what law, state or federal, governs the parties' conduct following rejection of the collective bargaining agreement.

Rejection of Collective Bargaining Agreements in Bankruptcy

In *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984), the Supreme Court held that unexpired collective bargaining agreements are executory contracts subject to rejection under section 365 of the Bankruptcy Code. n4 The Supreme Court clarified the legal standard for such rejection, i.e., the debtor must show that (1) the collective bargaining agreement burdens the estate, and (2) after careful scrutiny, the equities balance in favor of rejecting the labor contract. 456 U.S. at 526. The Supreme Court added that "the Bankruptcy Court should be persuaded that reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution." *Id.*

In response to the decision in *Bildisco*, Congress promptly amended chapter 11 of the Bankruptcy Code to add section 1113, which imposes certain procedural and substantive requirements on a debtor before the debtor is allowed to make unilateral changes to or reject a collective bargaining agreement. n5 Despite multiple opportunities, Congress has not extended section 1113 to chapter 9 cases. n6

Deferral to State Law in *In re County of Orange*

In re County of Orange, 179 B.R. 177 (Bankr. C.D. Cal. 1995), was the first case to consider the implications of *Bildisco* in a chapter 9 case. After filing for bankruptcy, the County unilaterally set aside certain provisions of its collective bargaining agreements, including procedural prerequisites for layoffs. A group of ten employee organizations (the "Coalition") sought an injunction from the bankruptcy court to stop the layoffs, arguing that California state law precluded the County from unilaterally changing the bargaining agreements without bargaining. The County argued that *Bildisco* controlled and allowed the County to make the unilateral changes.

The bankruptcy court noted that the "history of Chapter 9 reflects concern on the part of Congress not to overstep the boundary between legislation necessary for municipalities to reorganize and the rights of states to control the functions of their municipalities." *Id.* at 183. The court then proceeded to a compromise position, agreeing with the County that *Bildisco* applies in chapter 9 cases but finding that "*Bildisco* does not excuse attempts by the County to comply with the requirements of California law." *Id.* at 184. n7 Applying California law, the court found that the County's dire fiscal emergency did not necessitate the complete abrogation of the applicable layoff provisions. *Id.* Consequently, the court entered a temporary restraining order, enjoining the County from treating any of the employees as permanently laid off, and ordered the parties to meet and confer and attempt to resolve their differences. *Id.*

***In re City of Vallejo* Finds State Law Preempted**

More recently, in *In re City of Vallejo*, the Bankruptcy Court for the Eastern District of California held that once a municipal debtor is properly in chapter 9 proceedings, section 365 preempts any state law that would otherwise interfere with rejection of collective bargaining agreements under the Bankruptcy Code.

In resolving the City's motion to reject certain collective bargaining contracts, the court agreed with *In re County of Orange* that a municipality's rejection of a collective bargaining agreement in a chapter 9 proceeding is not governed by section 1113. n8 The court, also consistent with *In re County of Orange*, noted that Congress enacted chapter 9 of the Bankruptcy Code "to harmonize . . . two competing interests-reservation of powers to the states and the supremacy of federal bankruptcy law." 2009 Bankr. LEXIS 705, at *3. Congress did so, according to the court, by requiring states to specifically authorize a municipality to take advantage of the Bankruptcy Code. n9 When a state does so, the court stated, "it declares that the benefits of chapter 9 are more important than state control over its municipalities." 2009 Bankr. LEXIS 705, at *4. Additionally, "by authorizing the use of chapter 9 by its municipalities, California must accept chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest." *Id.* (quoting *In re County of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1995)). This is the point at which the decisions in *In re City of Orange* and *In re City of Vallejo* diverge.

The court in *In re City of Vallejo* held that when a state authorizes its municipalities to avail themselves of the benefits of chapter 9, it would be unconstitutional to superimpose a state's own law onto federal bankruptcy law. 2009 Bankr. LEXIS 705, at *7. This is so because federal law preempts contrary state law under the Supremacy Clause, the Bankruptcy Clause and the Contract Clause of the United States Constitution. See U.S. Const. art. 1, § 8, cl. 4; U.S. Const. art. VI, cl. 2; U.S. Const. art. IV.

Thus, the *In re City of Vallejo* court rejected the holding in *In re County of Orange* that deferred to California state law in relation to rejection of collective bargaining agreements under section 365. Instead, the court held that the factors established by the Supreme Court in *Bildisco* provide the exclusive standard for rejecting an unexpired collective bargaining agreement under section 365. 2009 Bankr. LEXIS 703, at *11.

Unresolved Issues

The first issue that remains unresolved is whether a municipal debtor in a chapter 9 bankruptcy can act unilaterally to reject a collective bargaining agreement and then seek bankruptcy court approval after the fact, as in *Bildisco*. *In re City of Orange* suggests that the answer is "no," because the court reversed the County's unilateral action by converting the permanent layoffs to temporary layoffs and ordering the parties to meet and confer. In contrast, *In re City of Vallejo's* answer would seem to be "yes," although, the court in that case also ordered the parties to continue their negotiations and report back to the court before the court would rule on whether the *Bildisco* standard had been satisfied.

Related unresolved issues in chapter 9 cases are: (1) what law governs the parties' conduct post-rejection; and (2) whether the union can strike in response to rejection, which is a subset of what law applies. When a debtor in chapter 11 is subject to the National Labor Relations Act and is permitted to reject a collective bargaining agreement, the courts have generally held that, although the contract has been abrogated, the debtor thereafter remains subject to all other obligations under the National Labor Relations Act (including the duty to bargain in good faith), n10 and that rejection of the collective bargaining agreement frees the union to strike. n11 Assuming a municipal debtor is permitted to reject a collective bargaining agreement, any continuing duty to bargain or right to strike would likely depend on the controlling labor law, which would often be state law.

In light of the current economic climate, other municipalities may turn to chapter 9 for relief. If they do so, these unresolved issues may be brought to the forefront sooner rather than later. Additionally, in light of the current labor movement and pending and contemplated labor legislation, Congress may get yet another opportunity to consider extending section 1113-like prerequisites to chapter 9 cases.

[Return to Text](#)

n1 The Municipal Bankruptcy Act of 1937, Pub. L. No. 302, 50 Stat. 653 (1937). Congress first enacted federal municipal bankruptcy law in 1934, to assist struggling municipalities during the Great Depression. Pub. L. No. 251, 48 Stat. 798 (1934). The Supreme Court struck down that law as an unconstitutional infringement on state sovereignty. *Ashton v. Cameron County Water Improvement District*, 298 U.S. 513, 531, 56 S. Ct. 892, 80 L. Ed. 1309 (1936). Congress subsequently tried again, and the 1937 Municipal Bankruptcy Act was upheld as constitutional by the Supreme Court in *Bekins v. Lindsay-Strathmore Irrigation District*, 304 U.S. 27, 58 S. Ct. 811, 82 L. Ed. 1137 (1938). Congress continued to reform municipal bankruptcy law, making both substantive and procedural amendments to the law, in 1976, 1978 and 1988. See Pub. L. No. 94-260, 90 Stat. 315 (1976); Pub. L. No. 95-598, 92 Stat. 2549 (1978); and Pub. L. No. 100-597, 102 Stat. 3028 (1988). In 1994, Congress amended the Bankruptcy Code to clarify how state consent could be authorized, providing that a municipal entity "may be a debtor under chapter 9 of this title if and only if ..specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law..." 11 U.S.C. § 109.

n2 Section 903 of the Bankruptcy Code provides that it does not "limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality" And section 904 provides that the bankruptcy court may not, "unless the debtor consents or the plan so provides," interfere with (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property. Due to Constitutional restraints and state sovereignty, municipal bankruptcy proceedings under chapter 9 are significantly different than corporate reorganizations under chapter 11. For example, under chapter 9 there is no provision for liquidation of the assets of the municipality and distribution of the proceeds to creditors. Additionally, the bankruptcy court does not take as active a role in managing a chapter 9 case as it does in a chapter 11 case.

n3 See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984).

n4 Section 365(a) provides: "Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." Section 365 is commonly referred to as the "business judgment" standard for rejection of collective bargaining agreements.

n5 Most courts adhere to the following nine requirements that must be satisfied for court approval of the rejection of a collective bargaining agreement under section 1113:

1. The debtor-in-possession must have made a proposal to the union;

2. The proposal must be based on the most complete and reliable information available at the time of the proposal;
3. The proposed modifications must be necessary to permit reorganization;
4. The modification must provide that all affected parties are treated fairly and equitably;
5. The debtor-in-possession must provide the union with such relevant information as is necessary to evaluate the proposal;
6. The debtor-in-possession must have met with the collective bargaining representative at reasonable times subsequent to making the proposal;
7. The debtor-in-possession must have negotiated with the union in good faith concerning the proposal;
8. The union must have refused to accept the proposal without good cause; and
9. The balance of the equities must clearly favor rejection of the agreement.

See 7 Collier on Bankruptcy, 1113.04 (Alan N. Resnick & Henry J. Sommer eds. 15th ed. rev.).

n6 For example, in 1991, Congress introduced the Municipal Employee Protection Amendments of 1991, which contemplated adding certain section 1113-like provisions to chapter 9 and would have required municipalities to comply with state labor laws as a prerequisite to rejecting a collective bargaining agreement. See H.R. No. 3949, 102d Cong., 1st Sess. (1991). The bill died in committee.

n7 California law provided that before the County could take the contemplated unilateral action with regard to the employee bargaining agreements, it had to satisfy the following four-part test: (1) a declared emergency must be based on an adequate factual foundation; (2) the agency's action must be designed to protect a basic social interest and not benefit a particular individual; (3) the law must be appropriate for the emergency and obligation; and (4) the agency decision must be temporary, limited to the immediate exigency that cause the action. The court noted that "[i]n my view, any unilateral action by a municipality to impair a contract with its employees must satisfy these factors if not as a legal matter, certainly from an equitable standpoint." 179 B.R. at 184.

n8 Like the court in *In re City of Orange*, the court noted that Congress has had multiple opportunities to extend section 1113 to chapter 9 proceedings, but has not done so, and stated that "this court will not presume to do what Congress has not done, whether by incorporating section 1113-like provisions into chapter 9, or by requiring compliance with state labor law." *Vallejo*, 2009 Bankr. LEXIS 705, at *11.

n9 The state of California grants specific authorization by statute in Cal. Gov't Code § 53760 (1995): "Except as otherwise provided by statute, a local public entity in this state may file a petition and exercise

powers pursuant to applicable federal bankruptcy law." Additionally, Section 53760 was amended in 2002 to include the following: "This section is intended to provide the broadest possible state authorization for municipal bankruptcy proceedings, and thus provides the specific state law authorization for municipal bankruptcy filing required under federal law."

n10 See 7 Collier on Bankruptcy, 1113.06[1][b].

n11 See *Id.* at 1113.06[2].

RELATED LINKS: For discussion of Bankruptcy Code section 365, see

■ Collier on Bankruptcy, ch. 365 (Matthew Bender).

For discussion of Bankruptcy Code section 113, see

■ Collier on Bankruptcy, ch. 1113 (Matthew Bender).

For a circuit-by-circuit review of section 365 and collective bargaining agreements, click

■ [here](#).

For discussion of the National Labor Relations Act and the bankruptcy laws, see

■ Labor and Employment, ch. 42 (Matthew Bender).

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47 of 197 DOCUMENTS

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Eric English on In re Gulf Coast Oil Corp.

2009 Emerging Issues 3629

Eric English on In re Gulf Coast Oil Corp., 2009 Bankr. LEXIS 313 (Bankr. S.D. Tex. Feb. 11, 2009)

By Eric English

May 14, 2009

SUMMARY: Eric English, of King & Spalding, looks at a bankruptcy court's rejection of a request to approve a 363(b) sale. Section 363 sales have never been more popular, and the decision in *In re Gulf Coast Oil Corp.* is significant because it demonstrates the narrow approach some courts favor, despite existing case law of a more expansive nature. As Mr. English notes, the decision will perhaps encourage the Fifth Circuit to revisit the issue.

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ARTICLE: Texas Bankruptcy Court Rejects Chapter 11 Debtors' Request to Sell All of Their Assets and Calls for Fifth Circuit to Clarify Legal Standard

In *In re Gulf Coast Oil Corp.*, 2009 Bankr. LEXIS 313 (Bankr. S.D. Tex. Feb. 11, 2009), the Bankruptcy Court for the Southern District of Texas denied the debtors' motion to sell all of their assets pursuant to section 363(b) of the Bankruptcy Code. The opinion is notable primarily for its thorough discussion of Fifth Circuit precedent, its attempt to provide a framework for considering section 363 sales by identifying thirteen relevant factors, and its arguably narrow interpretation of the applicable legal standard.

The prevalence of sales under section 363 of the Bankruptcy Code involving all or substantially all of a debtor's assets is well documented. The popularity of such sales is unsurprising given section 363's obvious advantages over filing and seeking approval of a disclosure statement and reorganization plan. Because section 363 sales typically are faster, less expensive and provide the debtor more flexibility than obtaining approval of a plan, the popularity of section 363 sales shows no signs of diminishing.

Section 363 sales can raise a number of issues, but no issue is more important than the familiar threshold question of whether a court will permit the sale of all or substantially all of a debtor's assets in the first place. Section 363(b) provides that a debtor in possession "after notice and a hearing may use, sell, or lease, other than in the ordinary course of business, property of the estate." This language does not address whether all or substantially all of a debtor's assets may be sold pursuant to section 363, and that question has been left to the courts. Many courts have recognized that such sales are permitted by section 363 when the debtor is able to articulate a legitimate business purpose. n1 This

standard generally has been adopted by the Fifth Circuit, although few Fifth Circuit opinions have directly applied it. n2 And despite the widespread acceptance of the legitimate business purpose test, some courts remain hesitant to approve section 363 sales of all or substantially all of a debtor's assets absent compelling or special circumstances. n3

Facts of *In re Gulf Coast Oil Corp.*

The debtors, affiliated oil and gas exploration and production companies, filed for chapter 11 in July 2008. The debtors listed real property assets (consisting of mineral leases and oil and gas wells) of \$30,000,000 and unsecured debts of \$120,000 in their amended schedules, and stipulated that they owed at least \$66,000,000 to Laurus Master Fund, Ltd. ("Laurus"), the debtors sole prepetition secured lender. However, the court noted that the value of the debtors' oil and gas interests had changed considerably given the unprecedented volatility in commodities markets that took place during the debtors' chapter 11 case.

Shortly after filing a chapter 11 plan and disclosure statement in November 2008, the debtors concluded that a corporate reorganization was not feasible. Falling prices for oil and gas had deteriorated the value of the debtors' assets to a level substantially below the amount of Laurus's secured claim and Laurus did not support the debtors' reorganization efforts. Further, the debtors' cash flow was inadequate to proceed with the proposed reorganization. Faced with these hurdles, the debtors abandoned their previously filed plan and sought approval to sell substantially all of their assets at an auction pursuant to section 363(b). As the court noted, however, there was little hope for a meaningful auction given the debtors' inability to attract interested purchasers for their assets. With no other interested buyers, Laurus became the only legitimate potential purchaser of the debtors' assets. n4

Court's Analysis

In considering the debtors' motion to sell all of their assets pursuant to section 363, the court reviewed the Fifth Circuit case law and the leading treatises, discussed recent developments regarding section 363 sales, and considered the views of various commentators. The court then distilled this authority into a list of factors courts can consider in approving section 363 sales. Finally, the court briefly applied these factors to the case at hand and concluded that the proposed sale was inappropriate under section 363.

The court commenced its analysis with a survey of the Fifth Circuit's treatment of section 363 transactions, starting with the venerable and oft-cited *In re Braniff Airways*, 700 F.2d 935 (5th Cir. 1983). In *In re Braniff Airways*, the Fifth Circuit rejected a transaction proposed under section 363 because the transaction went beyond a mere sale of assets, would have required creditors to vote for a certain plan, and required the release of claims against the debtor. *Id.* at 939. Because the section 363 "sale" was more akin to a reorganization plan-without the protections provided by section 1121-the court labeled it a "plan *sub rosa*" that was inappropriate under section 363. However, as the court noted in *In re Gulf Coast Oil Corp.*, the Fifth Circuit did not condemn the practice of selling all of a debtor's assets under section 363. 2009 Bankr. LEXIS 313, at *16 ("The [*In re Braniff Airways*] court held that when a transaction materially interfered with 'that carefully crafted scheme,' the transaction could not be authorized by a bankruptcy court under § 363(b). But the Fifth Circuit also expressly declined to hold that the sale of all property of the estate was *per se* improper." (quoting *In re Braniff Airways*, 700 F.2d at 940)).

The court then discussed several subsequent Fifth Circuit cases, including *Richmond Leasing Co. v. Capital Bank N.A.*, 762 F.2d 1303, 1313 (5th Cir. 1985), which distinguished *In re Braniff Airways* on the basis that the proposed lease assumption did not "alter creditors' rights, dispose of assets, and release claims to the extent proposed in [*Braniff*]," and *In re Continental Airlines, Inc.*, 780 F.2d 1223, 1227 (5th Cir. 1986), which also involved a lease transaction under section 363(b) and established the rule that objectors to section 363(b) transactions must state with particularity which procedural protections are being denied. n5

Unfortunately, neither *Richmond Leasing* nor *In re Continental Airlines Inc.* squarely addresses sales of all of a debtors' assets under section 363. However, the discussion of section 363 in those cases is generally in accord with the

leading treatises, which confirm that section 363 sales of all or substantially all of a debtor's assets are widely approved upon a showing of a sound business justification. See *In re Gulf Coast Oil, 2009 Bankr. LEXIS 313*, at *21-*24 (discussing treatises). For example, *Collier* concludes that "[i]t is now generally accepted that section 363 allows such sales [involving substantial assets] in chapter 11, as long as the sale proponent demonstrates a good, sound business justification for conducting the sale before confirmation" *Id.* at *22 (quoting 3 *Collier on Bankruptcy* 363.02[3] (15th ed. rev. 2005)). And *Norton* observes that "[n]otwithstanding the heightened scrutiny of substantial asset sales, courts will generally approve such sales without the procedural protections of a plan and disclosure statement when a debtor can establish a sound business justification for the sale." *Id.* at *23-*24.

Although the court cited authorities that generally approve section 363 sales of all a debtors' assets, the court also considered commentary that is critical of such sales and voiced its own concerns about several trends. For example, the court noted the increase in significant claims trading in large cases, "loan to own" lending strategies, venue selection, and in the Lehman Brothers case, the sale of assets that were not estate property. *Id.* at *24-*25, *32-*33. With these concerns in mind, and given the limited guidance provided by the Fifth Circuit, the court observed that "[i]t would be very helpful if the Fifth Circuit were to take another look at the boundaries of § 363(b) sales to provide more guidance to bankruptcy courts in the circuit." *Id.* at 34. n6 Thus, several themes emerge that persist throughout the opinion: (1) the court has several important concerns about section 363 sales of all of a debtor's assets; and (2) bankruptcy courts would benefit from more guidance from the Fifth Circuit regarding such sales.

Without the benefit of additional guidance here, the court attempted to distill the applicable authorities into a list of factors courts can consider in determining whether to approve a section 363 sale:

1. Is there evidence of a need for speed?
2. What is the business justification?
3. Is the case sufficiently mature to assure due process?
4. Is the proposed asset purchase agreement sufficiently straightforward to facilitate competitive bids . . . ?
5. Have the assets been aggressively marketed in an active market?
6. Are the fiduciaries that control the debtor truly disinterested?
7. Does the proposed sale include all of a debtor's assets and does it include the "crown jewel"?
8. What extraordinary protections does the purchaser want?
9. How burdensome would it be to propose the sale as part of confirmation of a chapter 11 plan?
10. Who will benefit from the sale?
11. Are special adequate protection measures necessary and possible?
12. Was the sale hearing a true adversary presentation?
13. Are any other factors applicable?

Id. at *36-*51.

Finally, the court applied some of these factors to the case at hand. First, the court concluded that no exigency existed that would preclude submission of a plan. *Id.* at *50. The court also found it irrelevant that the result of a sale would likely be the same as the result of a plan (i.e., Laurus would become the owner of the assets). *Id.* at *50-*51.

Next, the court construed the relief sought as a "foreclosure," release, assignment of certain executory contracts, elimination of liability, and preservation of a going concern, and held that these results could only be achieved through a reorganization plan, which was not possible here. *Id.* at *51-*53. The court also expressed concern that it could not accurately determine whether the proposed price was fair because there was no active market for the assets. *n7 Id.* at 52. Finally, the court voiced its concern that the sale involved all of the debtors' assets and observed that if the sale was approved "[t]he only effect of the bankruptcy process would be to transfer the debtors' assets to its secured creditor with benefits that the creditor could not achieve through foreclosure." *Id.* at *52-*53. After reaching these conclusions the court denied the debtors' motion.

Critique

As with virtually every case dealing with section 363 sales of all of a debtor's assets, there is the potential for considerable disagreement with the result of *In re Gulf Coast Oil Corp.* The debtors' proposal involved a relatively straightforward free and clear sale of their assets and the transaction did not limit voting rights or include many of the other restrictions associated with a "plan *sub rosa*." There is no mention that the objecting party specifically identified the protections being denied them, as required. *n8* Further, there was no discussion that the debtors proposed the plan in bad faith or that a prompt asset sale would have limited the recovery for creditors. Moreover, it is unfortunate that, despite the court's comprehensive discussion of authority and its listing of numerous relevant factors, only a few paragraphs are devoted to applying the law to the facts. Perhaps this is because many of the concerns that the court expressed about section 363 sales-widespread claims trading, "loan to own" lending strategies, venue selection, sales involving assets not belonging to the estate, and the like-simply were not present.

Criticism aside, the opinion in *In re Gulf Coast Oil Corp.* is clearly defensible given the discretion provided by the applicable legal standard. And differences of opinion about cases involving section 363 sales are the inevitable and direct result of the vague standards in place. Nonetheless, at the end of the day, the opinion in *In re Gulf Coast Oil Corp.* demonstrates that some courts construe section 363 and the applicable Fifth Circuit precedent rather narrowly. Whether the court's approach is a harbinger of things to come is unclear, but given the prominent place that section 363 sales occupy in chapter 11 cases, this decision will give debtors some pause and hopefully will encourage the Fifth Circuit revisit this issue in a substantive way.

Return to Text

n1 See, e.g., Stephens Indus. Inc. v. McClung, 789 F.2d 386, 390 (6th Cir. 1986); *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983); *see also, e.g., In re Bombay Co., 2007 Bankr. LEXIS 3218*, at *6 (N.D. Tex. Sept. 26, 2007) ("[T]here is also ample authority that section 363(b)(1) may be used to dispose of all or most of a chapter 11 debtor's assets through a sale in a going concern configuration or by liquidation.").

n2 See, e.g., In re Continental Airlines, Inc., 780 F.2d 1223, 1227 (5th Cir. 1986).

n3 See 2 Norton Bankr. L. & Prac. § 44:17 & n. 10 (3d rev. 2009).

n4 The debtors' financial advisors objected to the proposed sale on the basis that administered expenses would not be paid in full.

n5 The court also briefly considered two other decisions that did not involve section 363(b) sales. *In re Cajun Elec. Power Co-op., Inc.*, 119 F.3d 349 (5th Cir. 1997). In *In re Cajun Electric*, the court again distinguished *In re Braniff Airways*, this time in approving a settlement involving certain estate property that was actually an impediment to reorganization. *Id.* at 355. In *In re Babcock and Wilcox Co.*, 250 F.3d 955 (5th Cir. 2001), meanwhile, the court again distinguished *In re Braniff Airways*: "*Braniff* merely stands for the proposition that the provisions of § 363 . . . do not allow the debtor to gut the bankruptcy estate before reorganization or to change the fundamental nature of the estate's assets in such a way that limits a future reorganization." *Id.* at 960.

n6 To support its view that the Fifth Circuit should clarify the appropriate legal standard, the court summarized the rules from the Fifth Circuit's previous cases: a debtor's fiduciary duties must be considered, a valid business justification must be present, sales of all of a debtor's assets are subject to special scrutiny, those opposing such a sale must specifically articulate their objections, section 363 sales cannot be used as "scheme" to avoid the plan confirmation process (unless the court is able to protect creditors), and *In re Braniff Airways* type transactions are not allowed. 2009 Bankr. LEXIS 313, at *34.

n7 The court recognized, however, that the sale price probably did not matter because Laurus was substantially undersecured. See 2009 Bankr. LEXIS 313, at *52.

n8 See *In re Continental Airlines, Inc.*, ., 780 F.2d 1223, 1227 (5th Cir. 1986).

RELATED LINKS: For discussion of section 363, see

■ Collier on Bankruptcy (Matthew Bender).

For the American College of Bankruptcys Best Practices Report on Section 363 Sales, click
■ here.

For the American College of Bankruptcys Circuit-by-Circuit Review of 363 Sales, click
■ here.

For an introduction to sales outside the ordinary course of business, see
■ Collier Handbook for Debtors in Possession, ch. 24A (Matthew Bender).

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48 of 197 DOCUMENTS

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Richard Levin on PBGC v. Oneida Ltd.

2009 Emerging Issues 3623

Richard Levin on PBGC v. Oneida Ltd., 562 F.3d 154, 2009 U.S. App. LEXIS 7176 (2d Cir. Apr. 8, 2009)

By Richard Levin

May 13, 2009

SUMMARY: Richard Levin, of Cravath, Swaine & Moore LLP, considers the significance of the first appellate decision holding that a company is liable to the Pension Benefit Guaranty Corporation for pension termination premiums after it emerges from a chapter 11 reorganization. Because of continuing obligations to the PBGC, chapter 11 may not provide meaningful relief from pension liabilities. However, the decision does not address successor liability.

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ARTICLE: PBGC's Right to Pension Plan Termination Premium Survives a Chapter 11 Reorganization

The United States Court of Appeals for the Second Circuit has ruled that a company that terminates its defined benefit pension plan in a chapter 11 reorganization case is liable to the Pension Benefit Guaranty Corporation (PBGC) for pension termination premiums after it emerges from a chapter 11 reorganization. The decision, *PBGC v. Oneida Ltd.*, 562 F.3d 154, 2009 U.S. App. LEXIS 7176 (2d Cir. Apr. 8, 2009), though expected, is the first appellate court decision applying the termination premium provisions that Congress enacted in the Deficit Reduction Act of 2005 (DRA 2005) to protect the PBGC from employer bankruptcies, in which a pension plan termination usually gave the PBGC only a dischargeable general unsecured claim on which it recovered little, if anything.

Background

The DRA 2005 imposes an annual termination premium of \$1,250 per plan participant for three years after a distress or involuntary termination of a single-employer defined benefit plan, whether or not the termination occurs in a chapter 11 case. If a plan is terminated while the employer or a member of its controlled corporate group is undergoing reorganization under chapter 11, the DRA 2005 contains a "Special Rule" that defers application of the general rule, and therefore the start of the three-year period for premiums, until the date of discharge or dismissal of the chapter 11 case, apparently with the intent of ensuring that the termination premium obligation is a post-bankruptcy obligation that is not affected by the bankruptcy discharge.

In its chapter 11 reorganization case, Oneida Ltd. stipulated with the PBGC for a distress termination of one of its

single-employer defined benefit plans. Oneida then argued to the bankruptcy court that the termination premium was a claim that arose before bankruptcy and therefore was discharged in Oneida's chapter 11 case. Oneida reasoned that the Bankruptcy Code's definition of "claim" is broad, including contingent claims, that Oneida and the PBGC had a relationship with respect to the pension plan before bankruptcy and that the parties could contemplate before bankruptcy that this additional premium could arise. The bankruptcy court agreed with Oneida and discharged the PBGC's premium claim. 383 B.R. 29 (*Bankr. S.D.N.Y. 2008*).

The Decision

The Court of Appeals for the Second Circuit reversed. The court of appeals agreed that the definition of "claim" is broad, but concluded that it is not unlimited. A claim's existence depends on whether the claimant had a right to payment, and the claim is a prepetition claim only if that right arose prepetition. "No matter how broadly the term 'claim' is construed," the court explained, "it cannot extend to a right to payment that does not yet exist under federal law." 2009 U.S. App. LEXIS 7176, at *8. Nonbankruptcy law determines whether and when a claimant has a right to payment. The DRA 2005 established the PBGC's right to the termination premium as of "the date of discharge" specifically to prevent employers from evading the premium by a bankruptcy filing, and treating the termination premium as a dischargeable prepetition claim would directly thwart Congress's goals under the DRA 2005. Therefore, the PBGC's right to the termination premium survived Oneida's chapter 11 discharge.

The Effect of the Decision: Chapter 11 May Not Provide Meaningful Relief from Pension Liabilities

In the current economic environment, many companies are facing both financial distress and declining value in their pension assets, such that previously well-funded defined benefit pension plans are becoming seriously underfunded. The cost of bringing a company's plan back to fully funded status may prevent the company from surviving its general financial distress. A company's obligation to fund its pension plans is dischargeable in chapter 11. However, with this decision, which other courts are expected to follow, chapter 11 reorganization may not provide meaningful relief from pension liabilities because of continuing obligations to the PBGC. The result is likely to be either fewer successful reorganizations, as many companies with a substantial number of plan participants (including retirees and other inactive participants) who could otherwise reorganize will not be able to support the full amount of the termination premium, or lower recoveries for creditors of companies that are still able to reorganize.

The decision does not address the application of the termination premium to successors in interest following a sale of all or substantially all of a chapter 11 company's assets, and the statute appears not to apply the termination premium to a purchaser of all or substantially all of a company's assets. Thus, a buyer of a distressed company's assets, whether through a bankruptcy section 363 sale or otherwise, should not be liable for the termination premium. Even a company that undergoes a successful reorganization may be able to avoid the termination premium by structuring its reorganization as a sale to a new entity. The securities of the new entity and other consideration to be distributed under the plan would have to be distributed through the old company, which would continue to exist for the purpose of distributing creditor recoveries and other chapter 11 case closing administrative purposes. The buyer then would have two defenses to payment of the termination premium. First, a buyer is generally not liable for a termination premium under DRA 2005. Second, a company that liquidates in chapter 11 and does not continue in business does not receive a discharge, so the termination premium, which applies only upon discharge of the old company's debts, would never apply. However, all members of a controlled corporate group are jointly and severally liable for pension obligations. So any controlled group members that are left behind in their current form may continue to be liable for the termination premium.

[Return to Text](#)

n1 Deficit Reduction Act of 2005, Pub. L. 109-171, *120 Stat. 4 (2006)*, 29 U.S.C. § 1306(a)(7)(B).

n2 The court stated:

If there is any ambiguity in the statutory language of the Special Rule-and we perceive none-it is resolved in the PBGC's favor by the legislative history of the Deficit Reduction Act and the Pension Protection Act. The Termination Premiums were established in response to mounting financial pressure on the PBGC as a result of an increasing number of pension plan terminations. See H.R. Rep. 109-276, at 345-48 (2005). 2 Congress recognized, however, that its Termination Premium program could be jeopardized by employers seeking bankruptcy protection. It thus created the Special Rule.

2009 U.S. App. LEXIS 7176, at *8.

RELATED LINKS: For more discussion on protecting pension plan benefits, see

■ Labor and Employment Law, ch. 152 (Matthew Bender).

For discussion of defined benefit plans in bankruptcy and interactions with the PBGC, see

■ Collier Monograph: Employee Benefits and Executive Compensation, 7 (Matthew Bender).

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Richard Levin is a partner in the Restructuring Department of Cravath, Swaine & Moore LLP, in New York City. Mr. Levin's practice focuses on creditors' rights, insolvency, reorganization and bankruptcy. He has negotiated and structured complex domestic and international transactions involving distressed or insolvent companies and guided corporate debtors, creditors and acquirers through Chapter 11 and out-of-court restructurings. He has also conducted bankruptcy-related litigation both in connection with and independently of restructuring transactions. Before joining Cravath, Swaine & Moore, Mr. Levin spent 10 years as a partner in the Corporate Restructuring Department of Skadden, Arps, Slate, Meagher & Flom LLP and 16 years as a member of the Los Angeles insolvency and corporate reorganization firm of Stutman, Treister & Glatt P.C.. From 1975 to 1978, Mr. Levin served as counsel to a subcommittee of the House Judiciary Committee and was one of the principal authors of the Bankruptcy Code and the Bankruptcy Reform Act of 1978. Mr. Levin received an S.B. from the Massachusetts Institute of Technology in 1972, and a J.D. from Yale Law School in 1975, where he was an editor of the *Yale Law Journal*. Mr. Levin has served as a consultant to the World Bank and to the Central Bank of Brazil regarding new Brazilian bankruptcy legislation (2001-2004), as Faculty at the Federal Judicial Center (2001-present) and as a Lecturer in Law at Harvard Law School (2004, 2006). He is also a Fellow of the American College of Bankruptcy and a member of its Board of Trustees (2007-2009). Since 2004, he has been the vice chair of the National Bankruptcy Conference.

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Herrick, Feinstein LLP on the Madoff Litigation Landscape

2009 Emerging Issues 3571

Herrick, Feinstein, LLP: Madoff Victims Face Litigation Landscape Filled With Uncertain or Unsatisfying Recoveries and, Worst of All, the Prospect of Losing More

By Therese Doherty, Howard Elisofon and John Oleske

April 30, 2009

SUMMARY: In this Emerging Issues Analysis, Therese M. Doherty, Howard R. Elisofon and John Oleske of the New York City-based law firm Herrick, Feinstein, LLP examine the litigation strategies and courses of action for the victims of Bernard Madoff's Ponzi scheme and conclude that the best that most can hope for is not to actually lose even more.

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ARTICLE: Any meaningful discussion of Madoff-related legal action is bound to be both complicated and problematic, arising from the likelihood that for victims, attempts at recovery figure to be unsatisfying or unlikely. Those who lost their investment in Madoff's Ponzi scheme have several potential avenues to pursue restitution, but those options involve a return of mere pennies on the dollar, years of protracted litigation, or both. In fact, the more likely a litigation strategy is to lead to recovery, the less it will probably yield. While victims and their counsel contemplate that inverse relationship between likelihood of recovery and the amount to be recovered, the real battle -- with the most interesting legal arguments and possibly the most aggregate money on the line -- will be in the clawback arena.

Victims who redeemed all or part of their investment before the scheme's collapse face the prospect of being preyed on a second time. The SIPC trustee, Irving Picard, has already begun to pursue clawback redemptions to enlarge the estate for the benefit of the Madoff brokerage's estate and eventual pro rata distribution to the redeemers' fellow victims. In late April, he sent notices to more than 200 individual investors, funds, and former Madoff employees, demanding that they return redemptions made over the past six years. More notices are likely to follow.

Whether the discussion turns to offense (victims seeking recompense) or defense (trying to hold on to what they still have) practitioners and laypersons should realize that the Madoff-related litigation landscape is a minefield. Navigating it requires not only a thorough understanding of the opportunities, pitfalls, and precious few safe havens, but also a perspective and understanding that even generally favorable outcomes will be not be entirely satisfying.

This is the question on the mind of every Madoff victim, and the answers generally supplied by lawyers is "maybe

nobody" and "you won't get much back anyway." For the most part, these are sound predictions. Each investor's situation is different, however, and the potential for recovering part of their investment can vary widely. Although the likelihood of seeing the return of a substantial part of their losses may be small, at least there are several options available, some of which will be more promising or attractive than others, depending on an investor's circumstances and tolerance for a long-term legal strategy that may end up resulting in nothing but frustration and steep legal fees. We address each option in turn, in rough order of likelihood of success and prompt resolution.

SIPC Claims

For those victims who invested directly in the Madoff brokerage, SIPC is bound by statute to provide \$500,000 in coverage for losses in securities, and \$100,000 for losses in cash. The relevant case law indicates that because Madoff brokerage victims received statements indicating that they owned securities (even though they did not), they should be paid the \$500,000 maximum and not limited to the \$100,000 cash coverage payout. See *In re New Times Securities Services, Inc.*, 371 F.3d 68 (2d Cir. 2004). To date, the trustee has paid on only a handful of claims -- the most obvious ones at that, albeit at the \$500,000 level -- leaving us uncertain as to how he will proceed on the bulk of the claims. Given that SIPC is a private insurer and that being statutorily eligible for coverage is not tantamount to receiving it, we find it conceivable that SIPC will seek to deny coverage on claims, spawning coverage litigation.

Although it is not at all clear that the \$1.6 billion SIPC trust fund and \$1 billion in additional borrowing power will cover payments to all victims, it is possible, if not likely, that those funds or borrowing power will be expanded to ensure that at least the SIPC coverage promised to investors will actually be paid out.

In addition to those who invested directly and lost, there are thousands who invested indirectly, lost just as badly, and are statutorily ineligible for SIPC coverage by virtue of having invested through "feeder funds" that in turn invested in Madoff. These investors can hope only for a pro rata share of the \$500,000 that will presumably be paid to each of the investing funds -- in other words, a negligible recovery. See *Sec. Investor Prot. Corp. v. Morgan, Kennedy & Co.*, 533 F. 2d 1314 (2d Cr. 1976) (only trust fund, and not an individual investor in the fund, is eligible for SIPC coverage).

Finally, although there is additional relief available to brokerage investors beyond the SIPC payouts, that relief is not only limited but to the extent it is available it could benefit SIPC to the exclusion of the investors. Specifically, one of the SIPC trustee's duties is to gather all of the assets of the estate for pro rata distribution. As discussed below, this will include amounts "clawed back" from investors who made redemptions. But this is likely to provide the estate with a mere fraction of the losses taken by the non-redeeming investors, and the trustee may attempt to use these funds to offset SIPC payments to victims, which would likely make those distributions meaningless.

Class Action Lawsuits

Plaintiffs' firms have already begun flooding the courts with putative class-action lawsuits against virtually every individual or entity to have touched the Madoff scheme. The most obvious targets are Madoff, his immediate family, and professionals who assisted Madoff, such as the two-man accounting firm that was supposed to audit Madoff's books.

One degree of separation removed -- but still vulnerable -- are the hedge funds that invested in Madoff, plus their managers, advisers, and accountants. Indeed, one of these fund managers, Ezra Merkin, has already been charged by New York's Attorney General, which seems to bolster the civil lawsuits that already have been filed against him.

The potential merits of these lawsuits are readily apparent, and in some cases -- with fact patterns unfavorable to the defendants -- establishing liability can be a reasonably likely proposition. But it remains to be seen what kind of a recovery can actually be had, given the likely insolvency of many of the entities involved, and the relatively small amount of money that could be recovered from the others when compared to the losses sustained by the class-action plaintiffs. Moreover, plaintiffs' counsel in these lawsuits will be entitled to a substantial portion of any recovery, further reducing the recompense that their clients can expect to receive, even if the claims are successful.

Tax and Insurance Recoveries

These are examples of likely sources of recovery, but probably small comfort to victims.

Many investors will have an opportunity to recover some past tax payments, or offset future gains, through theft-loss claims on amended or future returns. The amount and timing of such recoveries will depend on each investor's tax circumstances, and can be reliably determined only with the assistance of an accountant and tax counsel. Be aware that an IRS ruling in March provides a safe harbor for victims to take an immediate deduction for losses without having to make a determination of their potential recovery of claims against Madoff or third parties. For more extended treatment of the tax issues, see our firm's client alert at <http://www.herrick.com/sitecontent.cfm?pageID=29&itemID=12800>.

Many homeowners' insurance policies, especially those written after the advent of the age of identity theft, cover losses due to theft and/or fraud. Some victims have already claimed under these policies, and issuers have in some cases paid out without objection. In cases where the amount of redemption exceeds the amount invested, however, we are aware of outright denials of coverage. Furthermore, the policy limits for these kinds of losses are usually minimal relative to the total amount of losses, often paying out as little as \$5,000 and sometimes less -- again, little comfort to those whose losses far exceed the policy limits. Still, for those who have lost everything, being able to pay another several months' bills will make submission of a claim well worth the time.

Suing the SEC

Some victims have retained our firm to bring actions against the Securities and Exchange Commission on a theory of negligence. They allege that if the SEC had performed its auditing, information-reporting, and investigative functions with ordinary care, the Madoff Ponzi scheme would have been exposed long ago, and, as a result, they never would have made the investments that led to their massive losses. At this time, we have filed two such claims, and anticipate filing at least a half-dozen more in the near future.

The upside to this course of action is that the SEC's liability, if proven, would be backed by the resources of the federal government -- the deepest of deep pockets. In theory, success on these claims would result in total restitution of victims' actual losses.

However, there are serious legal challenges as well. The first is timing. The Federal Tort Claims Act, which permits private citizens to bring actions for money damages against the federal government and its various agencies, requires that before filing a lawsuit in federal court, the claimants must first file administrative claims for relief. That gives the SEC six months to reject or ignore the claim -- as it certainly will -- before claimants can convert their administrative claims to lawsuits. Second, once the dispute moves to court, the SEC will assert the doctrine of sovereign immunity, which will trigger a motion-practice battle in which it will be difficult -- although hardly impossible -- for the plaintiff investors to prevail. Finally, regardless of the outcome of the motions to dismiss, the litigation would probably drag on for years, given the inevitability of multiple appeals, particularly if the government were to lose any of the motions that could establish adverse precedent on the sovereign immunity issue.

In the end, claims against the SEC may end up being more about leverage than an ultimate victory in litigation. If enough victims pursue this route, if enough pressure is brought to bear on the government, and if the government has enough fear of the possibility of losing key legal battles, it is conceivable that it might establish a victims' settlement fund. That would provide at least some compensation in exchange for a release of the negligence claims, as has been done in at least some other cases involving government agencies' negligence.

It is bitterly ironic that the victims have narrow avenues to recovery, but those who redeemed all or part of their investments face the danger of additional losses. The SIPC trustee began sending notices of clawback actions in April, and will likely begin filing lawsuits in late summer or the fall of 2009. Under current law, the best that victims who receive these demands can hope for is to keep their principal.

The Law of Clawbacks

The size of the clawback claims -- and the likelihood that Mr. Picard will file them against any particular investor -- turn on several key factors. Most critical are the sizes of the redemptions, their characterization as profits as opposed to principal, and their relative proximity to the time that the Madoff brokerage failed.

Redemptions that were made shortly before the collapse allow the SIPC trustee to invoke the "preferential transfer" bankruptcy statute, meaning that the trustee can avoid the entire transfer without distinguishing between profits and principal, or indeed, without making any other showing. The trustee has already instituted one such action, demanding the return of \$150 million that was redeemed less than two months prior to the collapse. (Under the preferential transfer law, the trustee can avoid transfers made within 90 days of his appointment). The trustee is likely to go after these easy targets first, but even redemptions made outside the 90-day preferential transfer window remain highly vulnerable to clawback.

Redemptions of profits made within six years under New York law are automatically recoverable by the estate; there appears to be no defense. Investors who made redemptions that could be characterized as profits anytime within the six-year period should expect to be the next-priority targets after the preferential transfers made within the 90-day period.

But even redemptions of principal made within those same time frames are not safe from a clawback. Indeed, some of the victims who have already received demand letters from the SIPC trustee redeemed only principal, and are double victims, because they lost money in the fraud as well and never took out profits. Whether this is the trustee's intent, or is the result of Madoff's faulty recordkeeping, remains to be seen. In what redeeming investors will undoubtedly see as a perversion of justice, the ability of investors to defend those redemptions will depend largely on their ability to bear the burden of proving that they made the redemptions in good faith for purposes unrelated to any suspicions that Madoff was a fraud. In a series of recent cases in the United States District Court for the Southern District of New York -- the same court administering the Madoff brokerage estate -- the court reaffirmed investors' obligation to "prove a negative" and show they had no knowledge of Madoff's criminal activities when they redeemed their principal. See *In re Bayou Group LLC*, 2008 U.S. Bankr. LEXIS 3261 (S.D.N.Y. Bankr. 2008).

However, the Bayou case provided something of an escape route for investors. Rather than requiring the usual proofs of good faith -- lack of knowledge of any red flags, or diligent investigation of such warning signs that were reasonably assuaged -- the court allowed for a shortcut to proving good faith. Specifically, the court noted that various circumstances indicated a lack of awareness of any fraud, including: redemptions to satisfy specific pre-existing obligations, such as tax liabilities; redemption of substantially less than the entire investment; or redemptions significantly before any "red flags" became evident.

On a final note, investors should keep in mind that although SIPC payouts will go only to direct investors in the Madoff brokerage, the trustee can seek clawbacks from any investor, direct or not, whose money was invested in the Madoff scheme and who redeemed. That means that although "feeder fund" investors can hope to share only pro rata in a single \$500,000 SIPC payout to their fund, every dollar they redeemed from that fund that could be attributable to the fund's investment with Madoff is vulnerable to a clawback. It will bear watching whether Mr. Picard attempts to pierce the feeder funds and go after the funds' individual investors who redeemed money.

Practical Considerations Limiting Clawbacks

The trustee's power to claw back redemptions is undeniably far-reaching. The existence of that power, however, does not necessarily mean that it should, or will, be exercised with respect to any particular investor. Indeed, it is reasonable to hope that the trustee, who is charged with administering the estate in the spirit of equity, will be sparing in seeking recovery from all but the most culpable and most well-resourced of those investors who made substantial redemptions. But we do know that some of the victims who have received clawback notices clearly do not meet this

description.

For one thing, there is the issue of what the trustee can reasonably hope to recover. Even if an investor made significant and recent redemptions of profits, those funds may have been dissipated or invested in illiquid assets. For example, an investor who liquidated \$1 million in profits to purchase a home may not have a significant pool of cash to repay the estate. It remains to be seen whether the trustee will pursue judgments and foreclosures against such victims, putting them out-of-house, just to enlarge the overall corpus of the estate

Moreover, some investors' redemptions will undoubtedly be so relatively small, or partial, or in arguable good faith, that the trustee may not deem it worthwhile to file a claim and pursue repayment. Like any administrator, the trustee can be expected to attempt to maximize efficiencies, and the evaluation of prospective litigations against victims should be no different. Of course, that is not to say that the trustee might not attempt to secure easy settlements by making compromise offers prior to making a claim. But victims should evaluate the likely cost and outcome of a claim before agreeing to such a compromise, given the unlikelihood that the trustee will pursue the entire universe of potential clawback targets.

Finally, there is the issue of fairness and equity. The trustee is not bound to any particular moral calculation, but some general guidelines seem obvious. For example, a number of Madoff's victims were charitable foundations, many of which lost everything after having redeemed money to advance their public-service missions. Other victims might be viewed in similarly sympathetic terms. Again, given the relatively low utility of the clawbacks it is difficult to see how the trustee could avoid public outrage (and potential reversal by the courts) if he seeks to inflict more pain on Madoff's most vulnerable victims.

Conclusion -- What Should I Do?

The trustee has been granted \$28 million to administer the estate and has an incentive to use those resources to exploit all possible avenues for additional discovery and adversary proceedings that might lead to significant returns.

Victims who redeemed will need sophisticated counsel, speedy action and the development of strong exculpatory evidence. The evidence should go to showing their good-faith use of the redemptions to meet financial obligations rather than maintaining a lifestyle or making optional purchases; that the redemptions were partial; and/or that redemptions were made significantly prior to the collapse of the scheme. Where an investor and their counsel detect vulnerabilities, they should consider settling with the trustee early, when it may be possible to avoid being caught up in unwanted, protracted, costly and painful involvement in the Madoff bankruptcy.

For those investors looking to be compensated, at least in part, and not merely to avoid clawbacks, there are the various options discussed above. They should be considered in consultation with counsel specialized in the relevant fields.

The headlines about Madoff-related litigation will inevitably center on victims' attempts to retrieve money they lost. But those are likely to result in pyrrhic victories of little recovery, or represent uphill legal battles, or both. The weightier matter for victims -- at least for those who made direct or indirect redemptions -- seems to be just holding on to what they have.

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RELATED LINKS: For further discussion of fraudulent transfers in bankruptcy, see, generally,

■ Chapter 548, Collier on Bankruptcy, 15th Edition, Revised.

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50 of 197 DOCUMENTS

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James M. Lawniczak on Statutory Interpretation in Bankruptcy Matters

2009 Emerging Issues 3542

James M. Lawniczak on Statutory Interpretation in Bankruptcy Matters

By James Lawniczak

April 21, 2009

SUMMARY: In this analysis, James Lawniczak surveys the Supreme Court's evolving approach to the interpretation of bankruptcy statutes. He explains how the Courts common law method has evolved into a "plain meaning" approach, where the Court reviews the statute and does its best to give effect to the language of the statute and the intent of Congress. This in turn has broadened, in some cases, into a "better meaning" method of statutory interpretation.

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ARTICLE: The U.S. Supreme Court's approach to the interpretation of bankruptcy statutes has changed over time. Quite some time ago, the Court used a common law approach. It would indeed start its consideration with the statutory language, just as a common law court starts its consideration with a prior court decision in another case. The Court would then use common law principles to seek out the fair and equitable result in the case pending before it, even though the statute did not necessarily lead to that result.

The Supreme Court's method of statutory interpretation then evolved into the current "plain meaning" approach, where the Court reviews the statute and does its best to give effect to the language of the statute and the intent of Congress, leaving the determination of what is fair and appropriate to Congress. This latter approach has been broadened in several cases, which have used a "better meaning" approach to interpret ambiguous statutory language, by choosing the better of the possible meanings solely from the structure of the statutory language itself.

The Constitution gives Congress the power to legislate on bankruptcy matters. Thus, the Constitution itself has determined that policy decisions on what is appropriate and fair in bankruptcy matters are for Congress and not the courts. Therefore, the appropriate approach in bankruptcy cases is indeed to give effect to the language that Congress has used in the statute.

Bank of Marin v. England--A Common Law Approach

When the Bankruptcy Reform Act of 1978 was passed and became effective for cases filed on and after October 1, 1979, an important Supreme Court case dealing with interpretation of bankruptcy statutes was *Bank of Marin v.*

England, 385 U.S. 99, 87 S. Ct. 274, 17 L. Ed. 2d 197 (1966). In that case, the Court considered a provision in the Bankruptcy Act of 1898 providing that anyone who delivered property of the estate to a third party after a bankruptcy proceeding had been filed would be liable to the trustee, with no exception for whether the party had any notice or knowledge of the bankruptcy filing. The Bank of Marin had cleared the bankrupt's checks after the filing, but before the bank had any actual knowledge of the filing. The trustee sought, successfully in all courts below, to recover against the bank for the amounts transferred out of the bankrupt's account.

The Supreme Court reversed. Even though Congress's language unambiguously made the bank liable, the Court found that result inequitable and inappropriate, stating: "Yet we do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction." 385 U.S. at 103, 87 S. Ct. at 277. The Court indicated that it believed the force of the statute would be maintained by allowing the trustee to proceed against the third party rather than the bank. The Court's approach was akin to the way courts resolve cases under the common law, using the statute only as a starting point, just as common law courts use legal principles and prior cases as the beginning of their analysis.

In a similar vein, the Court in *Kelly v. Robinson*, 479 U.S. 36, 43-44, 107 S. Ct. 353, 357-58, 93 L. Ed. 2d 216 (1986), indicated that the text of a statute is only the "starting point," and that a court must also consider the "whole law" and "its object and policy." In that case, the Court held that a criminal restitution obligation was not dischargeable, noting a "deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings." 479 U.S. at 47, 107 S. Ct. at 360.

The *Bank of Marin* case has never been overruled, so it remains theoretically available to support an argument that a court should do the right thing, notwithstanding an unambiguous statutory directive to the contrary. Indeed, in the early years of the Bankruptcy Reform Act of 1978, *Bank of Marin* was often cited by the party who had the losing statutory argument. However, in my experience, such an argument was never successful. Interestingly, if the same facts were to arise in a bankruptcy case today, the result would be the same as the result in *Bank of Marin*. That is because Congress itself changed the law when it adopted the Bankruptcy Reform Act of 1978, enacting 11 U.S.C. § 542(c), which allows an entity acting in good faith with neither "actual notice nor actual knowledge of the commencement of the case" to transfer property of the estate without liability for turnover.

Bank of Marin represents one of the last instances of federal courts using a common law approach to statutory interpretation. With the great proliferation of federal and state statutes in modern times, creating many different kinds of "codes," not just the Bankruptcy Code, the courts have become comfortable allowing Congress the right to make equity and policy determinations. Thus, as will be seen in the cases cited below, our legal system has generally stopped using a common law approach when statutory interpretation is involved. See Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, in *A Matter of Interpretation: Federal Courts and the Law* 3-47 (A. Gutmann ed., Princeton Univ. Press 1997).

Recently, in *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365, 127 S. Ct. 1105, 166 L. Ed. 2d 956 (2007), the Supreme Court allowed common sense and policy to affect its interpretation of bankruptcy legislation. The issue was whether a chapter 7 debtor had an absolute right to convert the case to one under chapter 13. A review of the relevant statute, 11 U.S.C. § 706(a), suggested that he did. The issue before the Court was whether the bankruptcy court, in deciding whether to allow conversion, could consider that the resultant chapter 13 case would be in bad faith and subject to dismissal.

The Court noted that its decision required it to review more of the Bankruptcy Code than just section 706(a), which allows the conversion. Section 706(d) provides that a case cannot be converted to another chapter unless the debtor may be a debtor under that chapter. The Court observed that case law nearly unanimously accepts the proposition that a debtor's pre-filing bad faith prevents that person from having a right to proceed in bankruptcy. See, e.g., *In re Alt*, 305 F.3d 413, 418-19 (6th Cir. 2002). Thus, this debtor was not a person entitled to be a debtor under chapter 13 and therefore did not have a right to convert the case to chapter 13.

In addition, the Court found that 11 U.S.C. § 105 (allowing a bankruptcy court to issue orders "necessary or appropriate to carry out the provisions of this title") and the "inherent power of every federal court to sanction 'abusive litigation practices'" supported its decision to deny an absolute right to convert. 549 U.S. at 375-76, 127 S. Ct. at 1112. The Court's decision allowed "a prompt, rather than a delayed, ruling on an unmeritorious attempt to qualify as a debtor under Chapter 13." *Id.*

Although the Court in *Marrama* certainly weighed and considered practicality and policy in its decision, the way in which it did so contrasts markedly from the way "equity" was done in *Bank of Marin*. In *Bank of Marin*, the Court determined that one of its functions was to do equity, despite a recognition that there was no support whatsoever in the statute for its decision. On the other hand, in *Marrama*, the Court premised its decision on a review of the entire statutory scheme, coming to the conclusion that the statute itself supported its decision. Similarly, in an Ohio state court case where the court used policy considerations to expand a statute, the court nonetheless still reached its decision by interpreting the language of the statute. *Covington v. HKM Direct Market Communications, Inc.*, 2003 Ohio App. LEXIS 5645, 2003 Ohio 6306 (Ohio App. 10th Dist. Nov. 25, 2003) (discussing "policy considerations" in incorporating an ordinary course of business defense to the Ohio insurance insolvency preference section, even though the statute did not contain one, but doing so by holding that payments made in the ordinary course were not made on "antecedent debt"). *Contra State ex rel. Wagner v. Gilbane Building Co.*, 276 Neb. 686, 694 757 N.W.2d 194, 201 (2008) (where insurance insolvency preference statute did not contain an ordinary course of business defense, there was none, because it is the legislature's function to "declare what is the law and public policy").

The "Plain Meaning" Doctrine-a Statutory Approach

Following the adoption of the Bankruptcy Reform Act of 1978, the "plain meaning" doctrine of statutory interpretation became the appropriate and recognized method of interpreting the Bankruptcy Code. This change from the approach in *Bank of Marin* to something more akin to a method of bankruptcy statutory interpretation that would be appropriate in a civil law code system is consistent with the constitutional grant to Congress in Article I, Section 8 to establish "uniform Laws on the subject of Bankruptcies throughout the United States."

The Supreme Court has often noted that if the meaning of a statute is unambiguous, then the inquiry has ended. *See, e.g., Lamie v. U.S. Trustee*, 540 U.S. 526, 534, 124 S. Ct. 1023, 1030, 157 L. Ed. 2d 1024 (2004) (interpreting 11 U.S.C. § 330(a)(1) so that a debtor's attorney is not entitled to compensation unless retained by the trustee and indicating that just because the statute is "awkward, and even ungrammatical" does not make it "ambiguous on the point at issue"); *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 6, 120 S. Ct. 1942, 1947, 147 L. Ed. 2d 1 (2000) (finding 11 U.S.C. § 506(c) available only to the trustee or debtor in possession); *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54, 112 S. Ct. 1146, 1149, 117 L. Ed. 2d 391 (1992) (28 U.S.C. § 1292 authorizes appeals of interlocutory orders of district courts sitting as an appellate court under certain circumstances, stating that "courts must presume that a legislature says in a statute what it means and means in a statute what it says there"); *Patterson v. Shumate*, 504 U.S. 753, 759, 112 S. Ct. 2242, 2247, 119 L. Ed. 2d 519 (1992) (determining that 401(k) retirement accounts are not part of a debtor's bankruptcy estate under 11 U.S.C. § 541(c)(2), indicating that "[w]e must enforce the statute according to its terms"). *See generally* K. Klee, Bankruptcy and the Supreme Court 14-36 (LexisNexis 2009); W. Effross, *Grammarians at the Gate: The Rehnquist Court's Evolving "Plain Meaning" Approach to Bankruptcy Jurisprudence*, 23 Seton Hall L. Rev. 1636 (1993).

In *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290 (1989), the Court considered a potentially ambiguous statute, 11 U.S.C. § 506(b), which allows an oversecured creditor to add interest and certain costs to its secured claim. The oversecured creditor is entitled to "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." The statutory interpretation issue was whether the modifier at the end of the clause requiring that the agreement must so provide applied only to the closer antecedent, "reasonable fees, costs, or charges," or whether it applied to both antecedents, including the right to interest. If the modifier applied to the right to interest, then the government would not be entitled to interest on its secured tax claim, because there was no agreement at all, as the tax lien was a statutory, not a consensual, lien.

Language of the form (a) and/or (b) followed by a modifier is often ambiguous and requires careful drafting. The language of 11 U.S.C. § 506(b) is not an example of such careful drafting because it is not 100 percent clear whether the modifier applies to just the last antecedent or to both of the prior antecedents. The language of 11 U.S.C. § 1328(f)(1), which provides that a chapter 13 discharge is not available if the debtor received a discharge in a case filed under chapter 7, 11 or 12 within four years of the filing of the current chapter 13 case, is also ambiguous, but in a different way. There the modifier (within four years) could logically apply only to one of the two prior antecedents (filing of the previous case, or discharge entered in the previous case), but not to both. See *Carroll v. Sanders (In re Sanders)*, 551 F.3d 397 (6th Cir. 2008) (holding that the modifier applied to the closer antecedent, the filing of the previous case).

In *Ron Pair*, the Supreme Court determined that it could interpret section 506(b) according to its plain language, despite its ambiguity, holding that the modifier applied only to the closer antecedent "fees, costs, or charges," and did not apply to the further removed antecedent, "interest." See *Barnhart v. Thomas*, 540 U.S. 20, 26, 124 S. Ct. 376, 380-81, 157 L. Ed. 2d 333 (2003) (using the "last antecedent" canon, which requires that the subsequent modifier be applied, in most cases, to the noun or phrase that it immediately follows and not to a noun or phrase that came earlier in the sentence, to reverse the Third Circuit's holding that the modifier unambiguously applied to both prior antecedents); *In re Sanders*, 551 F.3d at 399. Moreover, the comma in the statute between after "interest on such claim" and "and any reasonable fees," and the use of the words "and any" played a large factor in the Court's decision. *Ron Pair*, 489 U.S. at 241, 109 S. Ct. at 1030-31. Indeed, the dissent pointed out that the Court was able to read section 506(b) as it did "only because of the comma." 489 U.S. at 249-50, 109 S. Ct. at 1035. But cf. *United States v. Bass*, 404 U.S. 336, 340 n.6, 92 S. Ct. 515, 518, 30 L. Ed. 2d 488 (1971) (pointing out that "many leading grammarians" do not give credence to omitted commas, so that the Court did not "attach significance to an omitted comma").

Courts Use "Plain Meaning" Even Where There Is Some Ambiguity in the Statutory Language. *Ron Pair* shows that courts are willing to use the "plain meaning" doctrine even if a statute could be interpreted in two different ways, so long as the court finds that its way is a better or more reasonable interpretation of the statutory language. In *Carrieri v. jobs.com Inc.*, 393 F.3d 508, 519-20 (5th Cir. 2004), the court interpreted 11 U.S.C. § 101(16)(C), which provides that an "equity security" includes a "warrant or right, other than a right to convert, to purchase, sell or subscribe to a share" The bankruptcy court had read the language to contain four exceptions to rights that are equity securities—rights to convert, to purchase, to sell or to subscribe. The district court read the language to contain only one exception to rights, the right to convert, and that "to purchase, sell or subscribe" described warrants or rights that were equity securities. The court of appeals chose the district court's interpretation, indicating that it was applying the "plain meaning" rule, even though it only found that the district court's reading was "the more logical one," and notwithstanding an applicable canon of construction that supported the bankruptcy court's interpretation.

Thus, in certain circumstances when statutes are ambiguous, courts, like the *Ron Pair* Court, are actually using a "better meaning" rule rather than the announced "plain meaning" rule. See *Carroll v. Sanders (In re Sanders)*, 551 F.3d 397 (6th Cir. 2008) (finding the statutory meaning using only the statutory language and the "last antecedent" canon of construction to interpret the ambiguous language of section 1328(f), an example of a "better meaning" rule). However, they are finding the "better meaning" by reference to more objective language interpretation methods, rather than subjective fairness or other common law type determinations.

Use of Extrinsic Evidence, Going Beyond the Text

Legislative History. In *Ron Pair*, 489 U.S. 235, 242, 109 S. Ct. 1026, 1031, 103 L. Ed. 2d 290, the Supreme Court noted that the "plain meaning" of a statute is conclusive, except in the rare case where "the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters." However, in *Barnhill v. Johnson*, 503 U.S. 393, 401, 112 S. Ct. 1386, 1391, 118 L. Ed. 2d 39 (1992), the Court used a more liberal standard, allowing the use of legislative history "to resolve 'statutory ambiguity.'" In *Tennessee Valley Authority v. Hill*, 437 U.S. 153, 185 n.29, 98 S. Ct. 2279, 2297, 57 L. Ed. 2d 117 (1978), the Court accepted that it ordinarily did not review legislative history as to "plain and unambiguous" language, but that it did so in the case before it to address the dissent's contention that the result reached was "absurd" and "not in accord with congressional intent."

Legislative history should not be construed to be the collective intent of the entire legislative body. Both legislative reports and individual statements on the floor of Congress usually represent the views of only a few members of Congress, indeed often only one. See *West Virginia Univ. Hospitals, Inc. v. Casey*, 499 U.S. 83, 98-99, 111 S. Ct. 1138, 1146, 113 L. Ed. 2d 68 (1991) (statutory language should not be permitted to be expanded or contracted "by the statements of individual legislators or committees during the course of the enactment process"). Indeed, speaking about a specific piece of tax legislation, then Senator Danforth recalled "one night literally following one of my colleagues around the floor of the Senate for fear that he would slip something into the Congressional Record, and I would have to slip something else in." *Washington Post*, May 11, 1993, at A4.

Conclusion

The bankruptcy laws enacted by Congress pursuant to its constitutional Article I powers are interpreted by federal courts under the "plain meaning" rule. Extrinsic evidence, such as legislative history, is used only when the statutory language leads to absurd results or is, at least, ambiguous. Sometimes courts interpret ambiguous statutory language without reference to any extrinsic evidence, instead determining the meaning of the statute solely by reference to the statutory language itself—a type of "better meaning" approach.

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51 of 197 DOCUMENTS

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Lawniczak on Carroll v. Sanders

2009 Emerging Issues 3494

James M. Lawniczak on Carroll v. Sanders (In re Sanders), 551 F.3d 397 (6th Cir. 2008)

By James Lawniczak

March 30, 2009

SUMMARY: In this Emerging Issues Analysis, James M. Lawniczak looks at a decision of first impression from the Sixth Circuit interpreting Bankruptcy Code section 1328(f)(1), added in 2005. Relying solely on the text of the statute and "familiar canons" of statutory construction, the court considered whether the section's four-year period runs from the date of filing of the original chapter 7 case or the date the discharge was entered.

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ARTICLE: In a Case of First Impression, the Sixth Circuit Rules That the Four-Year Period of Section 1328(f)(1) Begins to Run From the Filing of the Original Chapter 7 Case

In *Carroll v. Sanders (In re Sanders)*, 551 F.3d 397, 2008 U.S. App. LEXIS 26421 (6th Cir. Dec. 29, 2008), the United States Court of Appeals for the Sixth Circuit interpreted section 1328(f)(1), which prevents a chapter 13 debtor from obtaining a discharge if that individual had previously obtained a discharge in a prior chapter 7 case "during the 4-year period preceding the date of the order for relief under this chapter." The issue before the court was whether the four-year period commences on the filing of the original chapter 7 case or on the date the chapter 7 discharge was entered. Noting that this was an issue of first impression in the circuit courts of appeals, 551 F.3d at 400, the court held that the appropriate interpretation of the statute was that the four-year period begins to run from the date of the filing of the original chapter 7 case. In reaching its result, the court relied solely on the text of the statute and "familiar canons of construction," rejecting a review of supplemental materials such as legislative history and legislative purpose. 551 F.3d at 402-03.

The Facts and Rulings Below

Jason Sanders filed a chapter 7 petition on July 29, 2002, and obtained a chapter 7 discharge on February 5, 2003. On January 5, 2007, he filed a chapter 13 petition and proposed a plan. The chapter 13 trustee objected to confirmation and to the second discharge, on the grounds that Sanders had obtained a discharge in a chapter 7 case within four years of the filing of the chapter 13 case. The United States Bankruptcy Court for the Eastern District of Michigan confirmed the plan but denied Sanders his discharge, holding that the four-year period of section 1328(f)(1) begins to run from the

date of discharge in the chapter 7 case. 368 B.R. 634, 2007 Bankr. LEXIS 1900 (Bankr. E.D. Mich. May 18, 2007). Because the discharge was entered in February 2003, the January 2007 filing was a month too soon.

Sanders appealed, and the district court reversed. The court determined that the four-year period begins to run from the date of the filing of the original chapter 7 case, in July 2002, and that the January 2007 chapter 13 filing was more than four years later. Therefore, Sanders was entitled to a chapter 13 discharge. 2008 U.S. Dist. LEXIS 6994 (E.D. Mich. Jan. 31, 2008). The chapter 13 trustee, Krispen Carroll, then took a further appeal to the Sixth Circuit.

Framing the Issue Before the Court

The sole issue before the Sixth Circuit was a pure question of law-the correct interpretation of section 1328(f)(1), specifically, whether the trigger for the start of the four-year period in the statute is the filing of the original chapter 7 case or the discharge in that case. Section 1328(f), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), provides as follows:

Notwithstanding subsections (a) and (b), the court shall not grant a discharge of all debts provided for in the plan or disallowed under section 502, if the debtor has received a discharge-

(1) in a case filed under chapter 7, 11, or 12 of this title during the 4-year period preceding the date of the order for relief under this chapter, or

(2) in a case filed under chapter 13 of this title during the 2-year period preceding the date of such order.

The Sixth Circuit's Interpretation of the Statute-Modifiers Apply to the Closer Antecedent

The court noted that the structure of the language in question was one of a modifier (here, "during the 4-year period") which linguistically relates back to one of two possible antecedents (here "received a discharge" or "a case filed under chapter 7"). In this case, unlike in the Supreme Court case of *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed.2d 290 (1989), discussed in detail below, the modifier had to apply to either one or the other of the antecedents and could not logically be applied to either the closest antecedent or to both of the antecedents. Whenever a modifier follows two or more antecedents, the language (as here) is often ambiguous and susceptible to multiple reasonable meanings, unless the drafter is very careful to make it clear which antecedent the modifier applies to, or in the case where logically the modifier could apply to both antecedents, whether it indeed applies to both.

The court determined that a filing-to-filing period was established by the language of section 1328(f). The court used a canon of statutory construction called the "last antecedent" rule, which requires that a subsequent modifier be applied, in most cases, to the noun or phrase that it immediately follows and not to a noun or phrase that came earlier in the sentence. 551 F.3d at 399; see, e.g., *Barnhart v. Thomas*, 540 U.S. 20, 26, 124 S. Ct. 376, 380-81, 157 L. Ed. 2d 333 (2003) (using the "last antecedent" rule and reversing the Third Circuit's holding that the modifier unambiguously applied to both prior antecedents); *National Surety Corp. v. Midland Bank*, 551 F.2d 21, 33-34 (3d Cir. 1977) (describing the "last antecedent" rule, including its application under New Jersey state law).

Additional Statutory Evidence in Support of the Sixth Circuit's Conclusion-Use of the Word "Filed"

The *Carroll* court further noted that if the four-year period began on the date of discharge, the use of the word "filed" in the statute was unnecessary. If the statute was intended to refer to the date of discharge as the beginning of the period, the phrase "if the debtor has received a discharge in a case under chapter 7" would have been sufficient. Thus, the court found that the addition of the word "filed" supported the interpretation that it was indeed the filing of the chapter 7 case that began the relevant period. 551 F.3d at 400.

Use of Extrinsic Evidence, Going Beyond the Text

Legislative History. According to the *Carroll* court, the legislative history of section 1328(f) presented a "truly peculiar view." The House Report, H.R. Rep. No. 109-31(I), at 76 (2005), *reprinted in* E-2 Collier on Bankruptcy at App. Pt. 10-341 (15th ed. rev.), described section 1328(f)(1) as having a four-year discharge-to-filing time period (contrary to the *Carroll* court's conclusion), while section 1328(f)(2) is described as having a two-year filing to filing period. The *Carroll* court could not understand how Congress might believe that essentially identical statutory language could be interpreted in two contrary ways, and also found it strange that it would be (f)(2), where it makes the "least sense," that a filing-to-filing rule would apply. 551 F.3d at 403. Thus, the court ignored the legislative history.

Congressional Desire to Limit "Chapter 20" and "Chapter 26" Filings. One of the purposes for the addition of section 1328(f) was to limit a debtor's ability to file bankruptcy petitions back to back. This purpose was discussed in the bankruptcy court's decision in the *Carroll* case, where the court noted that an individual debtor could file a chapter 7 case and discharge most debt there, and then immediately follow with a chapter 13 case to deal with debts (usually secured debts, often debts secured by residential mortgages) that could not have been affected in the chapter 7 case. This is known in bankruptcy vernacular as a "chapter 20." Back to back chapter 13s, called a chapter 26, were viewed as less of a problem (a reason why the time period is shorter in section 1328(f)(2)). See 368 B.R. at 638; *In re Grydzuk*, 353 B.R. 564, 568 (Bankr. N.D. Ind. 2006) (holding that for purposes of section 1328(f)(1), a case originally filed under chapter 13 but converted to chapter 7 was nonetheless "filed under chapter 7" as of the date of the chapter 13 filing); 12 Business Organizations with Tax Planning §156.05 n.20 (Matthew Bender 2007) (pointing out that section 1328(f)'s prohibition against successive discharges would not eliminate the right of a debtor to file a chapter 7 case to eliminate debt and then follow it with a chapter 13 case to cure defaults or to modify secured debt where no additional debt will be "discharged" in the subsequent chapter 13 proceeding).

The *Carroll* court used a different chapter 20 argument to support its decision. It reasoned that a discharge-to-filing ruling would encourage what would be a reverse chapter 20 filing—chapter 13 followed by chapter 7—because debtors who had received a chapter 13 discharge would then not be able to file a second chapter 13 case for two more years. 551 F.3d at 404. However, this reverse chapter 20 (with chapter 13 first) is very uncommon because it is hard to imagine circumstances where a discharged chapter 13 debtor would benefit from a chapter 7 filed shortly after the chapter 13. Thus, the *Carroll* court's reliance on the evils of a chapter 13 case followed by a chapter 7 case was not well taken.

The Court's Struggle with Whether Its Decision Is Consistent with Congressional Intent—A Look at Section 1328(f)(2). After discussing the canons of statutory interpretation, the *Carroll* court went on to consider whether there was evidence that its decision might be inconsistent with congressional intent. The chapter 13 trustee argued that the purpose of enacting 1328(f) was to discourage serial filings to obtain multiple discharges, but that the decision of the court below to use a filing-to-filing rule not only shortens the period Congress was worried about, but that its application to 1328(f)(2) would essentially eliminate all use of that section. 551 F.3d at 401.

Section 1328(f)(2) is not directly applicable to the case at issue because it applies to serial chapter 13 filings. However, because its language structure is identical to section 1328(f)(1), the two subsections must logically be interpreted the same way. Thus, if section 1328(f)(1) establishes a filing-to-filing period, so too must section 1328(f)(2).

The court noted that the bankruptcy court below had accepted the argument that the filing-to-filing interpretation essentially rendered section 1328(f)(2) a nullity and therefore was contrary to congressional intent. 551 F.3d at 401. Because most chapter 13 cases take three to five years from filing to discharge, in those cases there cannot be a two-year period between successive filings. It is only in the rare chapter 13 case where a discharge is quickly achieved that a two-year filing to filing period might be relevant. The only way that a discharge can be obtained in less than two years is to pay creditors in full, and in that case it would appear inappropriate to prevent a debtor who paid creditors in full from obtaining a discharge in a subsequent case. Thus, in the bankruptcy court's view, the only way to give effect to congressional intent and to give section 1328(f)(2) meaning would be to use a discharge-to-filing rule, and if a discharge-to-filing rule was required in section 1328(f)(2), it must also be required in section 1328(f)(1) due to the fact that the equivalent statutory structure was used. 551 F.3d at 401-02.

The Sixth Circuit struggled with this issue. It was bound to acknowledge that its interpretation left section 1328(f)(2) relatively useless, noting that cases where section 1328(f)(2) would apply "will be few and far between." 551 F.3d at 402. However, the court stressed that the statute as so interpreted would not be a complete nullity, as there were still some circumstances when the statute could apply, for example, when a chapter 13 debtor receives a hardship discharge or when all debts are paid off within two years. *Id.*

In discussing the use of non-textual materials to determine Congress's purpose, the court indicated that "the most conspicuous place to look for the purpose of a law" is the text of the statute. If a court is to "leave the safety of the statutory terms," it must then account for "all the clues," even if they do not all point in the same direction. 551 F.3d at 402-03. The court was unable to obtain a clear view of congressional intent from the clues it examined, which included legislative history (discussed more fully above) and many of the effects the statute has on chapter 7 and chapter 13 discharge issues, 551 F.3d at 403-04. The court thus concluded: "Searching for signals from competing policies, surrounded by perplexing results on all sides, brings us little closer to grasping Congress's intent than relying on text and familiar canons of construction." 551 F.3d at 404.

Other Case Law on the Issue Before the Sixth Circuit.

Although it was the first court of appeals case to consider section 1328(f)(1), the court noted that, except for the bankruptcy court decision in the case below, "every federal court to decide the question definitively has held that § 1329(f)(1)'s four-year embargo begins on the date of filing, not the date of discharge." 551 F.3d at 400; see, e.g., *In re Ybarra*, 359 B.R. 702, 709 (Bankr. S.D. Ill. 2007). Support for that proposition is also found in 8 Collier on Bankruptcy 1328.06[1] (15th ed. rev. 2007).

On the other hand, the Court of Appeals for the Seventh Circuit has indicated in *dictum* that BAPCPA amended the Bankruptcy Code to bar "relief under Chapter 13 within four years of receiving a discharge under Chapters 7, 11, or 12." *In re Sidebottom*, 430 F.3d 893, 897 n.1 (7th Cir. 2005). Several bankruptcy courts have also made similar statements in *dicta*. See, e.g., *In re Perkins*, 381 B.R. 530, 536 n.6 (Bankr. S.D. Ill. 2007). The fact that these courts, as well as the bankruptcy court in the *Carroll* case, read section 1328(f) as providing a four-year discharge to filing provision shows, at a minimum, that the statute is subject to conflicting interpretation and therefore ambiguous. See *Carrieri v. jobs.com Inc.*, 393 F.3d 508, 519 (5th Cir. 2004) (for language to be ambiguous it must be "susceptible to more than one reasonable interpretation").

The Court of Appeals for the Fourth Circuit considered whether section 1328(f)(2) created a discharge-to-filing or a filing-to-filing two-year period in *Branigan v. Bateman (In re Bateman)*, 515 F.3d 272, 277-78 (4th Cir. 2008). The court stated that it was interpreting the statute according to its "plain meaning," indicating that the "logical sequence of the language used" requires a filing-to-filing rule and that the "doctrine of the last antecedent" also lends support to the result. Accord *Gagne v. Fessenden (In re Gagne)*, 394 B.R. 219, 227-28 (B.A.P. 1st Cir. 2008).

A Plea for Concise Language.

The *Carroll* court returned at the end of its opinion to discuss why it would adhere to a strict canon of statutory construction, pointing out that "policy judgments" are for Congress, and not the courts, to make. By creating and consistently applying a strict set of "clear interpretative rules," the courts could help Congress to "say exactly what it means" in a statute. 551 F.3d at 404.

However, it is possible to draft statutory language that is absolutely clear and not ambiguous even when two nouns and a modifier are involved in a situation like this one. For example, here is an alternative method drafting the statute at issue that would not be in any way ambiguous:

The court shall not grant a discharge if the debtor received a discharge in a prior chapter 7, 11 or 12 case where the chapter 7, 11 or 12 case was filed within four years of the entry of the order for relief under this chapter.

Or if the interpretation of the bankruptcy court in the *Carroll* case is what is intended:

The court shall not grant a discharge if the debtor received a discharge in a prior chapter 7, 11 or 12 case where the discharge in that case was entered within four years of the entry of the order for relief under this chapter.

Indeed, Congress should be encouraged to draft clear and concise language when it legislates rather than to be given rules to apply when it creates ambiguous language. I cannot imagine that a drafter who is busily crafting ambiguous language, and thus not taking the time and effort to reflect carefully and clearly as to the language being drafted, will nonetheless take the time to review rules of construction on how to interpret ambiguous language and be accordingly guided in the drafting process. On the other hand, as the court correctly pointed out, mistakes are going to be made from time to time, and the courts will have to interpret less than precise language. *551 F.3d at 404*. In those cases, like the case before the court, strict rules of statutory interpretation make courts' tasks of statutory interpretation both easier and also more uniform.

RELATED LINKS: For discussion of Code section 1328(f), see

■ [Collier on Bankruptcy](#), § 1328.06.

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52 of 197 DOCUMENTS

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The Supreme Court's Use of Statutory Construction in Bankruptcy Decisions

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Kenneth N. Klee on the Supreme Court's Use of Statutory Construction in Bankruptcy Decisions

By Kenneth Klee

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SUMMARY: This Emerging Issues Analysis is an excerpt from the recently published book "Bankruptcy and the Supreme Court." Authored by UCLA law professor Kenneth N. Klee, the work is a comprehensive desk reference for lawyers, judges, and scholars examining the Courts bankruptcy decisions since 1898. Chapter 1, from which this excerpt is drawn, examines the Court as a governmental and political institution.

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ARTICLE: Kenneth N. Klee on the Supreme Court's Use of Statutory Construction in Bankruptcy Decisions n1

"The bankruptcy law has now been so thoroughly construed that there is not much doubt about any of its provisions" n2

Numerous articles and books discuss statutory construction, and some analyze the Supreme Court's use of statutory construction to decide cases. n3 A few do so specifically with respect to the Court's use of statutory construction in bankruptcy cases. n4 Although this article does not have the depth or breadth of analysis contained in articles and books dedicated solely to this topic, it might provide the reader with interesting insights about the Supreme Court's use of statutory construction in bankruptcy decisions.

The analysis begins by identifying and then examining the Court's use of maxims of statutory construction in bankruptcy cases. An illustration of their uses with specific examples, noting the use of conflicting maxims, and concluding with a discussion whether the Court uses the maxims as a basis for decision or to rationalize a decision ex post, follows.

During the twentieth century, the Court used several maxims of statutory construction in bankruptcy decisions generally reflective of the guiding principle that the Court is to interpret statutes, not make them. n5 Among the more important and frequently used are the following:

1. When the language of the statute is unambiguous, courts must interpret the language in accordance with its plain meaning n6 without regard to legislative history, n7 except in the rare case in which the literal application of the

"statute will produce a result demonstrably at odds with the intentions of its drafters." n8

2. When the language of the statute is clear, the court must enforce it in accordance with its terms notwithstanding prior practice. n9

3. Even when the language of the statute is clear, courts must consider the legislative history and issues of policy and previous practice to determine congressional intent. n10

4. The Court must not erode a past bankruptcy practice absent a clear indication in the legislative history that Congress intended such a departure. n11

5. When Congress uses different language in a successor statute, the Court presumes that Congress has changed its intent. n12

6. A later statute that does not apply retroactively cannot be invoked to influence construction of an earlier statute. n13

7. Under the rule of stare decisis, once the Supreme Court has decided an issue of statutory construction, the decision is final and binding in future cases, even if the plain meaning of the text is to the contrary. n14

8. If possible, every word of a statute must be given meaning. n15

9. Redundancy is not the same as surplusage. n16

10. That a statute is awkward and ungrammatical does not make it ambiguous. n17

11. A court must not interpret a statute to produce an absurd result. n18

12. If literal interpretation of the statute produces an unfair result, it is up to Congress to amend the statute to remedy the problem. n19

13. Congress "says in a statute what it means and means in a statute what it says there." n20

14. Different parts of a statute must be interpreted together (in pari materia). n21

15. A word is presumed to have the same meaning in all parts of the same statute. n22

16. As a general proposition, the Court will construe a statute to affect only property rights created after the date of enactment. n23

17. In a statute, "includes" is illustrative, not limiting or exclusive. n24

The Court has used conflicting maxims of statutory construction in numerous bankruptcy cases and sometimes within the same case. n25 For example, in *Keppel v. Tiffin Savings Bank* 197 U.S. 356 (1905) n26 the Court was required to interpret the meaning of "surrender" in section 57g of the Bankruptcy Act of 1898. n27 Under that statute, "the claims of creditors who have received preferences shall not be allowed unless such creditors shall surrender their preferences." The Sixth Circuit certified to the Supreme Court three questions, the first of which was "[c]an a creditor of a bankrupt, who has received a merely voidable preference, and who has in good faith retained such preference until deprived thereof by the judgment of a court upon a suit of the trustee, thereafter prove the debt so voidably preferred?" n28 In a 5-4 opinion, the Court held that even creditors who involuntarily "surrender" their preferences may prove claims in bankruptcy. n29 Both the majority n30 and dissent n31 focused on the plain meaning of the statute and the policy it was intended to accomplish. The majority looked to the dictionary definition of "surrender" and determined that it applied to both voluntary and involuntary actions. n32 The majority buttressed its statutory construction by

noting that the fundamental purpose of the provision was to secure an equality of distribution among creditors, and that denying a creditor who disgorge a preference the opportunity to prove a claim would create an inequality. n33 The dissent countered that a creditor who resists the trustee and disgorges a preference after judgment has nothing left to surrender; to hold otherwise would defeat the statute's policy of a prompt, equal, and inexpensive distribution of the estate. n34 The majority believed that to deprive the preferred creditor of a claim after disgorgement of the preference would be punitive and would "disregard the elementary rule that a penalty is not to be readily implied . . . unless the words of the statute plainly impose it." n35 Thus, each side passionately used maxims of statutory construction to support different interpretations and meanings of the same word. n36

More recently, in *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989) n37 the Court decided whether *Bankruptcy Code* § 506(b) n38 entitles a creditor to receive postpetition interest on an allowed, nonconsensual, oversecured claim. To resolve this issue, both the majority and dissent invoked different maxims of statutory construction. The war of the maxims resulted in a 5-4 decision in favor of granting postpetition interest to the oversecured-nonconsensual lien creditor. The majority invoked the maxim that a statute must be construed in accordance with its plain meaning. n39 In this case, the placement of the second of four commas in section 506(b) meant that interest was available to any oversecured creditor and did not have to be provided in an agreement. "The language and punctuation Congress used cannot be read in any other way." n40 The dissent noted that based on the position of a comma in the statute, the majority had adopted a statutory construction that reversed a clear past practice and Supreme Court ruling without any clear evidence that Congress intended a different result when it adopted *Bankruptcy Code* § 506(b). n41 The dissent contended that the majority's approach violated the maxims that "[p]unctuation is not decisive of the construction of a statute" and "if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific." n42

Indeed, several Supreme Court cases have held that as a matter of statutory construction, courts should "not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." n43 Sometimes the Court will go to an extreme to find such a past practice. For example, in *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494 (1986) n44 despite "unequivocal language" n45 in the statute authorizing a trustee to abandon "any property of the estate that is burdensome," the Court held that *Bankruptcy Code* § 554(a) n46 does not authorize a trustee to abandon hazardous property in contravention of a state statute or regulation reasonably designed to protect the public health or safety. Relying on only three pre-Code cases (including one that did not deal with state laws and another in which the relevant language was arguably dicta), the Court concluded that under pre-Code bankruptcy law there were restrictions on a trustee's power to abandon property." n47 On the other hand, the Court has limited the maxim of reliance on prior practice by noting that "where the meaning of the Bankruptcy Code's text is itself clear . . . its operation is unimpeded by contrary . . . prior practice." n48

The Court also has adhered to the maxim that in the absence of express language, courts will not construe statutes to affect property rights established before they were passed. For example, in *Holt v. Henley*, 232 U.S. 637 (1914) n49 Justice Holmes wrote for a unanimous Court in refusing to apply the trustee's newly enacted lien rights n50 to defeat the pre-existing rights of a vendor who installed a sprinkler system for the debtor. "[T]he reasonable and usual interpretation of such statutes is to confine their effect, so far as may be, to property rights established after they were passed." n51 The Court relied on this precedent 62 years later in *Security Industrial Bank* n52 when it refused to retroactively apply the Bankruptcy Code's newly-created section 522(f) n53 power to avoid liens in household goods and furnishings: n54 "No bankruptcy law shall be construed to eliminate property rights which existed before the law was enacted in the absence of an explicit command from Congress."

The rule of stare decisis plays a large role in Supreme Court decisions. Even if a statute has a plain meaning, if the Court previously has ruled against the plain meaning, a later court generally will not overturn the result. n55 The Court's recent Eleventh Amendment jurisprudence illustrates this point nicely. For example, the Eleventh Amendment, by its terms, plainly applies only to suits against a state by a citizen of another state. n56 But long ago, in *Hans v. Louisiana* 134 U.S. 1 (1890) n57 the Court construed the amendment to cover suits against a state by its own citizens.

n58 This expansive construction served the policy that it would be unseemly for a state to be sued by its own citizens even more than foreign citizens. n59 It also violated the maxim of statutory construction that every word must be given meaning or significance. n60 In *Hans* the Supreme Court effectively read "other" out of the Eleventh Amendment. Despite this plain departure from textualist principles, after *Hans*, Justices who adhere to textualism have followed *stare decisis* and refused to use textualism to overrule *Hans*. n61 Yet on other occasions, the Court has changed its position despite *stare decisis*. For example, in *Perez v. Campbell*, 402 U.S. 637 (1971) n62 the Court overruled its earlier decisions in *Kesler v. Department of Public Safety* 369 U.S. 153 (1962) n63 and *Reitz v. Mealey* 314 U.S. 33 (1941) n64 as misinterpreting the Supremacy Clause of the Constitution. In his April 9, 1971 letter to Justice Blackmun regarding *Perez*, Justice Harlan urges Justice Blackmun to turn his draft opinion into a dissent upholding *Kesler* with greater emphasis on *stare decisis*. n65

Some commentators hold the view that the Supreme Court's bankruptcy jurisprudence adopts "a 'plain meaning' posture where the language of the statute meets with judicial approval, and use[s] legislative intent to contradict the language of the statute where a literal reading is not kind to the desired result." n66 This pragmatic, perhaps somewhat cynical, view of the Court is borne out by the research of the decisions by most, but not all, Justices. n67 Over the years, a significant number of Justices appear to care deeply about the legislative history n68 and view their role as interpreting statutes to achieve congressional intent even when the statutory language is inconsistent with the desired outcome. For example, Bankruptcy Act § 75(s)(3) n69 permitted the debtor to redeem an encumbered farm by paying its appraised value. But the remedy was subject to two provisos, the second of which authorized the secured creditor to demand a public sale of the property. n70 In *Wright v. Union Central Life Insurance Co.* 311 U.S. 273 (1940) n71 the Court was asked to decide whether a debtor could redeem farmland at a value fixed by the court before the secured creditor could cause the farm to be sold in a public sale. n72 In deliberating about the Court's decision in *Wright*, Justice Roberts wrote Justice Douglas a letter specifically referencing congressional debates to influence the Court's interpretation of the statute. Justice Roberts writes to Justice Douglas as follows: n73

This was the congressional view: "Under existing language of the bill, whether or not there may be foreclosure in a case where the award is less than the debt secured is left to the discretion of the judge. Now, that is not a clear explanation, but it will suffice for the present purpose. I would make it clearer if it were important. However, the amendment proposed removes the judge's discretion, if the original debt has not been fully paid, and gives the creditor the right, as a matter of right, to have a foreclosure of the property in the event his debt has not been in full." (79 Cong. Rec. 14333)

This concern is evidenced in the unanimous reported opinion which states that "the [Bankruptcy] Act must be liberally construed to give the debtor the full measure of the relief afforded by Congress, lest its benefits be frittered away by narrow formalistic interpretations which disregard the spirit and the letter of the Act." n74

Similar themes pervade other Supreme Court bankruptcy decisions. For example, "[i]n expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy." n75 Justice Douglas made this point quite clearly in *Bank of Marin v. England* 385 U.S. 99 (1966) n76 when he wrote, "[y]et we do not read these statutory words with the ease of a computer." n77

Certain Justices are devoted textualists even when their politics would appear to favor a different outcome. For example, in *Dewsnup v. Timm*, 502 U.S. 410 (1992) n78 Justice Scalia, an avowed textualist, wrote a scathing dissent to a majority opinion that forbade lien-stripping of liens securing claims of undersecured creditors. n79 The substance of the dissent was that Congress could not have intended to use "secured claim" one way in *Bankruptcy Code* § 506(a) and another way in § 506(d). In *Bank of Marin*, Justice Harlan chided the Court for disregarding "both the proper principles of statutory construction and the most permanent interests of bankruptcy administration" in fashioning a pragmatic result "in its haste to alleviate an indisputable inequity to the bank." n80

Yet, if the policy at stake is overwhelmingly important, even the most ardent textualist might compromise his principles of statutory interpretation. n81 For example, in *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994) n82

Justice Scalia wrote for the Court interpreting "reasonably equivalent value" in *Bankruptcy Code* § 548. n83 In order to protect 400 years of real estate mortgage foreclosure practices from fraudulent transfer attack, Justice Scalia wrote that the value received at a regularly conducted real property foreclosure sale is per se reasonably equivalent to the value of the property sold. n84 Outside the real property foreclosure context, however, "the 'reasonably equivalent value' criterion will continue to have independent meaning (ordinarily a meaning similar to fair market value)." n85

The dissent made two textualist arguments, both of which had been used by Justice Scalia in other cases, to refute the soundness of the majority opinion. First, the dissent noted that engrafting a "foreclosure-sale exception" onto *Bankruptcy Code* § 548 was "in derogation of the straightforward language used by Congress," n86 noting that neither congressional intent nor the plain meaning of the statute support the conclusion that the distressed prices normally fetched at foreclosure sales qualify for "reasonably equivalent value" in section 548. In fact, "rejecting such a reading of the statute is as easy as statutory interpretation is likely to get." n87 Second, the dissent noted that the Court's construction of the statute to only permit avoidance of collusive or procedurally deficient foreclosure sales rendered several congressional amendments to the Bankruptcy Code superfluous. n88 This interpretation transgresses a well-known rule of statutory construction that every part of a statute must be given some meaning. n89 Moreover, the Court eviscerates another canon of statutory construction by interpreting the same words in section 548 to have one meaning for real property foreclosures and another meaning for all other transfers. n90 As Justice Scalia wrote in his dissent in *Dewsnup v. Timm*, "'Normal rule[s] of statutory construction'" require that "identical words [used] in the same section of the same enactment" must be given the same effect. n91

Instead of simply resting the BFP decision on policy grounds, however, Justice Scalia went to great efforts to answer the dissent's textualist attack on his opinion. n92 He countered that the meaning of the statute is not plain because it creates an ambiguity by failing to define what a foreclosed property is worth. n93 He wrote that the Court's opinion does not render congressional amendments superfluous because "[p]rior to 1984, it was at least open to question whether § 548 could be used to invalidate even a collusive foreclosure sale It is no superfluity for Congress to clarify what had at best been unclear, which is what it did here by making the provision apply to involuntary as well as voluntary transfers and by including foreclosures within the definition of 'transfer.'" n94 Finally, he noted that his opinion did not give two inconsistent meanings to "reasonably equivalent value." n95 The inquiry whether the debtor received reasonably equivalent value is "the same for all transfers"; but the fact that "a piece of property is legally subject to a forced sale . . . necessarily affects its worth [and] completely redefin[es] the market in which the property is offered for sale" n96

The exchange among the Justices in BFP is not an isolated example of sharp differences over statutory construction. For example, in *FCC v. NextWave Personal Communications, Inc.*, 537 U.S. 293 (2003) n97 Justice Scalia, writing for the Court, takes sharp issue with Justice Breyer's dissent, n98 at one point writing that "[i]n addition to distorting the text of the provision, the dissent's interpretation renders the provision superfluous." n99 Justice Breyer's dissent attacks the majority opinion in kind, largely based on issues of statutory construction, n100 at one point writing that the majority's reasoning "rests too heavily upon linguistic deduction and too little upon human purpose." n101

In fact, Justice Breyer's observation is characteristic of some of the Court's bankruptcy decisions. On occasion, the Court will adhere to plain meaning and overturn a pragmatic result that departs from the language of the statute. For example, the Court's *per curiam* opinion in *Central Trust Co. v. Official Creditors' Committee* 454 U.S. 354 (1982) n102 interpreted section 403(a) of the Bankruptcy Reform Act of 1978 to prohibit dismissal of a chapter XI case filed under the Bankruptcy Act and refiling it as a chapter 11 case under the Bankruptcy Code. n103 Even if the dismissal was in the best interests of the estate and would conserve judicial resources, the bankruptcy court was not free to disregard a clear congressional directive. n104 "While the Court of Appeals may have reached a practical result, it was a result inconsistent with the unambiguous language used by Congress." n105

In other instances, however, the Court will doggedly adhere to a plain meaning rule of statutory interpretation even when the result is harsh. For example, in *Laime v. United States Trustee*, 540 U.S. 526 (2004) n106 in a straight

forward manner, the Court dealt with Congress' 1994 deletion of an award of compensation from the bankruptcy estate "to the debtor's attorney" under *section 330 of the Bankruptcy Code*. n107 Even though the 1994 deletion left the statute "awkward, and even ungrammatical," the Court found it unambiguous. n108 The Court relied on its previous statement in *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.* and previous opinions that "when the statute's language is plain, the sole function of the courts--at least where the disposition required by the text is not absurd--is to enforce it according to its terms." n109 The plain meaning of the statute did not lead to absurd results because the statute does not prevent debtors from engaging counsel before filing for chapter 7, even though those same attorneys could not be compensated out of the estate after the filing. n110 The Court recognized that deference to the supremacy of the Legislature caused its "unwillingness to soften the import of Congress' chosen words even if . . . the words lead to a harsh outcome" n111

Sometimes the Court will adopt a sensible rule of construction that Congress later codifies. For example, in *American Surety Co. v. Marotta*, n112 the Court interpreted the meaning of the word "includes" in the definition of "creditor" in section 1(9) of the Bankruptcy Act of 1898. n113 The Court rejected the interpretation of the lower court which had interpreted "the word 'include' to be one of limitation, the equivalent of 'include only,' and to exclude every person not having a demand presently provable." n114 Rather, the Court noted that "[i]n definitive provisions of statutes and other writings, 'include' is frequently, if not generally, used as a word of extension or enlargement rather than as one of limitation or enumeration." n115 In the context of the Bankruptcy Act, the Court contrasted "shall include" with "shall mean" and concluded that in the context of section 1(9), "it is plain that 'shall include' . . . cannot reasonably be read to be the equivalent of 'shall mean' or 'shall include only.' " n116 Congress later adopted this reasonable rule of construction for the entire 1978 Bankruptcy Code. n117

Return to Text

n1 This material is excerpted from Kenneth N. Klee, *Bankruptcy and the Supreme Court* (LexisNexis 2009), available at <http://www.lexisnexis.com/store/us/>.

n2 See H.R. Rep. No. 1182, 63d Cong., 2d Sess. 1 (1914), reprinted in 52 Cong. Rec. 435.

n3 See, e.g., Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, in *A Matter of Interpretation* 3 (Amy Gutmann ed., 1997); Michael H. Koby, *The Supreme Court's Declining Reliance on Legislative History: The Impact of Justice Scalia's Critique*, 36 *Harv. J. Legis.* 368-95 (1999). See generally, H.L.A. Hart, *The Concept of Law* 121-44 (Oxford: Clarendon Press, 1961) (arguing for "open texture" position on judicial interpretation between formalism and rule-skepticism).

n4 See, e.g., Daniel J. Bussel, *Textualism's Failures: A Study of Overruled Bankruptcy Decisions*, 53 *Vand. L. Rev.* 889 (2000) (discussing legislatively overruled Supreme Court and lower court decisions); Karen M. Gebbia-Pinetti, *Interpreting the Bankruptcy Code: An Empirical Study of the Supreme Court's Bankruptcy Decisions*, 3 *Chapman L. Rev.* 173 (Spring 2000) (discussing the interpretive conflict and the Bankruptcy Code

and reviewing bankruptcy cases from the Court's 1981 through 1998 terms).

n5 See *N.Y. County Nat'l Bank v. Massey*, 192 U.S. 138, 146 (1904) ("We are to interpret statutes, not to make them."). See generally Abner J. Mikva & Eric Lane, *An Introduction to Statutory Interpretation and the Legislative Process* 24-27 (Aspen Law & Business 1997) (explaining and criticizing the use of canons because "canons are not a coherent, shared body of law from which correct answers can be drawn, and . . . viewed individually, many canons are wrong." *Id.* at 25); Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are To Be Construed*, 3 *Vand. L. Rev.* 395-406 (1950) (describing 28 pairs of canons of statutory construction and their opposites and how the current temper of the Court and needs to be addressed affects their use).

n6 See, e.g., *Patterson v. Shumate*, 504 U.S. 753, 760 (1992) (party seeking to defeat plain meaning of the Bankruptcy Code bears an "exceptionally heavy burden") (internal quotation marks omitted); *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 254 (1992) ("When the words of a statute are unambiguous, then . . . 'judicial inquiry is complete.'") (citation omitted); *Gleason v. Thaw*, 236 U.S. 558, 560 (1915) ("[T]he Bankrupt Law is a prosy thing intended for ready application to the everyday affairs of practical business, and when construing its terms we are constrained by their usual acceptation in that field of endeavor."); *Citizens Banking Co. v. Ravenna Nat'l Bank*, 234 U.S. 360, 368 (1914) ("The advantages and disadvantages have been balanced by Congress, and its will has been expressed in terms which are plain and therefore controlling."); *Crawford v. Burke*, 195 U.S. 176, 189 (1904) ("The language of this section is so clear as to require no construction.").

n7 See, e.g., *Barnhill v. Johnson*, 503 U.S. 393, 401 (1992) ("[W]e note that appeals to statutory history are well taken only to resolve 'statutory ambiguity.'") (citation omitted); *Toibb v. Radloff*, 501 U.S. 157, 162 (1991) ("[T]his Court has repeated with some frequency: 'Where, as here, the resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear.'"); *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 240-41 (1989) ("[A]s long as the statutory scheme is coherent and consistent, there is generally no need for a court to inquire beyond the plain language of the statute. The task of resolving the dispute over the meaning of [the statute] begins where all such inquiries must begin: with the language of the statute itself.") ("Ron Pair"); *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 449 (1937) ("The legislative history of this provision . . . cannot affect its interpretation, since the language of the act as adopted is clear.").

n8 See *Ron Pair*, 489 U.S. at 242 (quoting *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)); *United States v. Am. Trucking Ass'ns*, 310 U.S. 534, 543 (1940) ("There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole' this Court has followed that purpose, rather than the literal words." (citation omitted);

quoted with approval in *Perry v. Commerce Loan Co.*, 383 U.S. 392, 400 (1966)). Cf. *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 202-03 (1819) (adopting a rule of contract construction that overrides plain meaning to avoid "absurdity and injustice").

n9 See, e.g., *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 10 (2000) ("[W]hile pre-Code practice 'informs our understanding of the language of the Code,' it cannot overcome that language. It is a tool of construction, not an extratextual supplement.") (citation omitted); *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 546 (1994) ("Where the 'meaning of the Bankruptcy Code's text is itself clear,' . . . its operation is unimpeded by contrary state law or prior practice."); *Pa. Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 563 (1990); *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 245-46 (1989).

n10 See, e.g., *Kelly v. Robinson*, 479 U.S. 36, 43 (1986) ("[T]he text is only the starting point In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.") (internal quotation marks and citations omitted); *Bank of Marin v. England*, 385 U.S. 99, 103 (1966) ("[We] do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction."); *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 279 (1940) ("And so long as that right is protected the creditor certainly is in no position to insist that doubts or ambiguities in the Act be resolved in its favor and against the debtor. Rather, the Act must be liberally construed to give the debtor the full measure of the relief afforded by Congress, lest its benefits be frittered away by narrow formalistic interpretations which disregard the spirit and the letter of the Act.") (internal citations omitted); *Wright v. Vinton Branch of Mountain Trust Bank*, 300 U.S. 440, 459 (1937); ("The new Act does not in terms provide for 'The right to protect its [the mortgagee's] interest in the property by bidding at such sale whenever held.' But the committee reports and the explanations given in Congress make it plain that the mortgagee was intended to have this right. We accept this view of the statute.") (footnote omitted; parenthetical in original); *City of Lincoln v. Ricketts*, 297 U.S. 373, 376 (1936) ("In construing the words of an act of Congress, we seek the legislative intent. We give to the words their natural significance unless that leads to an unreasonable result plainly at variance with the evident purpose of the legislation.") (citations omitted); *Wis. Pub. Intervenor v. Mortier*, 501 U.S. 597, 611 n.4 (1991) ("[C]ommon sense suggests that inquiry benefits from reviewing additional information rather than ignoring it."); *United States v. Am. Trucking Ass'ns*, 310 U.S. 534, 543-44 (1940) ("When aid to construction of the meaning of words, as used in the statute, is available, there certainly can be no 'rule of law' which forbids its use, however clear the words may appear on 'superficial examination.'") (footnotes omitted); *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 555 (1915) ("And nothing is better settled than that statutes should be sensibly construed, with a view to effectuating the legislative intent.") (citations omitted). Cf. *Corn Exch. Nat'l Bank & Trust Co. v. Klauder*, 318 U.S. 434, 438 (1943) ("[W]e find nothing in Congressional policy which warrants taking this case out of the letter of the Act."); *United States v. Emory*, 314 U.S. 423, 430 (1941) ("We are aware of no canon of statutory construction compelling us to hold that the word 'first' in a 150 year old statute means 'second' or 'third', unless Congress later has said so or implied it unmistakably.").

n11 See, e.g., *Cohen v. de la Cruz*, 523 U.S. 213, 221 (1998) ("We . . . will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.") (internal quotation marks and citation omitted); *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) ("[T]his Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under

consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history."); *Midlantic Nat'l Bank v. New Jersey Dep't of Env'tl. Protection*, 474 U.S. 494, 501 (1986) ("The normal rule of construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. . . . The Court has followed this rule with particular care in construing the scope of bankruptcy codifications.") (citation omitted) (cited with approval in *United States v. Noland*, 517 U.S. 535, 539 (1996)).

n12 See *Crawford v. Burke*, 195 U.S. 176, 190 (1904) ("Our own view, however, is that a change in phraseology creates a presumption of a change in intent, and that Congress would not have used such different language . . . without thereby intending a change in meaning."). Cf. *Williams v. Austrian*, 331 U.S. 642, 661-62 (1947) ("This negation of long-standing policy should be given effect . . . and should not be hedged by judge-made principles not in accord with those aims. Congress need not document its specific actions in elaborate fashion in order to direct this Court's attention to statutory policy and purpose. The failure to provide appropriate fanfare for . . . the consequent expansion of federal jurisdiction, hardly invites our opinion as to the advisability of the action which Congress has taken."). But see *Maynard v. Elliott*, 283 U.S. 273, 277 (1931) ("Only compelling language in the statute itself would warrant the rejection of a construction so long and so generally accepted, especially where overturning the established practice would have such far reaching consequences as in the present case."); *Van Huffel v. Harkelrode*, 284 U.S. 225, 227 (1931) (finding the right to sell free and clear of encumbrances by implication under the Bankruptcy Act of 1898 even though the Bankruptcy Act of 1867 contained an express provision allowing the power to sell free and clear).

n13 See *Levy v. Indus. Fin. Corp.*, 276 U.S. 281, 284 (1928) ("But that statute did not govern this case and cannot be invoked for the construction of the earlier law."). But cf. *United States v. Emory*, 314 U.S. 423, 430 (1941) ("We are aware of no canon of statutory construction compelling us to hold that the word 'first' in a 150 year old statute means 'second' or 'third,' unless Congress later has said so or implied it unmistakably.").

n14 Technically speaking, the doctrine of stare decisis is not a rule of statutory construction but is a court-created doctrine that applies to preclude the Court from reconsidering its previous interpretation of statutory language. As with rules of statutory construction, however, the Court appears to invoke stare decisis only when its application suits the outcome that a majority of the Court want's to reach. For example, in *Tenn. Student Assistance Corp. v. Hood*, 541 U.S. 440, 446 (2004), the Court construed the Eleventh Amendment of the United States Constitution to apply to suits against a state by citizens of its own state even though the text of the Eleventh Amendment "refers only to suits against a State by citizens of another State." But see, e.g., *Perez v. Campbell*, 402 U.S. 637 (1971) (overruling *Kesler* and *Reitz* as misinterpreting the Supremacy Clause of the Constitution). Accord *Washington v. W. C. Dawson & Co.*, 264 U.S. 219, 238 (1924) (Frankfurter, J., dissenting) ("Stare decisis is ordinarily a wise rule of action. But it is not a universal, inexorable command. The instances in which the Court has disregarded its admonition are many.") (footnote omitted).

n15 See, e.g., *Rake v. Wade*, 508 U.S. 464, 471 (1993) ("To avoid deny[ing] effect to a part of a statute we accord significance and effect . . . to every word.") (citations and internal quotation marks omitted); *Hoffman v.*

Conn. Dep't of Income Maintenance, 492 U.S. 96, 103 (1989) ("It is our duty to give effect, if possible, to every clause and word of a statute . . .") (citations and internal quotation marks omitted); *D. Ginsburg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932) ("[I]f possible, effect shall be given to every clause and part of a statute.") (citations omitted). But see *Chickasaw Nation v. United States*, 534 U.S. 84, 94 (2001) ([T]he Court's preference for avoiding surplusage "is sometimes offset by the canon that permits a court to reject words 'as surplusage' if 'inadvertently inserted or if repugnant to the rest of the statute.'" (citation omitted).

n16 See, e.g., *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253 (1992) ("Redundancies across statutes are not unusual events in drafting, and so long as there is no positive repugnancy between two laws . . . a court must give effect to both.") (internal citation and quotation marks omitted).

n17 See *Laime v. United States Trustee*, 540 U.S. 526, 534 (2004) ("The statute is awkward, and even ungrammatical; but that does not make it ambiguous . . .").

n18 See, e.g., *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (It is well established that "when the statute's language is plain, the sole function of the courts--at least where the disposition required by the text is not absurd--is to enforce it according to its terms.") (internal quotation marks omitted); *INS v. Cardoza-Fonseca*, 480 U.S. 421, 452 (1987) (Scalia, J., concurring) (nonbankruptcy case).

n19 See *Cent. Trust Co. v. Official Creditors' Comm. of Geiger Enters., Inc.*, 454 U.S. 354, 360 (1982) (*per curiam*) ("While the Court of Appeals may have reached a practical result, it was a result inconsistent with the unambiguous language used by Congress."). But see *Tinker v. Colwell*, 193 U.S. 473, 490 (1904) ("[W]e think Congress did not intend to permit such an injury [criminal conversation] to be released by a discharge in bankruptcy. An action to redress a wrong of this character should not be taken out of the exception [to discharge] on any narrow and technical construction of the language of such exception.").

n20 See *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) ("In any event, canons of construction are no more than rules of thumb that help courts determine the meaning of legislation, and in interpreting a statute a court should always turn first to one, cardinal canon before all others. We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there."). Accord *Ron Pair*, 489 U.S. at 241-42.

n21 See, e.g., *Duparquet Huot & Moneuse Co. v. Evans*, 297 U.S. 216, 218 (1936) ("There is need to keep in view also the structure of the statute, and the relation, physical and logical, between its several parts."); *Lockwood v. Exch. Bank*, 190 U.S. 294, 300 (1903) ("The two provisions of the statute must be construed

together, and both be given effect."); *Pirie v. Chicago Title & Trust Co.*, 182 U.S. 438, 449 (1901) ("Undoubtedly all the sections of the act must be construed together . . ."). The same rule does not hold for words in other statutes. Although "[h]ere and there in the Bankruptcy Code Congress has included specific directions that establish the significance for bankruptcy law of a term used elsewhere in the federal statutes," in the absence of such specific directions the Court will not look to other statutes to define bankruptcy law terms. See *Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co.*, 547 U.S. 651, 662 (2006) (citing *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 219-20 (1996)).

n22 See *Cohen v. de la Cruz*, 523 U.S. 213, 220 (1998) (there is a presumption in the Bankruptcy Code that "equivalent words have equivalent meaning when repeated in the same statute . . .") (citation omitted); *Patterson v. Shumate*, 504 U.S. 753, 758 n.2 (1992) (citing *Morrison-Knudsen Constr. Co. v. Director, Office of Workers' Comp. Programs*, 461 U.S. 624, 633 (1983) ("[A] word is presumed to have the same meaning in all subsections of the same statute."). But see *Dewsnup v. Timm*, 502 U.S. 410, 417 n.3 (1992) ("[W]e express no opinion as to whether the words 'allowed secured claim' have different meaning in other provisions of the Bankruptcy Code.").

n23 See *United States v. Sec. Indus. Bank*, 459 U.S. 70, 79-81 (1982) ("The principle that statutes operate only prospectively . . . is familiar to every law student. . . . This principle has been repeatedly applied to bankruptcy statutes affecting property rights. . . . *Holt v. Henley*, 232 U.S. 637 (1914) No bankruptcy law shall be construed to eliminate property rights which existed before the law was enacted in the absence of an explicit command from Congress."); *Holt v. Henley*, 232 U.S. 637, 639 (1914) ("[T]he reasonable and usual interpretation of statutes is to confine their effect, so far as may be, to property rights established after they were passed."). The same principle does not apply to contract rights where the bankruptcy statutes usually are construed to apply to pre-existing rights. See, e.g., *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188 (1902) (cited with approval in *Sec. Indus. Bank*, 459 U.S. at 80).

n24 See *Am. Sur. Co. v. Marotta*, 287 U.S. 513, 517 (1933).

n25 One commentator has concluded that "the Court does not apply a single interpretive method in its Bankruptcy Code cases." See Karen M. Gebbia-Pinetti, *Interpreting the Bankruptcy Code: An Empirical Study of the Supreme Court's Bankruptcy Decisions*, 3 *Chapman L. Rev.* 173, 298 (Spring 2000).

n26 197 U.S. 356 (1905) ("*Keppel* 197 U.S. 356 (1905)").

n27 11 U.S.C. § 93g (1976) (repealed 1979). Section 57g of the Bankruptcy Act is the predecessor of

Bankruptcy Code § 502(d). See Staff of Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 95th Cong., Table of Derivation of H.R. 8200, 7 (Comm. Print 1977).

n28 See *Keppel*, 197 U.S. at 359.

n29 See *id.* at 374.

n30 See *id.* at 361. ("Let us first consider the meaning of this provision, guided by the cardinal rule which requires that it should, if possible, be given a meaning in accord with the general purpose which the statute was intended to accomplish.").

n31 See *id.* at 380 (Day, J., with whom Harlan, Brewer, and Brown, JJ., joined, dissenting). ("Therefore the sole question here is: What is meant by the term 'surrender' as used in the act of 1898?").

n32 See *id.* at 362. ("The word 'surrender,' however, does not exclude compelled action, but, to the contrary, generally implies such action.").

n33 See *id.* at 361.

n34 See *id.* at 378, 384.

n35 See *id.* at 362.

n36 For a more recent example of a 5-4 decision that follows a similar pattern of disagreement over statutory interpretation, see *United States v. Sotelo*, 436 U.S. 268 (1978).

n37 489 U.S. 235 (1989).

n38 11 U.S.C. § 506(b) (2000).

n39 See *Ron Pair*, 489 U.S. at 241 ("[W]here, as here, the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'") (quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917)).

n40 See *Ron Pair*, 489 U.S. at 242.

n41 See *id.* at 252-53 (O' Connor, J., with whom Brennan, Marshall, and Stevens, JJ., joined, dissenting).

n42 See *id.* at 250, 252 (citations omitted).

n43 *Pa. Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 563 (1990). Accord, e.g., *Cohen v. de la Cruz*, 523 U.S. 213 (1998); *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 221 (1996); *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 244-45 (1989); *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 380 (1988); *Kelly v. Robinson*, 479 U.S. 36, 53 (1986).

n44 474 U.S. 494 (1986).

n45 See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 251 (1989) (O'Connor, J., dissenting).

n46 11 U.S.C. § 554(a) (1988).

n47 See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 251-52 (1989) (O'Connor, J., dissenting). In

Midlantic, Justice Rehnquist's dissent, in which Justice O'Connor joined, made plain that a close reading of the three cases relied on by the majority "reveals that none supports the rule" of *Midlantic*. See *Midlantic*, 474 U.S. at 510 (Rehnquist, J., dissenting).

n48 See *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 10 (2000) (quoting *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 546 (1994)).

n49 232 U.S. 637 (1914) ("*Holt* 232 U.S. 637 (1914)").

n50 The Act of June 25, 1910, ch. 412, § 8, 36 Stat. 838, 840 amended section 47a(2) of the Bankruptcy Act to give the trustee the rights of a lien creditor.

n51 See *Holt*, 232 U.S. at 639.

n52 See *United States v. Sec. Indus. Bank*, 459 U.S. 70, 80 (1982).

n53 See 11 U.S.C. § 522(f)(2) (Supp. 1980).

n54 *Sec. Indus. Bank*, 459 U.S. at 81.

n55 Of course, stare decisis does not preclude the Supreme Court from overturning previous holdings, but this is seldom done on the basis of textualism as opposed to policy concerns. See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241-43 (1989).

n56 See U.S. Const. amend. XI ("The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.").

n57 134 U.S. 1 (1890).

n58 See *id.* at 20 ("[T]he obligations of a State rest for their performance upon its honor and good faith, and cannot be made the subjects of judicial cognizance unless the State consents to be sued, or comes itself into court . . .").

n59 See *Alden v. Maine*, 527 U.S. 706, 749 (1999) ("In some ways, of course, a congressional power to authorize private suits against nonconsenting States in their own courts would be even more offensive to state sovereignty than a power to authorize the suits in a federal forum.").

n60 See, e.g., *Rake v. Wade*, 508 U.S. 464, 471 (1993) ("To avoid deny[ing] effect to a part of a statute we accord significance and effect . . . to every word.") (citations and internal footnotes omitted); *Hoffman v. Conn. Dep't of Income Maintenance*, 492 U.S. 96, 103 (1989) ("It is our duty to give effect, if possible, to every clause and word of a statute . . .") (citations and internal footnotes omitted); *D. Ginsburg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932) ("[I]f possible, effect shall be given to every clause and part of a statute.") (citations omitted). But see *Chickasaw Nation v. United States*, 534 U.S. 84, 94 (2001) ("[T]he Court's preference for avoiding surplusage 'is sometimes offset by the canon that permits a court to reject words 'as surplusage' if 'inadvertently inserted or if repugnant to the rest of the statute.'") (citation omitted).

n61 "Regardless of what one may think of Hans, it has been assumed to be the law for nearly a century. During that time, Congress has enacted many statutes--including the Jones Act and the provisions of the Federal Employers' Liability Act (FELA) which it incorporates--on the assumption that States were immune from suits by individuals." *Welch v. Tex. Dep't of Highways & Pub. Transp.*, 483 U.S. 468, 496 (1987) (Scalia, J., concurring).

n62 402 U.S. 637 (1971).

n63 369 U.S. 153 (1962).

n64 314 U.S. 33 (1941).

n65 See April 9, 1971 letter from Justice Harlan to Justice Blackmun (contained in Blackmun papers) ("From my standpoint *Kesler* was correctly decided, and, further, I think that *stare decisis* should stand in the way of overruling.").

n66 See Kenneth N. Klee & Frank A. Merola, Ignoring Congressional Intent: Eight Years of Judicial Legislation, 62 *Am. Bankr. L.J.* 1, 2 (1988). See also Justice Powell's notes on a clerk's memorandum dated September 19, 1986 regarding congressional intent and *Kelly v. Robinson*, 479 U.S. 36 (1986) ("Congress could not have intended that restitution orders, analogous to criminal fines, are dischargeable.").

n67 The tendency of courts to sometimes depart from "plain meaning" has caused one Supreme Court Justice to "question whether our legal culture has so far departed from attention to text, or is so lacking in agreed-upon methodology for creating and interpreting text, that it any longer makes sense to talk of 'a government of laws, not of men.'" See *Patterson v. Shumate*, 504 U.S. 753, 766 (1992) (Scalia, J., concurring).

n68 In the context of the Bankruptcy Code, the Court has recognized that "[b]ecause of the absence of a conference and the key roles played by Representative [Don] Edwards and his counterpart floor manager Senator DeConcini, we have treated their floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent." See *Begier v. I.R.S.*, 496 U.S. 53, 64 n.5 (1990). See also *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 350 (1985) (quoting statements made by members of Congress). But see *Fid. Fin. Servs. v. Fink*, 522 U.S. 211, 220 (1998) ("Whatever weight some Members of this Court might accord to floor statements about proposals actually under consideration, remarks that purport to clarify 'related' areas of the law can have little persuasive force, and in this case none at all."); *Hoffman v. Connecticut*, 492 U.S. 96, 103-04 (1989) (in refusing to rely on floor statements, the Court noted that "'legislative history generally will be irrelevant to a judicial inquiry into whether Congress intended to abrogate the Eleventh Amendment.'") (citation omitted). The Court also has relied on House and Senate Reports in construing bankruptcy statutes. See, e.g., *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 351 (1985) ("Both the House and the Senate Reports state that § 542(e) 'is a new provision'"'). But see *Begier*, 496 U.S. at 69 (Scalia, J., concurring) ("I think it both demeaning and unproductive for us to ponder whether to adopt literal or not-so-literal readings of Committee Reports, as though they were controlling statutory text."). When congressional reports are silent, the Court has even looked at hearing testimony to determine legislative history. See *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 207 (1983) ("Although the legislative reports are silent on the precise issue before us, the House and Senate hearings . . . provide guidance."). In some instances, even when the congressional reports address the issue, the Court will refer to hearing testimony. See, e.g., *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 205 n.5 (1988). But see *Kelly v. Robinson*, 479 U.S. 36, 51 n.13 (1986) ("We acknowledge that a few comments in the hearings . . . may suggest that the language bears the interpretation adopted [below] But none of those statements was made by a Member of Congress, nor were they included in the official Senate and House Reports. We decline to accord any significance to these statements.").

n69 The Frazier-Lemke Act, ch. 869, 48 Stat. 1289 (1934) (formerly codified at 11 U.S.C. § 203(s)) (repealed 1949) (adding subsection (s) to Bankruptcy Act § 75).

n70 See *id.* ("[U]pon request in writing by any secured creditor or creditors, the court shall order the property upon which such secured creditors have a lien to be sold at public auction.").

n71 311 U.S. 273 (1940).

n72 See *id.* at 275-76 ("The narrow issue presented . . . is whether under § 75(s)(3) the debtor must be accorded an opportunity . . . to redeem the property at the reappraised value or at a value fixed by the court before the court may order a public sale.").

n73 See December 2, 1940, letter from Justice Roberts to Justice Douglas regarding *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273 (1940).

n74 See *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 279 (1940) (citations omitted). Accord *Wright v. Logan*, 315 U.S. 139 (1942).

n75 *Kelly v. Robinson*, 479 U.S. 36, 43 (1986) (quoting *United States v. Heirs of Boisdor*, 49 U.S. [8 How.] 113, 122 (1850)).

n76 385 U.S. 99 (1966) ("*Bank of Marin* 385 U.S. 99 (1966)").

N77 See *id.* at 103.

n78 502 U.S. 410 (1992).

n79 See *id.* at 420-36 (1992) (Scalia, J., dissenting).

n80 See *Bank of Marin*, 385 U.S. at 103 (Harlan, J., dissenting).

n81 See, e.g., *Young v. United States*, 535 U.S. 43 (2002) (Scalia, J., writing for a unanimous Court).

n82 511 U.S. 531 (1994) ("BFP" 511 U.S. 531 (1994)).

n83 11 U.S.C. § 548 (2000).

n84 See *BFP*, 511 U.S. at 542-43.

n85 See *id.* at 545.

n86 See *id.* at 549 (Souter, J., with whom Blackmun, Stevens, and Ginsburg, JJ., joined, dissenting).

n87 See *id.* at 550-51.

n88 See *id.* at 555.

n89 See *supra* n.14 and accompanying text.

n90 See *BFP*, 511 U.S. at 556-57.

n91 See *Dewsnup v. Timm*, 502 U.S. at 422 (Scalia, J., dissenting) (emphasis in original).

n92 See *BFP*, 511 U.S. at 546. ("The dissent's insistence here that no doubt exists--that our reading of the statute is 'in derogation of the straight-forward language used by Congress,' . . . does not withstand scrutiny.") (emphasis in original).

n93 See *id.* at 547. ("But what is the 'value'? The dissent has no response . . .") (emphasis in original).

n94 See *id.* at 543 n.7 (emphasis in original).

n95 See *id.* at 548.

n96 See *id.*

n97 537 U.S. 293 (2003).

n98 See *id.* at 305-07.

n99 See *id.* at 307.

n100 See *id.* at 313-21.

n101 See *id.* at 321.

n102 454 U.S. 354 (1982).

n103 See *id.* at 359-60.

n104 See *id.* at 359.

n105 See *id.* at 360.

n106 540 U.S. 526 (2004).

n107 See Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106, 4130-31 (§ 224(b) of the Act amending 11 U.S.C. § 330(a) (1994)).

n108 See *Laime*, 540 U.S. at 534.

n109 See *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (internal quotation marks omitted).

n110 See *Laime*, 540 U.S. at 535-36.

n111 See *id.* at 538; *Corn Exch. Nat'l Bank & Trust Co. v. Klauder*, 318 U.S. 434, 437-38 (1943) ("Such a construction is capable of harsh results . . . but we find nothing in Congressional policy which warrants taking this case out of the letter of the Act."). But see *Duparquet Huot & Moneuse Co. v. Evans*, 297 U.S. 216, 223 (1936) ("Such a reading of the act will help at the same time in the avoidance of other consequences too harsh or incongruous to have been intended by the Congress.").

n112 See *Am. Sur. Co. v. Marotta*, 287 U.S. 513 (1933).

n113 See *id.* at 516 ("(9) 'creditor' shall include anyone who owns a demand or claim provable in bankruptcy, and may include his duly authorized agent, attorney, or proxy.").

n114 See *id.* at 516-17.

n115 See *id.* at 517.

n116 See *id.*

n117 See 11 U.S.C. § 102(3) (1978) ("In this title, 'includes' and 'including' are not limiting."). See also H.R. Rep. No. 595, 95th Cong., 1st Sess. 315 (1977) ("Paragraph (3) is a codification of *American Surety Co. v. Marotta*, 287 U.S. 513 (1933)."). The Table of Derivation of the Bankruptcy Code also indicates this rule of construction was taken from *American Surety Co. v. Marotta*. See Table of Derivation of H.R. 8200, Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 95th Cong., 1st Sess. 2 (Comm. Print No. 6 1977).

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53 of 197 DOCUMENTS

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American College of Bankruptcy on 363(b) Sales

2009 Emerging Issues 3334

American College of Bankruptcy on Determining Whether to Sell Assets Outside or Pursuant to a Chapter 11 Plan

By American College of Bankruptcy

February 2, 2009

SUMMARY: A sale of assets in a bankruptcy case is often the best route for maximizing recovery to a debtor's creditors and equity interest holders. There are two ways to sell assets during a bankruptcy case -- through a sale under Code section 363(b) or pursuant to a confirmed chapter 11 plan. This Emerging Issues Analysis focuses on the factors to be considered in determining whether to sell assets outside or under a chapter 11 plan.

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ARTICLE: **American College of Bankruptcy on Determining Whether to Sell Assets Outside or Pursuant to a Chapter 11 Plan**

The following material is an excerpt from the Best Practices Report "Selling Assets Outside a Chapter 11 Plan Under Section 363(b) of the Bankruptcy Code," prepared by Marcia L. Goldstein, n1 Weil, Gotshal & Manges LLP, for the American College of Bankruptcy. The full Report is available in American College of Bankruptcy, 2008 Circuit Review and Best Practices Reports, published by LexisNexis.

Reorganizing under chapter 11 of title 11 of the United States Code offers financially distressed entities distinct advantages that are not available in an out-of-court restructuring or a straight liquidation under chapter 7 of the Bankruptcy Code. One advantage of chapter 11 is the ability to sell assets of a company without court approval under *section 363(b) of the Bankruptcy Code* either as a mechanism to dispose of assets that are not core to the reorganizing entity or to effect a sale of substantially all the entity's assets without shareholder approval as an alternative to a reorganization plan. Over the past few years, section 363(b) increasingly has been used to effect a sale of all or substantially all a chapter 11 debtors assets for a variety of reasons.

A sale of a debtor's assets, in whole or in part, often is required where other avenues of financing are not available. With the proliferation of private equity, venture capital, buyout, and vulture funds, as well as other forms of investments, junior debtholders have taken on a more active role in the restructuring process. These creditors typically

seek to assert control in the chapter 11 process, particularly with respect to advocating the sale or other disposition of a debtor's assets. Alternatively, secured lenders, which also may be comprised of such funds, often seek a quick monetization of assets through a section 363(b) sale to enable them to recover on their claims expeditiously, particularly when the value of the assets is deteriorating as a result of continuing losses from business operations.

In some instances, a creditor's desire to sell the company's assets as quickly as possible may collide with the debtor's desire to preserve its business as a going concern and maintain jobs for its employees or with the interests of junior creditors seeking long-term recovery opportunity from reorganization securities. In other instances, a debtor may be desirous of selling all or substantially all its assets under section 363(b).

Selling assets under section 363(b) basically involves (i) negotiation of an asset purchase agreement; (ii) a motion seeking approval of bidding procedures; (iii) a motion seeking approval of the asset sale pursuant to the terms of the asset purchase agreement; (iv) a hearing to approve the bidding procedures and the sale motion; and (v) entry of an order approving the sale. It offers numerous benefits not provided by a sale outside the bankruptcy process. For example, a sale of assets outside of bankruptcy does not convey assets to a purchaser free and clear of liens, claims, and other interests and may require a favorable vote of stockholders. Additionally, assets sold by a financially distressed entity prior to the commencement of a case under the Bankruptcy Code may be avoided as a fraudulent transfer if it was not for reasonably equivalent value and the seller was insolvent at the time of the sale or became insolvent as a result of the sale.

On the other hand, a sale of assets in a bankruptcy case might be the best avenue to maximize recovery to a debtors creditors and equity interest holders. The filing of a chapter 11 case often creates a market for the debtors assets that might not have otherwise existed. Companies often become more attractive once a chapter 11 case is commenced because it creates a forum for addressing the future of the entity's business operations as well as the liquidation of assets to pay creditors. The debtor in possession ("DIP")ⁿ² has the duty to seek the highest price or best overall benefit to the estate for the debtor's assets. As such, potential purchasers are given the opportunity to submit higher or better offers. Potential purchasers also are attracted by the Bankruptcy Code's ability to cleanse a debtor's assets, removing the cloud of uncertainty with respect to the purchase of such assets.

There are two ways to sell assets during a bankruptcy case: (i) outside a chapter 11 plan pursuant to *section 363(b) of the Bankruptcy Code*; or (ii) pursuant to a confirmed chapter 11 plan. Unlike selling assets pursuant to a chapter 11 plan, which preserves the democratic aspects of chapter 11 reorganization by requiring approval by a vote of the requisite majorities of impaired creditor and equity classes, selling assets outside a plan pursuant to section 363(b) may be approved over the objections of creditors and equity security holders.

What follows are "best practices" guidelines on determining whether to sell assets outside or pursuant to a chapter 11 plan. The full Best Practices Report should be consulted for an overview of the relevant provisions of the Bankruptcy Code and for the best practices guidelines on the fiduciary duties of directors and management; sales free and clear of liens, claims, and encumbrances; appellate review of a finding of good faith; proper notice; adequate protection; the rights of purchasers outside a chapter 11 plan; and the avoidance of collusive bidding. ⁿ³

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Selling assets outside a chapter 11 plan pursuant to *section 363(b) of the Bankruptcy Code* sometimes results in the inability to provide value to junior creditors and equity security holders, which can hinder the ability to obtain a consensus among parties in interest. A section 363(b) sale monetizes a debtor's assets such that creditors ultimately will receive cash instead of reorganization securities. Reorganization securities typically take the form of equity or debt securities in the reorganized debtor and are issued by the debtor pursuant to a plan of reorganization as partial payment for claims of creditors, who would benefit from any returns of the reorganized debtor. Plans that distribute cash and no reorganization securities typically favor senior creditors, with junior creditors receiving little recovery because they would not benefit from any increase in reorganization values. As a result, junior creditors may not be in favor of a sale

outside a chapter 11 plan. In addition, a number of courts have expressed concern over the use of section 363 to effect a sale of a debtors assets solely for the benefit of secured lenders. In effect, agreeing to a recovery for unsecured or junior creditors may be the price that secured lenders pay for the relative speed and certainty of a sale of assets in bankruptcy versus a foreclosure sale.

Selling assets under a chapter 11 plan that provides for the issuance of reorganization securities by the reorganized company or the acquiror, in contrast, provides more flexibility. Junior creditors, and sometimes equity security holders, have a greater chance of participating in the post-chapter 11 success of the reorganized entity and, therefore, may favor a sale of assets under a plan.

In light of these principles, factors that should be considered in determining whether to sell assets outside or under a chapter 11 plan include (i) whether the sale involves a substantial portion of the debtor's assets, which would predetermine the type of plan (i.e., whether the sale would leave the debtor with insufficient operating asset value to reorganize as an ongoing enterprise that can issue reorganization securities); (ii) whether there is any alternative to a sale or loss of control of the debtor's business (i.e., whether the business is viable and, if yes, whether management has access to adequate means to fund a plan and operate the business); (iii) whether the potential purchaser will include cash or noncash consideration, if necessary, for distribution to subordinated debt or equity security holders; n4 (iv) whether the potential purchaser has any affiliation or contractual relationship with any existing junior creditor or equity security holder; (v) whether management has any general concerns about the views of equity security holders; (vi) whether the debtor and purchaser are able to avoid or resolve objections to a sale of substantially all a debtor's assets outside a plan (i.e., creditors or equity security holders frequently object to a sale of substantially all the debtor's assets under section 363(b) on the basis that the sale predetermined the terms of a chapter 11 plan, pre-empted the creditor protections inherent in the plan process, or constituted a sub rosa plan).

In general, while it is more difficult to derail a plan or sever an integral asset sale from a plan, a sale of assets outside a plan provides different benefits. It typically is quicker and less expensive because it does not involve the complexities of the plan confirmation process. While historically it was difficult to overcome objections to a sale of substantially all a debtors assets, such sales are now generally accepted so long as the debtor demonstrates sound business reasons, provides adequate and reasonable notice of a proposed sale, negotiates and conducts the sale in good faith, and receives fair and adequate consideration for the assets.

It should be noted, however, that in light of the Supreme Court's recent decision in *Florida Department of Revenue v. Piccadilly Cafeterias, Inc.*, 128 S. Ct. 2326, 171 L. Ed. 2d 203 (2008), some chapter 11 debtors who would have chosen to sell their assets under section 363(b) may consider delaying the sale until plan confirmation, especially when the stamp tax exemption would provide a significant benefit to the debtor's estate and creditors. In order to do this, a debtor would have to have adequate financing to operate its business. In situations where the debtors' assets are fully encumbered or the business continues to generate losses, DIP lending may be limited and likely conditioned on a prompt sale.

[Return to Text](#)

n1 * The report was completed in September 2008 and was co-authored with Michele J. Meises, Weil, Gotshal & Manges LLP.

n2 Upon the filing of a chapter 11 case, the board of directors, through the management of the debtor

corporation, continues to operate the business and manage the assets as a DIP. *11 U.S.C. § 1108*. A DIP acts *qua* trustee under the Bankruptcy Code. *Section 1107 of the Bankruptcy Code* provides that a DIP "shall perform all the functions and duties . . . of a trustee serving in a case under" chapter 11, with certain exceptions. *Id.* § 1107.

n3 These guidelines should not be construed as prescribing or advocating particular solutions because the issues discussed herein are too complex for there to be one universal solution. Each financially distressed entity must devise its own specific solution to the issues it faces, subject to the requirements of the Bankruptcy Code and approval of the bankruptcy court.

n4 It is easier to accomplish this in a chapter 11 plan, where warrants or other debt or equity instruments can be issued under the exemption from the registration requirements of section 5 of the Securities Act of 1933, as provided in *section 1145 of the Bankruptcy Code*.

RELATED LINKS: For further discussion of section 363 of the Bankruptcy Code, see

■ Collier on Bankruptcy, ch. 363

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54 of 197 DOCUMENTS

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Am. College of Bankruptcy on Employee Compensation Programs

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American College of Bankruptcy on Debtor Employee Retention and Incentive Compensation Programs

By American College of Bankruptcy

February 2, 2009

SUMMARY: Bankruptcy Code section 503(c) severely limits a debtors ability to pay management retention bonuses, severance, and other amounts. Holding on to valuable employees during a bankruptcy case can be a daunting task, and this Emerging Issues Analysis offers specific best practices guidelines for corporate debtors seeking to formulate compensation programs that comply with section 503(c).

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ARTICLE: American College of Bankruptcy on Debtor Employee

Retention and Incentive Compensation Programs

The following material is an abridgement of Best Practices Report "Debtor Employee Retention and Incentive Compensation Programs in Light of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," prepared by the Executive Compensation Committee of the American College of Bankruptcy. The full Report n1 is available in American College of Bankruptcy, 2008 Circuit Review and Best Practices Reports, published by LexisNexis.

Among the many changes to federal bankruptcy law effectuated by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA" or the "Act") was the creation of a new Section 503(c). Section 503(c) imposes a variety of restrictions on the compensation that can be paid both to executives and other employees of companies that are in bankruptcy. Specifically, Section 503(c)(1) limits retention payments that can be made to insiders n2 of the debtor, imposing strict--and exceedingly difficult--requirements that must be met before such payments may be made. Section 503(c)(2) establishes strict limitations upon the payment of severance to insiders of the debtor. Finally, Section 503(c)(3) places limitations on the payment of other obligations outside of the ordinary course of business that are not covered by subsection (c)(1) or (c)(2). n3

Faced with these restrictions and the possibility of large-scale attrition among their most valuable employees, debtors have sought to adopt programs that are (a) designed to provide key employees with incentives to work to

enhance value (and, by implication, remain in the debtors' employ) and (b) consistent with Section 503(c). Each debtor, after weighing all relevant factors, must arrive at its own solution consistent with the Bankruptcy Code's requirements. The "best practices" guidelines articulated below are, therefore, not intended to prescribe particular solutions to the executive compensation issues faced by debtors. Rather, they are intended to outline those factors that might be considered in developing and analyzing debtor compensation programs.

Determining the Need for, and Propriety of, a Compensation Program

In determining whether to approve a debtor employee compensation program (whether structured as an initiative to motivate enhanced performance or a traditional pre-BAPCPA "pay-to-stay" retention initiative), among the factors that courts consider is the due diligence that has been undertaken in investigating the need for and propriety of such a program. A debtor should not blindly presuppose that a bankruptcy-specific compensation program is necessary or appropriate. The debtor, by way of the independent directors serving on its compensation committeeⁿ⁴ (ideally working in consultation with independent professionals), should inform itself of the relevant facts and make a determination about whether an employee compensation program is necessary and appropriate in light of those facts.

While they will vary from case to case, relevant facts for determining whether a bankruptcy-specific compensation program is needed *may* include (i) the extent to which the debtor's bankruptcy filing and/or financial condition has decreased morale and distracted key employees from the performance of their duties, (ii) the elimination in value of employee stock options and other equity-based awards and whether those options and awards have historically constituted a significant portion of employee compensation, (iii) the degree to which the debtor's bankruptcy might cause key employees to seek other employment, and (iv) the additional burdens and duties imposed upon employees as a result of the bankruptcy and whether current compensation levels are sufficient to compensate employees to perform such duties.

Similarly, the facts of the debtor's case will determine whether a bankruptcy-specific compensation program is appropriate. While the adoption of a bankruptcy-specific compensation program may be desirable to retain and motivate employees *ceteris paribus*, the adoption of such a program *may* not be appropriate if it imperils the debtor's ability to achieve important reorganization objectives.

For example, the success of the debtor's reorganization may depend upon achieving reductions in benefits offered under collective bargaining agreements and/or in retiree medical and death benefits.ⁿ⁵ The debtor's negotiations with its unions and retirees may be prejudiced if the debtor seeks bonuses for management while simultaneously asking unions and retirees for sacrifices. Furthermore, although not necessarily precluding a debtor from rejecting a collective bargaining agreement or reducing protected retiree benefits, seeking a compensation program may also make it more difficult for the debtor seeking such a rejection or reduction to establish to the satisfaction of the bankruptcy court that all parties are being treated "fairly and equitably" in the Chapter 11 case.ⁿ⁶ Conversely, the sacrifices made, or that will need to be made, by the debtor's unionized workforce and retirees *may* (again, depending upon the facts and circumstances of the case) impact upon the debtor's ability to persuade the court that a compensation plan should be approved.

Accordingly, a debtor *may* find that the adoption of a bankruptcy-specific compensation program may be inappropriate if it imperils the debtor's ability to achieve important reorganization objectives. Nevertheless, there may be instances in which a compensation program, while complicating or imperiling the achievement of certain important reorganization objectives, is necessary to ensure that the debtor's workforce is sufficiently motivated to undertake the additional burdens imposed by Chapter 11 and to achieve a successful reorganization. In this context, failing to institute a compensation program that will sufficiently motivate key employees (whose efforts are needed to successfully reorganize) may, itself, unduly threaten the debtor's reorganization prospects and the debtor may conclude that the pursuit of such a program is essential to its reorganization efforts. In such instances, the debtor should, to the extent *reasonably possible*, seek to achieve consensus among the principal constituencies in its case so as to minimize the threat to its other reorganization objectives. In all cases, however, the process by which decisions are made regarding a

compensation program and the identity and independence of the decision-makers will continue to remain of great importance. Determining Which Employees Should Participate in the Compensation Program

Another factor that courts consider in determining whether to approve a debtor employee compensation program is the due diligence that has been undertaken in determining which employees should be included in the program. Thus, the debtor, again by way of its compensation committee (working in consultation with independent professionals), should apprise itself of the relevant facts and determine participation in the program based upon those facts. Facts that might be considered in determining participation in the compensation program include, but are not necessarily limited to, (i) the importance of the employee's job functions to the debtor's business and reorganization efforts; (ii) whether the employee possesses unique or special skills; (iii) the importance of the employee's individual performance to the debtor's prospects for success; (iv) the extent to which the bankruptcy has imposed additional burdens and duties upon the employee; (v) how the employee's pay, absent the compensation program, compares to competitive practice; (vi) whether the employee has historically received incentive compensation; (vii) whether the employee's current compensation level is in line with the tasks that the employee is performing; and (viii) the strength of the job market demand for people whose skill set is the same as, or similar to, that of the employee. Structuring Programs for Insiders

Section 503(c)(1) establishes an extraordinarily difficult--if not *de facto* impossible--standard that must be met before a debtor may make a transfer to, or incur an obligation for the benefit of, "an insider of the debtor for the purpose of inducing such person to remain with the debtor's business ." n7 This statutory language is extremely broad and could conceivably apply to *any* payment made to an insider employee, including wages and salary. n8 The courts, however, have adopted a restrained interpretation and limited application of Section 503(c)(1) to payments that have retention as a primary or material purpose. n9 In this regard, the courts have also held that Section 503(c)(1) restricts payments to insiders under *retention* programs but does not impact upon payments made to insiders under *incentive* programs designed to enhance value, which are subject to Section 503(c)(3). n10 This distinction applies even if an ancillary effect of the incentive plan is that the plan promotes retention. n11

Given the onerous standard imposed by Section 503(c)(1), a debtor seeking to establish a bankruptcy-specific compensation program for the benefit of its insiders should structure the program as an incentive--as opposed to a retention--program so as to avoid the limitations of Section 503(c)(1) and, instead, fall within the purview of Section 503(c)(3). In practice, this means that the program should be structured in such a way as to tie awards to the achievement of meaningful goals that will enhance the value of the debtor's estate and otherwise support the debtor's business strategy. In this regard, there is some authority for the proposition that, given an appropriate set of facts, insider payments that are tied to the filing or consummation of a plan of reorganization, disclosure statement, or business plan may constitute incentive payments subject to Section 503(c)(3). n12 However, the existing case law does not provide extensive guidance on what those circumstances might be and there is authority that suggests that courts are likely to apply heightened scrutiny in analyzing insider bonuses that are tied to these metrics. n13

Furthermore, the debtor's bankruptcy-specific incentive program should not include any guaranteed payments to insiders, condition payment to insiders solely upon their remaining in the debtor's employ, or provide for insider payments that are based upon "soft" goals that are easily achieved. Such payments are hallmarks of a retention program and, thus, will be subject to the restrictions of Section 503(c)(1). n14 Instead, the program should condition payments to insider participants upon the achievement of objectives that are *meaningful* based upon the facts and circumstances of the debtor's case. n15

The development of a bankruptcy-specific incentive program for insiders represents only one mechanism by which a debtor may compensate insiders while avoiding the strict limitations of Section 503(c)(1). One alternative might be for the debtor to (i) institute an ordinary course management *incentive* program that is similar to programs adopted by the debtor prepetition or (ii) continue an ordinary course prepetition management *incentive* program. Courts have held that the institution, modification, or continuation of an ordinary course *incentive* program in a manner that does not differ significantly from the debtor's ordinary prepetition practice is not subject to the restrictions of Section 503(c) but is, instead, an ordinary course transaction that falls within the debtor's discretion under Code Section 363(c)(1). Of course,

a debtor may not have a prepetition management incentive program and even if it does, the prepetition program may not be sufficient to address the debtor's needs in the bankruptcy context. Accordingly, the viability of this alternative as a means of addressing the debtor's post-bankruptcy employee needs will depend upon the facts and circumstances of the case. Moreover, notwithstanding the foregoing, it is important to emphasize that the restrictions of Section 503(c)(1) seemingly do apply to ordinary course insider *retention* programs. n16 Accordingly, while the case law indicates that a debtor has discretion to institute or modify an ordinary course insider *incentive* program without being subject to the restrictions of Section 503(c), it also suggests that a debtor does not have the same flexibility with respect to ordinary course insider retention programs.

A second alternative might be the continuation/assumption of insider pension benefits. At least one court has held that true pension benefits are not for the purpose of retention (as that term is used in Section 503(c)(1)) and, thus, that a debtor's assumption of such benefits is subject to Section 503(c)(3) (as opposed to the strict limitations of Section 503(c)(1)). n17 It is also important to note, however, that the court in that case cited as being significant to its decision the fact that the assumption of insider pension benefits was conditioned upon continuation of the debtor's salaried and bargained unit defined benefit pension plans, which ensured parity of treatment among all employee pension plans. n18 Accordingly, a debtor should not necessarily expect that it will be allowed to selectively continue/assume only certain pension benefits while discontinuing others.

A third alternative might be to structure a program that does not create administrative expenses for the debtor's estate. At least two courts have held that the provisions of Section 503(c) are applicable only to administrative expenses of the debtor's estate. n19 Thus, the restrictions of Section 503(c) have been deemed inapplicable to a debtor's decision to provide its chief executive officer with an unsecured claim of \$4 million in the event that he is terminated prior to emergence. n20 The restrictions of Section 503(c) have also been deemed inapplicable to payment of retention bonuses to senior executives by one of the debtor's creditors, since such payments are not administrative expenses of the debtor's estate. n21 Accordingly, while Section 503(c) has been held to apply only to administrative expenses of the debtor's estate, a transparent attempt by the debtor (or another party) to structure a compensation proposal for the purpose of circumventing Section 503(c) may not meet with success. Furthermore, absent unusual circumstances, it may be inappropriate to allow one party in interest, such as a secured creditor, to pay bonuses to managers who have a duty to all parties in interest. It should also be noted that a court is likely to hold that incentive payments and/or retention payments made by the debtor are subject to the restrictions of Section 503(c) even if such payments have been funded by a non-debtor third party who has advanced sums to the debtor for the purpose of funding the payments. n22

Moreover, depending upon its needs, the debtor might consider entering into independent contractor relationships for limited consulting services with select former insider employees. Such arrangements may preserve the debtor's access to valuable knowledge possessed by such persons. While not specifically deciding the issue, the events of one case suggest that the requirements of Section 503(c)(1) are not applicable to independent contractor consulting relationships. n23 Depending upon its particular needs and the facts of the case, it may be appropriate for a debtor to consider pursuing an independent contractor relationship with select former insider employees. Structuring Programs for Non-Insiders

Debtors have greater flexibility in structuring compensation programs for non-insider employees than in structuring programs for insider employees. By its terms, Section 503(c)(1) applies only to retention payments made to insiders. n24 Accordingly, a debtor may propose a retention payment program for its non-insider employees without being subject to the restrictions of Section 503(c)(1). n25 Instead, such a program will be evaluated under Section 503(c)(3). Of course, the fact that a non-insider retention program will not be subject to the rigors of Section 503(c)(1) does not, in and of itself, mean that the debtor should structure its non-insider program as a retention program. Depending upon the facts and circumstances of the case, an incentive or other structure might be more appropriate than a retention structure. A determination regarding the appropriate structure for a non-insider program should, therefore, be made by the debtor's compensation committee (preferably working in consultation with independent professionals) based upon the particular facts and circumstances of the debtor's case. Developing Compensation Programs

Whether intended for insider or non-insider employees, an employee compensation program should be developed by the debtor's compensation committee working in consultation with independent professionals (if possible) and, to the extent reasonably possible, negotiated with other major constituencies in the case. The development of the program should be informed and based upon the relevant available facts. In developing the program, care should be taken to ensure, among other things, that (i) there is a reasonable relationship between the program that is being proposed and the results that are sought to be obtained (or, stated another way, that the program is appropriately calculated to motivate employees to achieve the desired goal), (ii) the scope of the program is fair and reasonable and does not discriminate unfairly, (iii) the program is consistent with industry standards, (iv) the cost of the program is reasonable in the context of the debtor's assets, liabilities, and earning potential, and (v) the overall compensation offered to program participants (including compensation received outside of the scope of the program) is reasonable. n26The Importance of Support Among Major Constituencies

The case law addressing debtor employee compensation programs following the enactment of Section 503(c) has highlighted the importance of support by major constituencies. For example, one court has emphasized that determinations under Section 503(c) are to be made based upon the particular circumstances of the case and that the issues raised by objecting constituencies constitute a significant aspect of those circumstances. n27 Furthermore, in approving the incentive programs there at issue, other courts have attached great significance to the fact that the programs had the support of the relevant creditors committees and/or other constituencies. n28 It is also worth noting that parties in interest who oppose employee compensation programs have the right to appeal any bankruptcy court approval of such programs, and that in light of the statute's broad language and the lack of appellate guidance in this area to date, the pendency of an appeal may create significant uncertainty among key employees as to whether they will receive their proposed compensation. A debtor's attempts to pay executive bonuses at the same time as it seeks major sacrifices from other constituencies (such as unionized employees or retirees) *may* also make it more difficult to accomplish important reorganization efforts.

Accordingly, the debtor should, to the extent reasonably possible, seek to secure the support of appointed committees and, to the extent applicable, other major constituencies for employee compensation programs. This is not to say, however, that the debtor must or should seek consensus at all costs. The cost of consensus may well prove to be too high. Thus, while the debtor should seek to build consensus among major constituencies regarding its compensation program, there may be instances in which consensus becomes unattainable and a debtor nevertheless concludes that a compensation program is still required given the facts and circumstances of the case. The Debtor's Evidentiary Burden

Courts have proven reluctant to approve employee compensation programs in the absence of strong evidentiary showings regarding the propriety of such programs. n29 In light of the stringent evidentiary demands that have been made by courts, a debtor should be prepared to present an extensive evidentiary record touching upon the various factors that courts consider in determining whether to approve employee compensation programs.

[Return to Text](#)

n1 * The Report was originally prepared in 2007.

n2 Section 101(31) of the Bankruptcy Code contains a non-exhaustive definition of "insider."

n3 For a complete overview of the provisions of Section 503(c), the reader should consult the full Report.

n4 Absent exceptional circumstances, the NYSE, the NASDAQ, and the AMEX require that the compensation committees of listed companies be composed entirely of independent directors and impose additional guidelines and standards to be followed by such committees. Each of these entities has its own definition of "independent director." Additional norms/standards regarding director independence may also be derived from applicable federal or state law. *See supra* note 2.

n5 A debtor may modify its collective bargaining agreements under Section 1113 and may modify or terminate its retiree medical and death benefit plans under Section 1114. But both Sections impose stiff requirements, requiring that (i) the debtor seriously bargain with its unions and retirees, (ii) the relief be "necessary" to the reorganization of the debtor, and (iii) all affected parties, including management, be treated "fairly and equitably," and that "the balance of the equities" favor the requested relief.

n6 *See, e.g., In re Northwest Airlines Corp.*, 346 B.R. 307, 326 (Bankr. S.D.N.Y. 2006); *In re Jefley, Inc.*, 219 B.R. 88, 89, 91-94 (Bankr. E.D. Pa. 1998); *In re Pierce Terminal Warehouse, Inc.*, 133 B.R. 639, 647-648 (Bankr. N.D. Iowa 1991); *In re Indiana Grocery Co., Inc.*, 136 B.R. 182, 194-195 (Bankr. S.D. Ind. 1990). But *see Truck Drivers Local 807 v. Carey Transp. Inc.*, 816 F.2d 82, 90-91 (2d Cir. 1987) (affirming the rejection of a collective bargaining agreement and indicating that the debtor was not required to show that management had sustained pay cuts where management's prepetition compensation levels were below-market); *United Food & Commercial Workers Local Union Nos. 455, 408, 540 & 1000 v. Appletree Mkts., Inc. (In re Appletree Mkts., Inc.)*, 155 Bankr. 431, 439 (S.D. Tex. 1993) (same); *In re Ormet Corp.*, 324 B.R. 655, 661 (Bankr. S.D. Ohio 2005), *aff'd*, 355 B.R. 37 (S.D. Ohio 2006); *In re Texas Sheet Metals, Inc.*, 90 B.R. 260, 268-271 (Bankr. S.D. Tex. 1988).

n7 11 U.S.C. § 503(c)(1).

n8 *See, e.g., In re Nellson Nutraceutical, Inc.*, 369 B.R. 787, 802 (Bankr. D. Del. 2007).

n9 *See In re Nellson Nutraceutical, Inc.*, 369 B.R. at 802; *In re Global Home Prods., LLC*, 369 B.R. 778, 786 (Bankr. Del. 2007); *In re Dura Automotive Sys., Inc.*, Case No. 06-11202 (KJC), Hr'g Tr., at 50 (Bankr. D. Del. June 28, 2007) ("June 28 Hr'g Tr."); *In re Advanced Mktg. Serv., Inc.*, Case No. 06-11480 (CSS), Hr'g Tr., at 41 (Bankr. D. Del. Mar. 13, 2007) ("Mar. 13 Hr'g Tr.").

n10 See, e.g., *In re New Century TRS Holdings Inc.*, Case No. 07-10416 (KJC), Order Authorizing Payment of Sale-Related Incentive Pay to Senior Management and (ii) Retention and Incentive Pay to Certain Employees Pursuant to Sections 105(a), 363(b)(1) and 503(c)(3) of the Bankruptcy Code, at F (Bankr. D. Del. May 25, 2007); *In re Global Home Prods. LLC*, Case No. 06-10340 (KG), Order Authorizing and Approving Payments Under Incentive Bonus Plan, at E (Bankr. D. Del. Oct. 6, 2006); *In re Global Home Prods. LLC*, Case No. 06-10340 (KG), Order Authorizing and Approving Payments Under Management Sale Incentive Plan for Wearever Debtors, at F (Bankr. D. Del. Aug. 8, 2006); *In re Global Home Prods. LLC*, Case No. 06-10340 (KG), Order Authorizing and Approving Payments Under Management Sale Incentive Plan for Burnes Group Debtors, at F (Bankr. D. Del. May 30, 2006).

n11 See *In re Nellson Nutraceutical, Inc.*, 369 B.R. at 802; *In re Global Home Prods., LLC*, 369 B.R. at 786; *In re Dura Automotive Sys., Inc.*, June 28 Hr'g Tr., *supra* note 8, at 50; *In re Advanced Mktg. Serv., Inc.*, Mar. 13 Hr'g Tr., *supra* note 8, at 41.

n12 See *In re Dura Automotive Sys., Inc.*, Case No. 06-11202 (KJC), Hr'g Tr., at 41-43 (Bankr. D. Del. May 30, 2007); *In re Musicland Holding Corp.*, Case No. 06-10064 (SMB), Order Approving, and Authorizing Payments Under Debtors' Incentive Plan (Bankr. S.D.N.Y. Aug. 10, 2006) (approving program that tied bonuses to, either, the consummation of a plan of reorganization or a sale of substantially all of the debtor's assets, and under which bonuses would be paid from proceeds of secured trade creditor collateral and would not increase the unsecured debt of the debtor's estate).

n13 See, e.g., *In re Dana Corp.*, 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006).

n14 See *In re Dana Corp.*, 351 B.R. at 102 (characterizing the disapproved program as a retention program, and citing as factors in this characterization that the program included guaranteed payments and payments tied to the achievement of artificially low targets).

n15 See *In re Dana Corp.*, 358 B.R. 567, 583 (Bankr. S.D.N.Y. 2006) (noting that the debtor's revised program goals were difficult and not "lay-ups," and holding that the program was an incentive program) *appeal docketed* Case No. 07-CV-01888 (PKC) (S.D.N.Y. Mar. 5, 2007); *In re Apton Corp.*, Case No. 06-10510 (CSS), Order Authorizing Payment of Salary Deferral and Sale-Related Incentive Pay to Debtor's Employees Pursuant to 11 U.S.C. §§ 105, 363(b) and 503(c)(3) (Bankr. D. Del. June 15, 2006) (finding that proposed salary deferral/sale incentive program was designed to encourage participating employees to act above and beyond the level required by their normal fiduciary duties and approving the program under Section 503(c)(3)); *In re Nobex Corp.*, Case No. 05-20050 (MFW), Hr'g Tr., at 88 (Bankr. D. Del. Jan. 12, 2006) (approving the proposed sales incentive program and noting that, by conditioning payment upon the achievement of a sale price that was higher than the stalking horse bid already in hand, the program gave participants incentives to go above and beyond their duties as fiduciaries).

n16 See *In re Nellson Nutraceutical, Inc.*, 369 B.R. at 800-01.

n17 See *In re Dana Corp.*, 358 B.R. at 577-578.

n18 See *id.* at 578.

n19 See *id.*; *Official Comm. of Unsecured Creditors v. Airway Indus., Inc. (In re Airway Indus., Inc.)*, 354 B.R. 82, 87-88 (Bankr. W.D. Pa. 2006).

n20 See *In re Dana Corp.*, 358 B.R. at 578.

n21 See *In re Airway Indus., Inc.*, 354 B.R. at 87-88. However, in *Airway* the court also cautioned that the bonuses at issue had to be "closely scrutinized so that they [were] not used to circumvent [Section] 503(c) or to compromise the fiduciary duties of insiders." *Id.* at 90. The court found that, under the circumstances of that case (where the bonuses were negotiated prepetition, before BAPCPA took effect, and where the debtor had expected to close the contemplated sale of its assets prior to filing bankruptcy or to file bankruptcy prior to BAPCPA taking effect), the payment of the bonuses was in good faith and was for the benefit of the entire creditor body. See *id.*

n22 See *In re Advanced Mktg. Serv., Inc.*, Case No. 06-11480 (CSS), Hr'g Tr., at 7-10 (Bankr. D. Del. Feb. 28, 2007) ("Feb. 28 Hr'g Tr.") (analyzing under Section 503(c)(3), and approving, retention plan for non-insider employees where payments would be made by the debtor but funded by purchaser of the debtor's business).

n23 See *In re L.G. Philips Displays USA, Inc.*, Case No. 06-10245 (BLS), Hr'g Tr., at 38, 44-45 (Bankr. D. Del. Apr. 13, 2006).

n24 See 11 U.S.C. § 503(c)(1).

n25 See, e.g., *In re Nellson Nutraceutical, Inc.*, 369 B.R. at 801; *In re Scotia Dev. LLC*, Case No. 07-20027, Order Granting Joint Motion by the Pacific Lumber Company and Britt Lumber Co., Inc. for Entry of an Order Authorizing and Approving Payments Under (I) Bonus Plan for Mill Employees and (II) Bonus Plan for Non-Officer Employees (Bankr. S.D. Tex. Aug. 28, 2007)); *In re Scotia Dev. LLC*, Case No. 07-20027, Unopposed Order Granting Scotia Pacific Company LLC's Motion for Entry of an Order Authorizing and Approving Payments Under (I) Scopac Bonus Plan for Non-Insider Employees and (II) Scopac Management Incentive Plan (Bankr. S.D. Tex. Aug. 24, 2007).

n26 See *In re Dana Corp.* 358 B.R. at 576-77.

n27 See *In re Dana Corp.*, 351 B.R. at 102.

n28 See *In re Advanced Mktg. Serv., Inc.*, Mar. 13 Hr'g Tr., *supra* note 8, at 47; *In re Advanced Mktg. Serv., Inc.*, Feb. 28 Hr'g Tr., *supra* note 21, at 9; *In re Global Power Equip. Group, Inc.*, Case No. 06-11045 (BLS), Hr'g Tr., at 40 (Bankr. D. Del. Dec. 20, 2006); *In re Radnor Holdings Corp.*, Case No. 06-10894 (PJW), Hr'g Tr., at 46-47 (Bankr. D. Del. Oct. 4, 2006); *In re L.G. Philips Displays USA, Inc.*, Hr'g Tr., *supra* note 22, at 73; *In re Nobex Corp.*, Hr'g Tr., *supra* note 14, at 87.

n29 See, e.g., *In re PlusFunds Group, Inc.*, Case No. 06-10402 (JMP), Hr'g Tr., at 52-54 (Bankr. S.D.N.Y. Apr. 18, 2006); *In re Riverstone Networks, Inc.*, Case No. 06-10110 (CSS), Hr'g Tr., at 115-116 (Bankr. D. Del. Mar. 23, 2006).

RELATED LINKS: For further discussion of executive compensation, see

- Collier Monograph: Employee Benefits and Executive Compensation in Corporate Bankruptcy.

For further discussion of section 503 of the Bankruptcy Code, see

- Collier on Bankruptcy, ch. 503.

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55 of 197 DOCUMENTS

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Glosband on In re Ran and In re Loy

2009 Emerging Issues 3329

Daniel Glosband on In re Ran and In re Loy: Habitual Residence and the Center of Main Interests Test

By Daniel Glosband

January 30, 2009

SUMMARY: In this Emerging Issues Analysis, Daniel Glosband discusses In re Loy and In re Ran, which suggest that the center of main interests of a peripatetic debtor will be in the United States in instances in which the debtor maintains a permanent residence here, while it will be outside of the United States in instances in which the debtors U.S. residence is temporary.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Chapter 15 of the Bankruptcy Code allows U.S. bankruptcy courts to recognize foreign insolvency proceedings if they are pending in a country where the debtor has its center of main interests (COMI) or an establishment. For COMI purposes, the location of an entity's principal place of business (as opposed to its country of registration) might be debatable, the location of an individual's habitual residence would ostensibly be self-evident. Individuals cannot physically be in more than one place at a time but, as two recent decisions demonstrate, the determination of an individual's center of main interests may not be perfectly straightforward. *In re Loy* and *In re Ran* suggest that the center of main interests of a peripatetic debtor will be in the United States in instances in which the debtor maintains a permanent residence here, while it will be outside of the United States in instances in which the debtors U.S. residence is temporary. n1

A foreign proceeding can be recognized under Chapter 15 of the Bankruptcy Code for purposes of obtaining ancillary assistance from a United States Bankruptcy Court if it meets the definitional requirements of a foreign proceeding, if the foreign representative also satisfies the definitional criteria and the proceeding is a foreign main proceeding or a foreign nonmain proceeding. n2 A foreign proceeding can be recognized as a foreign main proceeding if it is pending in the debtors COMI. n3 In proving eligibility for recognition of a foreign main proceeding, the foreign representative may be aided by the evidentiary presumption of § 1516(c): In the absence of evidence to the contrary, the debtors registered office, or **habitual residence in the case of an individual**, is presumed to be the center of the debtors main interests.

COMI is not defined in the Bankruptcy Code, leaving room for development through case law, both within and outside of the United States. n4 *In re Loy* and *In re Ran* both involved individuals living in the United States at the time that a petition for recognition of their foreign insolvency proceedings was filed but the cases had different outcomes on the issue of whether the U.S. or the foreign country was the debtors COMI. Taken together the cases suggest that an

individuals COMI will be in the United States when the debtor maintains a permanent residence here, while it will be outside of the United States when the debtors U.S. residence is temporary.

Jonathan Loy was a British citizen who lived in Hampton, Virginia. n5 Before living in Virginia, Loy lived and worked in Exeter, England. n6 While in England, Loy and his brother established a furniture making company, Cider House Furniture, in May 2000. n7 The furniture business never succeeded and Loy found himself in debt. n8 Loy individually filed a proceeding in England under the Insolvency Act of 1986 for a voluntary arrangement (the IVA). n9 The IVA required that Loy sell certain property in France to help satisfy his debts but anticipated that he would retain his Hampton, Virginia property. n10 The IVA was approved on July 31, 2003 with Anthony OSullivan appointed as its trustee. When Loy failed to meet its terms because of additional debt, OSullivan filed a default petition with the Exeter court and Loy was declared bankrupt. n11 After Loy moved to the United States, OSullivan first filed a *lis pendens* in Virginia, a subject of some controversy and much discussion in the opinion, but not the subject of this commentary. n12

OSullivan then filed a petition for recognition of a foreign main proceeding under Chapter 15. n13 The U.S. Bankruptcy Court for the Eastern District of Virginia (the *Loy Bankruptcy Court*) held a preliminary hearing on the trustees petition for recognition of a foreign proceeding. n14 OSullivan had presented the *Loy Bankruptcy Court* with a certified copy of the English Order declaring Loy bankrupt and appointing OSullivan as trustee of Loys estate. n15 OSullivan therefore met the initial two requirements for recognition of a foreign proceeding; he proved that he was a properly appointed foreign representative and that the English proceeding was properly a foreign proceeding. n16 Additionally, Loy had testified under oath that he was declared bankrupt in a foreign proceeding and that OSullivan was the trustee in the matter. n17

Before the *Loy Bankruptcy Court* could grant recognition as a foreign main proceeding, it had to find that the foreign proceeding satisfied the third criterion for recognition, that England was Loys COMI. As noted, in the absence of evidence to the contrary, the bankruptcy court is entitled to presume that the habitual residence of an individual is his/her COMI. Relying on the *Blacks Law Dictionary*, the court noted that habitual is understood to be customary or usual. n18 Bankruptcy courts have also relied on additional factors in determining COMI. For example, in *In re SPhinX, Ltd.*, the U.S. Bankruptcy Court for the Southern District of New York said the location of the debtors primary assets, the location of the majority of the debtors creditors and the jurisdiction whose law would apply to the disputes involved were all determinative factors in establishing the COMI. n19

The *Loy Bankruptcy Court* found that Loys COMI was in England and not the United States and that, consequently, the foreign proceeding qualified as a foreign main proceeding. n20 While Loy was resident in the United States, his habitual residence was in the United Kingdom. n21 Loy owned the Hampton property and had been living in the United States with his family, but his and his familys visas were temporary, and they had to return to Britain to renew their visas. n22 The *Loy Bankruptcy Court* also applied the *SPhinX* factors to corroborate its conclusion that the debtors COMI was in the United Kingdom. n23 *SPhinX* stated that the location of the debtors creditors was relevant for determining COMI and almost all of Loys creditors were in the United Kingdom. n24 *SPhinX* also held that the jurisdiction whose law was most relevant also helped determine COMI, and both Loys initial IVA and later bankruptcy proceeding, as well as the law that the trustee followed, were English. n25

In contrast to *In re Loy*, the U.S. Bankruptcy Court for the Southern District of Texas (the *Ran Bankruptcy Court*) denied recognition to the trustee of Yuval Rans Israeli bankruptcy proceeding by concluding that Rans habitual residence was in Texas. *Rans* procedural history is a bit complicated. The *Ran Bankruptcy Court* denied an application for recognition based on a finding that Rans habitual residence and, consequently, his COMI was in Texas. n26 Zuriel Lavie, the Israeli Trustee and foreign representative, appealed to the District Court. The District Court accepted the Bankruptcy Courts finding that Rans habitual residence was Texas but remanded the case to the *Ran Bankruptcy Court* for a more extensive consideration of the evidence of COMI and of whether the Trustee had rebutted the presumption that Rans habitual residence was his COMI. n27

Ran had been the chief executive officer of Israel Credit Lines Supplementary Financial Services, Ltd., a publicly traded Israeli company (ICL). n28 Ran came into financial trouble in 1997 which caused Bank Hapoalim of Israel to approach him about settling his personal debts with the bank. n29 Bank Hapoalim hired Lavie to negotiate with Ran to settle his debts. n30 After meeting with Ran and his attorneys on a few occasions, Lavie claims that he was told in April 1997 that Ran was going on a short business trip outside of Israel, but that Ran would be returning to Israel. n31 Ran never returned to Israel, which led Bank Hapoalim to seek an *ex parte* temporary attachment order over Rans assets in June 1997. n32 The Israeli court appointed Lavie as a temporary receiver and began bankruptcy proceedings over Rans assets on July 10, 1997. n33 In making his argument to the Israeli court that Ran should be declared a bankrupt, Lavie argued that Rans departure from Israel constituted an act of bankruptcy, an intent component of Israeli bankruptcy law, and was genuine and permanent. n34 The Israeli court declared Ran bankrupt on October 28, 1999 and appointed Lavie as trustee. n35

In seeking recognition of the Israeli proceeding as a foreign main proceeding, Lavie cited the following factors in support of Rans COMI being in Israel; (i) Ran owed debts to Israeli creditors; (ii) Ran left as a fugitive to escape the reach of Israeli justice; (iii) Ran continued to manage ICL from the United States; (iv) Ran is guilty of forum shopping; (v) Rans creditors chose Israel as their favored jurisdiction in which to initiate bankruptcy proceedings against Ran; and (vi) the court should defer to the jurisdiction of the Israeli bankruptcy court under principles of equity. n36

The *Ran* Bankruptcy Court engaged in an extensive examination of European law on the subject of habitual residence and of the implications of the debtor having relocated. n37 It then reviewed U.S and Israeli law on the determination of an individuals domicile as a proxy for his/her COMI. n38 In the end, the *Ran* Bankruptcy Court was not convinced by Lavies arguments, ruling that Lavie was not entitled to recognition of the Israeli bankruptcy because Rans COMI was in the United States and not Israel. The court found that Rans relocation to the U.S. might have been problematic if his motives were improper and if the chapter 15 petition were filed on the heels of the individuals flight. n39 However, the Court found that Ran had legitimate reasons to relocate to the U.S. and that the chapter 15 filing was certainly not on the heels of his flight, coming some ten years after Rans relocation and eight years after the Israeli bankruptcy ruling. n40

More stinging for Lavie, the *Ran* Bankruptcy Court borrowed his own words from the Israeli bankruptcy proceeding and characterized Rans move as so genuine and permanent that there was no question Rans COMI was in the United States. n41 The *Ran* Bankruptcy Court found 10 factors as evidence that Rans move was permanent, including the following: Ran owned a home in the United States in which he lived with his wife and five children; Rans wife and children were U.S. citizens and Ran himself was a permanent resident of the United States and was awaiting approval on his application for U.S. citizenship at the time of trial; Ran worked in the United States and maintained his bank accounts only here. n42 These factors all combined to indicate that Rans stay in the United States was permanent and not temporary, meaning that his COMI was here and that this case did not qualify for Chapter 15 recognition.

Even though the Bankruptcy Code does not provide a definition for COMI, the *Ran* and *Loy* cases together suggest that a debtors COMI will be where he maintains his permanent residence. First, permanent residence can depend on a variety of factors, but U.S. bankruptcy courts will only recognize those foreign proceedings in which the debtors permanent residence is outside of the United States. Second, U.S. bankruptcy courts will give more weight to objective criteria in determining the COMI, rather than subjective criteria.

The objective facts underlying *Loy* and *Ran* explain in large part why they came out as they did. Loys COMI remained in the United Kingdom because he and his family only had temporary visas to be in the United States and had to return to England to renew these visas. In contrast, Ran had purchased and was maintaining a home in Texas, his wife and children were citizens of the United States and Ran himself was in the process of becoming an American citizen

For the practitioner, these cases underscore the point that U.S. bankruptcy courts will decide COMI on a case-by-case basis and their decisions will be based on not just a few, but several factors. They also confirm the courts willingness to follow the instruction of § 1508 and look to foreign law for guidance. n43

[Return to Text](#)

n1 *In re Loy*, 380 B.R. 154 (Bankr. E.D. Va. 2007); *In re Ran*, 390 B.R. 257 (Bankr. S.D. Tex. 2008).

n2 11 U.S.C. § 1517.

n3 11 U.S.C. § 1502(4).

n4 11 U.S.C. § 1508 (In interpreting this chapter, the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions.).

n5 *In re Loy*, 380 B.R. at 159.

n6 *Id.*

n7 *Id.*

n8 *Id.*

n9 *Id.*

n10 *In re Loy*, 380 B.R. at 159.

n11 *Id.*

n12 *Id passim.*

n13 *Id. at 158.*

n14 *Id.*

n15 *Id.*

n16 *See In re Loy, 380 B.R. at 161-62. See also 11 U.S.C. § 102(23)* (The term foreign proceeding means a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.); *11 U.S.C. § 101(24)* (The term foreign representative means a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtors assets or affairs or to act as a representative of such foreign proceeding.).

n17 *Id. at 163.*

n18 *Id. at 162.*

n19 *351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006).*

n20 *In re Loy, 380 B.R. at 163.*

n21 *Id.*

n22 *Id.*

n23 *Id.*

n24 *Id.*

n25 *Id.*

n26 Order Denying Recognition of Foreign Proceeding Under 11 U.S.C. § 1515, *In re Ran*, No. 06-37067 (Bankr. S.D. Tex., May 22, 2007).

n27 Order, *In re Ran*, Civil Action H-07-1906 (S.D. Tex., February 6, 2008).

n28 *In re Ran*, 390 B.R. at 260.

n29 *Id.*

n30 *Id.* at 285.

n31 *Id.* at 286.

n32 *Id.*

n33 *Id.*

n34 *In re Ran*, 390 B.R. at 286

n35 *Id.*

n36 *Id.* at 288.

n37 *Id.* at 267-281. This overseas tour was invited by § 1508; see note 4.

n38 *Id.* at 281-285.

n39 *Id.* at 294.

n40 *In re Ran*, 390 B.R. at 295.

n41 *Id.* at 300.

n42 *Id.* at 295.

n43 * John T. Mulcahy, an associate at Goodwin Procter LLP, contributed to the research, drafting and editing of this article.

RELATED LINKS: For more information on sections 101(24), 1502, 1508, 1515, 1516(c) and 1517 of the Bankruptcy Code, see *Collier on Bankruptcy*

- § 101(24);
- § 1502(4);
- § 1508;
- § 1515;
- § 1516(c);
- § 1517

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Daniel Glosband is a partner in Goodwin Procter LLP's Financial Restructuring Practice, www.goodwinprocter.com. He recently represented the lead investors in the confirmed Chapter 11 plan of US Airways and its merger with America West and the fiduciaries for the employee stock plan in the Delta case.

Mr. Glosband is a Vice President of the American College of Bankruptcy and a conferee of the National Bankruptcy Conference, which advises Congress on bankruptcy legislation. He was a draftsman of the UNCITRAL Model Law on Cross-Border Insolvency and one of two primary draftsmen of Chapter 15 of the United States Bankruptcy Code, Ancillary and Other Cross-Border Cases. He is a contributing author to *Collier on Bankruptcy 15th Ed. Revised*, *Collier Bankruptcy Practice Guide* and *Collier International Business Insolvency Guide*.

He is admitted to practice in New York, Massachusetts, the U.S. District Courts in Massachusetts, Connecticut, Vermont and the Southern District of New York, the U.S. Court of Appeals for the First Circuit and the U.S. Supreme Court. He received a J.D. from Cornell University in 1969 and a B.A. from University of Massachusetts in 1966.

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56 of 197 DOCUMENTS

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Overview of Bankruptcy Crimes

2009 Emerging Issues 3290

Bankruptcy: Overview of Bankruptcy Crimes

By Publishers Editorial Staff 2009

January 19, 2009

SUMMARY: In the first quarter of 2008, the total number of bankruptcies has increased 26.9 percent over the same period in 2007. Thus, there is a likelihood of an increase in the commission of bankruptcy crimes. This Emerging Issues Commentary will provide an overview of the different bankruptcy crimes as well as discuss the elements, the necessary evidence, and the punishment for these crimes. Click on link for PDF version.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE:

RELATED LINKS: For a discussion of Bankruptcy Crimes, see

- 1-7 Collier on Bankruptcy-15th Edition Rev. P 7.02;
- 1-7 Collier on Bankruptcy-15th Edition Rev. P 7.03;
- 1-7 Collier on Bankruptcy-15th Edition Rev. P 7.04;
- 1-7 Collier on Bankruptcy-15th Edition Rev. P 7.05;
- 1-7 Collier on Bankruptcy-15th Edition Rev. P 7.06;
- 1-7 Collier on Bankruptcy-15th Edition Rev. P 7.07

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57 of 197 DOCUMENTS

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Sommer on Marrama v. Citizens Bank

2010 Emerging Issues 4930

Sommer on Marrama v. Citizens Bank

By Publisher's Editorial Staff

January 9, 2009

SUMMARY: This Emerging Issues Analysis contains links to documents related to Marrama v. Citizens Bank of Massachusetts.

ARTICLE: Choose an option below to search Marrama v. Citizens Bank of Massachusetts documents.

RELATED LINKS: To view the decision of the United States Supreme Court,
■ [click here.](#)

To view briefs filed with the United States Supreme Court,
■ [click here.](#)

To view the opinion of the United States Court of Appeals for the First Circuit,
■ [click here.](#)

To view the opinion of the Bankruptcy Appellate Panel for the First Circuit,
■ [click here.](#)

To view recent news concerning the Supreme Court's decision,
■ [click here.](#)

To view the transcript of the oral arguments before the United States Supreme Court,
■ [click here.](#)

To view the Emerging Issues Analysis, "Sommer on Marrama v. Citizens Bank,"
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58 of 197 DOCUMENTS

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Director and Officer Liability Insurance in Subprime Mortgage Bankruptcies

2008 Emerging Issues 2987

Bankruptcy's Effect on Director and Officer Liability Insurance in Subprime Mortgage Litigation

By Publishers Editorial Staff 2008

October 3, 2008

SUMMARY: The insurance market will be affected by the subprime mortgage crisis as corporate officers and directors seek coverage under director and officer (D&O) and errors and omissions (E&O) liability policies. This commentary examines whether insurance proceeds are the property of the corporation (and thus belong to the bankruptcy estate) or of directors and officers (and thus fall outside the reach of creditors). Click on link for PDF version.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: Introduction

The collapse of the subprime mortgage market has resulted in a wave of litigation between borrowers, lenders, brokers, and investment banks with allegations of negligent misrepresentation, fraud, and securities violations frequently being pled. With allegations of malfeasance being asserted against the corporate officers and directors, the insurance market will be affected by the subprime mortgage market crises as corporate officers and directors seek coverage under their director and officer (D&O) and errors and omissions (E&O) liability policies. Whether coverage is afforded under a particular policy or whether claims fall under an exception to coverage may themselves be the subjects of litigation, and resolution of coverage issues may become hindered if the corporation is forced into bankruptcy. This article discusses D&O insurance coverage, exceptions to coverage, and the impact that corporate bankruptcy may have in resolving coverage disputes.

Subprime Lending Explained

Subprime lending refers to the practice of making loans to borrowers who do not meet traditional credit underwriting standards. In general, subprime borrowers have poor or limited credit histories. According to federal banking agencies, subprime borrowers display a range of credit characteristics that may include one or more of the following:

At least two 30-day delinquencies on loans within the past year or at least one 60-day delinquency within the past

two years;

Judgment, foreclosure, repossession, or non-payment of a loan within the past two years;

Bankruptcy within the past five years;

Relatively high default probability as evidenced by a low credit score; and

Debt service-to-income ratio of 50 percent or more or otherwise limited ability to cover living expenses after deducting monthly debt-service requirements from income.

Expanded Guidance for Subprime Lending Program, 2001 FDIC Interp. Ltr. LEXIS 9 (FDIC Interp. Ltr. 2001) (Jan. 31, 2001); LexisNexis: Backgrounder on Subprime Lending (September 2007).

Because these loans involve greater risk, the interest rates and loan fees charged are higher than the rates and fees assessed to prime borrowers. Subprime borrowers obtain loans from financial institutions that specialize in subprime lending or that deal with subprime loans as part of their broader business. In general, most subprime lenders are not subject to traditional banking regulations.

The Subprime Mortgage Lending Crisis

The subprime mortgage lending crisis began when lenders started offering mortgages to high-risk borrowers and then selling the riskier mortgages to investment banks, which profited by turning the loans into mortgage-backed securities for large investors. Bill Marsh, *Housing Busts and Hedge Fund Meltdowns: A Spectator's Guide*, N.Y. Times, Aug. 5, 2007 (Week in Review). Pieces of mortgage-backed securities were then transformed from high-risk to low-risk by repackaging them as collateralized debt obligations, which were sold by investment banks to investors. *Id.* As the number of foreclosures increased significantly in late 2006 and early 2007, questions arose about subprime mortgage-backed securities, and several hedge funds that were heavily invested in risky securities with mostly borrowed money collapsed when investors wanted to take their money out. *Id.* The detrimental market collapse has been blamed on those who profited from the subprime mortgage market growth, especially subprime lenders, as subprime mortgage originations grew between 2001 and 2005 from \$173 billion to \$665 billion, an increase of nearly 300%. Eric Petroff, *Who is to Blame for the Subprime Crisis?*, Investopedia, 2008. Subprime borrowers are not without blame, having purchased homes that they could not afford. Investment banks worsened the situation by buying subprime mortgages from lenders and selling them as collateralized debt obligations (CDOs) with superficially high ratings to attract investors. Some blame the rating agencies for failing to assign more accurate ratings, which would have resulted in fewer investors having purchased the CDOs, while others blame the investors for purchasing the CDOs without conducting due diligence. *Id.* Finally, some blame the government for failing to regulate the subprime mortgage industry. *Opening Statement of Chairman Chris Dodd, Hearing on Mortgage Market Turmoil Causes and Consequences, U.S. Senate Committee on Banking, Housing, and Urban Affairs, Mar. 22, 2007.*

Lawsuits Arising from the Subprime Mortgage Lending Crisis

With so many varied parties sustaining significant pecuniary losses, litigation was inevitable, and a number of suits implicate D&O and E&O insurance liability, including:

Borrower Lawsuits: Borrowers are instituting suits against lenders and against investment banks. The former lawsuits accuse lenders of predatory lending, as borrowers were burdened with mortgage loans with unreasonably high interest rates, while lawsuits against investment banks typically allege malfeasance in providing backing to lenders engaged in questionable, if not unethical, business practices.

Lender Lawsuits: Mortgage lenders are filing lawsuits against banks after being forced into bankruptcy when they were asked to buy back loans. These suits claim that the banks imposed improper margin calls and valued the lender's underlying collateral incorrectly.

Investor Lawsuits: Investors who purchased subprime mortgages are asserting claims against the lenders from whom they purchased the mortgages, asserting that the over-valuation of underlying collateral resulted in losses upon mortgagor default.

Shareholder Lawsuits: Shareholders of bankrupt subprime lenders are asserting claims against the lenders, accountants, trustees, and underwriters, alleging misrepresentation and omission related to accounting for residuals, as well as claims of bad valuation and poor underwriting standards.

Insurer Lawsuits: With the filing of claims by corporate officers and directors under D&O and E&O insurance policies when they are made parties to the aforementioned suits, insurers are seeking rescission of insurance contracts based upon exclusionary conduct on the part of the insureds.

Kevin LaCroix, *This Year's Model (2007 Edition): Subprime Lending Lawsuits*, The D & O Diary, July 12, 2007; Faten Sabry, *The Subprime Meltdown*, NERA Economic Consulting, NERA Insights Series, June 21, 2007; Alistair Barr, *Subprime Crisis May Spark D&O Claims*, Marketwatch, Aug. 20, 2007.

D&O and E&O Policies of Liability Insurance

Coverage. Liability protection is afforded to corporate directors and officers under Directors and Officers liability policies of insurance (D&O insurance), while Errors and Omissions liability policies (E&O insurance) afford protection to members of management for losses attributed to unintentional and negligent acts, errors, omissions, or breaches of duty giving rise to claims. D&O insurance traditionally affords coverage to corporate directors and officers and the corporate-policyholder. Traditional E&O insurance affords coverage to a corporations directors, officers, employees and affiliates, including securities brokers and dealers working for financial institutions and investment banks, for losses arising from alleged wrongful acts committed in their capacities as managers, representatives, or agents of the corporation. R. Mark Keenan and Craig M. Hirsch, *Insurance Coverage for Subprime Lending and Securities Litigation*, FinAlternatives Weekly, Dec. 11, 2007.

D&O insurance policies often contain three separate insuring agreements: (1) Insuring Agreement A, which provides liability coverage paid to, or on behalf of, the individual officers and directors when a corporation does not, or is not allowed to, provide reimbursement to such officers and directors; (2) Insuring Agreement B, which provides corporate indemnification coverage, which reimburses a corporation for losses, judgments or other related expenses it may incur as a result of indemnifying its officers and directors for liability of covered wrongful acts and (3) Insurance Agreement C, which provides entity coverage, direct liability protection for the corporation's own losses from claims not otherwise covered, and typically includes coverage for securities claims. Leonard P. Goldberger, *Five Easy Pieces: A Guide to Dealing with D&O Insurance in Subprime Mortgage Bankruptcy Cases*, 26-8 ABIJ 18 (Oct. 2007).

Notice of Claims. Most D&O and E&O policies are claim-made policies, meaning that coverage is afforded only for claims made during a particular policy period, and notice of claim is an obligation the insured or policyholder must complete before seeking coverage. Most D&O and E&O policies put a specific time limitation on how late notice can be provided after the claim is filed, while others require notice as soon as practicable and forwarding of legal papers immediately. R. Mark Keenan and Craig M. Hirsch, *Insurance Coverage for Subprime Lending and Securities Litigation*, FinAlternatives Weekly, Dec. 11, 2007. Failure to comply with the policy's notice provision generally vitiates coverage. For example, in *National Union Fire Ins. Co. v. Talcott*, 931 F.2d 166 (1st Cir. 1991), the United States Court

of Appeals for the First Circuit held that the failure of the insureds counsel to notify the professional liability insurer of a claim against him until after the expiration date of applicable policy period precluded coverage, even though the insurer suffered no prejudice as a result of the untimely notice.

Some D&O and E&O policies contain a notice of circumstances provision, which permits the insured to report informal complaints as to its subprime practices to lock into the policy period if a subsequent lawsuit develops from these circumstances at a later date. R. Mark Keenan and Craig M. Hirsch, *Insurance Coverage for Subprime Lending and Securities Litigation*, FinAlternatives Weekly, Dec. 11, 2007.

Proper notice generally requires (1) a report to the insurer (2) during the policy period (3) including certain details, specifically (a) the reasons for anticipating the claim, (b) the nature and dates of the alleged wrongful act, (c) the alleged damages sustained, (d) the names of potential claimants, (e) any director or officer involved in the wrongful act, and (f) the manner in which the insureds first became aware of the specific wrongful act. *Asche v. Hartford Ins. Co.*, 2006 U.S. Dist. LEXIS 70192 (D. Conn. 2006).

Coverage for Investigations. Many D&O and E&O policies define claim to encompass investigations by any governmental entity into possible violation of law, and the insurance policies normally afford coverage for the costs incurred in responding to a government or regulatory examination as well. For example, the policy at issue in *Nat'l Stock Exch. v. Fed. Ins. Co.*, 2007 U.S. Dist. LEXIS 23876 (N.D. Ill. 2007) defined "claim" as "a formal administrative or regulatory proceeding commenced by the filing of a notice of charges, formal investigative order, or similar document." The United States District Court for the Northern District of Illinois determined that attorney fees and costs incurred in defending an SEC investigation constituted a loss in defending a claim as defined by the policy. The court found that SEC proceedings are legal in nature because they are commenced by a commission order in which witnesses are sworn and because officers may be designated to take testimony and receive evidence in formal investigative proceedings. However, an informal government request may not constitute a claim. At least one court has held that an informal document request from the Securities and Exchange Commission regarding a hedge fund or private equity funds subprime activities--as opposed to a formal investigation with the exercise of subpoena power--is not considered a claim as that term is defined by most D&O and E&O policies. R. Mark Keenan and Craig M. Hirsch, *Insurance Coverage for Subprime Lending and Securities Litigation*, FinAlternatives Weekly, Dec. 11, 2007.

Exclusions from Coverage

Dishonesty and Fraud. One of the most prominent exclusions found in D&O and E&O policies is a bad acts exclusion, under which coverage is not afforded for fraudulent acts, criminal acts, or intentional conduct arising from improper subprime practices. However, under typical policy language, the exclusion is not triggered merely by allegations of fraud or other unethical or illegal acts; rather, the insurer may rely upon the exclusion only after the underlying claim is adjudicated in a court of law. Despite the allegations of fraud or other wrongdoing, the insureds are entitled to advancement of legal costs, which are subject to recoupment by the insurance company only if a final adjudication shows the claim is not covered. Because recoupment becomes an issue only upon a final determination of fraud, an insured may want to settle subprime litigation. When the suit is settled, there is no final adjudication or fact finding of a wrongdoing that would trigger the exclusionary clause. Further, the exclusionary defense does not entitle the insurance company to relitigate the settled action in the subsequent coverage dispute with its insured. *Id.* See also Matthew R. Wildermuth, *Repercussions of the Subprime Mortgage Crisis on D&O Insurance, Part II of III*, 2008 Emerging Issues LEXIS 112 (Feb. 1, 2008).

Prior Acts. The prior acts exclusion precludes coverage for any claim alleging any wrongful act that the insured knew or could have reasonably foreseen could lead to a claim. For the exclusion to apply, an insurer must demonstrate that the insured had knowledge of a wrongful act such that it could have reasonably foreseen the action's filing, thereby leading to a claim under the policy. The date of occurrence of the acts giving rise to the claim will determine whether coverage is afforded. If the allegations concern acts occurring prior to the specified policy date, the insurer has a basis

for denying the claim. Daniel W. Gerber, Joanna M. Roberto and Carrie P. Appler, *Coverage Implications of the Subprime-Mortgage Meltdown*, 12-22 Mealey's Emerg. Ins. Disps. 17 (2007)

Illegal Profit or Advantage. This exclusionary clause bars coverage where a director or officer has received an illegal profit or advantage. This type of exclusion requires an "in fact" trigger, meaning that an insurance company must prove that the wrongful conduct actually occurred before it can deny coverage. The in fact language contained in profit advantage exclusionary provisions requires a final adjudication before an insurance company can assert exclusion as a bar to coverage. *St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp. 2d 1035 (C.D. Ill. 2003). See also Matthew R. Wildermuth, *Repercussions of the Subprime Mortgage Crisis on D&O Insurance, Part II of III*, 2008 Emerging Issues LEXIS 112 (Feb. 1, 2008).

Rescission. If a D&O or E&O insurance policy was procured based on alleged misrepresentations made in the insurance application, the insurer may seek to rescind the policy in its entirety. Many subprime litigations and investigations could yield a finding that the insured made misstatements in its public financial filings by overestimating the value of its subprime loan assets. While the insurer may argue that such misrepresentations provide a basis for rescission, the burden of proof to establish a right to rescission is a heavy one. The insurer must show that the insureds misrepresentation was material to the decision to issue the liability policy and that the misrepresentation was in fact made by the policyholder. Most rescission actions are unsuccessful. R. Mark Keenan and Craig M. Hirsch, *Insurance Coverage for Subprime Lending and Securities Litigation*, FinAlternatives Weekly, Dec. 11, 2007.

Effect of Corporate Bankruptcy on D&O Coverage

As if the litigation of subprime mortgage lawsuits wasn't complex enough, the filing of a bankruptcy petition by a party to the suit has a profound impact upon the continued progress of the litigation. Important issues to be resolved include ownership of the D&O Insurance policy, the effect of the automatic stay, and the benefit of settling the claim.

Ownership of the D&O Insurance Policy. Issues that are imbued in uncertainty include the ability of directors and officers to access coverage under a D&O policy and the ability of non-debtors to claim that such a policy or the proceeds of such a policy are not an asset of the bankruptcy estate. Deborah D. Williamson and Ronald Hornberger, *Benchnotes*, 24-5 ABIJ 3 (June 2005). While the courts generally agree that a D&O insurance policy held by a corporate debtor is "property of the estate" within the meaning of 11 USCS § 541, they are divided on the issue of whether the proceeds of a D&O insurance policy belong to the bankruptcy estate or to the individual directors and officers. Determining whether insurance proceeds are property of the estate is fact-sensitive and turns on whether the proceeds at issue are generated by D&O conduct, which the individual directors and officers are deemed to own, or for indemnification obligations or direct claims, which the corporate debtor is deemed to own. Leonard P. Goldberger, *Five Easy Pieces: A Guide to Dealing with D&O Insurance in Subprime Mortgage Bankruptcy Cases*, 26-8 ABIJ 18 (Oct. 2007)

In *In re Medex Reg'l Labs., LLC*, 314 B.R. 716 (Bankr. E.D. Tenn. 2004), Bankruptcy Judge Richard Stair Jr. held that in making such determinations, the court must analyze the facts of each particular case, focusing primarily upon the terms of the actual policy and the identity of the named insured(s) under the liability insurance policy, keeping in mind that the purpose behind a D&O policy is to provide protection for individual directors and officers. If only the debtor has a direct interest in receiving the proceeds, the proceeds are property of the estate. If only the directors and officers have a direct interest in the proceeds, they are not property of the estate. The conflict arises if the debtor has indemnification coverage or otherwise enjoys "entity" coverage. Relying on *In re Allied Digital Techs. Corp.*, 306 B.R. 505 (Bankr. D. Del. 2004), Judge Stair held that "when there is coverage for the directors and officers and the debtor,

the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution." Further, if the policy also provides the debtor with indemnification coverage "but indemnification either has not occurred, is hypothetical or [is] speculative, the proceeds are not property of the estate." The policy before the court provided indemnification coverage, but the debtor had not made any payments or agreed or committed itself to paying any indemnification other than for acts that did not constitute gross negligence or willful misconduct. Thus, any indemnification was found to be hypothetical and/or speculative. The policy did provide coverage for any security claims received during the policy period, but the parties stipulated that no notices, claims or demands had been made or received. The court found that as the proceeds were not an asset of the estate and thus not covered by 11 USCS § 362(a), the carrier was not precluded from disbursing the costs of defense directly to the directors and officers in accordance with the terms of the policy. The same conclusion, on slightly different facts, was reached in *Holloway v. Dane*, 316 B.R. 876 (S.D. Miss. 2004).

Effect of the Automatic Stay of Proceedings. If an insured corporation files for bankruptcy, the insurer may initiate insurance coverage litigation in the bankruptcy court or may remove pending litigation to the bankruptcy court. This effort is required by the operation of the automatic stay, which prevents the continued prosecution of any pending insurance coverage litigation by insurers that was filed pre-petition in a non-bankruptcy forum. *Id.* Despite the issuance of the automatic stay, however, an insurer may nevertheless be required to pay costs of a director or officer involved in litigation. If an exclusion is ultimately found to be applicable, any defense costs advanced would be subject to reimbursement. However, this right to reimbursement does not affect the insurer's obligation to advance defense costs, even in instances where the ability of the director or officer to repay the insurer is dubious. When a D&O policy includes coverage for a debtor corporation, a bankruptcy court may find that the proceeds of the policy are property of the estate. Even if the automatic stay does not apply, a bankruptcy court may extend the stay to apply to those proceeds. A director or officer would then be required to seek the approval of the bankruptcy court for the payment of defense costs. Susan N. Gummow, *D&O Insurer Beware: Payment of Defense Costs May Be Required Pending the Stay of Claims for Rescission and Determination of Exclusions*, 23-9 ABIJ 32 (Nov. 2004).

Advantages of Settlement. The bankruptcy court provides an hospitable environment for effecting comprehensive settlements that offer legal certainty and financial finality for insurers, insureds, and claimants. The bankruptcy court can provide the legal framework for approving compromise settlements pursuant to Bankruptcy Rule 9019(a) by which third parties can be bound. There are additional bankruptcy-specific features, such as settlement bar orders and channeling injunctions, which foster effective settlements by immunizing settling insurers against direct or collateral attacks by claimants and non-settling insurers. A carefully crafted settlement agreement can provide the appropriate balance between maximizing the value of D&O insurance assets and providing benefits to both settling and non-settling insurers. There is also the possibility that the bankruptcy estate may be negotiating with D&O and E&O insurers of third parties against whom the estate has claims. In that event, many of the same considerations would also apply to the extent that such claims against third parties are ultimately resolved by such parties' insurance-funded settlements. The certainty and finality sought by a debtor's insurers will be equally important to other insurers as well. Leonard P. Goldberger, *Five Easy Pieces: A Guide to Dealing with D&O Insurance in Subprime Mortgage Bankruptcy Cases*, 26-8 ABIJ 18 (Oct. 2007).

Conclusion

The fallout of the subprime mortgage crisis has been financial devastation for many corporations and individuals. Borrowers have lost their homes and financial security, corporations have been forced into bankruptcy, and investors and shareholders have suffered profound pecuniary losses as well. With so many suffering such profound losses, litigation was inevitable, and with many of the targeted corporations having to declare bankruptcy, turning to their directors and officers permits aggrieved parties to target another source of recovery--the D&O and E&O insurance liability policies. While such litigation is merely in its infancy, whether the conduct of directors and officers involved in

the subprime mortgage market constituted exclusionary conduct, or whether their conduct falls outside of exclusionary language, is already the subject of extensive litigation. These issues are complicated by entry of the insured corporation into bankruptcy, where these issues can become subject to the automatic stay. Whether a case remains in state or federal court or is removed to bankruptcy court, it will take years to sort through the blame, to determine the source of the underlying problems, and to ultimately determine which parties will shoulder the burden of the financial losses.



59 of 197 DOCUMENTS

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Land Bank Agreements in Bankruptcy Court

2008 Emerging Issues 69

Land Bank Agreements in Bankruptcy Court

By Publisher's Editorial Staff 2008

October 2, 2008

SUMMARY: This Emerging Issues Commentary examines the rights of the developer and the land banker depending on whether the agreement is found to be an executory contract or the agreement is recharacterized as a loan.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: ARTICLE: Introduction

A land bank agreement (LBA) is a form of alternative financing or, perhaps more accurately, an alternative to financing employed by residential developers. Rather than financing the purchase of land to be developed, a developer will enter into an agreement with another entity, the land banker, who acquires and holds title to the real estate. The use of an LBA decreases the developer's risk because the risk of the mortgage and other incidents of ownership of the real property fall on the land banker. An added benefit to the developer is the fact that the mortgage debt does not appear on the developer's books, because it is held by the land banker. Patricia A. Redmond & Jessica D. Gabel, *The Tip of the Iceberg: What Lies Beneath for Homebuilder Bankruptcies in the Wake of United Airlines*, American 26-9 ABIJ 20 (Nov. 2007).

The land banker makes the mortgage payments on the real property. The LBA typically requires the developer make option payments to the land banker, the amount of which may be measured by, and timed to coincide with, the mortgage payments due. The developer proceeds with development of the property under a "takedown schedule" until all planned units are built and sold. In the event of an uncured default by the developer, the developer's rights in the property and any improvements made are forfeited. Patricia A. Redmond & Jessica D. Gabel, *The Tip of the Iceberg: What Lies Beneath for Homebuilder Bankruptcies in the Wake of United Airlines*, 26-9 ABIJ 20 (Nov. 2007). No foreclosure would be required because the land banker already holds title.

Why Are LBAs Important Now?

The downturn in the housing market means that developers may be filing for bankruptcy and bringing LBAs before bankruptcy courts. It is unclear if LBAs will be regarded as executory contracts governed by 11 USCS § 365, or if they will be "recharacterized" as disguised loans pursuant to 11 USCS § 105. The rights of debtor developers, the land bankers, and other creditors will vary depending upon which tact is taken by the courts. A typical scenario would be the

filing of a voluntary Chapter 11 reorganization bankruptcy by a developer. If the LBA is advantageous to the developer, it will be assumed as an executory contract and the land banker's rights are relatively unaffected. If the LBA is unprofitable, the developer will likely reject the LBA as an executory contract. A somewhat different scenario will be presented if the developer or an appointed trustee claims that the LBA is actually a financing arrangement that created a debtor/creditor relationship between the parties. In such a case, the developer or trustee would be taking the position that the LBA is actually a secured loan arrangement, thereby enabling the developer to retain the property without curing the default, compensating the land banker for losses, and providing adequate assurances of future performance as required by 11 USCS § 365.

Executory Contracts in Bankruptcy

A contract is considered "executory" if performance remains to be completed on both sides such that failure of either to complete performance would be a material breach that excused the other party's complete performance. *Counties Contracting & Constr. Co. v. Constitution Life Ins. Co.*, 855 F.2d 1054 (3d Cir. 1988). An LBA would seem to fit this definition if a bankruptcy occurs at any time prior to completion of the development and sale of all lots. Executory contracts in bankruptcy are governed by *Section 365 of the Bankruptcy Code*, 11 USCS § 365, which allow a Chapter 7 trustee, or a Chapter 11 debtor-in-possession, to assume or reject such contracts, 11 USCS § 365(a).

Time and Procedure for Assumption or Rejection

A Chapter 7 trustee must assume or reject an executory contract within 60 days or it is deemed to be rejected, unless a longer period is set by the court, 11 USCS § 365(d)(1). Under Chapters 9, 11, 12, or 13, an executory contract may be assumed or rejected at any time prior to confirmation of a plan, but a party to the contract may ask the court to set a time for assumption or rejection, 11 USCS § 365(d)(2). Proceedings concerning rejection or assumption of executory contracts are governed by Bankruptcy Rule 6006, which references Bankruptcy Rule 9014, meaning that proceedings to assign or reject an executory contract other than as part of a plan, or to compel a trustee to act within a certain time, are contested matters initiated by motion. An attempt to recharacterize an LBA as a secured loan transaction requires an adversary proceeding.

Rights of the Parties upon Assumption

Although bankruptcy gives the developer an opportunity to get out of an LBA or other executory contract that has proved to be unprofitable, assumption will be the preferable route for the land banker in most cases.

If the LBA is to be assumed as an executory contract, the debtor/developer or its trustee must:

Cure any default or provide adequate assurance of a prompt cure, 11 USCS § 365(b)(1)(A);

Compensate the non-bankruptcy party for any actual pecuniary loss resulting from the default, 11 USCS § 365(b)(1)(B);

Provide adequate assurance of future performance under the contract, 11 USCS § 365(b)(1)(C).

Another provision important to the non-bankrupt party to an LBA is 11 USCS § 365(e), which prevents modification of executory contracts in bankruptcy.

Rights upon Rejection

If the debtor or developer is in trouble and unable to fulfill the requirements of the LBA, rejection will be the result. However, a debtor and developer has the incentive to act quickly because an executory contract must be performed until it is assumed or rejected, 11 USCS § 365(d)(3). If the LBA is to be rejected, the debtor and developer must surrender the

property, *United Air Lines, Inc. v. HSBC Bank USA (In re United Air Lines, Inc.)*, 453 F.3d 463 (7th Cir. 2006), which means the land banker will obtain the benefits of any improvements made and is free to dispose of the real estate unencumbered by any interest of the debtor, developer, or a trustee in bankruptcy.

Remedies of a Loan Creditor

As long as an LBA is treated as an executory contract, the non-bankrupt land banker will be relatively well-positioned in the event of a developer's bankruptcy. If, however, the LBA is recharacterized and treated as a loan, the rights of the land banker are very different.

If the LBA is construed as a loan and the land banker is considered a loan creditor, the land banker would have to file a claim to receive any compensation for damages resulting from the builder's default. This is in contrast to the affirmative duty to cure any default and to compensate the land banker for any losses if the LBA is considered to be an executory contract that is to be assumed.

Furthermore, the land banker's claim may be unsecured, at least in part, depending on the value of the collateral. If the transaction is construed as a loan from the land banker to the developer, the land banker's interest in the real property may also be subject to administration by the bankruptcy trustee. Unlike an executory contract that is protected from modification, even the LBA itself could be subject to modification of its terms and conditions of payment under a confirmed plan.

The Threat of Recharacterization

Court Authority to Recharacterize an LBA

The power of a bankruptcy court to recharacterize an LBA as a loan is based on 11 USCS § 105. This statute has been construed to confer general equitable powers on the Bankruptcy Court as necessary to carry out the other provisions of the *Bankruptcy Code*. *Miller v. Farmers Home Admin. (In re Miller)*, 16 F.3d 240 (8th Cir. 1994). Although the statute gives the Bankruptcy Court general equitable powers, it does not confer substantive rights, *Miller v. Farmers Home Admin. (In re Miller)*, 16 F.3d 240 (8th Cir. 1994), and it merely gives power to enforce other provisions of the *Bankruptcy Code*, *In re GGC Assocs.*, 178 B.R. 862 (Bankr. D. Fla. 1995).

The power to recharacterize an executory contract such as an LBA as a loan is based on the Bankruptcy Court's power over property of the estate, 11 USCS § 541, and creditors' claims, *Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 748 (6th Cir. 2001). Recharacterization can take place in a variety of contexts, such as recharacterization of debt as an equity contribution, 56 *Wash & Lee L. Rev.* 689, 715. Because recharacterization turns on whether a debt actually exists, *Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001), there is no reason why the process could not be applied to a challenge as to whether an executory contract actually exists, or whether it is actually a loan. As a court of equity, a bankruptcy court has the power to determine the true nature of a transaction, but bankruptcy courts should use their equitable powers sparingly. *Mirant Mid-Atlantic, LLC v. Morgantown OL1 LLC (In re Mirant Corp.)*, 327 B.R. 262 (Bankr. D. Tex. 2005).

Recharacterization Cases

Recharacterization has also been employed to "lease" transactions involving personal property, which were deemed to be disguised security interests instead, *In re G. A. Giancaterin & Associates, Inc.*, 9 B.R. 26 (Bankr. D.N.Y. 1981), *In re Tillery*, 571 F.2d 1361, 1363 (5th Cir.-OLD 1978). As to leases of real property, decisions are varied. In *Mirant Mid-Atlantic, LLC v. Morgantown OL1 LLC (In re Mirant Corp.)*, 327 B.R. 262 (Bankr. D. Tex. 2005), the court found no basis for recharacterizing real property leases as a debtor/creditor relationship. In *Westship, Inc. v. Trident Shipworks, Inc.*, 247 B.R. 856, 863 (D. Fla. 2000), the court found that the leases of real property were true leases, not security instruments for a sale, and noted that the most significant factor was whether the lessor retained a residual interest in the property at the end of the lease. The posture of such cases is closely analogous to an executory contract

such as an LBA, because executory contracts are given much the same treatment was unexpired leases under 11 USCS § 365.

Finding that a sale or lease-back of real property was not a true lease, but was in fact a financing arrangement, the court in *Big Buck Brewery & Steakhouse, Inc. v. Eyde* (*In re Big Buck Brewery & Steakhouse, Inc.*), 2005 U.S. Dist. LEXIS 10754 (D. Mich. 2005), looked at three factors: (1) whether the transaction actually transferred the risks and responsibilities of a landlord to the lessor; (2) whether the payments under the lease were designed to compensate the lessor for the use of the property, or rather, reflected the repayment of the lessor's acquisition costs plus interest; and (3) whether the lessor retained a significant interest in the property.

Controlling Law in Recharacterization Cases

Property interests are generally defined by state law, not federal bankruptcy law. A federal bankruptcy court should ensure that a property interest receives, in federal bankruptcy court, the same protection it would receive under state law if no bankruptcy had occurred. *Butner v. United States*, 440 U.S. 48 (U.S. 1979). Therefore, whether a transaction is a bona fide lease, executory contract, or a disguised financing instrument is a matter for state law to determine. *In re Nite Lite Inns*, 13 B.R. 900, 908 (Bankr. D. Cal. 1981).

The United Airlines Cases

The application of state law explains the different results reached in the same court in the same case, considering multiple leases entered into by United Airlines. In all three cases, municipal bond authorities sold bonds and provided the funds to the airline to construct facilities at the airports. The airline agreed to retire the bonds. Rent payments from the airlines represented repayment of the loaned funds. In the two cases involving leases on airport property in California, the 7th Circuit accepted the claim that the leases were actually loan transactions. *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 610 (7th Cir. 2005) (UAL San Francisco); *In re United Airlines*, 447 F.3d 504 (7th Cir. 2006) (UAL Los Angeles). This enabled the airline to continue operating without having to comply with the requirements for assumption of the leases, including curing any defaults. The court approached each case with two consistent principles: (1) case law required the courts to examine and base the decision on the substance of a transaction over its form, and (2) state law governed the substance of the transaction.

It was this second principle and a factual difference that resulted in the different result in the third case, *United Air Lines, Inc. v. HSBC Bank USA* (*In re United Air Lines, Inc.*), 453 F.3d 463 (7th Cir. 2006) (UAL Denver). In the third case, Colorado law applied rather than California law, which governed the first two. In the Colorado case, there was a single agreement that included elements of a ground lease and a lease of facilities that were to be constructed with the bond proceeds. The ground lease portion was conceded to be a true lease. Because Colorado law prohibited severing the ground lease provisions from the facilities lease, the entire agreement was considered to be a true lease. By contrast, in the California cases, there were separate agreements for the ground lease and the facilities lease.

Factors to be Considered

Although severability was the deciding factor in the UAL Denver case, a number of factors were discussed by the court leading to its decisions in the UAL San Francisco and UAL Los Angeles cases. In determining if a lease was a true lease or a financing arrangement, the court looked at:

Are payments based on the market value of the real property or a dollar amount?

Does the agreement contain a "hell or high water clause" requiring payment even if the property is unusable?

Does the agreement provide for reversion?

Does the agreement contain a balloon payment?

Does the agreement contain a pre-payment provision?

Is the property being developed the same property for which payments are made?

Discussion of Factors Considered

In the California cases, the court noted that the "rent" payments were based on the interest payable on the bonds that were issued to finance construction of the facilities, not the rental value of the property. This indicated that the transaction was a loan rather than a true lease. The existence of a balloon payment at the end of the lease term equal to the principal amount raised by the bonds and provided to the airline also indicated that this was a loan, not a lease, since balloon payments were typical provisions of loans but not of leases. The lease documents also contained "hell or high water clauses," which required payments to continue in all circumstances, even in the event that the property was unusable for any reason. Again, this would be typical of a loan, but not of a lease, which would generally permit a lessee to terminate a lease if the leased property became unusable for the purpose intended. If the lease document fails to provide for a reversion of the property to the lessor at the end of the lease, or allows the lessee to purchase it for a nominal sum, this indicates that the transaction was a loan disguised as a lease because a lender would normally not have any right or interest in the property upon completion of the payment schedule. The existence of a pre-payment provision was also found to be indicative of a loan transaction, because lease payments are typically spread out evenly over the term of the lease, while loan transactions often contain pre-payment provisions.

Conclusion

While the treatment of LBA in bankruptcy is far from certain, it is clear that they may be subject to recharacterization claims just as leases have been. An attorney representing a land banker under such an agreement should advise the client of the possibility that what seemed a straightforward agreement could end up in cutting edge litigation. In order to avoid the possibility of recharacterization, the parties' intent should be clearly expressed that the transaction is not considered to be loan. The draftsman should take care to avoid the factors that would result in recharacterization. If the developer does file for bankruptcy protection, the land banker's counsel should consult with a bankruptcy practitioner. Negotiation with the debtor and developer, even working out a compromise on the requirements for curing the default on an executory contract would be preferable to facing a recharacterization challenge. In the event of such a challenge, however, the land banker should be prepared with appraisals of the property in order to prove that the claim is secured to the maximum extent possible if it is found to be a disguised loan.

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60 of 197 DOCUMENTS

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Creditor Duty to Update Credit Report

2008 Emerging Issues 84

Creditor Duty to Update Credit Report

By Publisher's Editorial Staff 2008

October 2, 2008

SUMMARY: This Emerging Issues Commentary examines credit reporting and the relevant litigation along with proposed legislation.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: ARTICLE: Introduction

Robert Smith never managed his finances well. Robert earned a decent wage, but his spending was out of control and it had been for many years. Although he continued in his efforts to repay his substantial debts, it never seemed as though he made any measurable headway. Eventually, Robert was not able to make even the minimum payments on his numerous credit cards. Robert sought bankruptcy relief in 2003. Now, in 2007, Robert still cannot obtain credit. Just last month, four creditors turned down his applications for credit cards. When Robert recently reviewed his credit report, he noticed that his old debts remained on it. In fact, the old debts still reflected a "past due" status, even though the balance as to each debt was reported as a zero balance. Although filing for bankruptcy relief helped Robert, he wondered how he would ever again obtain credit.

In recent years, record numbers of consumers have sought a financial "fresh start" by seeking relief under either Chapter 7 or Chapter 13 of the Bankruptcy Code. In 2005, consumers initiated more than 2 million bankruptcy filings. While the number of bankruptcy filings fell significantly in 2006, the number of filings is again on the rise for 2007. Based on current economic conditions, including the increase in consumer defaults on sub-prime mortgage loans, it is likely that the number of bankruptcy filings will continue to increase in the coming years. Many consumers find, however, that the concept of a "fresh start" guaranteed by the Bankruptcy Code eludes them even after they seek bankruptcy relief. Quite often, creditors continue to report derogatory tradelines, as well as judgments that have been discharged in a bankruptcy proceeding. The significance of a strong credit report is indisputable. It is not possible to obtain a mortgage loan, an automobile loan, an education loan, or even a small personal loan, without a creditor conducting a credit check. Once a consumer initiates a bankruptcy proceeding and a creditor receives notice of it, what are the creditor's reporting obligations?

Bankruptcy Filing

A consumer may seek relief under either Chapter 7 or Chapter 13 of the Bankruptcy Code. A Chapter 7 bankruptcy, initiated pursuant to *11 USCS § 701* et seq., is often referred to as a "straight" bankruptcy and allows a consumer to liquidate his or her debts. The end result of a Chapter 7 filing is that the consumer is relieved of all dischargeable debts at the completion of the bankruptcy proceeding. In a bankruptcy filed under Chapter 7, *11 USCS § 727* sets forth the heart of the "fresh start" concept. Pursuant to § 727(a), the court must grant a consumer a discharge unless one of eight conditions is met. Chapter 13 of the Bankruptcy Code, *11 USCS § 1301* et seq., affords relief to consumers with some ability to repay their debts and is commonly referred to as a "wage-earner plan." Under Chapter 13, a consumer makes payments on his or her debts based on a court-approved plan. Upon completion of the plan, the consumer receives a discharge similar to that afforded under Chapter 7. Chapter 13 contemplates a similar "fresh start" for the consumer. Accordingly, whether a consumer files under Chapter 7 or under Chapter 13, the Bankruptcy Code contemplates that the financially-distressed debtor will receive a "fresh start" at the close of the bankruptcy proceeding.

Credit Reporting

The federal statute that governs credit reporting is the Fair Credit Reporting Act (FCRA), *15 USCS § 1681* et seq. The statute provides for the accuracy and fairness of credit reporting. Of particular relevance is § 1681(b):

Reasonable procedures. It is the purpose of this *title [15 USCS §§ 1681 et seq.]* to require that consumer reporting agencies adopt reasonable procedures for meeting the needs of commerce for consumer credit, personnel, insurance, and other information in a manner which is fair and equitable to the consumer, with regard to the confidentiality, accuracy, relevancy, and proper utilization of such information in accordance with the requirements of this *title [15 USCS §§ 1681 et seq.]*.

Creditors provide information on consumer debts to three credit reporting agencies:

Experian (<http://www.experian.com>)

TransUnion (<http://www.transunion.com>)

Equifax Credit Information Service (<http://www.equifax.com>).

The agencies collect the information about a consumer's debts and about how a consumer pays his or her debts, including whether debts are paid on time and whether a creditor ever took adverse action against the consumer in an effort to collect a debt. The credit reporting agencies then produce credit reports which set forth a compilation of all of the information available on a given consumer.

The FCRA sets forth limitations on the amount of time a credit reporting agency may report adverse information on a credit report. Generally, a bankruptcy may be reported for a period of 10 years; however, all other negative information may remain on the report for a period of 7 years only. *15 USCS § 1681c*. In the event a consumer initiates a bankruptcy proceeding and then voluntarily dismisses it prior to discharge, the credit reporting agency must report both the bankruptcy filing and the dismissal.

Often, when a consumer initiates a bankruptcy proceeding, creditors fail to report an update in status for discharged accounts or continue to report the same status and balance reported prior to the consumer's discharge. In other words, if a creditor reported an account as 120 days past due at the time it received notice of the consumer's bankruptcy filing, the creditor may simply change its internal coding to reflect the bankruptcy and note its records to discontinue any efforts to collect the debt in order to avoid a violation of the automatic stay provisions of the Bankruptcy Code, *11 USCS § 362*. After the internal re-coding, the creditor may never again report anything on the account to any of the three credit reporting agencies. Absent updated information, the credit reporting agencies often report the last known status and balance or, in this example, an account status of 120 days past due. Worse yet, some creditors continue to report a debt after discharge of the debt in a bankruptcy proceeding in an effort to unlawfully collect the debt. Such practices have become the source of extensive litigation.

Review of Relevant Litigation

While the FCRA provides creditors with some guidance as to the length of time negative information may be reported to credit reporting agencies and provides remedies for a creditor's non-compliance, the Bankruptcy Code is silent on the issue. To the extent that inaccurate credit reporting has been litigated, it has largely related to the question of whether inaccurate credit reporting, during the post-petition stage, violates either the automatic stay provisions of the Bankruptcy Code, 11 USCS § 362, or the Code's guarantee of a discharge upon completion of the proceedings, 11 USCS § 524.

In the case of *In re Sommersdorf*, 139 B.R. 700 (Bankr. S.D. Ohio 1992), a consumer initiated bankruptcy proceedings under Chapter 13 of the Bankruptcy Code. In accordance with the plan, the consumer agreed to make 100 percent repayment of a debt to the creditor at issue. Nevertheless, the creditor furnished the credit reporting agencies with information as to the consumer, as well as the consumer's co-obligor, that the debt had been charged off as a result of the consumer's bankruptcy. The court held that such action on the part of the creditor constituted a "flagrant" violation of the automatic stay provisions of the Bankruptcy Code, particularly in light of the fact that the consumer agreed to 100 percent repayment of the debt. In reaching its decision, the court noted that "[s]uch a notation on a credit report is, in fact, just the type of creditor shenanigans intended to be prohibited by the automatic stay." *Id.* at 701. Following the *Sommersdorf* decision, numerous other cases have addressed the same issue.

Most recently, several cases have considered whether furnishing credit information constituted an attempt to collect a debt in violation of either § 362 or § 524. Courts have held that credit reporting in and of itself, that is a creditor's failure to provide updated information to credit reporting agencies with regard to a consumer's bankruptcy, does not constitute a violation of either § 362 or § 524. *Bruno v. First USA Bank, N.A. (In re Bruno)*, 356 B.R. 89, 92 (Bankr. W.D.N.Y. 2006); *Irby v. Fashion Bug (In re Irby)*, 337 B.R. 293, 295 (Bankr. N.D. Ohio 2005); *In re Goodfellow*, 298 B.R. 358 (Bankr. D. Iowa 2003); *Vogt v. Dynamic Recovery Servs. (In re Vogt)*, 257 B.R. 65 (Bankr. D. Colo. 2000); *Singley v. American Gen. Fin. (In re Singley)*, 233 B.R. 170 (Bankr. S.D. Ga. 1999). In all of the cases cited, there was some other action on the part of the creditor, such as collection efforts, beyond merely reporting or failing to report information concerning the consumer's bankruptcy.

Presently, two related cases are pending which squarely address claims by consumers against credit reporting agencies based on the agencies' failure to update reported information concerning the consumers' bankruptcies: *White v. Trans Union, LLC*, 462 F. Supp. 2d 1079 (C.D. Cal. 2006) and *Acosta v. Trans Union, LLC*, 240 F.R.D. 564 (C.D. Cal. 2007).

In *White*, the consumers sought relief under the Fair Credit Reporting Act (FCRA), 15 USCS § 1681e(b), 15 USCS § 1681i(a), the California Consumer Credit Reporting Agency Act (CCRAA), Cal Civ Code § 1785.14(b), Cal Civ Code § 1785.16, and California's Unfair Competition Law (UCL), Cal Bus & Prof Code § 17200 et seq. With regard to each of the consumers named in the litigation, the credit reporting agency erroneously reported the consumers' discharged debts as due and owing on the consumer's credit report. The consumers initiated the class action litigation on behalf of themselves, as well as other similarly situated consumers. The credit reporting agency contended that the consumers failed to state a cause of action upon which relief could be granted and sought dismissal under USCS Fed Rules Civ Proc R 12(b)(6). On October 13, 2006, the United States District Court for the Central District of California denied the motion. The outcome of the litigation has yet to be determined by the court.

In the related case of *Acosta*, the proposed class of consumers presented similar claims before the same court adjudicating the *White* litigation referenced above. The consumers sought an order granting approval of their class, preliminary approval of the class action settlement, appointment of a class representative, appointment of class counsel, approval of notice and claim forms, scheduling of the final fairness hearing, and consolidation of *Acosta* with yet another case for settlement. On May 31, 2007, the court denied approval of the proposed class and denied approval of the proposed settlement. The court also held that because the other relief sought by the consumers was dependent upon the court's approval of the proposed class and the proposed settlement, the court denied the remaining requests for relief.

sought by the consumers.

When the United States District Court for the Central District of California reaches the merits of either the *White* or *Acosta* cases, the court may provide some guidance as to how similar claims will be dealt with in the future.

Review of Proposed Legislation

In the present Congress, several pieces of legislation deal with the FCRA; notably, however, the bills do not address the issue of whether a creditor's failure to report updated information concerning a consumer's bankruptcy violates the consumer's right to a "fresh start" as contemplated by the Bankruptcy Code. Furthermore, no relevant amendments to the federal regulatory schematic have been introduced at this time. The same is true on the state level.

Without a doubt, the issue of credit reporting agencies accurately reporting information concerning a consumer's bankruptcy will continue to be a serious concern and a source of litigation. Presently, consumer advocacy groups such as the National Consumer Law Center and the National Association of Consumer Advocates are encouraging consumers to litigate claims against credit reporting agencies for inaccurate reporting. Moreover, many attorneys now specialize in litigating such claims on behalf of consumers. For creditors and credit reporting agencies, the most prudent approach at this point is to report current, accurate information with regard to a consumer's account status during the pre-petition stage, as well as the post-petition stage.

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61 of 197 DOCUMENTS

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Bankruptcy Trustee Suits Against Law Firms

2008 Emerging Issues 86

Bankruptcy Trustee Suits Against Law Firms

By Publisher's Editorial Staff 2008

October 2, 2008

SUMMARY: This Emerging Issues Commentary examines the claims that lawyers may be subject to including malpractice, negligence in the form of deepening insolvency, aiding and abetting, breach of fiduciary duties by corporate management, and conspiracy. Also examined are the defenses of the Wagoner Rule, in pari delicto, the business judgment rule, and the incentives to settle.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: ARTICLE: Introduction

Law suits by bankruptcy trustees, who oversee a bankrupt company's estate, against the law firms representing debtors are growing. Since these suits benefit creditors, which are usually banks and investment funds, there is more aggressive litigation in an attempt to recoup losses. Claims for professional malpractice, negligence, aiding and abetting of breach of fiduciary duties, and civil conspiracy may be brought against debtors' complicit professional advisors.

In the wake of major bankruptcy cases and scandals involving corporations such as Enron, DVI, Inc., and Refco, Inc., lawyers must pay attention to the escalation of such suits against them. It has been found that even sham corporations may have interests separate from their promoters such that they may suffer injuries cognizable for the purpose of standing in such suits. *Lifeblood Biomedical, Inc., Opt-In Trust v. Mann (In re Sender)*, 423 F. Supp. 2d 1155, 1172 (D. Colo. 2006).

Some courts have come to the conclusion that the remote chance that a debtor might receive distribution of estate property should not deter the more fundamental policy of allowing a bankruptcy trustee to maximize the value of the estate so claims against it can be paid as fully as possible. *Logan v. JKV Real Estate Servs. (In re Bogdan)*, 414 F.3d 507, 515 (4th Cir. 2005). In order to do just that, many bankruptcy trustees are looking to the deeper pockets of law firms and other professional advisors or their debtors.

Applicable Statutes

11 U.S.C.S. § 704

Under *11 USCS § 704(a)(1)*, a bankruptcy trustee has a duty to collect and reduce to money the property of the

debtor's estate. *Moratzka v. Morris (In re Senior Cottages of Am., LLC)*, 482 F.3d 997 (8th Cir. 2007). The trustee has standing under § 704 to assert causes of action belonging to the debtor at time of filing of the bankruptcy petition.

11 U.S.C.S. § 541

This statute provides that the bankruptcy trustee succeeds to the rights of the debtor and has standing to bring any suit that the debtor could have brought outside of bankruptcy. The Bankruptcy Code provides that property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 USCS § 541(a)(1). Legal interests or equitable interests include any causes of action the debtor may have had at the time the bankruptcy petition was filed, as well as any interest acquired after commencement of the suit under § 541(a)(7), such as assignments of claims by creditors to the bankruptcy trustee. *Luzinski v. Peabody & Arnold LLP (In re Gosman)*, 2007 Bankr. LEXIS 899 (Bankr. D. Fla. 2007); *Logan*, 414 F.3d 507.

11 U.S.C.S. § 544

Under 11 USCS § 544, a bankruptcy trustee has standing to pursue derivative claims on behalf of creditors of the debtor. The Eighth, Ninth, and Eleventh Circuits construe this power narrowly, holding that a trustee lacks standing to assert claims for damages on behalf of the debtor's creditors. The Second, Fifth, and Seventh Circuits take a more expansive view. *Hill v. Gibson Dunn & Crutcher, LLP (In re MS55, Inc.)*, 2007 U.S. Dist. LEXIS 65791 (D. Colo. 2007). When a trustee chooses to act under § 544, the trustee may invoke the state law remedies provided to judgment lien creditors to satisfy judgments against the debtor. *Lifblood Biomedical, Inc.*, 423 F. Supp. 2d at 1172, *supra*.

Choice of § 541 or § 544

Whether a bankruptcy trustee can bring an action pursuant to either statute depends on the nature of the claim asserted. What a trustee must do to support his claims differs depending on the statute. If making a claim under § 541, the trustee must allege that the debtor was injured and the trustee is asserting rights on the debtor's behalf. If making a claim under § 544, he must assert that a hypothetical judgment lien creditor was injured, and the trustee is asserting rights on the creditor's behalf. *Hill v. Gibson Dunn & Crutcher, supra*. If a trustee takes unconditional assignments from creditors, the trustee must remember that as an assignee, he makes the claim on behalf of the estate, not the creditors. *Logan*, 414 F.3d at 511, *supra*.

Potential Claims Against Law Firms

Malpractice

Legal malpractice is characterized as a failure to perform. Steve H. Nickles, *Behavioral Effect of New Bankruptcy Law on Management and Lawyers: Collage of Recent Statutes and Cases Discouraging Chapter 11 Bankruptcy*, 59 Ark. L. Rev. 329, 392 (2006). A claim of malpractice that arose during the performance of services for a debtor or a debtor in possession in a chapter 11 proceeding is property of the bankruptcy estate because the debtor had a cognizable interest in the claim and the time of filing. *Maxfield v. Quarles & Brady LLP (In re Jennings)*, 2006 Bankr. LEXIS 4481 (Bankr. D. Fla. 2006); *Helbling v. Josselson (In re Almasri)*, 2007 Bankr. LEXIS 3973 (Bankr. D. Ohio 2007). The bankruptcy trustee is the right party to assert malpractice against the debtor's lawyers. *Moratzka*, 482 F.3d at 1006, *supra*.

Breach of Fiduciary Duties

Breach of fiduciary duties is characterized as failure to give undivided loyalty. Nickles, 59 Ark. L. Rev. at 392, *supra*. Corporate attorneys owe professional duties to their corporate client, not the corporation's management. If the management breaches fiduciary duties to the corporation, lawyers risk breaching duties to the corporation by not protecting the corporation. *Id.* at 389. When the corporation becomes insolvent, fiduciary duty expands to the corporation's creditors. Lawyers' liability exposure derives from the corporation's spiraling descent into insolvency.

Douglas R. Richmond, et al., *Lawyer Liability and the Vortex of Deepening Insolvency*, 51 *St. Louis L.J.* 127 (Fall 2006).

The Tenth Circuit implicitly found that bankruptcy trustees have standing to bring actions of breach of fiduciary duty when it barred a creditor from bringing such action. *Hill v. Gibson Dunn & Crutcher*, *supra*.

Aiding and Abetting

Liability for aiding and abetting is based solely on duty the attorney's client owes to creditors. Therefore, absolution of malpractice does not preclude a finding of aiding and abetting, even though the same piece of legal advice is at the center of both claims. Michael David Delcour, *Colorado Lawyers Beware: Anstine v. Alexander and the Attorney's New Duty to Non-Clients*, 78 *U. Colo. L. Rev.* 989, 995 (Summer 2007). Further, if a debtor owned a cause of action against a principal who breached a duty, it also owns a cause of action against its lawyers for aiding and abetting that breach. *Moratzka*, 482 *F.3d* at 1002.

This claim is based on state law. Under Colorado law, for example, a creditor may bring a breach of fiduciary duty claim against a director of a debtor corporation; therefore, there is no bar to an aiding and abetting or civil conspiracy claim against the debtor's counsel for their assistance in that breach. *Hill v. Gibson Dunn & Crutcher*, *supra*. However, Georgia does not recognize an aiding and abetting breach of fiduciary duties claim, *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 *F.3d* 1145 (11th Cir. 2006); and Pennsylvania does not recognize aiding and abetting fraud, *Buckley v. Deloitte & Touche USA LLP*, 2007 *U.S. Dist. LEXIS* 37107 (S.D.N.Y. 2007). Claims akin to aiding and abetting and deepening insolvency seem not to be a debtor's claim under New York law; it is owned by creditors. *Wallach v. McDermott, Will & Every (In re Promedica Health Group, LLP)*, 359 *B.R.* 45 (Bankr. W.D.N.Y. 2006).

Deepening Insolvency

Deepening insolvency is described as an injury to a debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life. A lawyer's liability derives from debtor's spiraling descent into insolvency. "When a corporation enters the zone of insolvency or becomes insolvent, its directors' and officers' fiduciary duties expand to include creditors. The directors and officers are obligated to protect creditors' financial interest in the company. If through fraud or other tortious conduct they prolong the company's life beyond insolvency and harm the creditors by increasing the corporation's debt or by dissipating its assets, liability may follow on a 'deepening insolvency' theory." Richmond, 51 *St. Louis L.J.* 127, *supra*.

Deepening insolvency potentially sucks in a debtor's lawyers through allegations that they aided and abetted the directors' and officers' breach of fiduciary duties or that they conspired with them to accomplish unlawful purposes. *Id.* at 128. This is not a clearly defined or limited tort claim. It seeks to hold lawyers liable to non-clients to whom they otherwise owe no duties and whose interests may conflict with the lawyer's corporate client.

Deepening insolvency is a matter of state law and is not universally recognized. Courts that do recognize it tend to treat it in one of two ways. First, it can be a theory of damages by which damages are measured by the failed corporation's increased debt or by the dissipation of its assets after the time it became insolvent. *Id.* at 131. Second, it can be treated as a separate cause of action. The Third Circuit found that Pennsylvania would recognize a theory of deepening insolvency as a cause of action because it may give rise to a cognizable injury. *Id.* at 136.

Courts that have rejected this theory have found directors and officers negligent, but good faith decisions to operate an insolvent business will not expose them to liability on a deepening insolvency theory. The business judgment rule applies to negate any liability. *Id.* at 145.

Other problems with deepening insolvency as a tort claim include proximate cause and foreseeability. Lawyers are not guarantors of clients' business judgments. This turns causation into speculation, which, given that proximate cause is

an essential element of all tort claims, defeats a deepening insolvency tort claim. Further, lawyers acting in line with ethical and professional mandates cannot be said to have foreseen an injury if the business fails.

To avoid liability under a deepening insolvency claim, it is recommended that lawyers document interactions with the management and shareholders of their corporate clients, and diligently follow through on troublesome developments. Lawyers should be especially careful to communicate to corporate clients all options for addressing particular situations and document all communications carefully and accurately. Any forewarnings must be fair, informed, and reliable. Lawyers should encourage detailed board minutes, and be sensitive to insider dealing or fraud. If the lawyer's lawful advice to avoid self-dealing or fraud goes unheeded, the lawyer may need to report up the ladder, to a court, or withdraw representation.

Defenses

Wagoner Rule

The Wagoner rule is a rule of standing. It states that "when a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee [lacks standing to] . . . recover against the third party for the damage to the creditors." *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991). Under this rule, inquiry begins in determining whether a bankruptcy trustee's cause of action is grounded in what the third party defendant had allegedly done to injure the innocent debtor. *Wallach v. McDermott*, *supra*.

The opposing inquiry is whether the wrongdoing the trustee complains of arose when the third party defendant acted in concert with the entity that later became the debtor. In that setting, the trustee lacks standing because of wrongdoing imputed to the debtor, and the claim against third parties for defrauding debtor with cooperation of management accrues to creditors only. *Id.* "'Johnny-Come-Lately' attestations by insiders to the effect that they would have been 'Whistle Blowers' or would have otherwise sought to prevent harm to the Debtor's creditors cannot be permitted to establish 'standing' in this Debtor (and therefore in the Chapter 7 Trustee) to overcome a Wagoner Defense." *Id.*

In Pari Delicto

Senate and House Reports accompanying the Bankruptcy Reform Act of 1978 suggest that Congress did intend for defenses like *in pari delicto* to follow causes of action into the debtor's estate. *Claybrook v. Broad & Cassel, P.A. (In re Scott Acquisition Corp.)*, 364 B.R. 562 (Bankr. D. Del. 2007); *Buckley v. Deloitte & Touche*, *supra*. The Tenth Circuit concluded that a bankruptcy trustee is subject to all defenses that could have been asserted against the debtor. *Mosier v. Ray Quinney & Nebeker, P.C.*, 2007 U.S. Dist. LEXIS 67599 (D. Utah 2007).

The *in pari delicto* doctrine is the main, and most successful, defense against bankruptcy trustee suits. It is based on basic principles of agency law, which state that the actions of an agent acting within the scope of his employment are imputed to the principle. It applies "to prevent culpable parties from benefitting from their wrongdoings, and to ensure that courts do not lend their good offices to mediating disputes among wrongdoers." *Claybrook v. Broad & Cassel*, *supra*. Insofar as a debtor corporation's officers' wrongdoing is imputed to the debtor, the debtor itself is guilty of the wrongdoing and claims by or on behalf of the debtor are subject to the *in pari delicto* defense.

This doctrine is equitable, not absolute, and not applied blindly regardless of circumstances. Courts have discretion whether to apply the defense in any particular situation. *Buckley v. Deloitte & Touche*, *supra*. Courts may apply *in pari delicto* where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public. *Id.* The doctrine generally bars a trustee from bringing claims on behalf of a debtor against a third party in a ponzi scheme situation. *Lifeblood Biomedical, Inc.*, 423 F. Supp. 2d at 1174; *Mosier*, 2007 U.S. Dist. LEXIS 67599, at 2. Where *in pari delicto* applies because of imputation of wrongdoing, the debtor did not possess the cause of action when bankruptcy commenced. *Luzinski*, 2007 Bankr. LEXIS

899 at 7-8.

While the doctrine applies to claims a bankruptcy trustee brings on behalf of the debtor, it does not apply to claims brought on behalf of creditors because creditors are not culpable for the misconduct of the debtor or its management. *Lifeblood Biomedical, Inc.*, 423 F. Supp. 2d at 1174.

Some courts are realizing that it is unfair to knock out claims on the basis of *in pari delicto*. In *Buckley v. Clifford Chance*, (E.D. Pa.) (06-CV-1003), the court declined to dismiss on *in pari delicto* grounds, citing the adverse interest exception. The adverse interest exception is a narrow one and applies only when the agent has totally abandoned the principal's interests. This exception cannot be invoked merely because the agent has a conflict of interest or because he is not acting primarily for his principal. The fact that the predominant motive of the agent is to benefit himself or a third person does not prevent the act from being within the scope of employment. Jonathan Witmer-Rich & Mark Herrmann, *Corporate Complicity Claims: Why There Is No Innocent Decision-Maker Exception to Imputing an Officer's Wrongdoing to a Bankrupt Corporation*, 74 Tenn. L. Rev. 47, 60 (Fall 2006). Management misconduct will not be imputed to the corporation if the wrongdoing officer acted entirely in his own interests and adversely to those of the corporation. *Claybrook v. Broad & Cassel*, *supra*; *Buckley v. Deloitte & Touche*, *supra*.

The adverse interest exception does not apply to cases in which the principal is a corporation and the agent is its sole shareholder. This creates a counter-exception called the sole actor rule. If the agent is the sole representative of the principal, his actions are imputed to the principal notwithstanding adverse interest. *Claybrook v. Broad & Cassel*, *supra*. When the sole actor counter-exception does not apply, the issue of imputation depends upon whether the wrongdoer acted only in his own interests. If his actions benefitted the principal at all, the wrongdoing is imputed to the principal.

Courts apply the sole actor rule to larger business organizations when all relevant shareholders and decisionmakers were involved in the fraud. Courts look to complaints to see whether the plaintiff has alleged an innocent member or management or shareholder who could or would have prevented the fraud had he known. This is known as the innocent decisionmaker exception. Under this exception, *in pari delicto* and the Wagoner rule would not apply if there were someone involved in the debtor's management who was ignorant of the ongoing fraud and could and would, if advised thereof, have taken steps to bring the fraudulent conduct to an end.

Some courts reject the innocent decisionmaker exception as a radical alteration of state law that clearly deviates from traditional agency doctrine. Jonathan Witmer-Rich & Mark Herrmann, 74 Tenn. L. Rev. at 79, *supra*. Other commentators argue that this exception may be doctrinal error because it is inconsistent with the basic principles of agency law underlying imputation. *Id.* at 50. The Tenth Circuit has rejected the doctrine on the grounds that "Congress intended the trustee to stand in the shoes of the debtor and take no greater rights than the debtor himself had." *Mosier v. Callister, Nebeker & McCullough*, 2007 U.S. Dist. LEXIS 75102 (D. Utah Oct. 9, 2007).

Other courts have declined to apply *in pari delicto* in other situations. The Eighth Circuit aligned itself with the First, Third, Fifth, and Eleventh Circuits in holding that *in pari delicto* could not be used at the dismissal stage of a suit. *Moratzka v. Morris*, *supra*. In *Buckley v. Deloitte & Touche*, the U.S. District Court of the Southern District of New York declined to apply the doctrine against tort claims because that would have lessened the deterrence of future wrongdoing. The U.S. District Court for the District of Colorado found that where a debtor was not complicit in conduct that damaged it, *in pari delicto* did not apply. *Lifeblood Biomedical, Inc.*, 423 F. Supp. 2d at 1175, *supra*.

Business Judgment Rule

Lawyers must supervise management of their debtor in possession clients to ensure that management does not obstruct the debtor's performance of its fiduciary duties to creditors. The lawyer must guide management to ensure the debtor properly maintains the estate. Nickles, 59 Ark. L. Rev. at 403, *supra*. The business judgment rule may aid the lawyer in a trustee suit against him, as long as the lawyer has acted lawfully and documented his actions well. The business judgment rule will not protect a lawyer who acted in a fraudulent or self-interested manner. Richmond, 51 St.

Louis L.J. at 156, supra.

The role of the lawyer assisting an insolvent corporation is to promote the corporation's best interests within the limits of his engagement. In doing so, the lawyer gives advice and makes recommendations on less-than-perfect information and often on urgent timetables. If the corporation's fiduciaries approve such advice before any action is taken and are protected against liability for harm caused by their own mistakes of judgment, the lawyer providing such advice deserves the same protection. This defense, however, remains untested.

Incentives to Settle

Getting past a motion to dismiss is often enough incentive to settle. Bankruptcy trustees often have access to multimillion-dollar litigation trusts and attorneys or law firms may not make sympathetic defendants at trial. Such suits are also highly disruptive of a law firm's business and may be damaging to the firm's or lawyer's reputation. Even baseless claims are expensive to defend and harm reputation. Enron's lawyers, Vinson & Elkins, settled with the bankruptcy for \$30 million without any suit being filed against them. Anthony Lin, *Bankruptcy Trustee Suits Cause Increasing Concern for Law Firms*, ___ N.Y.L.J. ___ (Nov. 27, 2007). This is a testament to the strength that such trustee suits have been gaining.

Conclusion

The bankruptcy trustee succeeds to the rights of the debtor and has standing to bring any suit the debtor could have brought outside of bankruptcy. As such suit is considered the property of the estate, and it is the duty of the trustee to maximize the estate assets, trustees are looking more and more at the debtor's professional advisors for potential assets. Therefore, lawyers representing corporate clients must be aware of their potential liability, even to non-clients, if the client slips into insolvency. Depending largely on state law, lawyers can be subject to claims of malpractice, negligence in the form of deepening insolvency, aiding and abetting breach of fiduciary duties by corporate management, and even conspiracy.

While there are defenses to these actions, the main defense of *in pari delicto* appears to be eroding. Although mainly still at the trial court level, courts are beginning to limit or completely reject the use of *in pari delicto* in such suits. As an affirmative defense, it cannot be used at the dismissal stage. Public policy concerns about innocent parties, such as creditors, the bankruptcy trustee, and even the debtor in some circumstances, are figuring into the application of this defense. Further, some courts are recognizing and expanding the use of exceptions to *in pari delicto*, such as the adverse interest exception and innocent decisionmaker exception.

The main defense for lawyers representing insolvent corporations is to take a cover all bases approach. Lawyers need to remember that, while their actions or advice may not be considered malpractice, they may be enough to establish liability for aiding and abetting breach of fiduciary duties. Lawyers should document everything they do and say with regard to their representation, be willing to report wrongdoing, and even end representation if fraud or self-dealing of corporate management becomes an issue.

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62 of 197 DOCUMENTS

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Effect Of Pending Legislation On Chapter 11 Business Bankruptcies

2008 Emerging Issues 87

Effect Of Pending Legislation On Chapter 11 Business Bankruptcies

By Publisher's Editorial Staff 2008

October 2, 2008

SUMMARY: This Emerging Issues Commentary discusses the provisions of the Bankruptcy Code that permit a Chapter 11 debtor to assume or reject an executory contract, case law that permitted the rejection of collective bargaining agreements and their pension plans as executory contracts, legislative changes intended to reverse that case law, and recently proposed legislation.

PDF LINK: Core Emerging Issues Commentary (\$)

ARTICLE: Introduction

According to an article in the September 25, 2007 edition of the Wall Street Journal, (Kris Maher, *Democrats to Push Bill to Protect Workers*), approximately 55,000 steel workers lost their jobs when 42 steel companies declared bankruptcy between 1997 and 2003. In addition, nearly 240,000 steel workers and retirees had their pensions cut when the government took them over, and 200,000 retirees and their spouses lost retiree health benefits entirely. In response to these statistics, unions have complained that notwithstanding the loss of jobs and worker benefits, executive compensation has remained largely protected.

A classic case of executive preservation involved the Chapter 11 bankruptcy filings by K-Mart Corporation in 2002 and by the Enron Corporation in 2001. K-Mart, formerly the nation's second largest discounter, in the months before it declared bankruptcy, loaned \$30 million to nine top executives and approved lucrative executive compensation packages. After the filing, in which 22,000 store employees lost their jobs, K-Mart received bankruptcy court approval to pay up to \$150 million in retention bonuses to its top executives. Enron, which was rife with executive fraud, received court approval to pay up to \$140 million to key employees as retention bonuses -- extra money for not quitting. Enron's employees' pension plan, of course, became worthless because of the fraud. See *Bankrupt Bosses Sitting Pretty*, CNNFN April 18, 2002.

On the heels of the Enron (2001) and K-Mart (2002) preservation filings, was the 2003 bankruptcy filing of U.S. Airways, which terminated its pilots' pension plan as part of its bankruptcy reorganization, and imposed over \$600 million in liabilities on the Pension Benefit Guaranty Corporation (PBGC), the quasi-corporate governmental agency created under the Employee Retirement Income Security Act of 1974 (ERISA), codified at 29 USCS § 1001 to 29 USCS § 1461, to insure pension plans. Chapter 11 bankruptcy was being used with increasing frequency as a tool to enable

corporations to rid themselves of burdensome collective bargaining agreements and employee pension plans, while enabling them to retain top executives' compensation and benefit plans.

The beneficiaries of pension plan terminations in bankruptcy are unsecured and priority creditors who usually receive more than they would have if the debtor's pension plan had been maintained and funded. Although the business creditors may receive reduced value for their claims, they consider the loss as a cost of doing business, and are most likely to recoup the loss by tax write offs and by passing it on to customers. The losers are employees and retirees who have to "take the hit," and who have the most difficult, if not impossible task of recovering from the loss. Executives rarely lose when pension plans are terminated, primarily because many of them receive separate plans from the firms they head. See Theo Francis & Ellen E. Schultz, *Guess Whose Retirement Benefits Aren't Endangered?; Many Companies Set Up Trusts to Protect Huge Pensions for Top Executives*, Wall St. J., Apr. 6, 2003. Note, *At the Crossroads of Three Codes: How Employers Are Using ERISA, the Tax Code, and Bankruptcy to Evade Their Pension Obligations*, 65 Ohio St. L.J. 1577 (2004).

The purpose of this commentary is to explore and discuss: (1) the provisions of the Bankruptcy Code that permit a Chapter 11 debtor to assume or reject an executory contract, (11 USCS § 365); (2) case law that permitted the rejection of collective bargaining agreements and their pension plans as executory contracts, (*NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (U.S. 1984) and its progeny); (3) legislative changes intended to reverse that case law, (11 USCS § 1113 and 11 USCS § 1114); and finally (4) recently proposed legislation, the Protecting Employees and Retirees in Business Bankruptcies Act of 2007, (2007 S. 2092 and 2007 H.R. 3652), a congressional response to perceived blatant abuses of the Bankruptcy Code.

Section 365 of the Bankruptcy Code

In a Chapter 11 bankruptcy reorganization, § 365 of the Bankruptcy Code permits a debtor-in-possession to reject, assume, or assign executory contracts and unexpired leases of the debtor. If there has been a default in an executory contract or unexpired lease of the debtor, the debtor-in-possession may not assume such contract or lease unless, at the time of assumption, the debtor-in-possession cures the default or provides adequate assurance that the default will be promptly cured. 11 USCS § 365(b)(1)(A). For additional substantive discussion concerning the right to assume or reject executory contracts, see 3-365 Collier on Bankruptcy-15th Edition Rev. P 365.03. For discussion of other aspects of the treatment of executory contracts under § 365, see generally, 3-365 Collier on Bankruptcy-15th Edition Rev. 365.syn. Prior to 1984, § 365 was utilized by Chapter 11 debtors-in-possession primarily to assume or reject real and personal property leases, equipment leases, rental-purchase agreements, contracts for goods and services rendered by or for the debtor, and similar types of agreements that were unfulfilled prior to the filing of the petition for relief. Most motions filed under § 365 were of a routine nature. In determining whether certain contracts should be assumed or rejected, the decision rested on the business judgment of the debtor, and upon the assumption of the contract, the debtor was required to comply with subsection (b)(1) of 11 USCS § 365. *In re McLouth Steel Corp.*, 20 B.R. 688 (Bankr. D. Mich. 1982).

National Labor Relations Board v. Bildisco & Bildisco

In 1984, the scope of heretofore permissible unfulfilled contracts that could be assumed or rejected under § 365 was dramatically changed when the United States Supreme Court decided *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (U.S. 1984).

Bildisco & Bildisco, a New Jersey partnership engaged in selling and distributing building supplies, filed a voluntary petition for reorganization on April 14, 1980, under Chapter 11 of the Bankruptcy Code. Bildisco and Local 408 of the Teamsters Union were parties to a collective bargaining agreement that on the date of the petition covered 18 of Bildisco's employees. Subsequently, the debtor-in-possession sought bankruptcy court permission to reject the collective bargaining agreement under subsection (a) of 11 USCS § 365.

The bankruptcy court granted permission to reject, retroactive to the date immediately preceding the date of the petition. The union appealed to the U.S. District Court, which affirmed the rejection order. The case was eventually appealed to the United States Supreme Court. During that process, the National Labor Relations Board (NLRB) was permitted to intervene. The NLRB had ruled, on the union's complaint, that Bildisco's rejection of the collective bargaining contract constituted an unfair labor practice in violation of the National Labor Relations Act in that it had made unilateral changes in the collective bargaining agreement.

The United States Supreme Court upheld the rejection of the collective bargaining agreement. The Supreme Court held that the collective bargaining agreement was an executory contract subject to rejection by the debtor-in-possession, and that Bildisco was not guilty of an unfair labor practice for rejecting the collective bargaining agreement before formal rejection by the bankruptcy court. The Court also held that collective bargaining agreements could be rejected if a debtor could show that the collective bargaining agreement burdened the estate and that after careful scrutiny, the equities balanced in favor of rejecting the labor contract. The *Bildisco* decision opened the doors to employers who sought to reject their labor contracts when the contracts became too burdensome.

The stream of contract rejection matters eventually led to the rejection of pension plans. A 1995 bankruptcy court ruling held that a pension plan could be terminated as an executory contract under 11 USCS § 365 because the termination provisions of Title IV of the Employee Retirement Income Security Act (ERISA) were not exclusive, and a bankruptcy court had jurisdiction over termination because it was requested by a debtor. *In re Bastian Co.*, 45 B.R. 717 (Bankr. D.N.Y. 1985). However, ERISA § 4041(a)(1), 29 USCS § 1341, was added to title IV of ERISA by the Single-Employer Pension Plan Amendments Act of 1986 in order to overturn the decision of *In re Bastion*, which allowed a bankruptcy estate to reject a pension plan as an executory contract. Therefore, ERISA-covered pension plans may generally not be rejected as executory contracts, but rather must be terminated in accordance with the appropriate procedures set forth in *ERISA. Pension Benefit Guar. Corp. v. Pritchard (In re Esco Mfg.)*, 33 F.3d 509 (5th Cir. 1994). For a detailed explanation on how a corporation may terminate multiple pension plans under the "distress test" during reorganization, see 25-8 ABII 26.

Bankruptcy Code §§ 1113 and 1114

Congress reacted to the decision in the *Bildisco* case by adding § 1113 to the *Bankruptcy Code*. 11 USCS § 1113. Section 1113 was signed into law on July 10, 1984 as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984. Section 1113 sets forth the standards and procedures for rejection of collective bargaining agreements in Chapter 11 cases; its use is the only statutory authority for the rejection of a collective bargaining agreement. Section 1113 expressly confirms the obligation of a trustee or debtor-in-possession to adhere to the terms of a collective bargaining agreement unless relieved of that obligation pursuant to § 1113, and it creates an emergency mechanism by which a trustee or debtor-in-possession can seek judicial approval of temporary changes to the terms of a collective bargaining agreement. 7-1113 Collier on Bankruptcy-15th Edition Rev. P 1113.01. The legislative history of this section reveals that the preferred outcome under § 1113 is a negotiated solution rather than contract rejection. Thus, although the addition of § 1113 to the *Bankruptcy Code* did not eliminate an employer's right under § 365 to reject a collective bargaining agreement, it did force the employer, the union, and retirees to bargain in good faith, and to the satisfaction of the bankruptcy court, before an agreement would be terminated. The lower federal courts have taken two different approaches to determining when modification or rejection of a collective bargaining agreement is necessary to the debtor's reorganization. The approach most favorable to unions and employees is the approach of the Third Circuit, which is that modification or rejection is only necessary if the alternative is the debtor's immediate liquidation. The approach most favorable to debtors and creditors is the approach of the Second Circuit, which focuses on the debtor's long-term goal of successful reorganization. 2001 L. Rev. M.S.U.-D.C.L. 1145, 1157.

Included in many collective bargaining agreements is the employer's obligation to maintain an employee pension fund. A pension plan that is incorporated by reference into a collective bargaining agreement is not excluded from the scope of 11 USCS § 1113. *In re Bunting Bearings*, 302 B.R. 210 (Bankr. D. Ohio 2003). When such a plan is covered by the collective bargaining agreement, the appropriate sections of *ERISA, supra*, must also be complied with before the

pension plan could be terminated by the employer.

Bankruptcy Code § 1114, 11 USCS § 1114, was added to the Bankruptcy Code by the Retiree Benefits Bankruptcy Protection Act of 1988 (Retiree Benefits Act) to protect the rights of retirees to continue to receive certain benefits. To afford protection of retiree benefits, the Retiree Benefits Act: (a) added paragraph (13) to the plan confirmation standards of *Bankruptcy Code § 1129(a)* to require that the plan must provide for the continued funding of retiree benefits at the level set by agreement or court approval; (b) granted administrative expense status under *Bankruptcy Code § 503* to the payment of retiree benefits required to be made prior to the effective date of a confirmed chapter 11 plan; and (c) excluded retiree benefit claims from the limitations on damages of *Bankruptcy Code § 502(b)(7)*.

2007 S. 2092: "Protecting Employees and Retirees in Business Bankruptcies Act of 2007"

Twenty-three years have elapsed since Congress responded to the *Bildisco* decision by enacting 11 USCS § 1113. Since then, Congress has addressed varying types of abuse and misuse of the bankruptcy system. For a listing of some of the legislative reform initiatives that culminated in the 2005 amendments, including the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-008 (2005), see, Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 *Am. Bankr. L.J.* 485.

Over the past several years, members of Congress have become increasingly aware of not only consumer abuses, but also what has been perceived as the overreaching effects that major corporate reorganizations have had on employees, employee pension plans, and retirees. In response to the mounting outcry against the abuses, a bill entitled the "Protecting Employees and Retirees in Business Bankruptcies Act of 2007 " ("Bankruptcy Bill of 2007" or "Bill"), 2007 S. 2092, was introduced in the U.S. Senate on September 25, 2007, and in the U.S. House of Representatives as 2007 H.R. 3652. The stated purpose of the Bankruptcy Bill of 2007 is:

To amend title 11, United States Code, to improve protections for employees and retirees in business bankruptcies.

The Bill sponsors detailed their reasons for the proposed legislation in the Bill's findings:

Recent corporate restructurings have exacted a devastating toll on workers through deep cuts in wages and benefits, termination of defined benefit pension plans, and the transfer of productive assets to lower wage economies outside the United States. Retirees have suffered deep cutbacks in benefits when companies in bankruptcy renege on their retiree health obligations and terminate pension plans.

The sponsors went on to say that the current Bankruptcy Code was designed to protect jobs and enhance enterprise value for all who have an interest in the business. The Code was not designed to be used as a "strategic weapon" to eliminate good paying jobs, strip employees and their families of a lifetime's worth of earned benefits, and hinder their ability to participate in a prosperous and sustainable economy. The sponsors' findings recognized that it was the workers and retirees who were forced to make "substantial economic sacrifices" while the debtor corporation's top executives (who put the company into bankruptcy) continued to benefit from their compensation packages. The sponsors bluntly stated that "Bankruptcy should not be a haven for the excesses of executive pay."

During a press conference held to announce the legislation, Representative John Conyers, (D., Mich.) lashed out at Chapter 11's inequitable playing field, wherein unions are busted; workers lose their jobs; and retiree health care benefits, medical benefits, prescription drug benefits, disability benefits and death benefits are eliminated, while executives reap the benefits of the savings gained by the elimination of the jobs and benefits. Representative Conyers specifically stated:

We need to restore the level playing field that the drafters of Chapter 11 originally envisioned and to ensure that workers and retirees receive fair treatment when their company is in bankruptcy. It is time that we include the interests of working families in the bankruptcy law and consider how we can add a measure of fairness to a playing field that is overwhelmingly tilted against workers.

For the full text of Representative Conyers' comments, see (c) 2007 Federal Information & News Dispatch, Inc., *Congressional Documents and Publications, Conyers Introduces Legislation Protecting the Rights of Workers and Retirees in Corporate Bankruptcies Congressional Documents and Publications*, September 25, 2007.

The Bankruptcy Bill of 2007 would add several new sections and modify a number of existing provisions of Title 11. In particular, there are a number of proposed changes to *11 USCS § 1113*:

Subsections (a) through (c), which set forth the basic requirements for the debtor-in-possession or trustee to meet with an authorized representative of the employees, are deleted, and replaced with a much more comprehensive (and presumably onerous) series of tests to terminate a collective bargaining agreement. The Act also mandates that only terminations of collective bargaining agreements can be obtained under § 1113; assumptions must be under *11 U.S.C.S. § 365*.

The time limitations are increased in subsection (d).

Subsection (f) has the following language added: "Any payment required to be made under this section before the date on which a plan confirmed under § 1129 is effective has the status of an allowed administrative expense, as provided in *11 U.S.C.S. § 503*."

New subsections (g) through (i) treat the rejection of a collective bargaining agreement as a breach of contract with the same effect as a rejection of such contract under *11 U.S.C.S. § 365*. The new subsections give greater rights to parties aggrieved by the termination of the contract.

Section 365, *11 U.S.C.S. § 365*, is amended by adding subsection (q):

(q) No deferred compensation arrangement for the benefit of insiders or senior management of the debtor shall be assumed if a defined benefit plan for employees of the debtor has been terminated pursuant to §§ 4041 or 4042 of the Employee Retirement Income Security Act of 1974, on or after the date of the commencement of the case or within 180 days prior to the date of the commencement of the case.

Section 502 of title 11, United States Code, is amended by adding at the end the following:

(l) The court shall allow a claim asserted by an active or retired participant in a defined benefit plan terminated under §§ 4041 or 4042 of the Employee Retirement Income Security Act of 1974, for any shortfall in pension benefits accrued as of the effective date of the termination of such pension plan as a result of the termination of the plan and limitations upon the payment of benefits imposed pursuant to § 4022 of such Act, notwithstanding any claim asserted and collected by the Pension Benefit Guaranty Corporation with respect to such termination.

Section 1114 of title 11, United States Code, is amended, inter alia, by deleting subsection (f) and replacing it, in part, with the following:

(f)(1) Where a trustee seeks modification of retiree benefits, a motion seeking modification of such benefits shall not be filed, unless the trustee has first met with the authorized representative (at reasonable times and for a reasonable period in light of the complexity of the case) to confer in good faith in attempting to reach mutually satisfactory modifications.

The remainder of the modified subsection (f) sets forth the substantive and procedural provisions necessary for a trustee or debtor-in-possession to surmount before the bankruptcy court could modify retiree benefits.

The listed additions and changes are the most significant portions of the proposed Bill. Other portions modify existing law in an effort to make a fairer distribution and balance the equities between the reorganizing employing corporation and its executives, its employees, and its retirees.

Conclusion

Labor representatives have argued that the bankruptcy process has become an all-too-common strategy for employers who want to void labor contracts. Corporations take the position that high labor costs have helped push them into bankruptcy and need to be lowered in order for a reorganized company to compete. Maher, *Democrats to Push Bill to Protect Workers*, supra. The number of plans terminated, the pension obligations assumed by the PBGC, and the number of retirees receiving benefits from the PBGC rose between 2000 and 2004 to levels never previously seen in the 29 year history of the agency, creating a demand for reform. See, *At the Crossroads of Three Codes: How Employers Are Using ERISA, the Tax Code, and Bankruptcy to Evade Their Pension Obligations*, supra. The Bankruptcy Bill of 2007 is arguably an ambitious effort to re-adjust the burden of employer-provided pension plans when a corporate employer files for Chapter 11 reorganization.

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63 of 197 DOCUMENTS

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Glosband on In re Oversight & Control Comm'n of Avanzit, S.A.

2008 Emerging Issues 2796

Daniel Glosband on In re Oversight & Control Comm'n of Avanzit, S.A., 385 B.R. 525 (Bankr. S.D.N.Y. 2008): Does a Foreign Proceeding Lose its Eligibility for Chapter 15 Recognition Before a Final Decree Enters? Bankruptcy Court Recognizes a "Post-Confirmation" Foreign Proceeding.

By Daniel Glosband

September 3, 2008

SUMMARY: A United States Bankruptcy Court recently clarified that a foreign proceeding in which a repayment plan had been approved and court supervision reduced was still eligible for recognition under chapter 15 of the U.S. Bankruptcy Code. This commentary discusses the "court supervision" and "pending proceeding" requirements for chapter 15 recognition and analyzes the arguments in *In re Oversight and Control Commission of Avanzit, S.A.*

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ARTICLE: Does a Foreign Proceeding Lose its Eligibility for Chapter 15 Recognition Before a Final Decree Enters? Bankruptcy Court Recognizes a Post-Confirmation Foreign Proceeding.

A United States Bankruptcy Court recently clarified that a foreign proceeding in which a repayment plan had been approved and court supervision reduced was still eligible for recognition under chapter 15 of the U.S. Bankruptcy Code. The Court rejected a challenge to recognition on grounds that the foreign court no longer exercised control and supervision over the debtors assets and affairs and that the foreign proceeding was no longer pending. This commentary discusses the court supervision and pending proceeding requirements for chapter 15 recognition and analyzes the arguments made by the parties in *In re Oversight and Control Commission of Avanzit, S.A.* n1

Background of Avanzit Foreign Proceeding

Avanzit S.A. (Avanzit), a global provider of technology and telecommunications services in 25 countries, filed a petition seeking a *suspensin de pagos* in a Spanish insolvency court on May 31, 2002. n2 Under the relevant Spanish law, a *suspensin de pagos* allows a court to stay litigation and collection actions against the insolvent company and appoint temporary trustees who control the debtors business operations jointly with existing management. These restrictions are lifted once the court approves a *convenio*, a repayment plan negotiated by the debtor and approved by a majority of its creditors. The *convenio* contains limitations on the debtor but continues the stay of creditor actions except as provided in the *convenio*. The proceeding does not terminate until the payment plan is fully consummated, and the Spanish court continues to exercise limited control in a manner analogous to a chapter 11 proceeding following confirmation of a plan. n3

Avanzits *convenio*, approved by the Spanish court in January of 2004, created a five member Oversight Commission to represent Avanzits creditors. The Oversight Commission does not control the daily operations of the company, but monitors compliance with the *convenio* until Avanzit repays its debts. The Spanish court retains the power to transform the *suspensin de pagos* into a *quiebra consecutiva*, an asset liquidation proceeding, if Avanzit cannot meet the terms of the *convenio*.

The conflict between Avanzit and a Peruvian bank, BNP Paribas Andes, S.A. (BNPP), originated several years before the *suspensin de pagos* and was manifested by two pending arbitrations. After one of the arbitrations resulted in an award to BNPP (several months after the *suspension de pagos* had been filed), BNPP set off \$25 million (U.S.) that Avanzit had deposited into a New York bank account under an agreement with the bank. The *convenio* required Avanzit to report its liabilities and assets and the report included as an asset the \$25 million that BNPP had previously set off. n4 In March of 2004, Avanzit brought a civil suit in Spain alleging that the setoff violated Spanish Bankruptcy law and was invalid. n5 A Spanish civil court dismissed this suit for lack of jurisdiction, indicating that Peru, where the bank had already commenced an action, was the proper venue to determine the validity of the setoff. n6 The Peruvian court had not issued its ruling by the time of the Avanzit chapter 15 petition. n7

The chapter 15 petition

The Oversight Commission then filed a motion in the Spanish insolvency court seeking permission to file a chapter 15 proceeding to investigate the facts relevant to the disputed \$25 million and to recover it for distribution according to Spanish law. n8 The Oversight Commission emphasized that the *convenio* had classified the funds as an asset of Avanzit, without which Avanzits liabilities would be greater than its assets, preventing resolution of the *convenio* and potentially forcing the insolvency court to transform the *suspensin de pagos* proceeding into a *quiebra consecutiva*. n9 The Spanish insolvency court authorized the Oversight Commission to commence the chapter 15 proceeding and designated the Oversight Commission as the authorized foreign representative of the Avanzit foreign proceeding. n10

The Oversight Commission filed a petition in the United States Bankruptcy Court for the Southern District of New York on November 29, 2007 seeking recognition of the *suspensin de pagos* as a foreign main proceeding and the Oversight Commission as its foreign representative. n11 BNPP opposed recognition, attempting to ensure that the Peruvian court proceeding would control the status of the disputed fund. n12 The bank claimed that the *suspensin de pagos* was no longer a pending foreign proceeding and that the Oversight Commission was not a proper foreign representative. n13 However, Chief Judge Stuart Bernstein rejected each of the banks arguments.

Chapter 15 eligibility issues

BNPPs objection focused on two elements of eligibility of a foreign proceeding for recognition under chapter 15. The first element resides within the definition of foreign proceeding while the second is within the specified requirements for recognition. A foreign proceeding is defined as follows :

§ 101(23) The term foreign proceeding means a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding **the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization** or liquidation. n14 (emphasis supplied)

For a foreign proceeding to be recognized, it must be either a foreign main proceeding or a foreign nonmain proceeding. n15 A foreign main proceeding is defined as follows:

§ 1502(4) foreign main proceeding means a foreign proceeding **pending** in the country where the debtor has the center of its main interests; n16 (emphasis supplied)

BNPP argued that the *suspensin de pagos* did not qualify as a foreign main proceeding because the Spanish court no longer exercised control and supervision of Avanzits assets and affairs for purposes of reorganization after the

convenio was approved. In the same vein, it asserted that the Spanish proceeding was no longer pending. n17 Upon approval of the *convenio*, the court dissolved the temporary trusteeship and approved the Oversight Commission, allegedly returning Avanzit to full control over the companys operations. n18 The foreign representatives replied that the *convenio* remains in place for six years from the time of signing, during which time the Spanish court retains authority over disputes and the Avanzit insolvency docket remains open. n19

Rejecting BNPPs argument, Judge Bernstein ruled that as a general matter, a *suspensin de pagos* fits squarely within the definition of a foreign proceeding. n20 A *suspensin de pagos* governs insolvency and debt adjustment and is a collective judicial proceeding in which the assets and affairs of the debtor are subject to control or supervision by a Spanish court, for the purpose of reorganization. n21 As to whether the proceeding was still a foreign proceeding, the court noted the similarity of the situation to a chapter 11 case during the period after confirmation but before final decree. n22 In a chapter 11 case, the bankruptcy court continues to exercise jurisdiction post-confirmation but in more limited fashion. Dispute and issue resolution may actually increase. Under BNPPs approach, an analogous U.S. proceeding would be denied assistance by courts in other countries that had adopted the Model Law, a result not required by chapter 15. n23

BNPP argued that the Spanish docket remained open only for procedural purposes, but the court rejected this claim, noting that the Spanish insolvency court continued to rule on matters relating to the *convenio*, including approval of the Oversight Commission as the foreign representative. n24 The court noted that the Spanish tribunal retains authority over the Avanzit bankruptcy proceeding, as a U.S. bankruptcy court would in a post-confirmation chapter 11 case, and therefore the foreign proceeding remains pending until the *convenio* is complete and the Spanish court enters an order formally closing the case. n25

The court dispatched the pending argument with a chapter 11 analogy as well: a bankruptcy case in general, and a chapter 11 case in particular, is pending until it is closed. n26 In addition, the Judge stated that pending refers to situs [of a proceeding,] not status. n27 The court declared that the reference to pending in section 1502(4) has the same meaning as the analogous section 2(b) of the U.N. Model Law, which describes a proceeding as taking place in a foreign country instead of pending there. n28

Having concluded that the Avanzit *suspensin de pagos* was a foreign proceeding pending in the Spanish court, the court recognized the *suspensin de pagos* as a foreign main proceeding. Avanzits center of main interests was in Spain: it was organized under Spanish law, its registered address was in Spain and it leased a large office building in Madrid for its management offices. n29

BNPP also questioned whether the Oversight Committee qualified as a foreign representative. n30 Judge Bernstein concluded that because it was a body authorized in the foreign proceeding to act as representative of that proceeding, the Oversight Committee was indeed a foreign representative. n31 The definition of a foreign representative includes the words person or body and may include artificial persons created by a legal authority, as well as the individual, partnership or corporation included with the definition of person in section 101(41). n32

BNPP also argued that the rules of comity barred the United States from controlling the setoff, because the Spanish civil court had already dismissed one attempt by Avanzit to have the setoff declared contrary to that countrys law. n33 Judge Bernstein rejected this logic, pointing out that the Spanish civil court dismissed that suit for want of jurisdiction, rather than on the merits, and thus its ruling did not bind a U.S. court. n34 Judge Bernstein did not rule, however, on the merits of the actual setoff dispute, confining his order to recognition of the Avanzit *suspensin de pagos* as a foreign main proceeding and of the Oversight Commission as foreign representative. n35 It remains to be seen how the court will rule with respect to the disputed fund itself.

For practitioners, Judge Bernsteins analysis confirms that a foreign proceeding remains pending and the debtor and its assets remain subject to sufficient supervision and control until the relevant tribunal enters an order closing its case. n36 The decision also confirms that a body not necessarily familiar in title or function to a U.S. court may be a foreign

representative when so-designated and authorized by the foreign court. n37

The Oversight Commission and Avanzit itself both face further hurdles. Judge Bernstein's order recognized the Avanzit insolvency hearing as a foreign main proceeding and the decision contemplates that the dispute over the set-off may continue in both Peru and in the chapter 15 case. n38 The Order accompanying the decision provides that the automatic stay imposed by § 1520(a)(1) will not stay the Peruvian litigation. n39 The Court gives no hint as to how the two matters might be coordinated or reconciled. Ongoing proceedings in both jurisdictions will determine the final outcome of this dispute.

[Return to Text](#)

n1 385 B.R. 525 (*Bankr. S.D.N.Y. 2008*).

n2 *Id.* at 529.

n3 *Id.* at 528-29.

n4 *Id.* at 529.

n5 *Id.* at 530.

n6 *Id.*

n7 *Id.*

n8 *Id.*

n9 *Id.*

n10 Notice of Foreign Representative's Intent to Commence Case at Exhibit A (Ancillary Case Order of Court of First Instance No. 26, Madrid, Spain), *Avanzit*, 385 B.R. 525 (*Bankr. S.D.N.Y. 2008*) (No. 07-13765).

n11 Chapter 15 Petition for Recognition of Foreign Proceeding of Avanzit, S.A., *Avanzit*, 385 B.R. 525 (No. 07-13765).

n12 Memorandum of Law in Support of Motion to Dismiss Chapter 15 Petition or for Summary Judgment Dismissing the Petition, *Avanzit*, 385 B.R. 525 (*Bankr. S.D.N.Y. 2008*) (No. 07-13765).

n13 385 B.R. at 531.

n14 11 U.S.C. § 101(23).

n15 11 U.S.C. § 1517.

n16 11 U.S.C. § 1502(4).

n17 *Id.* at 536.

n18 *Id.*

n19 Response in Opposition to BNP Paribas Andes, S.A.'s Motion to Dismiss Chapter 15 Petition or for Summary Judgment Dismissing the Petition at 7, *Avanzit*, 385 B.R. 525 (*Bankr. S.D.N.Y. 2008*) (No. 07-13765).

n20 385 B.R. at 533.

n21 *Id.*

n22 385 B.R. at 535-36.

n23 *Id.*

n24 *Id.* at 536.

n25 *Id.* at 538.

n26 385 B.R. at 537.

n27 *Id.* at 537.

n28 Model Law on Cross-Border Insolvency, (United Nations Commission on International Trade Law 1997).

n29 385 B.R. at 539.

n30 Motion to Dismiss, *supra*, note 12, at 21.

n31 385 B.R. 540; *see also* 11 U.S.C. § 101(24) (the term foreign representative means a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtors assets or affairs or to act as a representative of such foreign proceeding).

n32 385 B.R. at 540.

n33 Motion to Dismiss, *supra*, note 12.

n34 385 B.R. at 534.

n35 *Id.* at 540-41.

n36 *Id.* at 538.

n37 385 B.R. at 531.

n38 385 B.R. at 540.

n39 Order Denying Motion To Dismiss And Granting Recognition, *Avanzit*, 385 B.R. 525 (*Bankr. S.D.N.Y.* 2008) (No. 07-13765).

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Mr. Glosband is a Vice President of the American College of Bankruptcy and a conferee of the National Bankruptcy Conference, which advises Congress on bankruptcy legislation. He was a draftsman of the UNCITRAL Model Law on Cross-Border Insolvency and one of two primary draftsmen of Chapter 15 of the United States Bankruptcy Code, Ancillary and Other Cross-Border Cases. He is a contributing author to *Collier on Bankruptcy 15th Ed. Revised*, *Collier Bankruptcy Practice Guide* and *Collier International Business Insolvency Guide*.

He is admitted to practice in New York, Massachusetts, the U.S. District Courts in Massachusetts, Connecticut, Vermont and the Southern District of New York, the U.S. Court of Appeals for the First Circuit and the U.S. Supreme Court. He received a J.D. from Cornell University in 1969 and a B.A. from University of Massachusetts in 1966.



64 of 197 DOCUMENTS

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Jurs on Tidewater Finance Co. v. Kenney

2008 Emerging Issues 2778

S. Andrew Jurs on *Tidewater Finance Co. v. Kenney*, 531 F.3d 312 (4th Cir. June 25, 2008)

By S. Andrew Jurs

September 1, 2008

SUMMARY: In this Expert Commentary, S. Andrew Jurs discusses *Tidewater Finance Co. v. Kenney*, in which the court determined, in a matter of first impression in the circuit, whether the "hanging paragraph" in 11 U.S.C. § 1325(a) prevents a purchase money secured creditor from asserting its contractual right to an unsecured claim against a chapter 13 debtor for the deficiency portion of the debt owed after the collateral has been surrendered and sold.

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ARTICLE: The Fourth Circuit Adopts the Minority Approach for Dealing with the Hanging Paragraph of 11 U.S.C. § 1325(a), Holding That the Provision Does Not Deprive Undersecured 910 Creditors of Their Deficiency Claims

In *Tidewater Finance Co. v. Kenney*, 531 F.3d 312, 2008 U.S. App. LEXIS 13377 (4th Cir. June 25, 2008), the Court of Appeals for the Fourth Circuit determined, in a matter of first impression in the circuit, whether the hanging paragraph in 11 U.S.C. § 1325(a) prevents a purchase money secured creditor from asserting its contractual right to an unsecured claim against a chapter 13 debtor for the deficiency portion of the debt owed after the collateral has been surrendered and sold.

Facts and Procedural History. On September 29, 2006, Jennifer Lee Kenney (the Debtor) purchased a 2003 Chevy Impala under a Retail Installment Sales Contract (the Contract). Under the Contract, the Debtor made a down payment of \$700 and financed the remaining \$12,102.24 via a loan from the automobile dealership. In return, the dealership received a purchase money security interest in the Impala to secure the entire debt. The dealership timely perfected the security interest and assigned the Contract and perfected security interest to Tidewater Finance Company (Tidewater). Tidewater's lien was noted on the vehicle's title.

Less than three months later, on December 19, 2006, the Debtor filed bankruptcy under chapter 13 of the Bankruptcy Code. In her amended chapter 13 plan, the Debtor proposed to surrender the Impala in full satisfaction of the debt owed to Tidewater despite the fact that the vehicle was worth less than the total amount owed. For this reason, Tidewater objected to the Debtor's proposed amended plan and filed a proof of claim asserting a secured debt of \$12,341.84. Subsequently, Tidewater obtained relief from stay and sold the Impala, leaving a deficiency balance due of \$5,271.34 according to Tidewater's amended proof of claim.

Relying on the rule adopted by the majority of bankruptcy courts ruling on the issue in other circuits, the bankruptcy court overruled Tidewater's objection to confirmation. In doing so, the court concluded that the hanging paragraph of section 1325(a) prevented Tidewater from bifurcating the claim to assert an unsecured deficiency claim for the portion of the debt not covered by the sale of the collateral.

Tidewater timely filed a notice of appeal, and, pursuant to *Rule 8001(f) of the Federal Rules of Bankruptcy Procedure* and 28 U.S.C. § 158(d)(2)(A), the bankruptcy court certified that a direct appeal of this decision presented a question of law as to which there was no controlling Fourth Circuit or U.S. Supreme Court decision and that resolution of conflicting decisions among bankruptcy courts in various circuits was required. The Fourth Circuit granted the petition for direct appeal.

Legal Background. A bankruptcy court will confirm a chapter 13 reorganization plan so long as it meets the requirements of section 1325(a). Regarding a debtor's proposed treatment of secured claims, section 1325(a)(5) provides that such treatment will be confirmed if the plan can provide that:

(1) the debtor and secured creditor agree on how the claim will be paid (§ 1325(a)(5)(A)); or

(2) the debtor retains the collateral while the creditor retains the lien until either the debt is repaid under the plan or until the debtor receives a discharge, whichever occurs first, and the debtor pays adequate protection payments to the secured creditor, the total of which must not be less than the allowed amount of the claim as of the effective date of the plan (§ 1325(a)(5)(B)); or

(3) the debtor surrenders the secured collateral to the creditor holding the lien (§ 1325(a)(5)(C)).

When Congress enacted the 2005 amendments to the Bankruptcy Code, it revised section 1325(a) by adding to the end of the subsection an unnumbered paragraph, i.e., the hanging paragraph. The hanging paragraph provides:

For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred with the 910 days preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle . . . acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

The reference to section 506(a) incorporates that section's rules for dealing with secured claims by allowing a secured creditor to divide its claim into secured and unsecured amounts, with the unsecured amount equaling the amount by which the debt exceeds the collateral's value or equity. By allowing this bifurcation of secured claims, section 506(a) permits an undersecured creditor to become an unsecured creditor and seek a deficiency claim.

Under the pre-amendment section 1325(a)(5), an undersecured creditor who received and sold a surrendered 910 vehicle had a remedy under *federal* law (section 506(a)), to seek a deficiency after sale of the collateral. After the addition of the hanging paragraph, however, bankruptcy courts have disagreed as to the hanging paragraph's effect on an undersecured creditor's ability, under *state* law governing the creditor's contractual rights, to pursue a deficiency claim. The majority of bankruptcy courts considering the matter have concluded that the hanging paragraph's explicit elimination of the application of section 506(a) to 910 claims means that such creditors are without any remedy or basis to bifurcate their loans into secured and unsecured portions. The end result is that the loans are rendered non-recourse despite the language of the underlying contract and security agreement.

In contrast, the minority rule holds that Article 9 of the U.C.C. and contract law, both statutory and common, entitle 910 creditors to an unsecured deficiency judgment, unless the contract states that it is a non-recourse loan, even after surrender of the vehicle. Calling it the minority rule, however, is somewhat disingenuous, because a growing number of circuit courts have adopted this minority rule and recognize a 910 creditor's right to assert an unsecured deficiency claim. See *DaimlerChrysler Fin. Serv. Americas LLC v. Ballard (In re Ballard)*, 526 F.3d 634 (10th Cir. 2008); *Capital*

One Auto Fin. v. Osborn, 515 F.3d 817 (8th Cir. 2008); *In re Matter of Wright*, 492 F.3d 829 (7th Cir. 2007); cf. *In re Long*, 519 F.3d 288 (6th Cir. 2008) (filling statutory gaps according to the rule of the equity of the statute rather than nonbankruptcy law to preserve deficiency claims).

Commentary. For that very reason, the Fourth Circuits holding in *Kenney* is less noteworthy or contrarian than it appears at first glance. Instead, *Kenney* is simply one more example of the circuit courts, who do not deal regularly with bankruptcy law, going the opposite direction in interpreting the 2005 amendments than the majority of bankruptcy courts tasked with implementing its confusing provisions on a daily basis.

To begin its analysis, the appeals court clears the field by recognizing that: Based on a plain reading of the hanging paragraph, there is no question that Congress has unambiguously eliminated the 910 creditors access to a federal remedy under § 506(a). 2008 U.S. App. LEXIS 13377, at *13. The question, therefore, is whether there is any other body of law providing a 910 creditor recourse for the remainder of the debt after surrender of the vehicle. According to the Fourth Circuit, the Tenth, Eighth, and Seventh Circuits provide the correct answer by holding that the parties still have their contractual rights and obligations after surrender, and that a creditor may pursue an unsecured deficiency claim under state law. *Id.* at *14.

By posing the question in this way, the Fourth Circuit presumes that the hanging paragraph is incomplete and needs another body of law to fill in the gaps. The principle that state law determines the rights and obligations of debtors and creditors when the Bankruptcy Code fails to supply a federal rule is well recognized. *Id.* (citing *Butner v. United States*, 440 U.S. 48, 55, 99 S. Ct. 914, 59 L.Ed. 2d 136 (1970)). In support, the appeals court cites the Seventh Circuit for the proposition that it is a mistake to assume . . . that § 506 is the only source of authority for a deficiency judgment when the collateral is deficient. *Wright*, 492 F.3d at 832. In fact, according to the Seventh Circuit, (1) nothing in the Bankruptcy Code prohibits or qualifies an unsecured deficiency claim under state law following the surrender of collateral; (2) creditors don't need § 506 to create, allow, or recognize security interests, which rest on contracts (and the UCC) rather than federal law; and (3) section 502 tells bankruptcy courts to allow claims that stem from contractual debts, and nothing in § 502 disfavors or curtails secured claims. *Id.* at 832-33.

The Fourth Circuit rejects the majority approach in which bankruptcy courts found that the language of the hanging paragraph should be applied as written. As noted in *In re Pinti*, 363 B.R. 369 (Bankr. S.D. N.Y. 2007), while poorly drafted, the Hanging Paragraph is not ambiguous. Thus, under standard rules of statutory interpretation, there would have been no need to resort to nonbankruptcy law as a gap-filler to deal with situations not addressed in the Bankruptcy Code.

Also left undiscussed by the Fourth Circuit were other alternative arguments, such as alleged congressional intent to elevate the rights of secured 910 creditors, or the assertion that the hanging paragraph allows arbitrary treatment of deficiency claims and provides a windfall to the debtor. Instead, by agreeing that section 506 is not the exclusive method for separating out the deficiency as an unsecured portion of the 910, the end result was readily apparent to the Fourth Circuit: 910 deficiency claims must be allowed to the extent permitted by state law.

Therefore, because Tidewater's contract with the Debtor provided Tidewater with a security interest in the vehicle to secure payment of all sums owed under the contract, Tidewater was entitled under state law and the contract to a deficiency judgment against the Debtor. When the Debtor surrendered the vehicle, he gave Tidewater the full market value of the collateral, and any deficiency after the vehicle's sale was an unsecured claim in the Debtors chapter 13 plan.

In sum, despite pretensions to contrariness, the decision in *Kenney* further confirms that the putative minority rule has become the majority rule among those courts of appeals considering the issue. In the Fourth Circuit, as in the Tenth, Eighth, and Seventh Circuits, the rule is that a 910 creditor will be entitled to a deficiency claim against a chapter 13 debtor who surrenders a vehicle to the extent that the creditor would be entitled to a deficiency judgment under the applicable contract and state law.

RELATED LINKS: For further discussion related to the hanging paragraph in 11 U.S.C. § 1325(a), see generally Collier on Bankruptcy (Matthew Bender),

■ 1325

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65 of 197 DOCUMENTS

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Cornell, Hagen, Jesner & Eschbach-Hall on Employee Benefits in Corporate Bankr.

2008 Emerging Issues 2777

John R. Cornell, Daniel C. Hagen, Lisa Rothman Jesner and Tricia Eschbach-Hall on Employee Benefits and Executive Compensation in Corporate Bankruptcy

By John R. Cornell, Daniel C. Hagen, Lisa Rothman Jesner and Tricia Eschbach-Hall

September 1, 2008

SUMMARY: This Emerging Issues Analysis provides brief excerpts from the Collier Monograph Employee Benefits and Executive Compensation in Corporate Bankruptcy on (1) the treatment of defined benefit plans and interactions with the Pension Benefit Guaranty Corporation, (2) executive compensation and claims related to non-qualified retirement benefits and (3) modification of retiree welfare benefits under section 1114 of the Bankruptcy Code.

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ARTICLE: The following material is excerpted from the Collier monograph Employee Benefits and Executive Compensation in Corporate Bankruptcy, *written by John R. Cornell, Daniel C. Hagen, Lisa Rothman Jesner and Tricia Eschbach-Hall.*

There are unique issues that arise with respect to employee benefits and executive compensation when a business entity, typically a corporation, files for bankruptcy.

Employees of a company that enters bankruptcy are likely to be concerned about their livelihood and may seek more secure employment opportunities. Executives of the company may have personal interests very different from the interests of the debtor, and unless those interests are balanced, they may have difficulty envisioning the proper course for the reorganization and negotiating with creditors. Handling executive compensation issues can thereby become a challenge much larger than protecting the financial wellbeing of individual employees.

Unions generally present significant issues in a bankruptcy case where employee benefits of the debtor are collectively bargained. Labor laws are complex and negotiations are difficult outside of bankruptcy. The Bankruptcy Code imposes even more legal hurdles on modifying labor contracts, and the interests of labor unions (who may have a seat on the creditors committee) result in more challenging negotiations. At the same time, the escalating cost of union benefits, including retiree medical and retirement plans, may be a substantial contributing factor in the decision to file.

Debtors need to consider compensation and benefits issues carefully during the prepetition period, and will address these issues at the outset of the case, in first-day motions. Once in bankruptcy, the debtor will determine which benefits can be paid, and which benefits will remain as claims on the estate. Benefits that are claims will have differing levels of

priority under the Bankruptcy Code, and will receive differing treatment. For benefits that the debtor wishes to establish during the course of the case, restrictions often apply, and negotiations with creditors may be necessary, as well as approval by the bankruptcy court.

The recently published *Collier* monograph *Employee Benefits and Executive Compensation in Corporate Bankruptcy* presents a complete discussion of the intersection of bankruptcy and employee benefits law. It walks through the prepetition period to first-day motions and actions, discusses the priority of compensation and benefit claims and treatment of compensation and benefits in bankruptcy, including challenges to benefit plan contributions, and then turns to specific areas of concern. These areas include defined benefit pension plans, executive compensation, retiree benefits, voluntary employees beneficiary associations, and the group health plan continuation of coverage requirements of the COBRA. n1 Finally, the monograph discusses recent changes to the Bankruptcy Code affecting benefits and compensation.

This Expert Commentary provides brief excerpts from the monograph on (1) the treatment of defined benefit plans and interactions with the Pension Benefit Guaranty Corporation, (2) executive compensation and claims related to non-qualified retirement benefits and (3) modification of retiree welfare benefits under *section 1114 of the Bankruptcy Code*.

Treatment of Defined Benefit Plans and Interactions with the Pension Benefit Guaranty Corporation.

Underfunded defined benefit pension plans often play a major role in bankruptcy, particularly in traditionally unionized industries, such as steel and other primary metals, rubber, airlines and automotive. In some cases, serious underfunding may be one driving factor in a debtors decision to restructure.

Liability for both pension funding obligations and defined benefit plan termination underfunding extends to controlled group members. For companies not protected by the automatic stay in bankruptcy, a lien may arise for termination liability (essentially, underfunding at time of termination) and for missed minimum required contributions in excess of \$1 million. n2 As a result, at the outset of the case, and at such time as the debtor does not make minimum required contributions during the case, underfunded defined benefit pension plans may impact whether subsidiaries, including foreign subsidiaries, decide to file for chapter 11 protection so that the automatic stay will protect against the imposition of liens. Once the debtor is in bankruptcy, the PBGC will file contingent claims for underfunding and for contributions and premiums, and as a result, may play an important role on the creditors committee. If the PBGC is concerned about plan funding, it may threaten termination. If the debtor wants to terminate and the PBGC does not agree to the terms, it may threaten plan restoration. As a result, the PBGC can play a major role in the course of the bankruptcy case.

Termination Premium. As part of the Deficit Reduction Act of 2005 (DRA), ERISA was amended to include a termination premium, also known as an exit premium for companies that undergo a distress termination or involuntary termination in or out of bankruptcy. The premium is \$1,250 per participant for three years and is payable by the debtor *after* emergence from bankruptcy. n3 For debtors that elect special airline funding rules, this premium may be greater. While the DRA provision had a sunset date of 2010, the Pension Protection Act made this provision permanent. n4

The federal district court for the Southern District of New York recently held that the obligation to pay the premium was unenforceable following emergence, as the obligation was a prepetition claim under the Bankruptcy Code. Defining a claim as including a right to payment that is contingent and unmatured, the court concluded that the premium was a contingent claim in bankruptcy that was discharged at the time of confirmation of the plan of reorganization. If a debtor was permitted to contract with a private party for a payment to be made after confirmation of the plan of reorganization, it would essentially be a preference created by the parties, rather than by the Bankruptcy Code. The court refused to allow such a preference to arise in favor of the PBGC, as it was not clear that an explicit amendment of the Bankruptcy Code was intended by the DRA. Based on the specific facts of the case, where the DRA was in effect at the time of filing, and a plan termination was contemplated prior to bankruptcy (debtor and PBGC had two prepetition meetings), the court found that the exit premium was a prepetition claim. n5

Executive Compensation. Under the Bankruptcy Code there are several options for the treatment of employment agreements and other executive agreements after filing. Under certain circumstances, it is possible to assume or reject existing contracts with the approval of the bankruptcy court. In addition, it may be possible to modify contracts in the ordinary course of business. Similarly, if a debtor wishes to put in place a new employment or other executive agreement, court approval is necessary, unless it is in the ordinary course of business. The court is constrained by provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (2005 Act) that severely restrict retention and severance payments for insiders.

In addition to the legal requirements regarding such arrangements, more practical concerns govern. Executive compensation in bankruptcy typically involves intense negotiations with stakeholders, including creditors and unions. If creditors consent, it is more likely that the bankruptcy court will approve the compensation arrangement; on the other hand, the bankruptcy court is less likely to approve compensation over the objections of creditors.

There is often pressure to cut back preexisting employment arrangements with executives to show creditors that the executives are making sacrifices along with the creditors and other employees. n6

Non-Qualified Retirement Benefits--Claims. Non-qualified plan benefits that vest prior to the bankruptcy filing are an unsecured prepetition claim on the estate. n7 Treatment of the portions of non-qualified benefits that vest during the course of the bankruptcy case is less clear. Caselaw does not establish whether priority depends on whether an award (or part of an award) vested prepetition or postpetition. However, it is possible that a court would analyze the arrangement to determine which portion relates to postpetition service, and might use vesting as a guide. It is often difficult to determine an individual's accrued benefit under a non-qualified plan at any particular point in time, and therefore it is difficult to establish which portion of the benefit is vested at the time of filing, and also to establish the amount of the claim for any benefits determined to be prepetition claims. For example, some non-qualified plans provide benefits that cannot be provided under qualified benefit plans due to limits under *IRC section 401(a)(17)* (limit on compensation that may be taken into account under a qualified plan) or *IRC section 415* (limit on annual benefits payable to a retiree). n8 Decreases in compensation can cause the *IRC section 401(a)(17)* limits to have less of an impact in one year than it had in an earlier year, thus decreasing benefits payable under the non-qualified plan. Also, the limit under section 415 is generally reduced (and thus non-qualified plan benefits increase) if an employee retires before age 65. Therefore, non-qualified plan benefits depend to some extent on unknown future events.

A debtor may choose to reject its non-qualified benefit plans. Upon rejection, all claims for accrued benefits under the plans might be treated as prepetition unsecured claims. Alternatively, claims for benefits might be allocated between prepetition unsecured claims and postpetition administrative expenses, depending on when the benefits accrued. A debtor that rejects its non-qualified benefit plans may face employee morale problems, especially since the plans often cover executives critical to the success of the reorganization.

The debtor may request bankruptcy court approval for payment of prepetition non-qualified plan benefits (in either the first-day motions or at some subsequent date). For benefits that are payable to former employees, such approval is unlikely to be granted since the terminated employees are not providing any value to the estate of the debtor. More often, non-qualified benefits payable to terminated employees that accrued prepetition are simply treated as general unsecured claims of the debtor. Bankruptcy law does not typically allow rejection of a plan for former employees and assumption for current employees. n9

With respect to arrangements that cover only active employees who continue to be covered by the non-qualified plans and who terminate employment after the filing date, a debtor may request bankruptcy court approval to pay the prepetition benefits for these employees. Depending on the amount involved, a court may agree to such payments (and the creditors will not object to such payments) in order to help employee morale. Due to the controversy likely to surround such a request (*i.e.*, the amounts involved and the fact that the benefits are only paid to highly compensated employees), this request is almost never included in the first-day motion. If made, it generally occurs sometime later during the administration of the case.

If (a) an executives employment contract specifically provides for payment of non-qualified plan benefits and (b) the debtor assumes the employment contract, a court could provide for the full payment of the benefits by treating the executives employment contract as an executory contract. n10 Accordingly, if the executives employment contract is assumed, the debtor would have to cure any default in the contract, which, if the contract specifically requires payment of the non-qualified plan benefits, would include paying any claim for damages arising from the loss of those benefits. Payments would be treated as a second priority administrative claim. n11 If the benefit is a vested prepetition, however, the benefit will likely be classified as non-executory, and therefore it may not be assumed. n12

Following the amendments to the Bankruptcy Code in the 2005 Act, n13 approval to pay prepetition non-qualified plan benefits for insiders n14 may be more difficult to obtain. Payments made to induce insiders to remain in the employ of the debtor may not receive administrative priority unless it is proven that the insider has a bone fide job offer for the same or greater compensation, and only where employment of that insider is essential to the survival of the business. Even when this standard is met, payment must be less than 10 times the incentive payments provided to non-management employees in that year, or, if no incentive payments have been made in that year, no greater than 25 percent of the amount of any similar payment made to that insider in the previous year. n15

Prior to the 2005 amendments, a debtor could argue that assumption of the non-qualified plan benefit was required to retain executives critical to the success of the restructuring. Today, with respect to an insider, the principal purpose of the assumption can no longer be retention. n16

In one case, a bankruptcy court approved assumption (and therefore payment as an administrative priority claim) of a non-qualified pension benefit to a CEO (with respect to 60 percent of his prepetition benefit) and three senior management employees (with respect to the entire benefit) on the condition that all prepetition accruals would revert to prepetition unsecured claims in the event of a termination of the debtors defined benefit plan. All postpetition accruals were granted administrative priority. n17

Modification of Retiree Welfare Benefits under Section 1114 of the Bankruptcy Code. Retiree welfare benefits are given special protection in an employers chapter 11 bankruptcy case. *Section 1114 of the Bankruptcy Code* ensures that a chapter 11 debtor continues to pay certain retiree benefits postpetition and that the debtors plan of reorganization adequately provides for the claims of retired employees. Section 1114 provides generally that a chapter 11 debtor shall timely pay and shall not modify any retiree benefits. n18 Modification (including termination) of retiree benefits is permitted if the debtor and the retirees authorized representative agree to the modification or if a court orders the modification pursuant to statutory procedures. n19 Section 1114(a) defines retiree benefits as:

payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise) maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under this title. n20

The definition of retiree benefits therefore includes retiree health and life insurance premiums, contributions to multi-employer welfare funds on behalf of retirees and payments made directly to retirees under self-insured plans. Section 1114 does not apply to any retiree, or the spouse or dependents of such retiree, if such retirees gross income for the twelve months preceding the filing of the bankruptcy petition equals or exceeds \$250,000 unless the retiree is able to demonstrate that he or she is unable to obtain comparable coverage to that provided prepetition, elsewhere. n21

A debtor is permitted to modify its retiree benefit plans subject to the procedures set forth in section 1114. These procedures: (a) provide for the appointment of an authorized representative n22 for retirees (a union or a committee of retirees appointed by the U.S. trustee) for negotiation purposes; n23 (b) require the debtor to make a proposal for modification to the authorized representative based upon certain relevant information and to confer in good faith with the authorized representative and provide it with relevant information regarding the debtors proposal; n24 (c) permit

the authorized representative to approve or reject such proposal; n25 (d) in the case of rejection, require the court to hold a prompt hearing on the proposal; n26 and (e) set forth certain standards by which the court may approve the rejected proposal for modification. n27 Section 1114 was modeled after *section 1113 of the Bankruptcy Code*, which governs the debtors ability to assume or reject a collective bargaining agreement. As a result, the procedural requirements of section 1114 are nearly identical to those under section 1113. n28

Retiree benefits that were modified during the 180-day period prior to filing may be subject to reinstatement. Reinstatement may occur if the employer was insolvent at the time of the modification, unless a court determines that the balance of the equities favors the modification. n29

Return to Text

n1 Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272 § 10002(a), *100 Stat.* 227 (codified at *29 U.S.C. §§ 1161-1168*).

n2 *I.R.C. § 430(k)*; ERISA §§ 303(k), 4068, *29 U.S.C. § 1083(k)*, 1368.

n3 ERISA § 4006(a)(7), *29 U.S.C. § 1306(a)(7)*, as amended by the Deficit Reduction Act of 2005 § 8101(b), Pub. L. No. 109-171.

n4 ERISA § 4006(a)(7), *29 U.S.C. § 1306(a)(7)*.

n5 *Oneida Ltd. v. PBGC (In re Oneida Ltd.)*, 383 B.R. 29 (Bankr. S.D.N.Y. 2008).

n6 Allison K. Verderber Harriott, *Comment: Toward an Understanding of the Dialectical Tensions Inherent in CEO and Key Employee Retention Plans During Bankruptcy*, 98 Nw. U. L. Rev. 579, 593-94 (2004).

n7 *In re Merry-Go-Round Enterprises, Inc.*, 1999 WL 33457180, at *4 (Bankr. D. Md. Dec. 21, 1999) (holding that [b]ecause the Executives were fully vested prior to the petition, their postpetition employment with the Debtor did not entitle them to have these claims treated as an administrative expense.); *Kucin v. Devan*, 251 B.R. 269, 272 (D. Md. 2000) ([t]he court found that the agreement was properly characterized as a nonexecutory contract since the retirement agreement had already vested, quoting *In re Stewart Foods, Inc.* 64 F.3d 141, 145

n.2 (4th Cir. 1995)); see also *In re Bethlehem Steel Corp.*, 479 F.3d 167 (2d Cir. 2007) (treating prepetition accruals as unsecured claims on the estate).

n8 I.R.C. § 401(a)(17).

n9 Section 365(f) requires a debtor to assume a contract subject to the benefits and burdens thereunder. *In re ANC Rental Corp.*, 277 B.R. 226, 238 (Bankr. D. Del. 2002) (quoting *In re Italian Cook Oil Corp.*, 190 F.2d 994, 997 (3d Cir. 1951): The [debtor] ... may not blow hot and cold. If he accepts the contract he accepts it cum onere. If he receives the benefits he must adopt the burdens. He cannot accept one and reject the other."). The *cum onere* rule "prevents the [bankruptcy] estate from avoiding obligations that are an integral part of an assumed agreement." *United Air Lines, Inc v. U.S. Bank Trust Nat'l Ass'n (In re UAL Corp.)*, 346 B.R. 456, 468 n.11 (Bankr. N.D. Ill. 2006), quoted in *In re Fleming Companies, Inc.*, 499 F.3d 300, 308 (3d Cir. 2007); see also *N.L.R.B. v. Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984); *In re Italian Cook Oil Corp.*, 190 F.2d 994, 997 (3d Cir. 1951).

n10 The Bankruptcy Code provides that subject to court approval, the debtor may assume or reject any executory contract or lease. See 11 U.S.C. § 365. For a general discussion of a debtors right to assume or reject executory contracts or leases, see 3 *Collier on Bankruptcy*, 365.03.

Any decision by a debtor to assume an executory contract will be governed by the business judgment test. The business judgment test consists of analyzing whether assuming the contract would be a good business decision using the type of judgment a business person would exercise. See *Orion Pictures v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1099, 29 C.B.C.2d 1341 (2d Cir. 1993); see also 3 *Collier on Bankruptcy*, 365.03[2]. Furthermore, in order to assume an executory contract, the debtor must cure, or provide adequate assurance that the debtor will promptly cure any default in the contract that may exist at the time of assumption. See 11 U.S.C. § 365(b)(1)(A); see also 3 *Collier on Bankruptcy*, 365.

n11 11 U.S.C. § 507(a)(2).

n12 Kucin, 251 B.R. 269, 271-72 (D. Md. 2000).

n13 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

n14 For definition of insider, see 11 U.S.C. § 101(31); see also 2 Collier on Bankruptcy, 101.31.

n15 11 U.S.C. § 503(c)(1), as amended by Pub. L. No. 109-8, § 331 (2005).

n16 *Id.*

n17 *In re Dana Corp.*, 358 B.R. 567 (Bankr. S.D.N.Y. 2006).

n18 11 U.S.C. § 1114(e)(1). For a complete discussion of section 1114, see 7 Collier on Bankruptcy, ch. 1114.

n19 *Id.*; 11 U.S.C. § 1114(g). The requirements of section 1114 may not need to be followed if the retirees do not have a vested contractual right to the applicable benefits.

n20 11 U.S.C. § 1114(a).

n21 11 U.S.C. § 1114(m).

n22 11 U.S.C. § 1114(b)(1).

n23 11 U.S.C. § 1114(c), (d).

n24 11 U.S.C. § 1114(f)(1)(A), (B).

n25 11 U.S.C. § 1114(g)(2).

n26 11 U.S.C. § 1114(k)(1).

n27 11 U.S.C. § 1114(g)(3).

n28 Soon after section 1113 was added to the Bankruptcy Code, courts distilled these statutory procedural requirements into nine requirements that must be satisfied for court approval of rejection of a collective bargaining agreement.

n29 11 U.S.C. § 1114(l).

RELATED LINKS: For further discussion of Bankruptcy Code sections 1113 and 1114, see Collier on Bankruptcy (Matthew Bender), ch.

- 1113;
- 1114

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VEBAs involve legacy liabilities in the automotive, steel, aluminum and rubber industries. Mr. Cornell has lectured on ERISA fiduciary issues and pension, welfare, and bankruptcy compensation issues, and has written on ERISA litigation and fiduciary issues and benefits in bankruptcy proceedings. Mr. Cornell is admitted in New York and Maine. He received bachelors and masters (hon.) degrees from Colby College in 1965 and 1997, respectively. He graduated from Georgetown University Law Center in 1968, where he was an Executive Editor of the *Law Journal*, and he received an L.L.M. in Taxation from New York University in 1972.

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66 of 197 DOCUMENTS

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In re Bear Stearns: Court Slams Door on Subjective Approach to Ch. 15

2008 Emerging Issues 2739

Daniel M. Glosband on *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd: District Court Slams Door on Subjective Approach to Chapter 15 Eligibility -- Court Can Question Presumption Even if No One Objects*

By Daniel Glosband

August 20, 2008

SUMMARY: The liquidators of hedge funds appealed the bankruptcy courts refusal to grant recognition to foreign proceedings that did not satisfy chapter 15s eligibility requirements. The District Court rejected their assertions that the bankruptcy court was wrong to even consider the eligibility issues in the absence of any objections to the chapter 15 petition. Daniel M. Glosband examines *In re Bear Stearns*, 389 B.R. 325 (S.D.N.Y. 2008).

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ARTICLE: Daniel M. Glosband on *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd: District Court Slams Door on Subjective Approach to Chapter 15 Eligibility -- Court Can Question Presumption Even if No One Objects*

The liquidators of two Cayman registered hedge funds appealed the bankruptcy courts refusal to grant recognition to foreign proceedings that did not satisfy chapter 15s strict eligibility requirements. The District Court rejected their assertions that comity should add discretionary flexibility to the eligibility rules and that the bankruptcy court was wrong to even consider the eligibility issues in the absence of any objections to the chapter 15 petition. n1

The Bankruptcy Court was correct in rejecting the chapter 15 petition.

At the end of July 2007, Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd. (collectively, the "Funds") began voluntary winding up proceedings in the Cayman Islands. The liquidators appointed by the Cayman court immediately sought the assistance of the United States Bankruptcy Court for the Southern District of New York by seeking recognition (or an approval of the eligibility of the Cayman proceedings) under chapter 15 of the Bankruptcy Code.

Honorable Burton R. Lifland, United States Bankruptcy Judge, denied the petitions for chapter 15 recognition of the Cayman Islands liquidation proceedings, ruling that the Funds did not satisfy the eligibility criteria for assistance from the U.S. court. n2 Neither fund had its center of main interests (principal place of business) in the Cayman Islands as required for the Cayman proceeding to be recognized as a foreign main proceeding and entitled to full relief in the

U.S. Neither did they have an establishment (place of business) in the Caymans, as required for recognition as a foreign nonmain proceeding. n3 Instead, the documents filed with the chapter 15 petition disclosed that the funds assets, administrator, investment advisor and sponsors were all in the United States; there was nothing in the Cayman Islands but registration documents.

Registration did arm the petitioners with an evidentiary presumption:

§ 1516. Presumptions concerning recognition.

(c) In the absence of evidence to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the center of the debtor's main interests.

The presumption only holds, however, [i]n the absence of evidence to the contrary. As noted by the court in the Tri-Continental Exchange case : if the foreign proceeding is in the country of the registered office, and if there is evidence that the center of main interests might be elsewhere, then the foreign representative must prove that the center of main interests is in the same country as the registered office. n4 Judge Lifland disagreed with dicta in the earlier SPhinX case which hinted that, absent any improper motives, the court should grant recognition if there were no objections: To the extent that non-objection would make the recognition process a rubber stamp exercise, this Court disagrees with the dicta in the SPhinX decision. n5

With the door to the presumption short cut firmly locked, the focus narrowed to the issue of whether Congress meant to impose objective eligibility criteria for recognition under the Model Law and chapter 15. Critics of Judge Liflands decision including the appellants -- argued that the strict eligibility criteria for chapter 15 recognition should be tempered by subjective factors comity and flexibility. Chapter 15 should, in their view, provide an additional and not exclusive basis for assistance to foreign proceedings, augmenting the pre-existing ability of U.S. courts to grant comity based on subjective factors. The only change made by chapter 15 would be to focus all of the requests for assistance in the bankruptcy court in the first instance. Otherwise, Congress thought that it was making only procedural changes by enacting chapter 15. n6

The statute and its legislative history refute this argument. Section 1502(7) defines recognition as the entry of an order granting recognition of a foreign main proceeding or foreign nonmain proceeding under this chapter. The foreign proceeding, then, must be either a foreign main proceeding or foreign nonmain proceeding. As Judge Lifland put it: In other words, the recognition must be coded as either main or nonmain. n7 Sections 1502(4) and 1502(5) state:

(4)foreign main proceeding means a foreign proceeding pending in the country where the debtor has the center of its main interests;

(5) foreign nonmain proceeding means a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment.

Finally, establishment means any place of operations where the debtor carries out a nontransitory economic activity. § 1502(2)

Applying the definitions, Section 1517 provides as follows:

§ 1517. Order granting recognition

(a) Subject to section 1506 [public policy exception], after notice and a hearing, **an order recognizing a foreign proceeding shall be entered if--**

(1) **such foreign proceeding** for which recognition is sought **is a foreign main proceeding or foreign nonmain proceeding** within the meaning of section 1502;

(2) the foreign representative applying for recognition is a person or body; and

(3) the petition meets the requirements of section 1515.

(b) Such foreign proceeding shall be **recognized**

(1) as a foreign main proceeding if it is pending in the country where the debtor has the center of its main interests; or

(2) as a foreign nonmain proceeding if the debtor has an establishment within the meaning of section 1502 in the foreign country where the proceeding is pending. [emphasis added]

Section 1517 distills to the following list of findings necessary to grant recognition:

1. There is a foreign proceeding (as defined in § 101(23));
2. The foreign representative is a person or body (as defined in § 101(24));
3. The petition for recognition meets the requirements of § 1515;
4. The foreign proceeding is a foreign main proceeding or a foreign nonmain proceeding (as defined in §§ 1502(4),(5)).

Consequently, eligibility under chapter 15 requires more of a jurisdictional basis in the foreign country than former section 304. This change was intentional and more than procedural. While access to the United States courts under section 304 was not dependent on recognition, all relief under section 304 was discretionary and based on subjective, comity-influenced factors. Subsection 304(c) specifically included restrictive factors that limited the grant of relief.

Under section 304, the foreign proceedings as then defined that were eligible for bankruptcy court assistance included foreign proceedings whose jurisdiction was based solely on the presence of assets or domicile in the foreign country. By changing the definition of foreign proceedings to remove asset and domicile-based proceedings, Congress elevated the required level of jurisdictional connection between the debtor and the foreign country. The revised definition, blacklined against the prior version, is as follows:

§ 101(23): The term foreign proceeding means proceeding, whether a collective judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor's domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

Congress cannot have acted inadvertently, as accused by the appellants and other critics of Judge Liflands Bear Stearns Bankruptcy Decision, since it specifically revised and augmented the definitions of foreign main proceedings and foreign nonmain proceedings to eliminate definitional provisions that were inconsistent with the new eligibility criteria.

The House Report confirms the significance of the revisions:

The drafters of the Model Law understood that only a main proceeding or a nonmain proceeding meeting the standards of section 1502 (that is, one brought where the debtor has an establishment) were entitled to recognition under this section. The Model Law has been slightly modified to make this point clear by referring to the section 1502 definition of main and nonmain proceedings, as well as to the general definition of a foreign proceeding in section

101(23). A petition under section 1515 must show that the proceeding is a main or a qualifying non-main proceeding in order to obtain recognition under this section. n8

Neither Congress, nor the Model Law nor chapter 15 leave room for misinterpretation. The words center of main interests cannot plausibly be construed as place of incorporation or place as to which no objection is made or place that is irrelevant if the court wishes to grant comity. If the plain meaning of sections 1502, 1515, and 1516 were not plain enough, the House Report confirms the shift away from subjective section 304 factors to the new objective test of chapter 15:

This section closely tracks article 17 of the Model Law, with a few exceptions. **The decision to grant recognition is not dependent upon any findings about the nature of the foreign proceedings of the sort previously mandated by section 304(c) of the Bankruptcy Code.** The requirements of this section, which incorporates the definitions in section 1502 and sections 101(23) and (24), are all that must be fulfilled to attain recognition. n9

The District Court Agreed With Judge Lifland

Honorable Robert W. Sweet, United States District Judge for the Southern District of New York endorsed Judge Lifland's adoption of this strict interpretation:

Thus, Judge Lifland was right to reject Appellants' position that this Court should accept the proposition that the Foreign Proceedings are main proceedings because the Petitioners say so and because no [one] else says they aren't. 374 *B.R. at 129*.

He also recognized Judge Robert Gerbers denial of the unopposed summary judgment of recognition requested by the foreign representatives in the Basis Yield Alpha Fund (Master) case n10 because [the] foreign representatives of debtor had failed to submit sufficient information for the court to make a determination. 381 *B.R. 37*.

Judge Sweet agreed that comity did not affect the eligibility determination; instead, comity came into play in granting post-recognition relief:

Chapter 15 and the Model Law are designed to optimize disposition of international insolvencies by facilitating appropriate access to the court system of a host country (the United States, in the case of Chapter 15) by a representative of an insolvency proceeding pending in a foreign country. See § 1521; Model Law art. 21. If access is granted, then a wide range of relief from the host country's courts may be available. See § 1521; Model Law art. 21. "Recognition," the statutory parlance for such access, is distinct from the relief that may be granted post-recognition. Recognition turns on the strict application of objective criteria. See § 1517; Model Law art. 17. Conversely, relief is largely discretionary and turns on subjective factors that embody principles of comity. See, e.g., §§ 1507, 1521, 1525; Model Law art. 7, 21, 25. n11

Why did Congress (and UNCITRAL) impose strict eligibility criteria? Both chose an economic presence as one of the validation criteria for the foreign proceeding: a center of main interests test for a foreign main proceeding and an establishment test for a nonmain proceeding. The author recalls discussion at the UNCITRAL Working Group that drafted the Model Law that reflected concerns about forum shopping and a need to anchor the eligible foreign proceeding to an objective standard that would not be easily manipulated; they chose economic presence. Judge Sweet subscribed to this analysis as well:

The objective criteria for recognition reflect the legislative decision by UNCITRAL and Congress that a foreign proceeding should not be entitled direct access to or assistance from the host country courts unless the debtor had a sufficient pre-petition economic presence in the country of the foreign proceeding. See House Report at 110; § 1509(b)(3). If the debtor does not have its center of main interests or at least an establishment in the country of the foreign proceedings, the bankruptcy court should not grant recognition and is not authorized to use its power to effectuate the purposes of the foreign proceeding. See House Report 113; Guide paras. 73, 75, 128. Implicitly, in such

an instance the debtor's liquidation or reorganization should be taking place in a country other than the one in which the foreign proceeding was filed to be entitled to assistance from the United States. n12

When Judge Lifland issued the Bear Stearns Bankruptcy Decision, the offshore legal community howled in offense. Comity, they said, trumped the strict eligibility requirements of chapter 15. Congress could not have intended to limit access to the United States bankruptcy courts by its enactment of the UNCITRAL Model Law since the purpose of the Model Law was to increase cross-border assistance. n13 The evidentiary presumption that a debtors place of registration was its center of main interests (COMI) sufficed, they argued, to require recognition of a foreign proceeding emanating from the country of registration if no objection was filed, notwithstanding facts suggesting that the COMI was elsewhere. n14

Judge Liflands decision, as affirmed by Judge Sweet and reinforced by Judge Gerber in Basis Yield, should put an end to the polemics but may only serve to raise the volume. Is the United States being hypocritical, as suggested by critics of the Bear Stearns decisions, by imposing an economic test for the recognition of foreign proceedings while opening its court to chapter 7 and chapter 11 proceedings by a debtor that has a domicile, a place of business, or property in the United States...? n15 The question implies a forced imposition of U.S. bankruptcy law on unconsenting parties; i.e. the U.S. is exporting its bankruptcy law through proceedings of debtors with evanescent connections to the country while refusing to recognize foreign proceedings grounded on a similarly intangible basis. While the charge of double standards is theoretically appealing, in practice most examples of U.S. bankruptcy cases of debtors with insubstantial economic presence are ultimately consensual. Yukos and Fargo are recent examples of U.S. courts declining to entertain a non-U.S. debtor whose presence in bankruptcy court was opposed and whose lack of property in the U.S. led the courts to conclude that they could not effectively exercise their jurisdiction. n16

Consent may suffice for a U.S. bankruptcy court to apply its laws and procedures to a debtor that technically qualifies for jurisdiction and interested parties who accept that application and who consent to the courts jurisdiction. It is not inconsistent for that same court, as bound to enforce legislation enacted by Congress, to decline to extend its hospitality to a foreign proceeding whose jurisdictional basis is non-economic. U.S. bankruptcy laws are decidedly *in rem* and a lack of significant property in the foreign proceeding suggests a proceeding that may not effectively control the debtors assets. n17 Consent to recognition of a foreign proceeding is not a general solution to eligibility since the U.S. court cannot always know the extent of notice and due process afforded to persons who are not before it and who may be affected by the foreign proceeding. The chapter 15 eligibility criteria are, as suggested by UNCITRAL and adopted by Congress, objective. In light of the Bear Stearns decisions, they will remain so.

The Bear Stearns decisions do not signal an end to cross-border cooperation and coordination. Chapter 15, as interpreted in those decisions and as applied since its adoption, is working just fine. The only foreign proceedings to be denied recognition have been those that are pending in countries where the debtor either never had or no longer has the requisite presence. It seems neither irrational nor unduly limiting to require an economic connection between the debtor and the venue of the foreign proceeding as a condition to extending the effects of that proceeding through the courts of another country. Debtors similar to the Bear Stearns funds could commence proceedings under chapter 11 or 7 of the United States Bankruptcy Code in the United States, where their assets and operations were located. If the debtors were already in liquidation in another country, the liquidators would have the governance power necessary to commence the case in the United States. The U.S. proceedings could be coordinated with offshore proceedings if necessary. Chapter 15s provisions on coordination and cooperation, which do not turn on recognition, would then apply. n18

n1 *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 389 B.R. 325 (S.D.N.Y. 2008).

n2 *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007).

n3 *In re Tri-Continental Exch. Ltd.*, 349 B.R. 627, 634 (Bankr. E.D. Cal. 2006).

n4 *Id.* at 635.

n5 374 B.R. at 130; see *In re SPhinX, Ltd.*, 351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006), *affd*, 371 B.R. 10 (S.D.N.Y. 2007).

n6 See, e.g., Gabriel Moss, *Refusal of Recognition and Bear Stearns: Is the U.S. Denying to Others That Which It Expects for Itself*, INSOL World, Second Quarter 2008, at 14.

n7 374 B.R. at 126-27.

n8 H.R. Rep. No. 109-31, at 114 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 173.

n9 H.R. Rep. No. 109-31, at 113 (emphasis added).

n10 *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37 (Bankr. S.D.N.Y. 2008).

n11 389 B.R. 325, at 333.

n12 *Id.* at 333-34.

n13 See Moss, *supra* note 6, at 14.

n14 [T]he bankruptcy court wrongfully declined to honor the COMI presumption because there were no objections filed, creditors and investors should have expected Cayman law to control the debtors' insolvency proceedings and the debtors, as hedge funds have no 'operations' in the traditional sense.

See Appellants Opening Brief at 30, 389 B.R. 325 (No. 07-12383).

n15 11 U.S.C.S. § 109(a); see Moss, *supra* note 6, at 16.

n16 *In re Compania de Alimentos Fargo, S.A.*, 376 B.R. 427 (Bankr. S.D.N.Y. 2007); *In re Yukos Oil Co.*, 321 B.R. 396 (Bankr. S.D. Tex. 2005).

n17 *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356 (2006); see *Tenn. Student Assistance Corp. v. Hood*, 541 U.S. 440 (2004).

n18 11 U.S.C.S. §§ 1525-1527.

RELATED LINKS: For more information on sections 1502, 1506, 1507, 1509, 1515, 1516, 1521 and 1525 of the Bankruptcy Code, see Collier on Bankruptcy (Matthew Bender), ch.

- 1502;
- 1506;
- 1507;
- 1509;
- 1515;
- 1516;
- 1521;
- 1525.

For a one-stop source for all bankruptcy research, see the [lexis.com](http://www.lexis.com)

- bankruptcy area of law page.

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Mr. Glosband is a Vice President of the American College of Bankruptcy and a conferee of the National Bankruptcy Conference, which advises Congress on bankruptcy legislation. He was a draftsman of the UNCITRAL Model Law on Cross-Border Insolvency and one of two primary draftsmen of Chapter 15 of the United States Bankruptcy Code, Ancillary and Other Cross-Border Cases. He is a contributing author to *Collier on Bankruptcy 15th Ed. Revised*, *Collier Bankruptcy Practice Guide* and *Collier International Business Insolvency Guide*.

He is admitted to practice in New York, Massachusetts, the U.S. District Courts in Massachusetts, Connecticut, Vermont and the Southern District of New York, the U.S. Court of Appeals for the First Circuit and the U.S. Supreme Court. He received a J.D. from Cornell University in 1969 and a B.A. from University of Massachusetts in 1966.



67 of 197 DOCUMENTS

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Barack Obama: Bankruptcy Law and Consumer Protection Proposals

2008 Emerging Issues 2668

Barack Obama: Bankruptcy Law and Consumer Protection Proposals

By S. Andrew Jurs

August 12, 2008

SUMMARY: S. Andrew Jurs comments on Senator Barack Obamas outline for several new proposals to ease the effect of bankruptcy laws on military families, victims of natural disasters, and seniors, in addition to Obamas plans to reform the countrys bankruptcy laws, ostensibly to protect consumers in dire financial straits.

PDF LINK: Enhanced Emerging Issues Commentary (\$)

ARTICLE: On Tuesday, July 8, in a 15-minute speech, Senator Barack Obama, the presumptive Democratic nominee for president, outlined several new proposals to ease the effect of bankruptcy laws on military families, victims of natural disasters, and seniors. Additionally, he offered new plans to reform the countrys bankruptcy laws, ostensibly to protect consumers in dire financial straits. These new proposals go beyond anything Congress has discussed so far in light of the recent economic slump, and confirm that Obama would seek to undo or modify the 2005 amendments to the Bankruptcy Code. These proposals include:

Military Families. According to Obama, he would create a fast-track bankruptcy procedure for military families in several ways. First, he would ease restrictions against declaring bankruptcy by exempting service members from a harsh means test, cutting unnecessary paperwork, and removing the requirement for token counseling. Obama further said he would help service members and military families struggling financially after multiple moves, lengthy deployments and, in some cases, predatory lenders, by enacting a minimum federal homestead exemption to help them keep a greater share of their homes value, regardless of their state of residence, a significant departure from current law allows debtors to use federal bankruptcy exemption laws only if their state allows it.

Senior Citizens. Obama also seeks to help seniors over 62 keep their homes in bankruptcy, purportedly as cornerstones of a secure retirement, by promising a larger minimum homestead exemption equal to the median cost of a home in their state.

Mortgages on Debtors Primary Residence. In his Blueprint for Change, Obama proposes to close the alleged Bankruptcy Loophole for Mortgage Companies by eliminating the provision of the Bankruptcy Code that prevents bankruptcy courts from modifying an individuals mortgage payments. In Obamas opinion, the subprime mortgage industry, which has engaged in dangerous and sometimes unscrupulous business practices, should not be shielded by outdated federal law. Instead, under Obamas plan, courts would be able to renegotiate mortgages on a debtors primary

residence. Financial industry opponents, however, contend that this change would ultimately raise interest rates and loan costs due to increased lender risk.

Exemptions. Obama also proposes to waive some of the hurdles to filing personal bankruptcy, such as mandatory credit counseling and means testing, and to impose a 120-day moratorium on bad-credit reporting. Furthermore, Obama would make debtor-protection laws more equitable across states. In support of this proposal, Obama contends that state exemptions are uneven, sometimes nonexistent, and often too small. Instead, Obama would establish a minimum national homestead level of equity for certain homeowners that would be protected against creditors.

Bankruptcy Due to Health Costs. While Obama had previously proposed measures to alleviate bankruptcys effects on people who were facing bankruptcy as a result of illness, he has now proposed to create an exemption for individuals who can prove they filed bankruptcy because of medical expenses. This exemption would create a process to forgive the debt.

Bankruptcy Due to Natural Disaster. Similarly, Obama said he would help families recovering from a natural disaster by streamlining the bankruptcy process for those in certified natural disaster areas by eliminating unnecessary paperwork and waiving unneeded credit counseling requirements. He also promised to enact a 120-day moratorium on adverse credit actions from collectors, such as foreclosure for such families. His campaign further proposed amending the Equal Credit Opportunity Act to include protection for disaster victims so that lenders do not unfairly restrict credit to such families.

Predatory Credit Card Practices. Although not technically part of his bankruptcy law reforms, as part of his push for consumer protection, Obama proposes to create a credit card rating system, similar to the five-star systems used for other consumer products, to provide consumers an easily identifiable ranking of credit cards based on the cards features. Credit card companies would be required to display the rating on all application and contract materials, enabling consumers to quickly understand all the major provisions of a credit card without having to interpret the fine print.

Furthermore, Obama promises to create a Credit Card Bill of Rights to protect consumers by:

Banning unilateral changes;

Applying interest rate increases only to future debt;

Prohibiting interest on fees;

Prohibiting universal defaults; and

Requiring prompt and fair crediting of cardholder payments.

Payday and Small Consumer Loans. In an effort to cap outlandish interest rates on payday loans, Obamas Blueprint for Change supports extending a 36 percent interest cap throughout the country. Additionally, lenders would be required to provide clear and simplified information during the application process about loan fees, payments and penalties.

Obama also would encourage banks, credit unions and community development financial institutions to provide affordable short-term and small-dollar loans in the hope of driving unscrupulous lenders out of business.

Pensions and Retirement Savings. In Obamas eyes, current bankruptcy laws protect banks before workers, so he proposes to protect pensions by giving such promises to workers a higher priority on the list of debts that companies cannot shed. He also proposes barring bankrupt companies from issuing executive bonuses while cutting worker pensions. He further plans to increase the amount of unpaid wages and benefits workers can claim while limiting the circumstances under which retiree benefits can be reduced.

RELATED LINKS: To access articles on recent bankruptcy developments, search the

- Mega News, Bankruptcy Law file on lexis.com.

For a one-stop source for all bankruptcy research, see the

- bankruptcy area of law page on lexis.com.

For more news on lexis.com concerning Barack Obama and the Bankruptcy Code,

- [click here](#).

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S. Andrew Jurs received his B.A. for both Economics and History in 1991 from Duke University, and his J.D. in 1994 from the Emory University School of Law. For the two years after graduation from law school, Mr. Jurs had the honor of clerking for United States District Court Judge James G. Carr of the Northern District of Ohio. Since 1996, Mr. Jurs has gained substantial experience in bankruptcy, workouts, and creditors rights, and has become a Board Certified Specialist in Consumer and Business Bankruptcy Law. Author of numerous short pieces on bankruptcy law in various publications, including the *American Bankruptcy Institute Journal* and the *Banking Law Journal*, Mr. Jurs also has lectured widely on bankruptcy issues. He resides in Gastonia, North Carolina.



68 of 197 DOCUMENTS

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Jurs on Schultz v. United States

2008 Emerging Issues 2644

S. Andrew Jurs on Schultz v. United States, 2008 U.S. App. LEXIS 11686 (6th Cir. June 2, 2008)

By S. Andrew Jurs

July 30, 2008

SUMMARY: S. Andrew Jurs comments on *Schultz v. United States*, 529 F.3d 343, 2008 U.S. App. LEXIS 11686 (6th Cir. June 2, 2008), in which the Court of Appeals for the Sixth Circuit was confronted by a challenge to the constitutionality of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Jurs, S. Andrew. *Schultz v. United States*. LexisNexis Expert Commentary, (Insert date you accessed the document online).

The Sixth Circuit Rules That the Means Test Does Not Violate the Uniformity Requirement of the Bankruptcy Clause of the United States Constitution

In *Schultz v. United States*, 529 F.3d 343, 2008 U.S. App. LEXIS 11686 (6th Cir. June 2, 2008), the Court of Appeals for the Sixth Circuit was confronted by a challenge to the constitutionality of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 on the grounds that, to the extent BAPCPAs means test relies on state and county income calculations, it is not a uniform bankruptcy law for the entire United States. The appellate court concluded that BAPCPA was a uniform law on the subject of bankruptcy in that BAPCPA focused only on two classes of debtors: those with family income above the family median income for the debtors state, and those debtors with income below the state median. In doing so, the Sixth Circuit rejected the argument that differences in state median income rendered BAPCPA unconstitutional.

Facts and Procedural History. On November 21, 2006, Bernard Francis Schultz and Elizabeth Mary Sabatine (the debtors) filed a chapter 13 bankruptcy petition. At the time of filing, the debtors had an annualized current monthly income of \$89,975.84. This amount clearly was greater than the median income for a family of five in Tennessee, or \$63,174, thereby subjecting debtors to BAPCPAs more rigorous standards for above-median debtors. For example, by virtue of being above-median, the debtors were required to use a five-year repayment period and could not benefit from the more generous income exclusions available to below-median chapter 13 debtors.

The bankruptcy court subsequently confirmed the debtors chapter 13 plan and its required payments for 60 months. The chapter 13 plan anticipated a pro-rata distribution to unsecured creditors of less than 100 percent of allowed claims.

At the time of the confirmation of the debtors chapter 13 plan, they also filed a lawsuit against the United States in the U.S. District Court for the Eastern District of Tennessee seeking a declaratory judgment that the five sections of BAPCPA that use the means test are unconstitutional. Ruling on the parties cross-motions for summary judgment, the district court rejected the debtors arguments and concluded that the uniformity requirement does not proscribe different results in different states because of state law variations. *Schultz v. United States*, 369 B.R. 349, 352 (E.D. Tenn. 2007). The debtors timely filed their notice of appeal, and the appellate court reviewed *de novo* the grant of summary judgment. *Miller v. Admin. Office of the Courts*, 448 F.3d 887, 893 (6th Cir. 2006).

Standing. As an initial matter, the Sixth Circuit had to address an issue that had not been raised by the United States before the district court: whether the debtors even had standing to bring the lawsuit. Because standing is not a use it or lose it affirmative defense, *Community First Bank v. NCUA*, 41 F.3d 1050, 1053 (6th Cir. 1994), the failure to argue the debtors lack of standing did not automatically bar the United States from asserting the defense at the appellate level.

To establish standing under Article III of the Constitution, a plaintiff must show: (1) an injury-in-fact that (2) was fairly traceable to the defendants allegedly unlawful conduct, and (3) is likely to be redressed via a favorable decision. *Prime Media, Inc. v. City of Brentwood*, 485 F.3d 343, 349 (6th Cir. 2007) (quoting *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560, 112 S.Ct. 2130, 119 L. Ed. 2d 351 (1992)). According to the government, the debtors, as debtors under chapter 13, could not show an injury-in-fact, and therefore lacked standing to challenge the two BAPCPA provisions applicable only to chapter 7 cases: sections 707(b)(2) and 704(b). The Sixth Circuit, however, determined that it did not need to resolve this issue because its resolution of the debtors challenges to the chapter 13 provisions addressed identical claims for the chapter 7 provisions. To put it simply, we could not invalidate some of the means test provisions without invalidating the others. 2008 U.S. App. LEXIS 11686, at *13.

BAPCPA as a Uniform Bankruptcy Law. The Bankruptcy Clause of the Constitution provides that Congress has the power to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States. U.S. Const. art. I, § 8, cl. 4. This specific reference and emphasis on uniformity, according to Chief Justice Marshall, deserve[s] notice. Congress is not authorized merely to pass laws, the operation of which shall be uniform, but instead to establish uniform laws on the subject throughout the United States. *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 193-94, 4 L. Ed. 529 (1819). The question before the Sixth Circuit, therefore, was whether BAPCPA's classification system based on the median income of a debtors particular state violates the Bankruptcy Clause because debtors with the same income might receive different bankruptcy relief based solely on the state or county in which they reside.

Commentary. The Sixth Circuit's decision in *Schultz* is significant in that it is the first appellate decision resolving BAPCPA's constitutionality under the uniform Laws provision of the Bankruptcy Clause. Accordingly, it had to look to that sections historical roots to determine how much uniformity is required under bankruptcy law.

The first question faced by the Sixth Circuit in its historical analysis was whether uniformity pertained to persons, such that similar results would occur no matter where a debtor lived, or to states or regions. According to the Supreme Court, the Bankruptcy Clause's uniformity requirement is geographical, and not personal, *Hanover Natl Bank v. Moyses*, 186 U.S. 181, 188, 22 S.Ct. 857, 46 L. Ed. 1113 (1902), which is wholly satisfied when existing obligations of a debtor are treated alike by the bankruptcy administration throughout the country regardless of the State in which the bankruptcy court sits, *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 172, 67 S. Ct. 237, 91 L. Ed. 162 (1946) (Frankfurter, J., concurring). This means that different results are allowed in different states due to differences in state law, so long as federal law applies uniformly among classes of debtors. See, e.g., *Moyes*, 186 U.S. at 189-90 (upholding incorporation of varying state exemptions into the 1898 Bankruptcy Act); *Stellwagen v. Clum*, 245 U.S. 605, 613, 38 S. Ct. 215, 62 L. Ed. 507 (1918) (allowing Bankruptcy Acts incorporation of different state fraudulent conveyance statutes although the laws may lead to different results in different states).

As an extension of this principle, Congress may enact non-uniform laws to handle geographically isolated problems as long as the law operates uniformly upon a given class of creditors and debtors. *Blanchette v. Connecticut Gen. Ins.*

Corp., 419 U.S. 102, 95 S.Ct. 335, 42 L. Ed. 2d 320 (1974). In holding that the Regional Rail Reorganizational Act (the Rail Act) satisfied the uniformity requirement, although it operated only in a single statutorily defined region of the northeast United States, the Supreme Court in *Blanchette* concluded that the uniformity provision does not deny Congress power to take into account differences that exist between different parts of the country, and to fashion legislation to resolve geographically isolated problems, so long as the law applies equally to all creditors and debtors. *Id.* at 159-60. As an example of the narrow limits of the uniformity clause, the Supreme Court has only once struck down a statute as non-uniform. In *Railway Labor Executives Assn v. Gibbons*, 455 U.S. 457, 470-71, 102 S. Ct. 1169, 71 L. Ed. 2d 335 (1982), the Court held that Congress overstepped its authority when it passed a private bankruptcy law concerning only a single company, the Rock Island & Pacific Railroad Company, and its employees.

In light of these standards, the Sixth Circuit concluded that BAPCPA is a uniform law under the Bankruptcy Clause because it distinguishes only among classes of debtors. The provisions of BAPCPA applying the means test distinguish between only two classes of debtors: those above the median income, and those below the median income. All chapter 13 debtors who are below the median income have only a three-year repayment period and more advantageous treatment for calculating disposable income, whereas all above-median debtors have a five-year repayment period and more rigorous standards for disposable income. Consequently, [t]he general operation of the law is uniform although it may result in certain particulars differently in different states. *Moyses*, 186 U.S. at 190.

Additionally, the Sixth Circuit rejected the debtors argument that, even if a federal bankruptcy law may vary in application from state to state, employing federal income standards enables preferential treatment of debtors in some states over debtors in other states in a discriminatory manner. According to the appellate court, there is no Supreme Court precedent for such a federal versus state distinction, and the Sixth Circuit was unable to find any other case law explaining why using federal variations somehow makes a bankruptcy law non-uniform. The lesson of *Moyses* and its progeny--that Congress may permissibly address regional variations--would apply equally to variations based on either state laws or federal statistics. 2008 U.S. App. LEXIS 11686 at 23. In fact, in light of the motivations at the time the Constitution was adopted, the purpose of uniformity in the Bankruptcy Clause was to safeguard the nations interest in establishing and maintaining a single system of debt and credit without interference from the parochial or otherwise obstreperous action on the part of the fifty states. *Id.* at 27 (citing *In re Dehon, Inc.*, 327 B.R. 38, 56 n. 34 (Bankr. D. Mass. 2005)).

As a final matter, the appellate court determined that it did not need to apply a heightened scrutiny to its interpretation of the Bankruptcy Clause. Whereas, in *United States v. Ptasynski*, 462 U.S. 74, 84, 103 S. Ct. 2239, 76 L. Ed. 2d 427 (1983), the Court presumed that the uniformity provision of the Taxing Power required a form of heightened scrutiny, the Sixth Circuit concluded that the background and text of the Bankruptcy Clause was sufficiently different that no such heightened scrutiny was necessary. While the Taxing Power *limits* congressional authority by stating that all Duties, Imposts and Excises *shall be* uniform throughout the United States, U.S. Const. art. I, § 8, cl. 1 (emphasis added), the Bankruptcy Clause *grants* Congress an additional power at the expense of the states that would otherwise be imposing a wide array of conflicting debt collection laws. Consequently, the debtors argument that BAPCPA should receive close examination similar to the Taxing Powers uniformity provision was overruled.

All told, the Sixth Circuits decision in *Schultz* is important because it provides the first appellate court decision upholding the constitutionality of BAPCPAs means test. By finding that the means test fit within the uniformity requirement of the Bankruptcy Clause, the Sixth Circuit upheld perhaps the provision in BAPCPA most hated by debtors and their attorneys, and forced them to seek other avenues to challenging the new, more rigorous standards under BAPCPA.

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69 of 197 DOCUMENTS

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Glosband on In re Bancredit Cayman Ltd.

2008 Emerging Issues 2600

Daniel Glosband on In re Bancredit Cayman Limited (In Liquidation), No-06-11026, 2007 Bankr. LEXIS 3805 (Bankr. S.D.N.Y. Nov. 2, 2007)

By Daniel Glosband

July 24, 2008

SUMMARY: Despite a ruling by the United States Bankruptcy Court for the Southern District of Mississippi in *In re Condor Insurance Limited* that applied section 108(a) of the Bankruptcy Code in a chapter 15 case, both a bankruptcy court and a district court for the Southern District of New York clipped Condors wings.

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No Comfort in *Condor*: Bancredit Bankruptcy Court and District Court Clip Condors Wings Regarding Applicability of Bankruptcy Code Section 108

Bancredit Cayman Limited (Bancredit) is a Cayman Islands financial institution with banking affiliates located in Central America. n1 In May 2004, a Cayman Islands court entered a winding-up order regarding Bancredit and appointed Joint Official Liquidators (the JOLs or Foreign Representatives). n2 Two years later on May 10, 2006, the JOLs filed a petition in the Bankruptcy Court for the Southern District of New York (the Bankruptcy Court) for recognition under chapter 15 as a foreign main proceeding to investigate the existence of assets in the United States, including causes of action, and to liquidate such assets. n3 In June 2007, the Bankruptcy Court entered a Recognition Order recognizing the Cayman proceeding as a foreign main proceeding and thereafter entered a Supplemental Recognition Order. This Supplemental Recognition Order authorized the JOLs as foreign representatives under chapter 15 to take discovery and file suit in the United States to the extent permitted under *section 1509 of the Bankruptcy Code*. n4

On August 15, 2007, the Foreign Representatives filed an application (the Application) with the Bankruptcy Court seeking clarification of the Supplemental Recognition Order to declare that the Foreign Representatives were entitled to the benefits of extensions of statutes of limitations pursuant to section 108 n5 of the Bankruptcy Code. The Foreign Representatives conceded that both section 108 and case law under chapter 15 and its predecessor *section 304 of the*

Bankruptcy Code are silent as to whether a foreign representative is to be treated as a trustee for the purpose of section 108. Nevertheless, they sought a declaration that section 108(a) applied, invoking the courts power under section 1521(a)(7) to grant them any additional relief that may be available to a trustee...[.] n6 They argued in their Application that, because they were entitled pursuant to the Supplemental Recognition Order to both operate Bancredits business and exercise certain powers of a trustee pursuant to section 1520 n7 and to file suit within the United States pursuant to section 1509 n8 of the Bankruptcy Code, the Bankruptcy Court should also grant them a general extension of statutes of limitations.

The Bankruptcy Court denied the Application on grounds that it essentially sought an *ex parte* extension of the statute of limitations. n9 At a hearing on the matter, Chief Judge Stuart Bernstein raised both the inapplicability of the statutory language of section 108 and procedural concerns with respect to the relief sought. Judge Bernstein noted that a foreign representative is not a trustee as contemplated by section 108(a) and that, because there is no order for relief from which to measure the two year extension in a chapter 15 proceeding, the clarification sought by the Foreign Representatives could possibly result in [an] endless statute of limitations. n10 In response, the Foreign Representatives argued that Judge Bernstein could construe the order of recognition as the order for relief[.] n11 But Judge Bernstein was concerned that to grant the Foreign Representatives the protections of section 108 would strip someone of a possible defense and not give them the opportunity to argue that [section] 108 has no application based upon the plain language of the statute. n12

The Foreign Representatives countered, arguing that section 108 relief is automatic in cases under both chapters 7 and 11 and analogizing the automatic effect of section 108 to the imposition of the automatic stay under each of chapters 7, 11, and 15 where there are parties who can be impacted . . . by that stay that arent heard at the time. n13 Noting that unlike the relief sought by the Foreign Representatives the automatic stay does not affect substantive rights, Judge Bernstein suggested that the Foreign Representatives file any actions prior to the running of the relevant statute of limitations because he would not extend the statute of limitations as to parties that were not before the Bankruptcy Court. n14

Judge Bernstein denied the Application. The Foreign Representatives filed a Motion For Reargument (the Motion) on the grounds that there had been only limited opposition to the Application that did not raise the section 108 issue. Consequently, the Foreign Representatives did not adequately address the Bankruptcy Courts concerns about application of section 108. In addition, subsequent to Judge Bernsteins ruling on the Application, the bankruptcy court in the *Condor* case entered the same relief as that sought by the Bancredit Foreign Representatives. n15

The Foreign Representatives argued that an examination of the Bankruptcy Code and its prior history support the position that the filing of a chapter 15 recognition petition is itself the order for relief that Judge Bernstein noted was literally absent in chapter 15. The Foreign Representatives argued that section 301 n16 of the Bankruptcy Code provides that the commencement of a voluntary case under a chapter of title 11 constitutes an order for relief by virtue of section 301(b). This argument ignores the language of section 301(a) that requires that the petition be filed by an entity that may be a debtor while a chapter 15 petition is filed by a foreign representative, not a debtor. It also ignores the applicability provisions of sections 103(a) and 152 which do not make section 301 applicable to chapter 15 cases. Somehow, the Bancredit foreign representatives asserted that the definition of debtor in section 1502 n17 leapt this chasm: the term debtor includes an entity that is the subject of a foreign proceeding. n18 But the debtor in the foreign proceeding is not the entity that filed the petition! The court did not address this argument since it disposed of the case on procedural grounds and did not reach substantive issues.

While section 108 applies only to trustees, the Foreign Representatives next argued that section 108 is routinely applied to parties that are the functional equivalents of trustees[,] including chapter 11 and 12 debtors in possession, creditors appointed by the bankruptcy court to bring actions, and state court appointed receivers. n19 The Foreign Representatives also relied on precedent from the Fifth Circuit Court of Appeals which reasoned that non-trustee fiduciaries charged with pursuing the interests of all creditors of an estate should be accorded the protections given to the bankruptcy estate on behalf of all creditors under section 108. n20 The court did not reach this argument either,

specifically noting that [n]othing in this decision should be read to decide the ultimate issue: whether section 108 is available to the foreign representative. n21 The lack of a case or controversy and lack of notice to potentially affected parties were enough to warrant denial.

The court *In re Condor Insurance Limited* received a nearly identical request to that made in *Bancredit*. In *Condor*, the foreign representatives were the Joint Official Liquidators (JOLs) appointed by the Eastern Caribbean Supreme Court in the High Court of Justice of St. Christopher and Nevis (the Nevis Court). The *Condor* foreign representatives asserted that they had been recently appointed, had discovered a substantial transfer of assets but had not yet learned the details of the timing and recipients. They were concerned that statutes of limitation would run out before they had concluded their investigation and sought a determination that section 108 applied to them. Application of section 108(a) was warranted, they argued, based on either (a) a determination that Congress intended that all of section 108 apply in chapter 15 or (b) the courts determination that it should be applied as a matter of comity under section 1507(a)(7).

The Foreign Representatives in *Condor* (and later in *Bancredit*) advanced a rather insidious argument based on an erroneous application of the legislative history to section 1520. Section 1520, Effects of Recognition of a Foreign Main Proceeding, applies the automatic stay of section 362. Section 1520(b) contains an exception to stay to permit commencement of actions in foreign countries to the limited extent necessary for the plaintiff to preserve claims (which, under the laws of some countries might otherwise expire). The language of section 1520(b) specifies that the stay does not affect the right to commence an individual action or proceeding in a foreign country to the extent necessary to preserve a claim against the debtor[.] n22 The exception was limited to actions in foreign countries n23 because Congress believed that, for actions in the United States, section 108 n24 provided for the tolling protection intended by Article 20 of the Model Law. n25

The legislative history to section 1520 states Section 108 provides the tolling protection intended by Model Law article 20(3), so no exception is necessary for claims that might be extinguished under United States law. n26 In other words, section 1520(b) protects creditors with claims in foreign countries while section 108(c) protects creditors with claims in the United States; ergo, all creditors with claims to be asserted anywhere in the world are protected against losing their rights while they are stayed from commencing an action.

The *Condor* motion, later adopted in the *Bancredit* Motion, then takes a wholly unjustified leap of logic and statutory construction and asserts: The legislative history, although in the context of section 108(c) rather than 108(a), indicates that Congress deviated from the Model Law because it intended and even assumed that all of section 108 applies in Chapter 15 cases. n27 As one of those who assisted Congress with the drafting, the author disagrees strongly. This assertion ignores the logic of sections 1520(b) and 108(c), which is to insure that parties who are stayed from acting against a debtor by section 362 do not lose their rights to make a claim against the debtor as a consequence of the stay. Section 108(c) does not create a benefit to a trustee, as does section 108(a), but rather creates a benefit to a holder of a claim against the debtor. Section 108(c) is triggered by the termination of the section 362 stay not by the entry of an order for relief.

There is no logic in applying any aspect of section 108(c) or section 1520(b) or its history to section 108(a). The two subsections of section 108 serve completely different purposes. It insults the intelligence of Congress to suggest that it conflated the two and then neglected to reflect that improbable conflation in the legislative drafting.

The *Condor* court apparently did not rely on the Foreign Representatives flawed argument that section 108(a) applied automatically since its order granted the motion on the alternative section 1521(a)(7) grounds, as relief available to a trustee. n28 The Order entered by the *Condor* court indicates a lack of objections and a finding that proper notice was given, but it is not clear that the notice included possible defendants to be affected by the relief. n29

Judge Bernstein was unpersuaded by the *Condor* citation and issued a written memorandum denying reargument to the *Bancredit* foreign representatives. He noted that the root problem with the Application was that the Foreign Representatives failed to give notice of same to any party that might contest it, namely the parties which section 108(a)s

extension of the statute of limitations may have affected. n30 Describing the relief sought in the Application as presently unnecessary and plainly inappropriate, at least as a procedural matter[.] n31 Judge Bernstein noted that no controversy was present before the court and that the clarification requested would provide comfort to the Foreign Representatives at the expense of those who may be adversely affected by the relief [. . .], even though those persons did not receive notice or the chance to oppose the relief sought. n32 Judge Bernstein summarily dismissed the arguments of the Foreign Representatives as without merit, but stopped short of deciding whether section 108 is available to foreign representatives generally. n33 The Foreign Representatives were free to argue that issue, reasoned Judge Bernstein, in the appropriate forum, at the appropriate time and upon appropriate notice. n34

The Foreign Representatives appealed both the denial of the Application and the Motion to the United States District Court for the Southern District of New York. In their appeal, the Foreign Representatives placed at issue (i) whether Judge Bernstein erred by abstaining to decide an issue arising in a core proceeding under the Bankruptcy Code, and (ii) whether the Foreign Representatives were entitled to (A) a determination that section 108 would have automatic application in any action they might subsequently commence, or (B) a discretionary determination pursuant to section 1521(a)(7) as to whether they should have been granted the benefit of section 108. n35 The District Court found that Judge Bernstein did not err in his rulings because Judge Bernstein had concluded that there was no live controversy before the Bankruptcy Court where no action had been commenced and no statute of limitations defense was asserted against the Foreign Representatives. n36

Noting that the Bankruptcy Court had subject matter jurisdiction to the extent that an ancillary case had been commenced under chapter 15 and assuming the dubious assertion of the Foreign Representatives that the issues raised in the Bankruptcy Court related to a core proceeding, the District Court held that what the Foreign Representatives in substance sought here was an advisory opinion[.] n37 Recognizing that Article III of the United States Constitution limits the judicial power of the courts to live cases and controversies, the District Court stated that [n]either the district courts nor the bankruptcy courts [. . .] have the power to grant such relief. n38 Accordingly, the District Court affirmed the denial of the Application and Motion. n39

So what is the insolvency practitioner to make of this nascent split of authority of the availability of section 108 relief to foreign representatives in the absence of a case or controversy? Perhaps the *Condor* facts were further advanced in terms of a potential recovery action, but in neither case was a defendant named or noticed. The real question, whether section 108(a) can be applied to extend a foreign representatives statute of limitations, went unanswered in *Bancredit* and, while affirmatively answered in *Condor*, went unexamined. In a real case or controversy situation, after notice to an affected potential defendant, a court might decide to apply section 108(a). The decision should analyze the introductory purposes of chapter 15 in section 1501 and the qualifying requirements of section 1521(a). Would applying section 108(a) effectuate the purposes of chapter 15 and protect the assets of the debtor or the interests of the creditors?

The arguments in both cases that Congress intended section 108(a) to apply automatically in chapter 15 cases hold no water and are specifically refuted by principles of plain language jurisprudence and by the omission of section 108(a) from the applicability sections of the Bankruptcy Code.

A foreign representative may be hard pressed to overcome the procedural and live case and controversy requirements propounded by both the Bankruptcy Court and District Court in *Bancredit* and must therefore be prepared to act quickly. In *Bancredit*, the Foreign Representatives waited over two years from the commencement of the Cayman liquidation to seek recognition from United States courts. As statutes of limitations were slowly slipping away, the Foreign Representatives could have, concurrently with the Cayman liquidation, investigated possible causes of action in the United States. With such a head start, the advisory relief sought from Judge Bernstein could have been unnecessary.

A foreign representative under pressure of a soon-to-expire statute of limitations may also, prior to the expiration of the statute of limitations, commence cases against everyone and anyone against whom the foreign representative supposes he may have a claim, subject to having enough of a basis to satisfy *Rule 11 of the Federal Rules of Civil Procedure*. Although neither efficient nor the best use of court resources, it would certainly avoid the procedural and

Article III questions raised in *Bancredit*. The uncertainty of whether a bankruptcy court would indeed grant section 108 relief to a foreign representative may also mitigate in favor of commencing a full blown chapter 7 or chapter 11 case, where there will be an order for relief and a trustee or a debtor in possession who automatically receive section 108(a) benefits.

As a potential defendant, an argument that a literal reading of section 108 prohibits anyone but a trustee in a case where an order for relief has been entered from receiving the extension of statutes of limitations seems most appropriate. Or, if the unlucky potential defendant is in the Southern District of Mississippi and is sued subsequent to what he or she expected to be the running of the statute of limitations, the procedural arguments touched upon in *Bancredit* should be made in an affirmative defense or in a motion to dismiss in answer to a foreign representatives complaint.

Whether the ruling in *Condor* has been permanently grounded by the reasoning of the *Bancredit* decisions remains to be seen. Neither the *Condor* ruling nor any one of the *Bancredit* decisions are binding precedent outside those particular courtrooms. That may change, however, as the Foreign Representatives in *Bancredit* have appealed the District Courts ruling to the Second Circuit Court of Appeals. Stay tuned. n40

For further discussion of *Bankruptcy Code section 108*, see Collier on Bankruptcy, ch. 108 (Matthew Bender).

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Return to Text

n1 . *In re Bancredit Cayman Limited (In Liquidation)*, No-06-11026, 2007 Bankr. LEXIS 3805, at 2 (Bankr. S.D.N.Y. Nov. 2, 2007).

n2

[2]. *Id.*

n3

[3]. *Id.*

n4

[4]. *Id.*

n5

[5]. Specifically, the Foreign Representatives sought relief under section 108(a), which provides in relevant part:

If applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of

(1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or

(2) two years after the order for relief.

11 U.S.C. § 108 (2008).

n6

[6]. *11 U.S.C. 1521(a)(7).*

n7

[7]. Specifically, section 1520(a)(3) provides that [u]pon recognition of a foreign proceeding that is a foreign main proceeding [], unless the court orders otherwise, the foreign representative may operate the debtors business and may exercise the rights and powers of a trustee under and to the extent provided by sections 363 and 552[.] *11 U.S.C. 1520(a)(3).*

n8

[8]. Section 1509(b) provides in particular:

(b) If the court grants recognition under section 1517, and subject to any limitations that the court may impose consistent with the policy of this chapter--

(1) the foreign representative has the capacity to sue and be sued in a court in the United States;

(2) the foreign representative may apply directly to a court in the United States for appropriate relief in that court; and

(3) a court in the United States shall grant comity or cooperation to the foreign representative.

11 U.S.C. § 1509(b) (2008).

n9

[9]. *In re Bancredit Cayman Limited (In Liquidation)*, No-06-11026, 2007 Bankr. LEXIS 3805, at 2 (Bankr. S.D.N.Y. Nov. 2, 2007).

n10

[10]. Tr. at 6, *In re Bancredit Cayman Limited (In Liquidation)*, No-06-11026 (Bankr. S.D.N.Y. Oct. 11, 2007) (Docket No. 30).

n11

[11]. *Id.* at 7.

n12

[12]. *Id.* at 8.

n13

[13]. *Id.* at 9.

n14

[14]. *Id.*

n15

[15]. *In re Condor Insurance Limited (In Official Liquidation)*, No. 07-51045 (Bankr. S.D. Miss. Oct. 10, 2007). Notably, the foreign representative in the case where the relief sought under section 108 was granted was also one of the Foreign Representatives in the *Bancredit* case.

n16

[16]. Section 301 provides:

(a) A voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition under such chapter by an entity that may be a debtor under such chapter.

(b) The commencement of a voluntary case under a chapter of this title constitutes an order for relief under such chapter.

11 U.S.C. § 301 (2008).

n17

[17]. Section 1502 provides that for purposes of chapter 15, debtor is defined as an entity that is the subject of a foreign proceeding[.] 11 U.S.C. § 1502(1) (2008).

n18

[18]. See Mot. at 5-6, *In re Bancredit Cayman Limited (In Liquidation)*, No. 06-11026 (Bankr. S.D.N.Y. Oct. 29, 2007) (Docket No. 31).

n19

[19]. *Id.* at 6-8.

n20

[20]. *Id.* at 8.

n21

[21]. *In re Bancredit Cayman Limited (In Liquidation)*, No-06-11026, 2007 Bankr. LEXIS 3805, at 2 (Bankr. S.D.N.Y. Nov. 2, 2007).

n22

[22]. 11 U.S.C. § 1520(b).

n23

[23]. Unlike Article 20 of the Model Law on Cross Border Insolvency (the Model Law) of the United Nations Commission on International Trade Law (upon which *section 1520 of the Bankruptcy Code* was based) which provides for an exception to the stay for a creditor to bring and preserve a claim against the debtor anywhere.

n24

[24]. Specifically, section 108(c) provides as follows:

Except as provided in section 524 of this title, if applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period for commencing or continuing a civil action in a court other than a bankruptcy court on a claim against the debtor, or against an individual with respect to which such individual is protected under section 1201 or 1301 of this title, and such period has not expired before the date of the filing of the petition, then such period does not expire until the later of

(1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or

(2) 30 days after notice of the termination or expiration of the stay under section 362, 922, 1201, or 1301 of this title, as the case may be, with respect to such claim.

11 U.S.C. § 108(c).

n25

[25]. Although the Foreign Representatives did concede that the legislative history only appears in the context of section 108(c) and not 108(a), they argued that it nonetheless showed Congress deviated from the Model Law because it assumed and intended that section 108 would apply *in toto* to chapter 15 cases. *See* Mot. at 10, *In re Banccredit Cayman Limited (In Liquidation)*, No. 06-11026 (Bankr. S.D.N.Y. Oct. 29, 2007) (Docket No. 31).

n26

[26]. H.R. Rep. 109-31(I) at 115, 109th Cong., 1st Sess. 2005, 2005 U.S.C.C.A.N. 88, 178.

n27

[27]. See Mot., *In re Condor Insurance Limited (In Official Liquidation)*, No. 07-51045 (Bankr. S.D. Miss. August 30, 2007) (Docket No. 39).

n28

[28]. See Order, *In re Condor Insurance Limited (In Official Liquidation)*, No. 07-51045 (Bankr. S.D. Miss. October 10, 2007) (Docket No. 44).

n29

[29]. *Id.*

n30

[30]. *In re Bancredit Cayman Limited (In Liquidation)*, No-06-11026, 2007 Bankr. LEXIS 3805, at 3 (Bankr. S.D.N.Y. Nov. 2, 2007).

n31

[31]. *Id.*

n32

[32]. *Id.* at 4.

n33

[33]. *Id.* at 5.

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[34]. *Id.* at 6.

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[35]. *In re Bancredit Cayman Limited (In Liquidation)*, No. 07-11338, 2008 U.S. Dist. LEXIS 30596, at *3 (S.D.N.Y. March 31, 2008).

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[36]. *Id.*

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[37]. *Id.* at *4.

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[38]. *Id.*

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[39]. *Id.* at *5.

n40

[40]. Jonathan P. Olsson, an associate at Goodwin Procter LLP, contributed to the research, drafting and editing of this article.

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70 of 197 DOCUMENTS

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Jurs on In re Geiger

2008 Emerging Issues 2506

S. Andrew Jurs on IRS v. Geiger (In re Geiger), 2008 Bankr. LEXIS 1287 (Bankr. C.D. Ill., April 28, 2008)

By S. Andrew Jurs

July 8, 2008

SUMMARY: S. Andrew Jurs comments on *IRS v. Geiger (In re Geiger)*, 2008 Bankr. LEXIS 1287 (Bankr. C.D. Ill., April 28, 2008), in which the bankruptcy court had to determine whether husband and wife debtors (the Debtors) could discharge the husbands tax liabilities for the years 1993, 1995, 1997, and 1998, and the Debtors joint tax obligations for 2000 and 2001, when the IRS contended that the debtors willfully attempted to defeat or evade payment.

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The bankruptcy court holds that husbands tax liabilities and interest were not dischargeable, but that the penalties were dischargeable. The bankruptcy court further held that the wifes liabilities for such amounts were fully dischargeable despite the fact that she signed certain returns

In *IRS v. Geiger (In re Geiger)*, 2008 Bankr. LEXIS 1287 (Bankr. C.D. Ill., April 28, 2008), the bankruptcy court had to determine whether husband and wife debtors (the Debtors) could discharge the husbands tax liabilities for the years 1993, 1995, 1997, and 1998, and the Debtors joint tax obligations for 2000 and 2001, when the IRS contended that the debtors willfully attempted to defeat or evade payment.

Facts

The debtor husband, Richard, was 53 years old and had only a tenth grade education. From 1993 to 2001, he worked as a trader in the stock brokerage industry. Beginning in the early 1990s, however, he developed a cocaine addiction which consumed much of his disposable income. He did not timely file federal income tax returns for 1993, 1995, and 1997.

After he married the female debtor, Stephanie, in 1998, Richards cocaine use slowed, and he began trying to resolve his issues with the IRS. He retained an accountant and obtained an extension of time to file his 1998 return. He timely filed his individual 1998 return on May 17, 1999. Although Richards 1998 individual return showed a tax due of \$51,234, no payment was made with the return. The next day, Richard filed his 1993 individual tax return showing

unpaid tax of \$28,843. In August 1999, he filed his 1995 and 1997 returns, showing unpaid tax of \$9,932 and \$19,333 respectively. No payments were made when these individual returns were filed. n1

On June 14, 1999, the IRS issued a statutory Notice of Assessment for the 1998 taxes. Subsequent Notices of Assessment were filed on October 4, 1999, for the 1993 taxes, and October 11, 1999, for the 1995 and 1997 taxes. The IRS also issued notices of intent to levy.

Relying on a customers tip, Richard, Stephanie, Richards mother, and Richards brother acquired shares of BluePoint stock, which was cleared for trading on March 6, 2000. By that afternoon, the trading account holding all of their contributions had profited by \$600,000, of which 60% went to Richard. In the next three months, Richard purchased a 1999 Cadillac for almost \$65,000, and Stephanie and Richard purchased a new home for roughly \$238,000. According to Richard, his mother contributed \$120,000 to the homes purchase price, and the title was in her and Stephanies name. The Debtors then spent between \$75,000 and \$90,000 on improvements to the house. In Richards words, their spending during this time was completely amazing and ridiculous.

The Debtors timely filed their 1999 joint income tax return on April 15, 2000. Prior to the filing of this return, the Debtors had made three estimated tax payments totaling \$25,309, and they made a further payment of \$57,628 at the time of the filing of the 1999 return. Because this still left the Debtors short by \$11,898, they made a subsequent tax payment in July 2000, with penalties added, to fully satisfy their 1999 tax liability.

As to their 2000 joint income tax liability, the Debtors made four estimated tax payments in 2000 totaling \$56,252, and a fifth payment in April 2001 of \$21,875. After obtaining an extension, the Debtors timely filed their 2000 tax return on August 14, 2001. That return showed a tax due of \$324,483, but no payment accompanied the return on the \$246,356 still owed. By November 2001, the Debtors had no more cash and were forced to take out a \$179,000 mortgage on their house to make a payment of \$100,000 toward their 2000 taxes and an estimated payment of \$12,000 toward their 2001 tax liability.

Despite obtaining the automatic extension for filing their 2001 tax return, the Debtors were unable to file it in a timely manner; in fact, it was not filed until May 21, 2003. On June 23, 2003, the IRS assessed interest, an estimated tax penalty, a late filing penalty, and a failure to pay tax penalty on the Debtors for their 2001 tax liability. Around the same time, the Securities and Exchange Commission (SEC) sued Richard and others for problems arising from the BluePoint stock trades, including a claim against Richard for approximately \$545,000 and up to \$1,250,000 in penalties.

Procedural History

The Debtors filed an adversary proceeding as part of their bankruptcy case seeking a determination of the dischargeability of their federal income tax liabilities for 2001 and previous years. The Debtors asserted that the taxes were dischargeable because the returns were filed, and the taxes were both due and assessed, well outside the lookback periods of §§ 523(a)(1) and 507(a)(8). The IRS answered by invoking the tax evasion exception, and the matter went to trial in December 2007.

At trial, Richard testified that he knew he had an obligation to file tax returns for 1993, 1995, and 1997, and that he knew he would owe taxes for each of those years. Because of his cocaine addiction and the expense of maintaining residences in Ohio and Illinois, however, he failed to file the returns. Additionally, the accountant who eventually prepared the tax returns did not advise Richard on how to resolve his tax liability delinquencies. Although Richard believed that his good fortune from 2000 would continue such that he would be able to pay these delinquencies from future income, he was unable to account for the nearly \$500,000 that was consumed after the BluePoint trades. The Debtors did not contest the amount of taxes, penalties, and interest claimed by the IRS.

Legal Analysis

Although one of the general goals of the Bankruptcy Code is to give debtors a fresh start, there are several

exceptions to ensure that undeserving debtors do not benefit from the general discharge. Section 523(a)(1)(C) provides that a debtor is not discharged from any tax debt with respect to which the debtor . . . willfully attempted in any manner to evade or defeat such tax. Courts have interpreted the phrase in any manner expansively and found that it covers a broad range of conduct. *Dalton v. I.R.S.*, 77 F.3d 1297 (10th Cir. 1996). The tax evasion exception encompasses both actions to avoid assessment and actions to evade payment, *Smith v. U.S.*, 202 B.R. 277 (S.D. Ind. 1996), including acts of commission and omission. *In re Toti*, 24 F.3d 806 (6th Cir. 1994). n2

To meet its burden of proving that a debtors tax is nondischargeable under § 523(a)(1)(C), the United States must satisfy two requirements: a conduct requirement showing that the debtor attempted to evade or defeat a tax, and a mental state requirement revealing that the attempt was done willfully. *Matter of Birkenstock*, 87 F.3d 947, 951-52 (7th Cir. 1996). See also *In re Fretz*, 244 F.3d 1323 (11th Cir. 2001); *In re Fegeley*, 118 F.3d 979 (3rd Cir. 1997) (agreeing with the two-requirement interpretation of § 523(a)(1)(C) in *Birkenstock*). Mere nonpayment of taxes is, in itself, insufficient to prove conduct to evade or defeat taxes; however, nonpayment coupled with a pattern of failure to file tax returns or affirmative acts to conceal assets or income could satisfy the conduct requirement. *Id.*

Courts judge the totality of circumstances to determine whether the conduct requirement is met. *Indicia* of tax evasion include: (1) understatement of income; (2) extensive cash dealings; (3) inadequate record keeping; (4) intra-family transfers for insufficient consideration; (5) failure to acquire significant assets relative to earnings; and (6) a lavish and extravagant lifestyle. *In re Hamm*, 356 B.R. 263 (Bankr. S.D. Fla. 2006); *In re Klayman*, 333 B.R. 695 (Bankr. E.D. Pa. 2005). Similarly, as with fraud, courts use various badges to determine whether the mental state requirement is met, which the IRS may establish by showing that the debtor: (1) knew he had a duty to file income tax returns and pay taxes, and (2) voluntarily and intentionally violated that duty. Such badges include: (1) the recurrence of the understatement of income for more than one tax year; (2) the understatement of income; (3) implausible or inconsistent explanations of behavior; (4) inadequate records; (5) transfer of assets to a family member; (6) transfer for inadequate consideration; (7) transfers which greatly reduce assets subject to IRS execution; and (8) transfers made in the face of serious financial difficulties. *In re Spiwak*, 285 B.R. 744 (S.D. Fla. 2002); *In re Sommers*, 209 B.R. 471 (Bankr. N.D. Ill. 1997). A rebuttable presumption of willful evasion arises if multiple factors are present. *In re Peterson*, 317 B.R. 556 (Bankr. N.D. Ga. 2004). Additionally, the IRS must meet its burden of proving nondischargeability with regard to each individual tax year. *In re Lynch*, 299 B.R. 62, 83 (S.D. N.Y. 2003).

Commentary

The bankruptcy courts holding in *Geiger* is useful for practitioners because of its analytical thoroughness, presenting a clear outline of the burdens, standards, and factors to be used in these types of cases. Furthermore, it provides a useful contrast between the application of these standards and factors to both the bad actor and the innocent spouse.

Richards Individual Tax Liability. As to Richards individual tax liability for 1993, 1995, and 1997, the court found that his failure to file his tax returns, along with his failure to pay those taxes at all, established an attempt on his part to evade his tax obligations for those years. The court further dismissed his late filing of those returns, and determined that the late filings did not rectify the initial failure to file and pay. Accordingly, the IRS met its burden of meeting the conduct requirement for those tax years.

With regard to the willfulness requirement, the court noted that Richard admitted he knew he was required to file tax returns and to pay taxes for those years. Richards cocaine addiction did not mitigate this finding. *In re Berzon*, 145 B.R. 247 (Bankr. N.D. Ill. 1992) (finding debtor acted willfully in failing to file tax returns not precluded by drug abuse). Nor did Richards drug abuse render his failure to pay taxes involuntary and unintentional; instead, Richard voluntarily chose to spend his money on things other than his tax liability. Even though Richard did file a timely return for 1998, the court noted that his failure to pay taxes for a sixth year in a row was a strong indication that this year was simply one more in an ongoing pattern of tax evasion.

The court further held that Richards subsequent actions left no doubt that he willfully attempted to evade his taxes. Even though the Debtors income in 1999 and 2000 was sufficient to pay both Richards individual and the Debtors joint tax liabilities, the Debtors did not do so. Instead, Richard left his name off of the house title even though one-half of the price was paid with his commissions. The Debtors also maintained inadequate records, could not explain checks written for significant amounts, and spent money recklessly. The end result was a finding by the court that Richards tax debts, of principal and interest, for 1993, 1995, 1997, and 1998 were nondischargeable. As described more fully below, Richards tax debt for 2000 was also found nondischargeable; however, the penalty amounts for those years were dischargeable because, under § 523(a)(7), tax penalties are dischargeable if they are imposed for an event or transaction occurring more than three years before the petition date.

Debtors Joint Tax Liability and Stephanies Tax Liability. As to the Debtors joint tax liability for 2001, the court found that the IRS failed to meet its burden of showing that the Debtors did not intend to pay their taxes for that year. Of particular importance to the court was the fact that the Debtors made a substantial estimated tax payment of \$12,000 in November 2001, even though they were broke according to Richard, which left them only \$4,690 short of satisfying their tax liability. To the court, this evidenced intent to pay which was clearly different than the intent shown in previous years.

In contrast, the Debtors conduct for tax year 2000 was problematic because the substantial income that year could have been used to satisfy tax liability but was not. The Debtors estimated tax payments covered only 17% of the tax due, which the court considered to be only a token amount. Thus, the court concluded that Richard also willfully evaded his tax obligations for that year.

With regard to Stephanies liability for tax year 2000, the IRS failed to meet its burden of proving nondischargeability when the IRS offered no explanation for Stephanies failure to appear at trial. In fact, the IRS never asserted that Stephanie had been required to appear and testify, nor did the IRS mention Stephanie in its closing argument or contend that the record supported a determination of willful misconduct on her part. Accordingly, the tax liability for tax year 2000 was dischargeable as to Stephanie.

Conclusion

In sum, the decision in *Geiger* is useful because it addresses so many different aspects of the discharge of tax indebtedness and the tax evasion exception in § 523(a)(1)(C). The court deals with late filed returns, which could have been construed as attempts to cure past deficiencies, a taxpayers potential incapacitation and lack of intent or willfulness due to drug addiction, asset protection, inadequate record keeping, profligate spending and consumption instead of paying debts, and a possibly innocent spouse. In doing so, the court lays out the burdens, standards, and factors in a useful and organized way, thereby providing practitioners and courts with a blueprint for analyzing other cases and situations arising at the sometimes confusing crossroads of tax and bankruptcy law.

For further discussion related to the discharge of tax indebtedness under 11 U.S.C. § 523(a), see generally *Collier on Bankruptcy* ch. 523 (Matthew Bender).

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[Return to Text](#)

n1 . Richard also did not file tax returns for 1994 and 1996, but the IRS did not make a claim for unpaid taxes for those years. According to Richards testimony, there were several years in which he earned no income.

n2 . Section 523(a)(1)(C) also excepts from discharge debts arising from fraudulent returns; however, the IRS did not contend that any of the Debtors tax returns were fraudulent.

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71 of 197 DOCUMENTS

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Noel on Florida Dept of Revenue v. Piccadilly Cafeterias, Inc.

2008 Emerging Issues 2498

Charolette F. Noel on Florida Dept of Revenue v. Piccadilly Cafeterias, Inc.: U.S. Supreme Court Limits the Bankruptcy Code's Transfer Tax Exemption to Transfers That Occur "After" Confirmation of the Chapter 11 Plan

By Charolette F. Noel

July 7, 2008

SUMMARY: Florida Dept of Revenue v. Piccadilly Cafeterias, Inc. limits the Bankruptcy Codes transfer tax exemption to transfers that occur after confirmation of the Chapter 11 plan. Charolette Noel, a state tax partner with Jones Day, comments on the Piccadilly decision and its impact on real estate owners and investors, states and local governments, and tax practitioners.

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ARTICLE: From a practical perspective, n1 real estate and other tax costs for bankruptcy acquisitions recently increased as a result of the U.S. Supreme Courts June 16, 2008 decision in *Piccadilly*. n2 The decision limits the Bankruptcy Codes transfer tax exemption to transfers that occur after confirmation of the Chapter 11 plan. Despite acknowledging that most bankruptcy sales occur before confirmation, the Supreme Court imposed the temporal limitation based on the natural reading of the statute in light of competing canons of statutory construction. n3

Will this decision affect the ability of cash-strapped real estate owners to reorganize and restructure their debts through bankruptcy sales? Possibly, but probably not significantly. Will the increased costs affect the price of sales in bankruptcy? Probably, at least in some locations. The increased tax costs, if any, will likely be paid either (i) out of the purchase price, which otherwise would be available to creditors, or (ii) by investors who may seek to recover the cost through a lower purchase price. Thus, from a practical perspective, the creditors and/or investors lose and the states, counties, and municipalities win. n4

Investors expecting bargains in bankruptcy should consider the potential increased tax costs resulting from *Piccadilly*. Unfortunately, quantifying the increase is not easy. As discussed below, if and how much tax costs of bankruptcy sales increased after *Piccadilly* depends primarily on the location of the property and the timing of the transaction. The costs may also vary based on controlling authority of the particular bankruptcy court, the investors assumption of transfer-tax risk, and the eventual outcome of any further disputes over the scope of transfer-tax exemptions available under state law or *Bankruptcy Code* § 1146(a). n5

The Bankruptcy Codes Transfer Tax Exemption under § 1146(a). Bankruptcy Code § 1146(a) provides in its entirety:

The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under Section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.

The provision generally applies as an exemption to certain state and local taxes. Courts typically apply a three-part test when determining if the tax is exempt under § 1146(a). For a tax to be exempt: (i) the tax must be a stamp or similar tax; (ii) the tax must be imposed upon the making or delivery of an instrument transferring an interest in property; and (iii) the transfer taxed must be made in connection with a confirmed bankruptcy plan. ⁿ⁶ Like all multi-part tests, each prong comes with its own set of questions (*e.g.*, what is a stamp tax and what state transfer taxes are sufficiently similar to a stamp tax?). The exact scope of this exemption has been debated in courts of all levels for decades.

The *Piccadilly* Decision. Shortly after filing for Chapter 11 bankruptcy protection, Piccadilly asked the court for permission to sell substantially all its assets and requested that the sale be exempted from state transfer taxes under § 1146(a). An auction was conducted to find the highest bidder for Piccadilly's assets. The winner of the auction agreed to pay \$80 million for the assets, which were packaged as a going concern in order to maximize value.

Prior to closing the asset sale, Piccadilly entered into a Global Settlement Agreement with its creditors to distribute the proceeds of the assets. The court approved the sale, the Global Settlement Agreement, and the request for § 1146(a) exemption from Florida's stamp tax and other taxes.

Ten days after the sale closed, Piccadilly filed a plan to distribute the proceeds of the sale consistent with the Global Settlement Agreement. Before the plan was confirmed, Florida timely objected, seeking a declaration that § 1146(a) did not exempt \$39,200 of stamp taxes Florida assessed Piccadilly on the sale of its assets.

The bankruptcy court granted summary judgment to Piccadilly, finding that the words under a plan confirmed can indeed mean before the plan is confirmed if the sale is necessary to the ultimate confirmation of the plan. The district court and the Eleventh Circuit both affirmed the bankruptcy court's ruling, although under differing rationales. Florida appealed, and the Supreme Court granted certiorari to resolve a split between the circuits as to whether § 1146(a) applies to transfers prior to confirmation.

The case presented a chance for the court to sift through what it termed dueling canons of statutory construction. Citing *Sierra Summit, Inc.*, ⁿ⁷ Florida argued that the court should proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed. ⁿ⁸ Not to be outdone, Piccadilly cited its own canons, arguing that *Sierra Summit* does not apply because § 1146(a) is a clear expression of an exemption from state taxation, that a remedial statute such as the Bankruptcy Code should be liberally construed, and that the objectives of Chapter 11 include preserving going concerns and maximizing property available to satisfy creditors. ⁿ⁹

Relying on the substantive canon created by *Sierra Summit*, the Supreme Court narrowly construed § 1146(a) to apply only to transfers made pursuant to a Chapter 11 plan that has been confirmed. ⁿ¹⁰ States, counties, and municipalities may impose taxes on transfers in bankruptcy that occur before the plan is confirmed.

This is not, however, the last we will see of debates on the scope of § 1146(a). The *Piccadilly* case addresses only one of the debated interpretations of § 1146(a) described in the general three-part test described above. The case did not address the scope of what constitutes a stamp or similar tax or making or delivery of an instrument. In light of *Piccadilly*, we are left to ponder the appropriate canon of construction and natural reading for those phrases. Until Congress or the Supreme Court step in to clearly define the scope of transfer tax exemptions in bankruptcy, debates will continue. Nevertheless, it is hard to imagine further debate of a significant national interest to cause the Supreme Court to take another § 1146(a) case.

Prior Interpretations of § 1146(a). Prior to *Piccadilly*, the circuit courts split over whether § 1146(a) prevented debtors from using the exemption when selling assets *during* a Chapter 11 bankruptcy case. In practice, most

jurisdictions allowed the § 1146(a) tax exemption even if the sale occurred prior to the time the bankruptcy plan was confirmed. Most courts, including the Second Circuitⁿ¹¹ and the Eleventh Circuit,ⁿ¹² found the phrase under a plan confirmed to be ambiguous because the word under has several meanings and does not necessarily imply a timing restriction (*i.e.*, that the sale must occur after confirmation). In 1999, the Fourth Circuit held that § 1146(a) applied only to transfers occurring after the date of confirmation.ⁿ¹³ In 2003, the Third Circuit similarly held that § 1146(a) does not apply to transactions that occur prior to the confirmation of a plan under Chapter 11 of the Bankruptcy Code.ⁿ¹⁴

In most jurisdictions, bankruptcy attorneys regularly asserted in sale motions that the § 1146(a) exemption should be construed more broadly.ⁿ¹⁵ From a practical perspective, the decision whether to sell or retain assets inherently needed to be made prior to confirmation of the plan.ⁿ¹⁶ A relatively small percentage of sales in bankruptcy occur postconfirmation. Thus, many bankruptcy lawyers argued that the general policy behind § 1146(a), to facilitate reorganizations and maximize the value of the estate, is frustrated if the exemption were limited to the relatively few sales that occur postconfirmation.

Historically, there were relatively few objections to the broader assertions of exemption under § 1146(a). In many jurisdictions, transfers in bankruptcy are exempt from tax under state law so the Bankruptcy Code exemption is moot.ⁿ¹⁷ Some state tax administrators themselves interpreted the § 1146(a) exemption broadly. Sometimes states desire to maintain sovereign immunity from appearing before a federal bankruptcy court. In many situations, the cost to object may exceed the disputable tax. Thus, for a variety of reasons, most taxing jurisdictions failed to timely object.ⁿ¹⁸

Impact of the Narrowly Constructed § 1146(a). Because of cash flow needs, it seems unlikely that many bankruptcy sales would be delayed until plan confirmation to take advantage of the § 1146(a) exemption. If enough tax is at issue, creative minds will find ways to decide to sell before confirmation but have the sale take effect postconfirmation. Investors are now more likely to carefully evaluate the state and local transfer-tax costs of bankruptcy acquisitions (and any related requirements for exemption) before submitting bids on assets in bankruptcy.

In several states it is easier to satisfy the state law transfer tax exemption than the Bankruptcy Code exemption in § 1146(a).ⁿ¹⁹ The exemptions and procedures for claiming exemptions vary by state (and sometimes locality) and by tax type. Since they can no longer rely on broad § 1146(a) language in the sale motion and confirmation order, debtors and investors (who are typically jointly and severally liable for transfer taxes) should take care to identify and satisfy the relevant state exemptions that are typically broader than the § 1146(a) exemption. Several states have broad occasional or casual sale exemptions that apply to sales and use tax, and less often to real estate and motor vehicle transfer taxes. For the majority of bankruptcy sales that occur preconfirmation, the only current option for exemption is state law.

If Congress does not step in, states and local governments, many themselves in financial distress, may view the *Piccadilly* decision as an opportunity to raise revenue by enacting new taxes or denying previously-allowed exemptions for sales in bankruptcy. Twenty-seven states joined in filing an amicus brief in support of the State of Florida urging the Courts narrow interpretation of the § 1146(a) exemption. Particularly in the current economic environment, states are regularly seeking revenue opportunities.

Conclusion. Although Congress did not enact a tax increase, the transfer tax costs in bankruptcy have increased. Fewer sales in bankruptcy will escape transfer tax. States, counties, and municipalities expect more revenue from the future sales of distressed properties. Although debtors counsel wonder if equity will demand a return to broader transfer-tax exemptions in bankruptcy, the Supreme Court has ruled that bankruptcy sales occurring before the Chapter 11 plan is confirmed are not exempted from tax under § 1146(a). State and local tax practitioners will likely be in higher demand to evaluate and reduce the tax costs of large bankruptcy sales.

[Return to Text](#)

n1 . This article focuses on the practical and economic effects of the Supreme Courts recent interpretation of the Bankruptcy Codes transfer tax exemption. Technically, the relevant statute has not changed.

n2

[2]. *Florida Dept of Revenue v. Piccadilly Cafeterias, Inc.*, No. 07-312, 2008 U.S. LEXIS 5025 (June 16, 2008).

n3

[3]. *Id.* at *15, 30-35.

n4

[4]. This could be an important victory for cash-strapped taxing authorities that have lost significant tax revenue streams as a result of declining property values and have limited options for raising revenue promptly.

n5

[5]. 11 U.S.C. § 1146(a) (2000 ed. Supp. V). Former Bankruptcy Code § 1146(c) was redesignated as § 1146(a) by the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, P.L. 109-8, § 719, effective for cases beginning on or after October 17, 2005. Consistent with the Supreme Courts references in *Piccadilly*, this article refers to the former and current versions of this provision as § 1146(a).

n6

[6]. See, e.g., *In re The Baldwin League of Indep. Schools*, 110 B.R. 125, 126 (S.D.N.Y. 1990); *In re Amsterdam Ave. Dev. Assocs.*, 103 B.R. 454, 456 (S.D.N.Y. 1989).

n7

[7]. *California State Bd. of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844 (1989).

n8

[8]. *Piccadilly* at *26.

n9

[9]. *Id.* at *28-30.

n10

[10]. *Id.* at *30-35.

n11

[11]. *In re Jacoby-Bender, Inc.*, 758 F.2d 840, 841 (2nd Cir. 1985).

n12

[12]. *In re Piccadilly Cafeterias, Inc.*, 484 F.3d 1299 (11th Cir. 2007), *revd and remanded by Florida Dept of Revenue v. Piccadilly Cafeterias, Inc.*, 2008 U.S. LEXIS 5025 (June 16, 2008) (No. 07-312).

n13

[13]. *In re NVR, L.P.*, 189 F.3d 442, 447 (4th Cir. 1999).

n14

[14]. *In re Hechinger Investment Co. of Delaware, Inc.*, 335 F.3d 243, 246 (3rd Cir. 2003).

n15

[15]. Sale orders and confirmation orders often exempted bankruptcy sales from real estate transfer, sales/use and other transfer taxes that occurred before or after confirmation of the plan.

n16

[16]. See *Piccadilly* at *23 (In the context of § 1146(a), the decision whether to transfer a given asset under a plan confirmed must be made prior to submitting the Chapter 11 plan . . .).

n17

[17]. See, e.g., Fla. Admin. Code 12B-4.013(19) and 12B-4.014(15) (The sale of real property by debtors in federal bankruptcy proceedings is subject to tax unless the transfer is made pursuant to a plan confirmed under § 1129 of the *Bankruptcy Code*, is a precondition or essential to the confirmation of the plan, or is necessary to consummate or implement a confirmed plan and the debtor is a party to the transfer. If the bankruptcy court does not ultimately confirm the plan under 11 U.S.C. 1129, the transfer would not be exempt pursuant to 11 U.S.C. 1146(c), and would be subject to tax.); 35 Ill. Comp. Stat. 200/31-45(i) (A stamp tax exemption is provided for deeds or trust documents made pursuant to mergers, consolidations or transfers or sales of substantially all of the assets of corporations under plans of reorganization under the Federal Internal Revenue Code or Title 11 of the United States Bankruptcy Act.); and Tenn. Code § 67-4-409(e) (Instruments made pursuant to mergers, consolidations, sales or transfers of substantially all of the assets in this state of corporations, pursuant to plans of reorganization are exempt from the recordation tax.).

n18

[18]. For those taxing authorities that had notice or filed claims in the respective bankruptcy case for which a plan was subsequently confirmed, claims for erroneously exempted tax are likely procedurally barred.

n19

[19]. Compare the exemptions described in footnote 15 above to § 1146(a).

RELATED LINKS: For more information on section 1146 of the Bankruptcy Code,

- see Collier on Bankruptcy, ch. 1146 (Matthew Bender).

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72 of 197 DOCUMENTS

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Glosband on In re Manhattan Fund Ltd.

2008 Emerging Issues 2456

Daniel Glosband on In re Manhattan Fund Ltd.: Not Just Cocktail Party Talk: Prime Brokers and the Need to Know Your Hedge Fund Clients

By Daniel Glosband

July 2, 2008

SUMMARY: At a time when Wall Street firms are earning billions of dollars by acting as prime brokers to hedge funds, what do these firms need to know about their hedge funds clients? Is having no actual knowledge of fraud still considered sufficient protection? Or do you need to ask questions? Daniel Glosband examines these issues in light of the decision in *In re Manhattan Investment Fund Ltd.*, 2007 U.S. Dist. LEXIS 92194.

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ARTICLE: Not Just Cocktail Party Talk: Prime Brokers and the Need to Know Your Hedge Fund Clients

Wall Street firms earn billions of dollars by servicing hedge fund clients, many of whom often use multiple prime brokers and rely on short selling strategiesⁿ¹ to enhance returns. Bear Stearns Securities Corp. (Bear Stearns) recently came under fire when one of its clients, the Manhattan Investment Fund (the Fund), was found to have perpetrated a fraud on its investors and was forced into bankruptcy. On December 17, 2007, The United States District Court for the Southern District of New York (the District Court) partially overturned a recent bankruptcy court decision that found that transfers made by the Fund to its margin account at Bear Stearns should be avoided because: (1) the transfers were made with actual intent to hinder, delay, or defraud the Funds creditors as defined by *section 548(a)(1)(A) of the Bankruptcy Code* (the Code); (2) Bear Stearns was an initial transferee under section 550(a) of the Code; and (3) Bear Stearns did not prove that it accepted the transfers in good faith.ⁿ² On appeal, the District Court held that actual intent to defraud existed as to all transfers related a Ponzi scheme and that Bear Stearns was in fact the initial transferee of the fraud-tainted funds. Consequently, it was potentially liable to return the funds. However, the District Court concluded that genuine issues of material fact existed as to whether Bear Stearns diligently investigated the Fund and thus could prevail on a good faith defense.ⁿ³

The Facts and Postsure of *Manhattan Investment Fund*. Bear Stearns served as prime broker for the Fund, a hedge fund controlled by Michael Berger. As prime broker, Bear Stearns facilitated the Funds strategy of short selling technology stocks by borrowing stocks from third parties, selling them for the Fund and depositing the proceeds in a short account which credited the proceeds to the Fund. The Fund would then direct Bear Stearns to repurchase the stocks and return them to the third party lenders in order to close out its short positions. In addition to the short account, the Fund was required to maintain a margin account, which served to protect Bear Stearns from the risk associated with

fluctuations in the value of the stock loaned to the Fund. Bear Stearns was given a security interest in the money in the margin account as well other controls over the account. In the year preceding the Funds bankruptcy, the Fund transferred \$141.4 million into the margin account. The monies transferred into the margin account at issue in this case.

Berger hid the losses of the Fund from its brokers, auditors and service providers, and solicited new funds by reporting high returns to prospective investors while paying off old investors with newly acquired funds. In December 1998, a Bear Stearns executive, Frederik Schilling, overheard at a cocktail party that the Fund was reporting a 20% profit for the year. Schilling believed that the Fund was losing money on transactions conducted with Bear Stearns as prime broker and confirmed with other Bear Stearns executives that the Fund had lost between \$150 and \$200 million in 1998. Upon inquiry by Bear Stearns, Berger explained the discrepancy between the losses in the Funds Bear Stearns account and the Funds reported performance as being due to the fact that the Fund used as many as eight other prime brokers; its transactions with others implicitly offset its losses with Bear Stearns. Although Bear Stearns viewed this explanation as reasonable, it contacted the Funds administrator to ensure that the Funds daily trading reports were being received. Bear Stearns also notified the Funds auditor, Deloitte & Touche (Deloitte), of its inquiry and of Bergrers explanation.

According to Bear Stearns, in the spring of 1999, it was informed by Deloitte that the Funds audit reflected the Fund to be in good standing. By November 1999, however, Bear Stearns was making nearly daily margin calls to the Fund. Bear Stearns spoke with another Deloitte auditor and again urged caution. In December of that year, Bear Stearns made a series of discoveries which prompted it to run a credit check. n4 The credit check did not reveal more than one prime broker and calls to various other prime brokers confirmed that none of them had a relationship with the Fund. After signing a confidentiality agreement, Bear Stearns was permitted to view the Funds financial statements. Subsequently, Bear Stearns reported the Fund to the Securities and Exchange Commission (the SEC). This led to the Fund eventually seeking protection under chapter 11 of the Code.

The Funds chapter 11 Trustee sought to avoid the transfers made to the Funds Bear Stearns margin account on the grounds that the transfers were fraudulent transfers and to have the funds returned to the estate. Upon cross motions for summary judgment, the bankruptcy court denied Bear Stearns motion for summary judgment to dismiss and granted the Trustees motion for summary judgment finding Bear Stearns accountable for \$125 million plus interest, or approximately \$160 million. n5 Applying the standard for summary judgment which requires that the District Court resolve all evidentiary conflicts and draw all reasonable inferences in favor of Bear Stearns, the District Court partially overturned the bankruptcy courts decision. n6 The bankruptcy court had ruled that Bear Stearns response to the cocktail party notice was not sufficient to entitle it to the good faith defense. The District Court was not so sure.

The Manhattan Investment Fund Opinion. First, the District Court affirmed that actual fraud existed as a matter of law under Section 548(a)(1)(A) n7, which provides for avoidance of any transfer made by the debtor in the year prior to the filing of its bankruptcy petition as a fraudulent conveyance provided that the transfer was made with actual fraudulent intent. The District Court concurred with the bankruptcy courts finding that the Fund operated as a Ponzi scheme n8, and the transfers to its margin account were made in furtherance of the scheme because the Fund had to maintain its margin account in order to continue with its strategy of short-selling stocks. n9 Under the Ponzi scheme presumption, such a scheme demonstrates actual intent as a matter of law because transfers made in the course of a Ponzi scheme could have been made for no purpose other than to hinder, delay or defraud creditors. n10

The District Court further affirmed that Bear Stearns was an initial transferee under section 550(a)[11] of the Code because Bear Stearns, while not a mere conduit, had dominion and control over the transferred funds. n12 The District Court reasoned that Bear Stearns had control over the transfers while the Funds short positions were open, had the ability to close out the Funds short positions at any time and that Bear Stearns in fact used the money to cover certain of the Funds positions. n13 Accordingly, Bear Stearns was an initial transferee. Under section 550(a), a transfer which can be avoided under the Code can be recovered from an initial transferee, unless the transferee can establish that it accepted such transfers in good faith. n14

Good Faith Defense. Turning to the good faith defense, the District Court applied a two prong test: (1) was Bear Stearns on inquiry notice of the Funds fraud and (2) was Bear Stearns diligent in its investigation of the Fund. n15 The District Court considered whether the information Bear Stearns knew or should have known triggered an obligation to investigate further and whether its investigation was reasonable under the circumstances. n16

First, the District Court affirmed the bankruptcy courts decision that Bear Stearns was put on inquiry notice of the Funds fraudulent activity beginning the day after the cocktail party where Schilling was alerted to a potential issue with the Fund. n17 Schilling investigated the cocktail party information further by confirming with his superiors that Bear Stearns records did not match the Funds reported performance. He confirmed the Funds losses with other Bear Stearns executives and then investigated further by arranging a conference call with the Funds introducing broker and Berger. Despite Bergers reasonable explanation for the discrepancies, Bear Stearns took further action by contacting Deloitte and putting it on notice. After learning of the Funds investor redemptions in 1999, Bear Stearns continued its investigation and eventually reported the Fund to the SEC. Applying a reasonable prime broker standard, the District Court found that while Bear Stearns was on inquiry notice, its actions to investigate the Fund may serve as evidence of its good faith. n18

Next, the District Court considered whether Bear Stearns could prevail on its good faith defense by showing that its investigation was diligent. n19 The Trustee argued that Bear Stearns was not diligent because the Funds fraudulent activity would have been exposed earlier had the actions taken by Bear Stearns in December 1999 of running a credit check and contacting other prime brokers been taken in 1998. Under the summary judgment review standard, viewing the facts and inferences in favor of Bear Stearns, the District Court could not find as a matter of law that Bear Stearns should have taken the actions in December 1998 that it eventually took in December 1999. First, the circumstances changed between 1998 and 1999 in that Bear Stearns begin to witness investor redemptions, increased margin calls and correspondence with an investor about its inquiries into the Fund. Additionally, Bear Stearns took other steps such as notifying Deloitte of a potential problem, obtaining the Funds financial statements and informing the SEC of the Funds misrepresentation. Therefore, the District Court could not find that no reasonable jury could find Bear Stearns actions diligent. n20

Given that there existed questions of material fact as to whether the steps taken by Bear Stearns amounted to a diligent investigation, the District Court partially overturned the bankruptcy courts ruling and found that a trial on the issue was necessary. n21

Commentary on *Manhattan Investment Fund*. Bear Stearns close call with being responsible for almost \$160 million is a lesson to practitioners that prime brokers must know their hedge fund clients or risk liability for transfers made in furtherance of such clients trading activities. The risk that an innocent party can be exposed for transfers made as part of a fraud is not generally perceived. With the subprime debt crisis looming in the background of a deteriorating economy and volatile marketplace, hedge fund implosions are a genuine concern. It is no longer sufficient for a prime broker to rely on the defense that it had no actual knowledge of fraud. In todays landscape, a prime broker should consider whether, acting as a reasonable prime broker, it has an obligation to investigate into whether there is a fraud being carried out by its customer. Prime brokers should be cautious to not ignore questionable performance reports and to inform themselves, at the least, of the credit background of their hedge fund clients including determining whether particular clients rely on multiple prime brokers. Only putting Bear Stearns actions to test at trial will answer the greater question of how much investigating is enough. Stay tuned.

For more information on sections 548 and 550 of the *Bankruptcy Code*, see Collier on Bankruptcy, ch. 548, 550. (Matthew Bender).

For a one-stop source for all bankruptcy research, see the [lexis.com](http://www.lexis.com) bankruptcy area of law page.

[Return to Text](#)

n1 . Short selling, or shorting, refers to the practice of selling securities that are borrowed from a third party in the hope of repurchasing them later at a lower price and returning them to that third party. This strategy is used where the investor expects a decline in the security's price.

n2

[2]. *In re Manhattan Investment Fund Ltd.*, 2007 U.S. Dist. LEXIS 92194, 1-2 (Bankr. S.D.N.Y. 2007).

n3

[3]. *Id.* at 64-69.

n4 . Among other discoveries, Schilling learned that a former marketer of the Fund was suing Berger alleging that he had not been paid by Berger for his work. Additionally, Schilling discovered that the Deloitte entity which he believed was the Fund's auditor was not in fact the Fund's auditor and that answers provided to another investor's questions by the Fund were not adequate. *Id.* at 10, n 8.

n5 . Julie Creswell, *Bear Stearns Told to Pay \$160 Million to Investors*, N.Y. Times, February 16, 2007.

n6

[6]. 2007 U.S. Dist. LEXIS 92194, at 68-69.

n7

[7]. Section 548(a)(1)(A) provides that the trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor

voluntarily or involuntarily made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted. *11 U.S.C. § 548(a)(1)(A)*.

n8

[8]. The District Court held that the Fund was a Ponzi scheme because it had at least two characteristics of such a scheme. It required and secured new investors to perpetuate the scheme, and it also used new monies to make redemption payments to earlier investors. *Id.* at 26-27.

n9

[9]. *Id.* at 30-31.

n10

[10]. *Id.* at 14 (citations omitted).

n11

[11]. Section 550(a) of the Code provides:

Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from--

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a).

n12

[12]. *2007 U.S. Dist. LEXIS 92194, at 55*.

n13

[13]. *Id.* at 54-55.

n14

[14]. Section 548(c) of the Code provides that, even if a transfer is voidable, a transferee that takes for value and in good faith may retain any interest transferred to the extent that such transferee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C. § 548(c).

n15

[15]. *2007 U.S. Dist. LEXIS 92194, at 59.*

n16

[16]. *Id.*

n17

[17]. *Id.* at 59-60.

n18

[18]. *Id.* at 63-64.

n19

[19]. *Id.* at 64.

n20

[20]. *Id.*

n21

[21]. Id. at 69.

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73 of 197 DOCUMENTS

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Hunt on the Application of the Servicemembers Civil Relief Act of 2003

2008 Emerging Issues 357

Peggy Hunt on the Application of the Servicemembers Civil Relief Act of 2003 in Bankruptcy

By Peggy Hunt

June 26, 2008

SUMMARY: Service in the armed forces can have an adverse impact on a servicemembers finances and on his or her ability to defend civil actions. The Servicemembers Civil Relief Act of 2003, as amended in 2004 (SCRA), is the most recent provision, updating previous relief laws enacted during times of war. SCRA is generally applicable in any action or proceeding commenced in any court, including in bankruptcy courts.

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ARTICLE: Service in the armed forces can have an adverse impact on a servicemember's finances and on his or her ability to defend civil actions. Accordingly, in times of war, Congress has enacted legislation to protect servicemembers. The Servicemembers' Civil Relief Act of 2003, as amended in 2004 (SCRA), n1 is the most recent provision, updating previous relief laws enacted during times of war. n2 SCRA is generally applicable in any action or proceeding commenced in any court, including in bankruptcy courts. n3 This Emerging Issue Commentary discusses the application of the Servicemembers' Civil Relief Act on bankruptcy cases and proceedings. The SCRA provides protection to servicemembers against the entry of default judgments and empowers the court to stay proceedings against military debtors where the debtors have notice and to stay or vacate the execution of judgments, attachments and garnishments against servicemembers.

I. General Background on SCRA

SCRA provides for a temporary suspension of judicial and administrative proceedings and transactions that may adversely affect the civil rights of servicemembers during military service n4 so as to provide for, strengthen, and expedite the national defense by enabling servicemembers to devote their entire energy to the defense needs of the Nation n5 unhampered by obligations prior to their call to service. n6 Enacted in 2003, SCRA updates similar provisions enacted in former times of war, n7 and it applies in any civil case or proceeding that was pending as of December 19, 2003. SCRA applies to persons in military service, which includes: (1) persons on active duty in the Army, Navy, Air Force, Marine Corps, or Coast Guard; (2) active duty in the National Guard when called to service by the President or Secretary of Defense for a period of more than 30 consecutive days for purposes of responding to a national emergency; and (3) commissioned officers of the Public Health Service and the National Oceanic and Atmospheric Administration when in active service. n8 In addition, SCRA extends to a servicemember's dependants if the dependant's ability to comply with a lease, contract, bailment, or other obligation is materially affected by reason of

the servicemember's military service. n9 SCRA protections also may be afforded to persons who are liable on an obligation with a servicemember. Finally, SCRA provides that a servicemember's assets may not be available during his or her military service to satisfy business obligations or liabilities on which the servicemember is personally liable. n10

It is uniformly held that SCRA should be liberally construed to effectuate its purpose. n11 Its provisions apply in the context of judicial or administrative proceedings in any court n12 where the matters being adjudicated affect the rights of a servicemember, or in some instances, co-debtors with a servicemember n13 and/or a servicemember's dependents. n14 Thus, SCRA is applicable in bankruptcy cases and proceedings adjudicated in bankruptcy courts involving servicemembers, and/or co-debtors with and dependants of servicemembers. n15

Servicemembers are given notice of their rights and the protections afforded under SCRA by the government. n16 They may waive SCRA rights and protections, but restrictions exist if the waiver applies to: (1) the modification, termination or cancellation of a contract, lease, bailment, or an obligation secured by a mortgage, trust, deed, lien or other security; or (2) the repossession, retention, foreclosure, sale, forfeiture or taking possession of property that is security for an obligation, or that was purchased or received under contract, lease or bailment. n17 In these instances, the waiver is effective only if it is in writing and is executed as an instrument separate from the obligation or liability to which it applies. n18 Additionally, such written agreement must be executed during or after the servicemember's period of military service . . . specify the legal instrument to which the waiver applies and identify the servicemember concerned. n19

Under SCRA section 518, a servicemember's assertion of SCRA rights and protections may not be used in isolation to affect his or her future financial transactions. n20 Thus, generally speaking, a servicemember may not be denied credit or insurance and his or her credit rating should not be adversely affected due to the use of SCRA rights and protections. Likely, however, section 518 will not be very effective because that section expressly states that adverse actions may be taken if other considerations (e.g., late payments outside of the service period, the filing of a bankruptcy petition) warrant such action, and SCRA has no built-in enforcement provisions to provide a servicemember quick relief for a creditor or insurer's violation of section 518. For those servicemembers who have filed or are contemplating filing a bankruptcy petition, consideration should be given to section 518 and *section 524 of the Bankruptcy Code*, which governs the effect of a bankruptcy discharge. n21

II. Protections Afforded by SCRA in the Context of Bankruptcy

A. Bankruptcy Cases and Proceedings

To understand the application of protections afforded to servicemembers by SCRA in the context of bankruptcy, one must first understand the difference between a bankruptcy case and an adversary proceeding filed within a bankruptcy case.

A bankruptcy case is commenced by the filing a petition in the bankruptcy court under one of the applicable chapters of the Bankruptcy Code. This petition may be filed voluntarily by the debtor, or it may be filed against the debtor involuntarily by creditors. When an involuntary petition is filed, the petitioning creditors must show that the petition is warranted at which time the court will enter an order for relief. For purposes of this article, it is assumed that the petition would be one filed under chapter 7 (liquidation) or chapter 13 (individual reorganization) of the Bankruptcy Code.

Individuals who seek bankruptcy relief typically must file a statement with their petition declaring that they have

complied with Bankruptcy Code provisions requiring credit counseling prior to filing. Servicemembers on active military duty in a military combat zone do not need to comply with these provisions, but must declare themselves to be servicemembers as part of their petition. n22

While many disputes in a bankruptcy case are adjudicated on motion, certain matters require the filing of a civil lawsuit. Debtors, creditors and parties in interest may commence lawsuits that relate to the debtor and/or the debtor's bankruptcy case by filing a complaint in the bankruptcy court. These lawsuits are referred to as adversary proceedings. Adversary proceedings typically are adjudicated by the bankruptcy court in conjunction with the bankruptcy case, and for the most part, the Federal Rules of Civil Procedure apply by reference in the Federal Rules of Bankruptcy Procedure. n23 The most typical matters involving individual debtors that must be adjudicated by adversary proceeding, as opposed to motion, are those related to the validity and/or priority of liens (Lien Actions), matters related to the debtor's right to a discharge of a single debt or all debts (Discharge Actions), proceedings where the sale of property co-owned by the debtor and a non-debtor is sought (Co-owner Sale Actions), and declaratory judgment requests (Declaratory Judgment Actions).

B. SCRA Protections

SCRA offers servicemembers three fundamental protections: (1) protection against the entry of default judgments; (2) the stay of proceedings where the servicemember has notice of the proceeding; and (3) the stay or vacation of execution of judgments, attachments and garnishments. Each of these major protections in the context of bankruptcy is discussed in subparagraphs (1)-(3) below. Subparagraph (4) contains a short analysis of the interaction between certain miscellaneous SCRA protections and bankruptcy.

(1) Default Judgments

Federal Rule of Civil Procedure 55, which governs the entry of default judgments in federal district courts and which is made applicable in bankruptcy proceedings pursuant to *Federal Rule of Bankruptcy Procedure 7055*, does not reference SCRA. But, section 521 of SCRA protects servicemembers from having default judgments entered against them by mandating courts to require that plaintiffs file an affidavit stating (1) whether or not a defendant who has not made an appearance in the proceeding is in military service and showing necessary facts to support the affidavit, or (2) that the plaintiff is unable to identify whether the non-appearing defendant is in military service. n24 This section applies to all civil actions and proceedings in which a defendant fails to enter an appearance and, therefore, applies in bankruptcy adversary proceedings, including in Lien Actions, Discharge Actions, Co-Owner Sale Actions, and Declaratory Judgment Actions, all discussed above. Thus, most bankruptcy courts have adopted local rules related to default, mandating the filing of an affidavit that conforms to SCRA section 521 with an application seeking a default judgment. n25 Presumably, the affidavit requirement also would apply to requests for the entry of an order for relief against an individual who has not appeared to contest the filing of an involuntary bankruptcy petition.

The requirement for an affidavit under section 521 may be satisfied by a statement, declaration, verification, or certificate, in writing, subscribed and certified or declared to be true under penalty of perjury. n26 The affidavit must be based on personal knowledge and it will not be sufficient to submit an affidavit that is based on information and belief. n27

Under section 521, if an adversary proceeding is filed against a servicemember, the bankruptcy court may not enter a default judgment against that person until it appoints an attorney to represent the defendant. The bankruptcy court may, and if requested by the servicemember's appointed attorney, must stay the proceeding for a minimum of 90 days if a defense exists and the servicemember must be present to defend, or if counsel is unable to contact the servicemember or determine if a meritorious defense exists.

In the event that a default judgment is entered against a servicemember, it is not void *per se*, but SCRA authorizes the bankruptcy court to vacate it or set it aside upon application made by or behalf of the servicemember. This application must be made within 90 days after the servicemember's military service. But, even if a judgment is vacated or set aside, the bankruptcy court has no power to affect the rights, title or interest in property acquired by a party who is deemed to be bona fide purchaser. n28

(2) Stay of Proceedings

Servicemembers who are bankruptcy debtors or who are co-debtors with a person who has filed a chapter 13 petition receive certain protections staying proceedings under bankruptcy law. In addition, section 522 of SCRA provides a more general stay of proceedings. Each are discussed below.

(a) Bankruptcy Code Stays

Servicemembers who are bankruptcy debtors are protected by the automatic stay set forth in *section 362 of the Bankruptcy Code*. n29 This stay applies upon the filing of the servicemember's petition, or in an involuntary case, upon the filing of the involuntary petition. While some exceptions exist, this stay serves as a statutory injunction, prohibiting creditors and parties in interest from attempting to collect claims against the debtor or property of the debtor. Thus, for instance, garnishments and foreclosure proceedings are stayed by the automatic stay. Parties seeking to collect claims or proceed with foreclosure must obtain an order of the bankruptcy court granting relief from this stay. n30

The *section 362 Bankruptcy Code* stay also *prevents* servicemembers who are creditors of a bankruptcy debtor from taking certain actions, including debt collection. The administration of a bankruptcy case likely will not be stayed as a result of a servicemember's inability to be present during matters related to the case. n31

A separate stay also applies to servicemembers who are not bankruptcy debtors, but rather, are co-debtors on a debt with an individual who has filed a chapter 13 petition, such as a child or a spouse. n32 This co-debtor stay applies as long as the debtor's chapter 13 case is pending, but does not apply to co-debts incurred by the servicemember in the ordinary course of his or her business. Creditors may not collect on debts on which the servicemember is a co-debtor with a chapter 13 debtor unless it obtains relief from the co-debtor stay from the bankruptcy court.

(b) SCRA Section 522 Stay

SCRA section 522 authorizes courts, including bankruptcy courts, to stay proceedings on its own motion when the servicemember is (a) in military service or is within 90 days after termination of or release from military service; and (b) has received notice of the action or proceeding. n33 Furthermore, when a servicemember submits an application with supporting letters from both the servicemember and his or her commanding officer stating that the servicemember's military duty materially affect[s] his or her ability to appear and that military leave is not authorized, the bankruptcy court must issue at least a 90-day stay. n34 Additional stays may be granted upon further application, and if an additional stay is not granted, the court is required to appoint counsel to represent the servicemember. n35

As discussed above, the Bankruptcy Code automatically stays the collection of debts existing as of the date that the bankruptcy petition is filed n36 when servicemembers are bankruptcy debtors or persons entitled to the protection of a co-debtor stay. In such cases, the SCRA section 522 stay, which is not automatic, may supplement the Bankruptcy Code by authorizing the bankruptcy court to stay a creditor's request for relief from any applicable Bankruptcy Code stay. n37 The section 522 stay may also be invoked by a servicemember debtor or co-debtor who has been named as a defendant in an adversary proceeding commenced in the bankruptcy court. n38 Furthermore, because the Bankruptcy Code stays only apply to debts related to the period of time prior to the filing of a bankruptcy petition, SCRA section 522 may serve to stay proceedings for the collection of debts that have arisen after the date the debtor files his or her petition, although such relief may need to be requested in a court other than the bankruptcy court, as that court typically

has jurisdiction only over matters related to pre-petition debts. n39

The automatic Bankruptcy Code stays discussed above only apply to servicemembers who have filed a bankruptcy petition or who are co-debtors with an individual who has filed a chapter 13 petition. When a servicemember is not a bankruptcy debtor or a co-debtor, the application of the SCRA section 522 stay may be invoked in the bankruptcy court if a person entitled to its protection is a non-debtor defendant in an adversary proceeding commenced in the bankruptcy court. When the servicemember is a creditor or party in interest, it is unlikely that a SCRA section 522 stay will be used to delay administration of the case in general. n40

Note that the SCRA section 522 stay only prevents the collection of the servicemember's debts that existed *prior to* military service. Thus, the section 522 stay does not stay the collection of debts that a servicemember, or more likely his or her dependants, has incurred while on active duty. Furthermore, the SCRA section 522 stay is not automatic, it may be costly to have imposed, and it may not be timely in cases of self-help repossession and non-judicial foreclosure. In such instances, the servicemember and/or any dependants may want to consider filing a bankruptcy petition to obtain the benefits of the Bankruptcy Code's automatic stay.

(3) Stay of Execution or Vacation of Judgment, Attachment or Garnishment

SCRA section 524 allows a court on its own motion, or upon application, (a) to stay the execution of any judgment or order entered against the servicemember, and (b) to vacate or stay a prejudgment or post judgment attachment or garnishment of property, money, or debts in the possession of the servicemember or a third party. Such action may only be taken if the court determines that the servicemember is materially affected by reason of military service in complying with a judgment or order . . . n41 This relief may apply to an action or proceeding commenced in a court against a servicemember before or during the period of the servicemember's military service or within 90 days after such service terminates. n42 The court may order the servicemember to make installment payments to the plaintiff during the stay period. n43

When an adverse judgment or order has been entered against a servicemember, the servicemember may be better served by filing a bankruptcy petition, thus being afforded the protection of the broader and automatic stay that applies under the Bankruptcy Code. n44

Note that the provisions of SCRA section 524 do not apply to codefendants with the servicemember who are not in military service. n45 In such cases, such as when a servicemember's spouse is a codefendant, consideration should be given to the appropriateness of filing a bankruptcy petition. If the spouse/codefendant files individually under chapter 13 of the Bankruptcy Code, the co-debtor stay may apply to the servicemember regardless of SCRA section 524. n46 Furthermore, if both the spouse and the servicemember file a bankruptcy petition, whether under chapter 7 or chapter 13 of the Bankruptcy Code, the automatic stay will apply, which as noted, is broader than the protections afforded under SCRA section 524.

(4) Miscellaneous SCRA Protections

(a) Tolling of Statute of Limitations

Other than any statute of limitations under the Internal Revenue Code, SCRA section 526(a) states that: The period of a servicemember's military service may not be included in computing any period limited by law, regulation, or order for the bringing of any action of proceeding in a court . . . by or against the servicemember or the servicemember's heirs,

executors, administrators, or assigns. n47 Also, the period of military service may not be included in computing any period provided by a law for the redemption of real property sold or foreclosed to enforce an obligation, tax, or assessment. n48 In the context of bankruptcy, consideration should also be given to *section 108 of the Bankruptcy Code*, n49 which governs extensions of time that apply when a bankruptcy petition is filed.

When a servicemember is a bankruptcy debtor, SCRA section 526(a) may serve to extend the time for the debtor or trustee to file avoidance actions under *section 546 of the Bankruptcy Code*. n50 It may also apply in computing critical deadlines applicable to individual debtors under, for example, *sections 362, 365, 521, and 522 of the Bankruptcy Code*. n51

The tolling provisions in SCRA may also affect time limits applicable to servicemembers who are creditors in a bankruptcy case. For instance, SCRA section 526(a) may automatically extend the bar date by which a servicemember must file a proof of claim against a debtor, the deadline to file Discharge Actions against a debtor, and the deadline to file objections to a debtor's claimed exemptions. n52

(b) Interest Rate Cap

SCRA section 527 states that debts bearing interest at a rate in excess of 6 percent per year that is incurred by the servicemember, or the servicemember and the servicemember's spouse jointly, before the servicemember enters military service shall not bear interest at a rate in excess of 6 percent per year during the period of military service. n53 This excess interest is forgiven, and payments must be reduced to reflect this forgiveness of interest. n54 The servicemember must provide written notice and documentation to the creditor for the interest rate cap to apply. n55 This protection is significant because, even if a servicemember or servicemember spouse has filed a chapter 13 bankruptcy petition, the contract rate of interest continues accrue on the debt. Thus, in chapter 13, SCRA section 527 may allow for a reduction in interest on debts being paid off as part of the bankruptcy case during the period of military service. n56 Furthermore, although interest does not accrue post-petition in most chapter 7 cases, the amount of a creditor's claim may be reduced if the interest rate cap applies during the pre-filing period. Note, however, that a court, including a bankruptcy court, may grant a creditor relief from the interest rate cap if the creditor demonstrates that the servicemember's ability to pay the contract rate of interest on the obligation is not materially affected by military service. n57

(c) Other SCRA Protections in the Context of Bankruptcy

In addition to those provisions expressly discussed above, individuals covered by SCRA are afforded with numerous tools related to debt relief, protection of insurance coverage, treatment of tax debts and the stay of proceedings related, among other things, eviction, foreclosure, repossession and redemption. n58 If any of these provisions apply to a servicemember who qualifies for relief under the Bankruptcy Code, n59 consideration should also be given to filing a bankruptcy petition because the protections afforded in bankruptcy may be broader than those under SCRA, and less expensive. The stay relief afforded by the Bankruptcy Code occurs automatically upon the filing of a petition and, therefore, may provide the servicemember and his or her dependants with a stay in a more timely fashion than by invoking rights under SCRA. Additionally, because SCRA typically only applies to debts arising prior to a servicemember's military service, filing bankruptcy may protect a servicemember in matters related to the collection of debts incurred during service. Note that seeking bankruptcy relief will not aid a servicemember with regard to certain types of debt. Specially, most student loan and divorce-related debts are not dischargeable in bankruptcy. n60 Also, debts incurred as a result of a servicemember's bad acts typically will not be dischargeable in bankruptcy. n61

If bankruptcy is an option, one may consider the timing of the petition in relation to SCRA remedies. Under SCRA, for example, penalties on a contract may not accrue while the enforcement of the contract is subject to a SCRA stay. n62 Thus, obtaining a SCRA stay prior to filing a bankruptcy petition may serve to reduce a debt administered in the

bankruptcy case. Once the servicemember files a bankruptcy petition, the automatic stay in bankruptcy typically prevents further accrual of penalties.

Once a bankruptcy petition is filed, SCRA may intersect with federal bankruptcy law to define a servicemember's rights within the bankruptcy case, whether the servicemember is a bankruptcy debtor or creditor. *Section 541 of the Bankruptcy Code* defines the property of the estate administered in a bankruptcy case. n63 This definition is expanded in chapter 13 cases where debtors use property that they obtain after their filing date to fund a reorganization plan. n64 Although these sections define what is included within a bankruptcy estate, nonbankruptcy law determines the extent of a debtor's and creditor's respective interests in the property. Thus, to the extent that SCRA applies, it may serve to govern the rights of a servicemember as a debtor or as a creditor. For instances, the interest rate cap discussed *supra*, may serve to impact the amount of lender's claim against a debtor.

Bankruptcy law governs the treatment of allowed claims and the administration of the property of the debtor's estate, and bankruptcy administration is not affected by SCRA, with one exception. Section 547(b)(3) of SCRA provides that debts payable to the United States by a servicemember as a result of the United States' payment of the servicemember's unpaid life insurance premiums n65 are not dischargeable in bankruptcy. n66 Thus, even if a servicemember files a bankruptcy petition, he or she will be liable for any debt asserted by the United States related to such payments.

III. Pending Bankruptcy Relief for Servicemembers

In addition to the relief provided for servicemembers under the SCRA, Congress is currently considering legislation directly amending the Bankruptcy Code to make it easier for National Guard members and Reservists to file for bankruptcy. On June 23, 2008, the House of Representatives passed H.R. 4044, the National Guard and Reservists Debt Relief Act of 2008. n67 This Act excuses National Guard members and Reservists called to active duty or a homeland defense activity from the chapter 7 means test, which requires debtors to prove their inability to pay their debts. n68

Specifically, the Act amends *section 707(b)(2)(D) of the Bankruptcy Code* n69 to prohibit the bankruptcy court from dismissing or converting a case based on presumptive-means testing while the debtor: (1) is either on active duty in the military service of the United States or performing a homeland defense activity for at least 90 days, and during the 540 days following the end of such period; and (3) was called to such active duty or performed such homeland defense activity after September 11, 2001, as a member of a reserve component of the Armed Forces or the National Guard. n70

The Act was passed by voice vote in the House of Representatives and was referred to the Senate Committee. n71 The Act was received in the Senate, read twice, and referred to the Committee on the Judiciary. n72

[Return to Text](#)

n1 *50 U.S.C. App. § 501 et seq.*

n2 *See e.g., The Soldiers' Civil Relief Act of 1940, 50 U.S.C. App. § 501 et. seq.*

n3 50 U.S.C. App. § 511(5).

n4 50 U.S.C. App. § 502(2).

n5 50 U.S.C. App. § 502(1).

n6 *Omega Indus., Inc. v. Raffaele*, 894 F.Supp. 1425 (D. Nev. 1995) (servicemembers must have peace of mind that they will not be subject to civil actions during times of service); see *In re Templehoff*, 339 B.R. 49, 53 (Bankr. S.D.N.Y. 2005).

n7 See n.2 *supra*.

n8 50 U.S.C. App. § 511(2).

n9 50 U.S.C. App. § 538.

n10 50 U.S.C. App. § 596.

n11 See, e.g., *Omega Indus., Inc. v. Raffaele*, 894 F.Supp. 1425 (D. Nev. 1995); *In re Watson*, 292 B.R. 441 (Bankr. S.D. Ga. 2003).

n12 50 U.S.C. App. § 512(b).

n13 50 U.S.C. App. § 513 (protection afforded to persons secondarily liable).

n14 *See* 50 U.S.C. App. § 511 (defining dependent, servicemember, and military service).

n15 *See, e.g., In re Cockerham*, 336 B.R. 592 (Bankr. S.D. Ga. 2005).

n16 50 U.S.C. App. §§ 515--515a.

n17 50 U.S.C. App. § 517(b).

n18 50 U.S.C. App. § 517(a); *see id.* § 513(d) (waivers by co-debtors).

n19 50 U.S.C. App. § 517(a).

n20 50 U.S.C. App. § 518.

n21 11 U.S.C. § 524; *see also id.* § 525.

n22 *See* Official Form 1 (Petition), Exhibit D.

n23 *See, e.g., Fed. R. Bankr. P.* 7001--7087, 9023 & 9024.

n24 When a court cannot determine the defendant's military status based upon the required section 521 affidavit, it may require the plaintiff to post a bond before entry of a default judgment. If it is later discovered that the defendant is a servicemember, the bond would serve to indemnify the servicemember against any loss or damage that he or she has incurred in the event that the default judgment entered is set aside.

n25 *See, e.g.,* Bankr. S.D.N.Y. LBR 7055-1; Bankr. D. Ut. LBR 7055-1.

n26 50 U.S.C. App. § 521(b)(4).

n27 *See, e.g., United States v. Simmons*, 508 F. Supp. 552, 552-53 (D. Tenn. 1980); *In re Templehoff*, 339 B.R. 49, 53 (Bankr. S.D.N.Y. 2005).

n28 50 U.S.C. App. § 521(h).

n29 11 U.S.C. § 362.

n30 11 U.S.C. § 362(d).

n31 *See, e.g., In re Wlaschin*, 260 B.R. 306 (Bankr. M.D. Fla. 2000).

n32 11 U.S.C. § 1301.

n33 50 U.S.C. App. § 522(a).

n34 50 U.S.C. App. § 522(b)(2).

n35 50 U.S.C. App. § 522(d).

n36 Debt in bankruptcy is very broadly defined to include contingent and unliquidated debts existing as of the petition date. *See 11 U.S.C. § 101(5) & (12)* (defining claim and debt).

n37 *See In re Burrell*, 230 B.R. 309 (Bankr. E.D. Tex. 1999) (discussing application of SCRA stay to servicemember-debtor in relief from stay matter); *but see 11 U.S.C. § 362(e)(1)* (stay terminates within 30 days of request unless bankruptcy court orders stay continued pending a final hearing).

n38 *See supra* for discussion of adversary proceedings.

n39 *See 28 U.S.C. §§ 157(b) & 1334* (bankruptcy courts have jurisdiction over bankruptcy cases and all civil proceedings arising under the Bankruptcy Code or arising in or related to bankruptcy cases).

n40 *See, e.g., In re Wlaschin*, 260 B.R. 306 (Bankr. M.D. Fla. 2000).

n41 50 U.S.C. App. § 524(a).

n42 50 U.S.C. App. §§ 524(b) & 525(a).

n43 50 U.S.C. App. § 525(a).

n44 11 U.S.C. § 362(a); *see discussion supra* on the Bankruptcy Code stay.

n45 50 U.S.C. App. § 525(b).

n46 11 U.S.C. § 1301; *see discussion supra* on co-debtor stay.

n47 50 U.S.C. App. § 526.

n48 50 U.S.C. App. § 526(b).

n49 11 U.S.C. § 108.

n50 11 U.S.C. § 546.

n51 11 U.S.C. §§ 362, 365, 521, 522.

n52 *See, e.g., In re A.H. Robins Co.*, 996 F.2d 716 (4th Cir. 1993) (deadline for filing proof of claim extended); *In re Wlaschin*, 260 B.R. 306 (Bankr. M.D. Fla. 2000) (deadline to file Discharge Action and exemption objection extended).

n53 50 U.S.C. App. § 527(a)(1).

n54 50 U.S.C. App. § 527(a) (1)-(2).

n55 50 U.S.C. App. § 527(b).

n56 *See, e.g., In re Watson*, 292 B.R. 441 (Bankr. S.D. Ga. 2003).

n57 50 U.S.C. App. § 527(c); *see In re Watson*, 292 B.R. 441 (Bankr. S.D. Ga. 2003) (explaining burden of

proof).

n58 *See* 50 U.S.C. App. §§ 531--596.

n59 *See* 11 U.S.C. § 109.

n60 11 U.S.C. §§ 523 & 1328.

n61 11 U.S.C. §§ 523, 727 & 1328.

n62 50 U.S.C. App. § 523(a); *see* discussion *supra* on SCRA stay.

n63 11 U.S.C. § 541.

n64 11 U.S.C. § 1306.

n65 *See* 50 U.S.C. App. §§ 541--49.

n66 50 U.S.C. App. 547(b)(3).

n67 2008 H.R. 4044. *See also* The Library of Congress, THOMAS, *National Guard and Reservists Debt Relief Act of 2008 (Engrossed as Agreed to or Passed by House)* (last visited June 29, 2008) <<http://thomas.loc.gov/>>.

n68 *Subcommittee Approves Service Member Bankruptcy Relief, Revisions to Congressional Review Act* (last visited June 29, 2008) <<http://www.lindasanchez.house.gov/news.cfm/article/417>>.

n69 *11 U.S.C. § 707(b)(2)(D)*.

n70 *2008 H.R. 4044. See also The Library of Congress, THOMAS, H.R. 4044, Summary as of 6/20/2008 Reported to House amended* (last visited June 29, 2008) <<http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR04044:@@@D&summ2=m&>>.

n71 Govtrack.us, *H.R. 4044: National Guard and Reservists Debt Relief Act of 2008* (last visited June 29, 2008) <<http://www.govtrack.us/congress/bill.xpd?bill=h110-4044>>.

n72 *2008 H.R. 4044. See also The Library of Congress, THOMAS, H.R. 4044, Summary as of 6/20/2008 Reported to House amended* (last visited June 29, 2008) <<http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR04044:@@@D&summ2=m&>>.

RELATED LINKS: For more information on sections 101, 108, 109, 362, 365, 521, 522, 523, 524, 525, 541, 546, 727, 1301, 1306, and 1328 of the Bankruptcy Code, see

- Collier on Bankruptcy, ch. 101;
- 108;
- 109;
- 362;
- 365;
- 521;
- 522;
- 523;
- 524;
- 525;
- 541;
- 546;
- 727;
- 1301;
- 1306;
- 1328

For the full text of The Soldiers Civil Relief Act of 1940, see

- 50 U.S.C. App. § 501, et seq.

For a one-stop source for all bankruptcy research, see the [lexis.com](http://www.lexis.com) bankruptcy area of law page.

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74 of 197 DOCUMENTS

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Jurs on In re Lanier

2008 Emerging Issues 2415

S. Andrew Jurs on In re Lanier

By S. Andrew Jurs

June 25, 2008

SUMMARY: In re Lanier is noteworthy in that it had the potential to deal in a substantial manner with the bankruptcy systems opposing goals of paying a debtors creditors and not rewarding an undeserving debtor with a discharge. However, Laniers value as a precedent is undermined because the opinion appears result-driven rather than the product of an even-handed and thoughtful balancing of the evidence.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: The bankruptcy court denies the Chapter 7 trustees motion for approval of a compromise settlement with the debtor in which the Chapter 7 trustee would permit the debtor to obtain his discharge upon the debtors payment of a sum in quarterly installments over a three-year period.

In *In re Lanier*, 383 B.R. 302, 2008 Bankr. LEXIS 609 (Bankr. E.D.N.C. Feb. 29, 2008), the bankruptcy court determined whether a proposed settlement of litigation between the chapter 7 trustee and a debtor, in which the trustee sought to deny the debtors discharge, was in the best interests of the creditors and whether such a settlement was appropriate when it appeared that the debtor was buying his discharge despite his bad acts.

Facts and Procedural History

Randy and Phyllis Lanier filed their chapter 7 petition for relief on September 8, 2006. On April 27, 2007, their chapter 7 trustee (the Trustee) filed an adversary proceeding (the Discharge Proceeding) against Randy Lanier in which the Trustee objected to Mr. Laniers discharge pursuant to 11 U.S.C. § 727(a)(3), (a)(2)(b), (a)(5), and (a)(7). According to the Trustee, he filed the discharge proceeding against Mr. Lanier after conducting a Rule 2004 examination and discovering unusual activity with regard to Mr. Laniers bank account during the year before the bankruptcy filing. Such discoveries included the fact that Mr. Lanier did not segregate his personal bank accounts from the bank accounts of his corporation. Additionally, Mr. Lanier had taken several trips to Russia, Paris, and Rome during this one-year period. Finally, the accounts were garnished by the North Carolina Department of Revenue just prior to the bankruptcy filing, and there was no money or assets available in the debtors estate to pay creditors.

The Trustee and Mr. Lanier subsequently agreed to settle the discharge proceeding. According to the terms of the settlement, Mr. Lanier would receive his discharge after paying \$36,000 in 12 quarterly installments of \$3,000. If Mr. Lanier ever was more than 20 days delinquent on an installment payment, his discharge would be denied.

On January 3, 2008, the Trustee filed a motion seeking bankruptcy court approval of this settlement. Several creditors filed objections to the motion to compromise. These objections alleged fraud on the part of Mr. Lanier, and these allegations had been known by the Trustee at the commencement of the discharge proceeding.

In support of his motion for approval of the settlement, the Trustee contended that, although he did not generally believe that debtors should be permitted to purchase a discharge, he believed that Mr. Lanier was judgment proof and that settlement of the discharge proceeding was the only means of making a return to creditors. Furthermore, the Trustee noted that the objecting creditors had failed to take advantage of the opportunity to file their own adversary proceedings objecting to the dischargeability of the debts owed them by Mr. Lanier.

Taking upon itself the burden to test the Trustees evidence, the bankruptcy court questioned the Trustee (but not Mr. Lanier) at the hearing on the motion to compromise. In response to the bankruptcy courts inquiries, the Trustee revealed that Mr. Lanier stated he had lost a boat and SUV in Mexico, abandoning them there to return to the United States for a medical emergency. The Trustee admitted that he had not sought proof to verify Mr. Laniers story because the property was fully encumbered by a lien to GMAC such that there was no equity to be realized for the estates unsecured creditors. The Trustee further acknowledged that he was unsure of the amount of priority claims held by the North Carolina Department of Revenue, which already had garnished Mr. Laniers accounts, and had not even sent out a notice to file claims.

Debtors counsel also argued in favor of approving the compromise settlement. The arguments included the assertion that Mr. Lanier believed he had some defenses to the Discharge Proceeding. Furthermore, the total amounts claimed by the objecting creditors totaled less than the \$36,000 offered by Mr. Lanier to settle the discharge proceeding. In fact, most of the Debtors potential unsecured debt was actually corporate debt which could be assessed to the Debtor only if the creditors could pierce the corporate veil.

Legal Analysis

Pursuant to *Federal Rule of Bankruptcy Procedure 9019(a)*, On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement. This rule is augmented, in these circumstances, by *Federal Rule of Bankruptcy Procedure 7041*, which provides:

Rule 41 F.R. Civ. P. applies in adversary proceedings, except that a complaint objecting to the debtor's discharge shall not be dismissed at the plaintiff's instance without notice to the trustee, the United States trustee, and such other persons as the court may direct, and only on order of the court containing terms and conditions which the court deems proper.

The Bankruptcy Code, however, does not provide any standards for bankruptcy courts to apply when determining whether to approve a compromise. Instead, courts have created three basic approaches to reviewing proposed settlements of section 727 complaints. *In re de Armond*, 240 B.R. 51, 55 (*Bankr. C.D. Cal.* 1999).

The first approach is the *per se* rule. It holds that no settlement of a section 727 objection is permissible. *See In re Levine*, 287 B.R. at 692-93 (*Bankr. E.D. Mich.* 2002); *In re Vickers*, 176 B.R. at 290 (*Bankr. N.D. Ga.* 1994) (Discharges are not property of the estate and are not for sale.).

The second approach is the trustee approach, which recognizes the tension between the public interest in the policies behind section 727 and the public interest in the peaceful, just, speedy and inexpensive resolution of disputes.

In re Margolin, 135 B.R. at 673 (Bankr. D. Colo. 1992). Because the objection to discharge is for the benefit of all creditors, the trustee may discharge his fiduciary duties and resolve this tension by giving notice of the settlement, making full disclosure of the terms of the proposed settlement and affording all the opportunity to become the plaintiff and conclude the litigation. If there is no objection or motion to substitute, the settlement will generally be approved. *Id.*

The third approach has been characterized as the cautious but pragmatic approach. It is similar to the trustee approach, but the terms of settlement are carefully reviewed to assure that they are in the best interests of the estate and that the settlement is not tainted. See *In re Traxler*, 277 B.R. at 705 (Bankr. E.D. Tex. 2002); *Hass v. Hass (In re Hass)*, 273 B.R. 45 (Bankr. S.D.N.Y. 2002). The best interests of the estate are met by considering the same factors a court considers in reviewing any proposed settlement: (1) the probability of success on the merits in the litigation; (2) possible difficulties of collecting any judgment which might be obtained; (3) the complexity, expense, and likely duration of any ensuing litigation; and (4) the interests of the creditors, giving proper deference to their reasonable views. *In re Martin*, 91 F.3d at 393 (3d Cir. 1996) (citing *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. at 424-25, 88 S. Ct. 1157, 1163-64, 20 L. Ed. 2d 1 (1968)).

In *Lanier*, the bankruptcy court purported to apply the four factors of the cautious but pragmatic test without discussion or acknowledgment of the other approaches. Nonetheless, the court spent the greatest part of the opinion judging the probability of success on the merits in the discharge proceeding, with the interests of the creditors receiving little mention, and the second and third factors not discussed at all.

Commentary

The bankruptcy courts holding in *In re Lanier* is noteworthy in that it had the potential to deal in a substantial manner with the bankruptcy systems opposing goals of providing money to pay a debtors creditors and not rewarding an undeserving debtor with a discharge. Bankruptcy trustees often operate in this gray area, entering settlements with debtors whose discharge might be denied due to various bad acts in exchange for payments that are often the bankruptcy estates only assets for distribution. These settlements can easily have the unwanted appearance of a debtors purchasing his discharge, so *Lanier* could have been helpful in setting limits on this questionable practice. The *Lanier* decisions value as precedent is diminished, however, by the bankruptcy courts failure to discuss the evidentiary standards and burdens of proof to be met in approving such a compromise, as well as the decisions minimal analysis of all four factors of the cautious but pragmatic test.

Code Section 727(a)(3). As a starting point, the bankruptcy court took the interesting step of finding *sua sponte*, based solely on the allegations in the complaint and answer in the Discharge Proceeding, that there was *prima facie* evidence that Mr. Laniers discharge could be denied pursuant to 11 U.S.C. § 727(a)(3). That section provides for a denial of discharge in the case of concealment, destruction, falsification, or failure to keep or preserve recorded information, including financial and business records.

In his answer, Mr. Lanier admitted that, at times, he paid personal expenses from his corporate account and did not segregate the accounts, but he further stated that these failures were not done with intent to defraud. He further confessed that he sent money to his mistress in Russia for English lessons and to meet him in Paris and Rome and also acknowledged that he did not adequately maintain records after his bookkeeper left his company. Instead, sometimes he would meet his subcontractors at the bank, withdraw money, and pay them in cash. These withdrawals and payments, however, could not be substantiated by invoices from subcontractors. Similarly, cash payments were made to Mr. Laniers son, purportedly for work performed for Mr. Laniers company, without supporting documentation.

According to the bankruptcy court, these admissions by Mr. Lanier were grounds for denial of discharge under section 727(a)(3) because he failed to maintain personal business records and corporate business records in such a manner as to avoid commingling of assets. What makes this finding by the bankruptcy court interesting, and potentially

questionable, is the fact that a vast majority of chapter 7 debtors do not keep good business records and often commingle personal and corporate monies. The bankruptcy court, however, did not engage in any discussion of how Mr. Laniers acts were more egregious, and therefore an appropriate basis for denial of discharge, than those of other chapter 7 debtors who receive discharges as a matter of course.

Code Section 727(a)(2)(B). Similarly questionable was the bankruptcy courts finding that there was *prima facie* evidence that Mr. Laniers discharge could be denied pursuant to 11 U.S.C. § 727(a)(2)(B), which provides for denial of discharge if:

The debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated or concealed--

...

(B) property of the estate, after the date of the filing of the petition.

According to the bankruptcy court, this finding was based solely on evidence to suggest that the debtor concealed the location of a sport utility vehicle and boat, which would be property of the estate. 2008 Bankr. LEXIS 609, at *10. Left undiscussed, though, is why a mere suggestion of evidence of concealment should be grounds for denial of the compromise between the debtor and the Trustee.

Code Section 727(a)(5). The bankruptcy court further determined that there was *prima facie* evidence that Mr. Laniers discharge could be denied under 11 U.S.C. § 727(a)(5). Under that section, a discharge can be denied if the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtors liabilities. Here, the bankruptcy court did not explain what the *prima facie* evidence was to support this finding, nor did the bankruptcy court state why such *prima facie* evidence was sufficient to deny the desired settlement.

Piercing the Corporate Veil. The bankruptcy court also concluded that Mr. Laniers unsecured debt was \$779,819, some of which arose from alleged corporate debts. Per the bankruptcy court, sufficient facts existed to support an action to pierce the corporate veil to make Mr. Lanier liable for his companys debts, but the bankruptcy court did not explain how this finding impacted the approvability of the settlement.

Best Interests of the Creditors. Finally, the bankruptcy court found that Mr. Lanier had significant tax liabilities, which, in addition to the Trustees commissions and reasonable attorneys fees, would have priority over the unsecured creditors claims. Thus, the bankruptcy court concluded that it was unlikely that the unsecured creditors would receive any distribution from the settlement.

Conclusion

The decision in *Lanier* is disappointing, not so much because of its final outcome, but because of its lack of analytical thoroughness. While it is perfectly likely that Mr. Lanier may have engaged in conduct for which denial of discharge would be appropriate, it was incumbent on the bankruptcy court to explain in greater detail who bore the burden of proof and why that burden was not met. The bankruptcy court similarly failed to explain why *prima facie* evidence derived solely from the pleadings, or just the suggestion of evidence, was sufficient to judge the likelihood of success on the merits in the Discharge Proceeding and deny the Trustees motion. Most significantly, the bankruptcy court did not analyze at all the second and third factors of its stated test for approval; there is no consideration of possible difficulties of collecting on a judgment or the complexity, expense, and likely duration of continuing the litigation. Because of this deficient analysis, the bankruptcy court gave the appearance that its denial of the motion to

approve the settlement was result-driven and not the product of an even-handed and thoughtful balancing of the evidence and the interests of all parties.

For further discussion related to the approval of settlements of objections to discharge under Code section 727 and Bankruptcy Rules 7041 and 9019, see generally Collier on Bankruptcy, chs. 727, 7041, and 9019 (Matthew Bender).

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75 of 197 DOCUMENTS

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Lawniczak on Walker v. Walden

2008 Emerging Issues 2344

Lawniczak on Walker v. Walden

By James M. Lawniczak

June 2, 2008

SUMMARY: The Eleventh Circuit has joined the majority of circuits and ruled that the removal of a chapter 7 trustee is a final, appealable order. In particular, the Walker court was influenced by the Third Circuit's pragmatic and flexible subjective approach. As James Lawniczak discusses in his Emerging Issues Analysis, the court weighed the interests of judicial efficiency and judicial economy and found that the former was more significant.

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ARTICLE: The Eleventh Circuit Joins a Majority of the Circuits Holding that Decisions to Appoint or Remove a Trustee Are Final Orders Subject to Immediate Appeal

In *Walker v. Walden*, 515 F.3d 1204, 1210 (11th Cir. 2008), the United States Court of Appeals for the Eleventh Circuit resolved an issue it called one of first impression in this circuit, namely, whether an order removing a chapter 7 trustee is a final order. In its opinion, the court generally discussed finality in the context of contested matters and adversary proceedings in bankruptcy cases. It then considered both judicial economy and judicial efficiency in holding that the order removing the trustee was a final, appealable order. 515 F.3d at 1210-11.

The court noted that cases dealing with the removal of a trustee require the same finality analysis as cases dealing with the appointment of a trustee. 515 F.3d at 1210, n.4. The court also observed a split in authority among the various circuit courts of appeals as to whether orders appointing or removing trustees are, or are not, final. The court then discussed the positions of the various circuits, noting that the Third and Fourth Circuits have held that such orders are final; the Seventh disagrees, holding that such orders are not final; while the Fifth Circuit has concluded both ways. n1

Facts. Linda Walden was appointed trustee for James Walkers chapter 7 bankruptcy case, after election by the creditors under 11 U.S.C. § 702(b). The court held a ratification hearing at which time the issue of the trustees connections with a creditor, Florida Caliper Manufacturers, and its owner (the Creditor) was raised. The trustee testified that she did not have any direct business relationship with that Creditor.

However, the chapter 7 debtor later discovered that the trustee had performed accounting services, prepared an

expert report in a 2000 state-court action and had served as registered agent for two related businesses of the Creditor. He filed an Emergency Motion to Remove the Trustee, which was granted. *In re Walker*, 2004 Bankr. LEXIS 2187 (Bankr. S.D. Fla., Dec. 1, 2004). The order was affirmed on appeal, and an appeal to the Eleventh Circuit followed.

Court Must Consider Appellate Jurisdiction *Sua Sponte*. The courts discussion on the finality issue began with its recognition that neither party to the appeal had raised the jurisdictional issue. The court pointed out, however, that it is the duty of a court to determine its jurisdiction over a matter, even if the issue is not raised by the parties. 515 F.3d at 1210.

Appellate Court Jurisdiction Is Not Co-Extensive With District Court Jurisdiction. The court then discussed the principal that a court of appeals will not necessarily have jurisdiction over a bankruptcy appeal just because the district court, the first level of appeal, had jurisdiction. This is because the court of appeals has jurisdiction only over final orders, 28 U.S.C. § 158(d), while the district court is given jurisdiction over both final and interlocutory orders. 28 U.S.C. § 158(a); see *Lockwood v. Snookies, Inc.* (*In re F.D.R. Hickory House, Inc.*), 60 F.3d 724, 725 (11th Cir. 1995).

Finality in the Context of Bankruptcy Court Proceedings. The finality rule is not always easy to apply in the context of a bankruptcy case. This is because a bankruptcy case ordinarily consists of a number of discrete matters, all of which are dealt with in a single bankruptcy case. Therefore, there is no requirement that the entire bankruptcy case be completed before appeals can be entertained, only that the discrete matter under consideration be resolved, with nothing further for the court to do as to that matter. See 1 *Collier on Bankruptcy*, 5.07[1][b] (Matthew Bender); *Martin Bros. Toolmakers, Inc. v. Industrial Dev. Bd.* (*In re Martin Bros. Toolmakers, Inc.*), 796 F.2d at 1435, 1437-38 (11th Cir. 1986); cf. *Catlin v. United States*, 324 U.S. 229, 233, 65 S. Ct. 631, 633-34, 89 L. Ed. 911, 916 (1945) (a final decision is one that ends the litigation and leaves nothing for the court to do but execute its judgment).

Thus, all courts dealing with orders in bankruptcy cases have generally noted that there is a broader concept of finality from those bankruptcy decisions than from other civil matters. Virtually all such cases note that some flexibility is necessary. See, e.g., *Millers Cove Energy Co., Inc. v. Moore* (*In re Millers Cove Energy Co., Inc.*), 128 F.3d 449, 451 (6th Cir. 1997) (district court order remanding matter to bankruptcy court was not final; court noted split in court of appeals authority on how to approach the issue); *In re Devlieg, Inc.*, 56 F.3d 32, 33 (7th Cir. 1995) (*per curiam*) (myriad are the cases which say that finality is to be interpreted more liberally in bankruptcy cases); 1 *Collier on Bankruptcy*, 5.07[1][b] (Matthew Bender).

The Third and Second Circuits Flexible Approach. The Third and Second Circuit, in particular, use a very liberal, pragmatic view of finality of orders in bankruptcy matters. See, e.g., *In re Armstrong World Indus., Inc.*, 432 F.3d 507, 511 (3d Cir. 2005); *Bank Brussels Lambert v. Coan* (*In re Arochem Corp.*), 176 F.3d 610, 619-20 (2d Cir. 1999). The *Armstrong World Industries* case discussed four factors to be considered in determining the finality of a bankruptcy appeal: (1) the impact on the assets of the estate; (2) the need for further fact finding on remand; (3) the preclusive effect of a decision on the merits; and (4) the interests of judicial economy.

The Second Circuit also uses what it calls a flexible test, although it has a different focus than the Third Circuits test. In *Bank Brussels Lambert*, 176 F.3d at 619-20, the court discusses a flexible and relaxed approach to finality in bankruptcy matters. As a result, an order retaining counsel was determined by the court to be final in a bankruptcy case, although a similar order would not have been final in nonbankruptcy litigation. The courts focus, following the analysis of *U.S. Trustee v. Bloom* (*In re Palm Coast, Matanza Shores Ltd. Partnership*), 101 F.3d 253, 256 (2d Cir. 1996) (retention of trustees firm as a real estate consultant to the estate was a final order that could be appealed), was whether there was any indication in the disposition of the matter below that the decision could be reconsidered.

The Third and Second Circuits flexible approach to finality takes into account pragmatic matters that go beyond

answering the question whether the order at issue finally resolves a discrete matter in the bankruptcy case. Thus, it is more likely that orders will be found to be final in those two circuits. For example, in the Second Circuit *Bank Brussels Lambert* case, the court held that an order authorizing retention of counsel in bankruptcy was final. In doing so, the court pointed out that four circuits, the Seventh, Ninth, Fifth and First have all determined that orders involving retention of bankruptcy counsel are not final orders. *See, e.g., Brouwer v. Ancel & Dunlap (In re Firstmark Corp.)*, 46 F.3d 653, 657-59 (7th Cir. 1995). On the other hand, the Third (no surprise given its pragmatic approach) and the Fourth Circuits hold to the contrary. *See, e.g., Committee of Dalkon Shield Claimants v. A.H. Robins Co.*, 828 F.2d 239, 241 (4th Cir. 1987).

The Eleventh Circuits citation to the Third Circuit cases in *Walker*, and its discussion of the principles of judicial economy and judicial efficiency show that the Eleventh Circuit, at least in this case, has joined the Third Circuit in using a pragmatic and flexible subjective approach.

The Tenth Circuit Approach. Other circuits are not willing to be quite as flexible as the Third and Second Circuits. The Tenth Circuit uses what it also refers to as a flexible approach, but does so in the context of a more objective determination of whether a discrete dispute within the bankruptcy proceeding has come to the appellate court in a posture that objectively satisfies traditional finality principles. *See, e.g., Mason v. Young (In re Young)*, 237 F.3d 1168, 1172-73 (10th Cir. 2001); *Cascade Energy & Metals Corp. v. Banks (In re Cascade Energy & Metals Corp.)*, 956 F.2d 935, 939 (10th Cir. 1992); *Eddleman v. U.S. Dept of Labor*, 923 F.2d 782, 786 (10th Cir. 1991). The flexibility of the Tenth Circuit approach lies in its willingness not to require finality of the entire proceedings, focusing instead on a distinct subset thereof.

Eleventh Circuits Analysis--Majority Position. In reaching its conclusion that decisions appointing and removing trustees are final opinions entitled to immediate review, the *Walker* court relied primarily on the Third Circuit decision in *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 470-71 (3d Cir. 1998). In that case, the court noted that if the appeal on the appointment of a trustee were to be put off until the entire bankruptcy proceeding was over, it would effectively eliminate the right to appellate review, because it would be impossible to take the case back to the point where the trustee had been appointed (or removed). 140 F.3d at 470.

The underpinnings of the decision of the Eleventh Circuit in the *Walker* case are the same. The court believed that judicial efficiency outweighed judicial economy, for the same reason as given in the *Marvel Entertainment* case: to wait to the end of the case to review the decision appointing or removing the trustee would preclude review. Review of those orders cannot be meaningfully postponed; the reviewing court could not jettison years of bankruptcy infighting because the wrong trustee had been handling the matter. 515 F.3d at 1210-11.

Cases Supporting the Eleventh Circuits Majority Position. As noted above, the Third Circuit has held that the appointment of a trustee is a final order subject to appeal. *Marvel Entertainment*, 140 F.3d 463, 470-71. The Third Circuit has also held that an order removing a trustee is a final order. *In re B H & P Inc.*, 949 F.2d 1300, 1307 (3d Cir. 1991).

The Fourth Circuit has held that an order denying a creditors committees request for the appointment of a trustee is a final order. *Committee of Dalkon Shield Claimants v. A.H. Robins Co., Inc.*, 828 F.2d 239, 241 (4th Cir. 1987). That court has also held that a decision not to remove a bankruptcy trustee is final for collateral estoppel purposes. *Turshen v. Chapman*, 823 F.2d 836, 839 (4th Cir. 1987).

Although the *Walker* court claimed that the Fifth Circuit had concluded both ways, 515 F.3d at 1210, the two cited

Fifth Circuit cases are actually reconcilable. In the first case, the court concluded that the appointment of an interim trustee was not a final order. *Foster Securities, Inc. v. Sandoz (In re Delta Services Industries)*, 782 F.2d 1267, 1270-71 (5th Cir. 1986) (the nature of the role an interim trustee plays shows that the appointment of such a trustee is only a preliminary step). In the subsequent case, *Cajun Electric Power Cooperative v. Central Louisiana Electric Co., Inc. (In re Cajun Electric Power Cooperative, Inc.)*, 69 F.3d 746, 748 (5th Cir. 1995), cert. denied, 519 U.S. 808, 117 S. Ct. 51, 136 L. Ed.2d 15 (1996), the court held that the appointment of a permanent trustee is a final appealable order, and specifically distinguished the *Delta Services* case because it involved an interim trustee.

Although not noted by the court in the *Walker* case, one other circuit court of appeals has also found that orders appointing a trustee are final. In *In re Plaza De Diego Shopping Center, Inc.*, 911 F.2d 820, 825-26 (1st Cir. 1990), the court held that the order appointing a trustee was final and appealable because it was a final decision of a significant and discrete dispute (i.e., a dispute over the authority and procedure for appointing a trustee[]). In addition, the court noted that an appeal could not be meaningfully postponed. 911 F.2d at 826.

Finally, in *Oklahoma Refining Co. v. Blaik (In re Oklahoma Refining Co.)*, 838 F.2d 1133 (10th Cir. 1988), the court affirmed an order appointing a trustee, without discussion of whether the order it was affirming was indeed a final order. Thus, it could be said that the Tenth Circuit has, by implication, determined that such orders are final, particularly because the issue may be raised by the court *sua sponte*. See *Walker*, 515 F.3d at 1210.

Minority Position--the Seventh Circuit. As noted by the *Walker* court, the Seventh Circuit has held that the appointment of a trustee is not a final order that can be immediately appealed to a court of appeals. *Cash Currency Exchange, Inc. v. Shine (In re Cash Currency Exchange, Inc.)*, 762 F.2d 542, 546 (7th Cir.), cert. denied, 474 U.S. 904, 106 S. Ct. 233, 88 L. Ed. 2d 232 (1985). In that case, the court found that orders permitting limited intervention, denying a motion to dismiss the case and appointing a bankruptcy trustee were interlocutory. The court did not comment further on this issue. The court went on to decide that the orders, including the order to appoint a trustee, could not be reviewed under the collateral order doctrine, which does, under certain circumstances allow interlocutory appeals. On that issue, the court pointed to the three-part test of *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 468, 98 S. Ct. 2454, 57 L. Ed. 2d 351 (1978), which requires that the order (1) conclusively determine the disputed question, (2) resolve an important issue separate from the merits of the action and (3) be effectively unreviewable on appeal from an eventual final judgment. The Seventh Circuit held that the order appointing the trustee failed the third part of the test because it could be reversed on appeal from the approval of a plan of reorganization. 762 F.2d 542, 547.

Were the specific issue of the finality of the appointment of a bankruptcy trustee to come before the Seventh Circuit today, it is quite possible that the court might reconsider the matter. The *Cash Currency Exchange* case was the first case to decide the issue of the finality of the appointment or removal of a trustee. Since that decision came down, all four circuits considering the issue have concluded otherwise. In addition, the decision of the Seventh Circuit was made with no legal analysis.

Additional Issue Before the Court--Standing of the Debtor. The trustee in the *Walker* case challenged the standing of the debtor, as a party without a pecuniary interest in the chapter 7 estate, to move for her removal. The court sidestepped the issue, pointing out instead that the bankruptcy court itself had the power, without need for a request by a party in interest to remove a trustee under 11 U.S.C. § 324. 515 F.3d at 1211-12.

Conclusion. The Eleventh Circuit has joined the majority of the circuit courts of appeal in holding that an order removing a bankruptcy trustee is a final order. Moreover, it indicated in *dictum* that an order appointing a bankruptcy trustee is also final.

For further discussion of appeals in bankruptcy cases, see Collier on Bankruptcy, ch. 4 (Matthew Bender).

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n1 . However, as noted below, the Fifth Circuit cases are reconcilable--the case holding that the order was not final dealt with the appointment of an *interim* trustee, while the case holding that the order was final dealt with a permanent trustee.

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76 of 197 DOCUMENTS

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Jurs on In re McCormick

2008 Emerging Issues 2247

S. Andrew Jurs on In re McCormick

By S. Andrew Jurs

April 30, 2008

SUMMARY: A chapter 13 debtor who was the sole owner of a limited liability company (LLC) was not entitled to have the automatic stay extended to the LLC. Under no provision of the Bankruptcy Code was the LLC, as a nondebtor, entitled to the shield of the stay. Nor was it appropriate that the court exercise its extraordinary powers under Code section 105, because there were no immediate adverse consequences of leaving the LLC unprotected.

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ARTICLE: Cite as: Jurs, S. Andrew. *In re McCormick*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

S.D.N.Y Bankruptcy Court Refuses to Extend the Automatic Stay to a Limited Liability Company of Which the Chapter 13 Debtor Was the Sole Owner

In *In re McCormick*, 381 B.R. 594, 2008 Bankr. LEXIS 298 (Bankr. S.D.N.Y. Feb. 8, 2008), the bankruptcy court confronted whether the court could use its equitable powers under 11 U.S.C. § 105 to extend protection under the automatic stay to a limited liability company (LLC) of which a chapter 13 debtor was the sole member. In its decision, the bankruptcy court rejected the debtors application and found that the LLC was not eligible for protection under chapter 13 and had not filed its own petition under chapters 7 or 11. Furthermore, the debtor had not provided evidence of pending actions against the LLC that would have immediate adverse economic consequences for the debtors bankruptcy estate.

The decision in *In re McCormick* is noteworthy in that it puts the brakes on debtors attempts to push the limits of the automatic stay under 11 U.S.C. § 362. Increasingly, bankruptcy courts had been invoking their powers under section 105(a), at the behest of debtors, to extend the automatic stay to nondebtors for equitable reasons. By denying the debtors Application in *McCormick*, the bankruptcy court reaffirmed the tenet that such equitable exceptions are limited and that if a third party wants the protection of the automatic stay, it should file for bankruptcy itself.

Facts and Procedural History. The underlying facts were not disputed, although there was some confusion. The debtor was a self-employed general contractor and also the sole member of his LLC. n1 In the section of his chapter 13 bankruptcy petition labeled Type of Debtor, the debtor selected only the first option, Individual (includes joint debtors).

The second option, Corporation (including LLC and LLP), was not selected.

In his petition, the debtor further indicated that his debts were not primarily consumer debts, a fact which was borne out by his schedules. Among the various creditors listed, there were numerous commercial entities that would have dealt with the debtor as part of his construction business. Many of these claims also were purportedly shared with codebtors, including his spouse and the LLC. Furthermore, according to the petition, the LLC was the debtors employer, from which he earned an individual monthly income of \$2,150.26. After deductions, however, the debtor had a total monthly disposable income of \$4,255.31. The debtors plan proposed 60 monthly payments of \$100.

Eighteen days after submitting his chapter 13 petition, the debtor filed an Application for an extension of the automatic stay to the LLC. In his Application, the debtor predicted imminent irreparable harm to the LLC and his ability to reorganize under chapter 13 if the LLC was not protected by the automatic stay. Although he did not identify exactly what harm would occur, the debtor alluded to creditors collection actions against the LLC and implied that these actions would impact his ability to reorganize.

Legal Background. With the exception of the codebtor stay under *11 U.S.C. § 1301*, the general rule is that the automatic stay created at the filing of the bankruptcy petition covers only debtors and not nonfiling codefendants. See *Teachers Ins. & Annuity Assn v. Butler*, 803 F.2d 61, 65, 15 C.B.C.2d 952 (2d Cir. 1986). Several bankruptcy courts, however, have recognized circumstances in which the bankruptcy courts could use their extraordinary powers under *11 U.S.C. § 105(a)* to extend the automatic stay to nondebtors. In such cases, the bankruptcy courts foresaw adverse economic consequences that would negatively impact the debtors ability to reorganize if the relief were not granted. In his Application, the debtor contended that his situation was similar to the circumstances in this line of cases in that collection actions against the LLC would render him unable to reorganize under chapter 13.

Bankruptcy Courts Analysis. In reaching its decision to reject the debtors Application, the bankruptcy court engaged in a multipart analysis. At the outset, the bankruptcy court recognized the basic statutory limitations on its ability to shield the LLC under the automatic stay in this case. First, a limited liability company is not qualified to be a debtor under chapter 13, as eligibility to be a debtor under that chapter is limited to only an individual with regular income, *11 U.S.C. § 109(e)*, and limited liability companies are not individuals under the Bankruptcy Code. Additionally, a limited liability company may not be a codebtor or joint debtor under chapter 13. The codebtor stay of *11 U.S.C. § 1301(a)* bars actions to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor. Because the debtor conceded that his debts were not consumer debts, and because the LLC was not an individual under the Bankruptcy Code, it was improper to list the LLC as a codebtor, and the LLC was not entitled to protection under the codebtor stay. Lastly, the bankruptcy court noted that there is [n]o provision in the Code [permitting] an individual and a business to file jointly. Thus, when an LLC and one of its members both seek to file a bankruptcy petition, they must do so separately. 200 Bankr. LEXIS 298, at *8 (quoting *In re Calhoun*, 52 C.B.C.2d 1060, 312 B.R. 380, 383 (N.D. Iowa 2004)).

The debtor made several other arguments in favor of extending the automatic stay to the LLC, which the bankruptcy court rejected in turn. With regard to the debtors contention that *11 U.S.C. § 1304* allowed him as a chapter 13 debtor to engage in business, the court explained that section 1304 does not, by its terms, extend the automatic stay to limited liability companies. Instead, that sections purpose is to allow a self-employed debtor in a sole proprietorship to continue in that capacity. Although the debtor was self-employed, he had chosen to avail himself of the protection for his assets offered by the limited liability company form. Thus, he excluded himself from the class of self-employed debtors covered by section 1304, and the automatic stay could not be extended to the LLC on that basis.

The bankruptcy court also declined to extend the automatic stay to the LLC under the extraordinary powers granted to the court under section 105(a). In doing so, the bankruptcy court recognized that some courts have extended the automatic stay to nondebtors who are officers, guarantors, sureties, and/or directors of corporations when necessary. See

A.H. Robins Co. v. Piccinin, 788 F.2d 994, 999, 15 C.B.C.2d 235 (4th Cir. 1986) (holding that automatic stay could be extended to enjoin civil proceedings against nondebtors in unusual circumstances); *Calpine Corp. v. Nevada Power Co. (In re Calpine Corp.)*, 354 B.R. 45, 49 (Bankr. S.D.N.Y. 2006) (using its section 105 powers to extend the automatic stay and preliminarily enjoin litigation against the chapter 11 debtors surety); *Gucci, America, Inc. v. Duty Free Apparel, Ltd.*, 328 F. Supp. 2d 439 (S.D.N.Y. 2004).

According to the bankruptcy court in *McCormick*, the extraordinary relief sought by the debtors in these cases can only be granted in limited circumstances. These limited circumstances can occur where the debtor is a corporation and the nondebtor is an individual or related corporation deemed necessary for the reorganization of the debtor corporation. *McCormick*, 2008 Bankr. LEXIS 298, at *16 (citing generally *A.H. Robins* and *Calpine supra*). These limited circumstances also can arise in an individual chapter 11 debtors case where the bankruptcy court expands the automatic stay to the debtors wholly owned corporation. *Queenie, Ltd. v. Nygard Intl*, 321 F.3d 282, 287 (2d Cir. 2003). According to the Second Circuit, though, the automatic stay can apply to nondebtors, but normally does so only when a claim against the nondebtor will have an immediate adverse economic consequence for the debtors estate. *Id.* Such immediate adverse economic consequences may include (1) a claim against a nondebtor for an obligation for which the debtor is a guarantor, (2) a claim against a debtors insurer, and (3) actions where a judgment against the third-party defendant will have the effect of being a judgment or finding against the debtor. *Id.*

Applying that standard, and its emphasis on limiting the circumstances under which such relief would be available, to the case at hand, the bankruptcy court found itself unpersuaded that immediate adverse consequences would result from leaving the LLC unprotected by the automatic stay. Although it recognized the debtors concerns that adverse consequences might result and that any action against the LLC may impact the debtors employment and ability to reorganize, the bankruptcy court felt that the debtor did not carry his burden of showing immediate adverse consequences. In particular, the bankruptcy court was troubled by the fact that the debtor never satisfactorily explained why he could not cause the LLC to file its own bankruptcy case, thereby staying all of the pending collection actions. Furthermore, the bankruptcy court observed that the debtors in *Calpine* and *Queenie* filed for protection under chapter 11, rather than chapter 13. Without any precedent for expanding the automatic stay in a chapter 13 case, the bankruptcy court stated that it could not enlarge the holdings of *Queenie* and *Calpine* to extend the automatic stay to the debtors LLC.

Altogether, the decision in *McCormick* adds a useful precedent restraining debtors attempts to extend the reach of the automatic stay under section 362. By declining to invoke its equitable powers under section 105(a), the bankruptcy court confirmed that equitable exceptions to the precise statutory boundaries of the automatic stay are limited to extraordinary circumstances. In doing so, the court reinforced the rule that a party is entitled to the protection of the automatic stay only if it files for bankruptcy itself.

For further discussion related to limits on the reach of the automatic stay, see generally Collier on Bankruptcy, ch. 362 (Matthew Bender).

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n1 . The debtor actually included two limited liability companies on his Schedule H: Donald J. McCormick Const. and McCormick Construction, LLC. In his Application, though, the Debtor identified an LLC not named in Schedule H, but the bankruptcy court stated that it appeared that Debtor meant Donald J. McCormick Const. when referring to the LLC. Accordingly, the use of the term LLC herein refers only to that LLC.

n2 . At the hearing, the debtor proposed an additional new argument that the automatic stay for the LLC was not only necessary to protect his employment, but that the LLC was also protected as property of the estate. The bankruptcy court admitted that the debtors membership interest in the LLC was personal property which became property of the bankruptcy estate at the filing of his bankruptcy petition. *11 U.S.C. § 541*. The bankruptcy court, however, also noted that Debtors property interest in the LLC was restricted to the intangible rights of ownership allowed under the New York limited liability company statute. The impact of collection actions on such intangible rights of ownership were particularly unclear because, according to the debtors petition, the shares in the LLC had no value and the debtor admitted that the LLC was essentially a shell. The debtor simply was unable to provide the bankruptcy court with satisfactory evidence that actions against the LLC would have an immediate adverse consequence on the estates interest in the LLCs stock.

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77 of 197 DOCUMENTS

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Jurs on In re Lanning

2008 Emerging Issues 2250

S. Andrew Jurs on In re Lanning

By S. Andrew Jurs

April 30, 2008

SUMMARY: The Tenth Circuit BAP held that an above-median debtor's projected disposable income under Code section 1325(b)(1)(B) means something more than current monthly income multiplied by the anticipated number of monthly payments. The decision ameliorates the rigidity of BAPCPAs reliance on formulas to calculate plan payment and allows bankruptcy courts to consider a debtors present financial reality and ability to pay.

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ARTICLE: Cite as: Jurs, S. Andrew. *In re Lanning*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

The Tenth Circuit Bankruptcy Appellate Panel Holds That Projected Disposable Income Under Section 1325(b)(1)(B) Means More Than Simply Multiplying Current Disposable Income by the Anticipated Number of Monthly Payments

In *In re Lanning*, 380 B.R. 17 (B.A.P. 10th Cir. Dec. 13, 2007), the Bankruptcy Appellate Panel for the Tenth Circuit (the Tenth Circuit BAP) faced an unusual combination of litigants on the narrow issue of whether projected disposable income under 11 U.S.C. § 1325(b)(1)(B) means more than simply multiplying current disposable income, as calculated on the debtors Form 22C, by the anticipated number of monthly payments. The chapter 13 trustee had appealed the decision of the U.S. Bankruptcy Court for the District of Kansas affirming the debtors chapter 13 plan, and the United States trustee weighed in (probably to the surprise of many debtors attorneys) with an *amicus curiae* brief in opposition to the chapter 13 trustees position and in support of the debtors chapter 13 plan. In a concise opinion, the Tenth Circuit BAP affirmed the bankruptcy courts decision and adopted the United States trustees argument that determining projected disposable income requires a forward-looking and reality-based analysis by the bankruptcy court rather than an artificial mathematical computation based on solely historical income figures.

Facts and Procedural History. The parties did not contest the underlying facts, which were presented to the bankruptcy court by stipulation. In 2004, the debtors annual income was \$43,147, which increased to \$56,516 in 2005. She filed her petition for chapter 13 relief on October 16, 2006, and subsequently filed her Statement of Financial Affairs and schedules in a timely manner. This annual income was above the median annual income for a family of one in Kansas.

Calculating debtors current monthly income, though, was complicated by the fact that, during the six months prior to filing her bankruptcy petition, she received a buy-out as part of her termination by her employer. This buy-out increased debtors monthly income to \$11,990 in April 2006 and \$15,356 in May 2006. At the time of debtors filing, her actual monthly income (as shown on Schedule I) was \$1,922, for an annualized amount of \$23,604. Because of the bump in income during April and May as part of the buy-out, however, debtors current monthly income (as determined on her Statement of Current Monthly Income, or Form 22C) was \$5,344, or \$64,124 annually. Obviously, this annualized current monthly income was well above-median, thereby subjecting debtor to the more rigorous standards for above-median debtors mandated by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

According to her Schedule J, the debtors actual monthly expenses were \$1,773, while her deductions on Form 22C totaled \$4,228. Under the pre-BAPCPA formula of I minus J, the debtor would have \$149 in excess monthly income available for plan payments. In contrast, calculating debtors monthly disposable income, under BAPCPA's new rules, on Form 22C shows \$1,114 available for plan payments (\$5,344 current monthly income minus \$4,228 using the standardized deductions).

In its final Order confirming debtors chapter 13 plan (the plan), n1 the bankruptcy court held that the appropriate starting point was to presume that the number resulting from the debtors Form 22C was the debtors projected disposable income unless the debtor could show that there had been a substantial change in circumstances such that the Form 22C figures were not a fair projection of the debtors future budget. The chapter 13 trustee appealed this decision. At the appellate level, the debtor, understandably, declined to participate, so the BAP invited the United States trustee to file an *amicus curiae* brief on behalf of the debtors position.

Legal Analysis. Section 1325(b)(1)(B) of the Bankruptcy Code allows court approval of a proposed chapter 13 plan over the chapter 13 trustees objection only if the plan provides for payment of all of the debtors *projected disposable income* to be received during the plan period (emphasis added). The Bankruptcy Code, however, does not define projected disposable income. Instead, the closest analogous term is disposable income, which, under section 1325(b)(2), is calculated for above-median debtors as current monthly income minus the standardized deductions. This computation involves another term, current monthly income, which is defined under section 101(10A) as the average monthly income from all sources that the debtor receives . . . during the 6-month period preceding filing of the petition.

In her appeal, the chapter 13 trustee contended that an above-median debtors projected disposable income is simply a multiple of the debtors disposable income as determined on Form 22C. Under this analysis, the debtors plan would have been required to provide for 60 payments of \$1,115, for a total payout of \$66,900 over five years. In other words, the trustees interpretation of section 1325(a)(5)(B) would require the debtor to commit to payments she cannot possibly make in order to obtain the protections afforded by bankruptcy. 380 B.R. at 20. n2 The question before the Tenth Circuit BAP, therefore, was whether an above-median debtors projected disposable income could deviate from the debtors current disposable income as determined on Form 22C when there had been a significant change in circumstances. As noted, the Tenth Circuit BAP affirmed the bankruptcy courts decision and adopted the United States trustees argument that determining projected disposable income requires something more than a purely artificial mathematical computation based solely on historical income figures.

Commentary. The BAPs decision in *In re Lanning* is significant in that it is the first appellate decision resolving whether modifications to projected disposable income are permitted when the debtors current monthly income is *above-median*. Both earlier decisions by appellate courts regarding projected disposable income involved below-median debtors who experienced a change in circumstances just before the filing of their petitions such that the debtors had actual income substantially greater than their current monthly income.

For example, in *In re Kibbe*, 361 B.R. 302 (B.A.P. 1st Cir. 2007), the debtor calculated a negative disposable income on her Form 22C, so she proposed a plan that provided no payments for the benefit of unsecured creditors. The trustee objected because the debtor had obtained a higher paying job shortly before filing her petition, and her actual

income was nearly \$2,400 more than her expenses. The chapter 13 trustee in *Kibbe* took a position counter to the position offered by the chapter 13 trustee in *Lanning* and argued that a bankruptcy court may still consider significant changes in circumstances that cause Form 22Cs monthly disposable income to be an inaccurate projection of a debtors future ability to make plan payments. Both the bankruptcy court and the First Circuit BAP agreed, specifically rejecting the debtors interpretation of projected as a synonym for multiplied.

Similarly, in *Pak v. eCast Settlement Corp. (In re Pak)*, 378 B.R. 257 (B.A.P. 9th Cir. Nov. 7, 2007), the Ninth Circuit BAP was confronted by the case of a below-median debtor whose income increased significantly right before his bankruptcy filing, and who proposed plan payments well below his actual ability to pay. Again, the bankruptcy court and the Ninth Circuit BAP refused to confirm the debtors proposed plan, and the debtors case was in fact dismissed when he refused to propose a new plan paying more to his unsecured creditors.

In both *Kibbe* and *Pak*, the appellate panels noted that, although BAPCPA added a definition of disposable income in section 1325(b)(2), BAPCPA linked the new disposable income definition to Form 22Cs calculation of current monthly income, which is a historically based figure, but left unchanged the well-established body of pre-BAPCPA law pertaining to projected disposable income. BAPCPA neither defined nor modified the preexisting term projected disposable income. Before BAPCPA, bankruptcy courts determined projected disposable income by starting with Schedules I and J and then considering other evidence if those schedules did not accurately predict the debtors ability to pay. Consequently, before BAPCPA, projected disposable income was not determined solely by rote application of a mathematical formula.

In reaching its conclusion that, post-BAPCPA, projected disposable income still is not determined only by formula, the Tenth Circuit BAP followed what it considered to be the majority position among bankruptcy courts. Typically, these courts reasoned that the use of the word projected and the phrase to be received by the debtor in section 1325(a)(5)(B) indicates a congressional intent that bankruptcy courts include in their analysis a debtors *future* ability to pay when determining projected disposable income. If bankruptcy courts did not engage in this forward-looking analysis, the word projected would be superfluous; to these courts, projected disposable income must mean something more than simply disposable income.

Furthermore, in reaching its decision in *Lanning*, the Tenth Circuit BAP rejected the reasoning of courts which insisted on a narrower interpretation of projected disposable income and the calculations from Form 22C. According to these courts, BAPCPA eliminated bankruptcy courts discretion and made the Form 22C computations binding, regardless of changed circumstances. Such courts refuse to find that the word projected in projected disposable income is as important as the majority of bankruptcy courts have determined. To this minority of courts, projected simply means multiplied.

Agreeing with the decisions in *Kibbe* and *Pak*, the Tenth Circuit BAP held that BAPCPA did not affect the practice of inquiring about other factors when computing projected disposable income. Instead, BAPCPA changed only the starting point of the analysis from Schedules I and J to the Form 22C calculation. The Tenth Circuit BAP simply was not willing to believe that Congress, through BAPCPA, intended to eliminate the discretion of bankruptcy courts to deviate from an application of the Form 22C formula when significant changed circumstances support doing so. Therefore, parties contending that the Form 22C disposable income figure does not accurately project the debtors future ability to make plan payments will have to provide documentation supporting their position in order to use this exception to the general rule that the Form 22C figures are binding.

All told, the Tenth Circuit BAPs decision in *Lanning* adds another precedent ameliorating the rigidity of BAPCPAs reliance on formulas to calculate plan payment rather than allowing a bankruptcy court to use its discretion and consider a debtors present financial reality and ability to pay. If the significant change in circumstances means a debtor should either be paying more or less than the amount calculated on Form 22C, such calculation can be modified to reflect reality in a reasonable manner.

For further discussion related to the determination of projected disposable income for purposes of computing necessary chapter 13 plan payments under BAPCPA, see generally Collier on Bankruptcy, ch. 1325 (Matthew Bender).

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n1 . The bankruptcy court actually sustained the trustees objection to the debtors plan, but only on the grounds that the debtors plan allowed for the possibility of discharge without making payments for the full five years in violation of section 1325(b)(4). Because the bankruptcy court allowed the debtor to simply notify the chapter 13 trustee and court that she would allow the standard confirmation order to reflect that the plan would run five years, though, she was not required to file an amended plan and the original plan would be confirmed as so modified.

n2 . In its decision, the BAP clearly was upset by the almost punitive nature of the chapter 13 trustees position. For example, the BAP took pains to note that the trustee sought to have the debtor make payments that would leave her only \$807 (her actual income of \$1,922 minus a monthly plan payment of \$1,115) to pay \$1,773 in actual expenses. Because the trustee neither alleged that the debtor lacked good faith in filing her petition, nor disputed the debtors actual income and expenses as shown on her Schedules I and J, the BAP remarked that such an outcome seem[s] especially unreasonable. *380 B.R. at 21 n. 11.*

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78 of 197 DOCUMENTS

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Jurs on In re White

2008 Emerging Issues 2225

S. Andrew Jurs on In re White

By S. Andrew Jurs

April 24, 2008

SUMMARY: In *In re White*, the court considered whether a chapter 13 debtor can take an ownership deduction for a car owned free and clear of any liens. Unlike some courts that have relied on the Internal Revenue Manual in ruling that an ownership expense is not available in that circumstance, the White court rejected incorporation of the IRS's internal standards and held that a deduction is permissible even if the debtor owes no lease of finance payment.

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ARTICLE: Cite as: Jurs, S. Andrew. *In re White*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

In Allowing a Chapter 13 Debtor to Take an Ownership Deduction for Two Cars, One of Which Was Owned Free and Clear of All Liens, the Bankruptcy Court Declined to Utilize the Internal Revenue Manual's Interpretations of the IRS Deduction Rules

In *In re White*, 382 B.R. 751, 2008 Bankr. LEXIS 449 (Bankr. C.D. Ill. Feb. 28, 2008), the bankruptcy court clarified the confusing interplay between the Bankruptcy Code and the Internal Revenue Manual, particularly with regard to whether portions of the Manual and its interpretative provisions may have become incorporated in various standards under the Bankruptcy Code.

Facts and Procedural History. On the petition date, the debtors in *White* owned two automobiles: a Chevrolet pickup truck and a Ford SUV. The Ford was subject to a lien held by debtors' credit union, but the Chevy was owned free and clear of all liens. On their Official Form 22C, debtors, whose income was above-median, claimed an ownership expense deduction for the Ford as Vehicle 1 in the amount of \$471.00 and for the Chevy as Vehicle 2 in the amount of \$332.00.

The chapter 13 trustee objected to plan confirmation on the grounds that debtors were not allowed to claim an ownership expense deduction on a vehicle owned free and clear. If the allegedly improper ownership expense deduction was backed out, the chapter 13 trustee believed that the plan would fail to provide the minimum payment required by section 1325(b)(1)(B) of the Bankruptcy Code.

The United States trustee supported the chapter 13 trustee's objection and filed a brief espousing this same argument. The United States trustee further argued that Congress's goal under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) was to guarantee that chapter 13 debtors repay creditors the maximum the debtors could afford. In light of this goal, the United States trustee felt that the ownership deduction should be disallowed to debtors not actually making a car payment.

Legal Background. Under *Bankruptcy Code* section 1325(b)(1)(B), courts may not approve a proposed chapter 13 plan over a chapter 13 trustee's objection if the plan does not provide for payment of all of the debtors projected disposable income to be received during the plan period. The Bankruptcy Code, however, does not define projected disposable income. Instead, the closest analogous term is disposable income, which, under section 1325(b)(2), is calculated for above-median debtors as current monthly income *minus the standardized deductions*.

The standardized deductions consist of reasonably necessary expenses for, among other things, maintenance or support of a debtor and the debtors dependents. 11 U.S.C. § 1325(b)(2). Additionally, section 1325(b)(3) provides that section 707(b)(2)(A) governs the determination of such expenses for above-median debtors. Under section 707(b)(2)(A)(ii)(I), [t]he debtors' monthly expenses shall be the debtors' *applicable monthly expense amounts* specified under the National Standards and Local Standards, and the debtors' actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtors reside. (Emphasis added.)

Debtors and the chapter 13 trustee disputed whether the ownership expense deduction for the unencumbered Chevy was a proper applicable monthly expense amount under this subparagraph and the National and Local Standards. According to debtors, the only factors to consider when determining applicable monthly expense amounts from the IRS's tables involve debtors' date of filing, family size, geographic location, and number of vehicles.

In contrast, the chapter 13 trustee argued that debtors were allowed an automobile ownership interest deduction only if they actually owed money on the vehicle as of the petition date. To reach this conclusion, the chapter 13 trustee contended that BAPCPA not only has incorporated the IRS expense standards by reference, but that by doing so, Congress intended to further incorporate the instructions of the Internal Revenue Manual (the Manual) that accompany those standards. The Manual provides that a taxpayer may not take an ownership expense unless he has an actual debt service or lease payment for the vehicle. The trustee argued that if the National and Local Standards must be applied in bankruptcy, they should be applied in the same manner as they would be by the IRS such that a debtor who has no debt or lease payment may not receive an ownership deduction. In support, the trustee cited the IRS explanatory statement: [T]ransportation standards consist of nationwide figures for monthly loan or lease payments referred to as ownership costs. Thus, according to the trustee, an ownership expense is not applicable unless the debtor has a car payment.

Bankruptcy Court Opinion. As a starting point, the bankruptcy court noted that interpreting the IRS expense allowances is itself a difficult task. n2 It is unclear, according to the bankruptcy court, whether they function:

- (1) As fixed allowances, that are both an entitlement and a cap, whereby a debtors' actual expenditures are disregarded, no matter whether they are more or less than the IRS amounts;
- (2) As a cap but not an entitlement, such that a debtor may deduct only the lesser of his actual expenses or the IRS amount;
- (3) As an entitlement, but not a cap, such that a debtor is allowed to deduct his actual expenses or the IRS amount, whichever is greater.

2008 Bankr. LEXIS 449, at *6. After analyzing both the IRS's National and Local Standards, the bankruptcy court determined that the National Standards, as used by the IRS, are entitlements. Every taxpayer receives the standard full allowance even when the taxpayer's actual expenditures are less. Furthermore, under the National Standards, the taxpayer has the possibility of substantiating a claim for a greater amount. In contrast, the Local Standards for housing

and utilities function as a cap, because taxpayers get the lesser of actual expenses or the standard amount. Taxpayers, though, may rebut this presumptive cap and substantiate a higher amount.

Transportation expenses are more complicated because the Local Standard has three components: (1) a single national allowance for public transportation costs available to everyone, even without proof of using public transportation; (2) a single national ownership cost allowance for one or two cars; and (3) an operating cost allowance for one or two cars that varies by place of residence. The transportation Local Standard for the third component, the operating cost allowance, is a presumptive cap, with the taxpayer receiving the lesser of actual expense or the standard expense. Consequently, a taxpayer who owns a car and has a car payment gets an allowed operating expense *and* an ownership expense, while a taxpayer who owns a car but has no car payment receives *only* the operating allowance.

To interpret and apply the Local Standards, the bankruptcy court next confronted the question of whether it should consider the IRS Manual as a resource. Some courts have used the Manual to interpret section 707(b)(2)(A) and the term applicable. *See In re Talmadge*, 371 B.R. 96, 100-01 (Bankr. M.D. Pa. 2007); *In re Slusher*, 359 B.R. 290, 308-09 (Bankr. D. Nev. 2007). Other courts have found it inappropriate to consider the Manual in interpreting these provisions. *See In re Moorman*, 376 B.R. 694, 697-98 (Bankr. C.D. Ill. 2007); *In re Sawdy*, 362 B.R. 898, 912-13 (Bankr. E.D. Wis. 2007); *In re Barrett*, 371 B.R. 855, 858-59 (Bankr. S.D. Ill. 2007); *In re Chamberlain*, 369 B.R. 519, 525 (Bankr. D.Ariz. 2007); *In re Swan*, 368 B.R. 12, 18 (Bankr. N.D. Cal. 2007).

The bankruptcy court in *White* concurred with this second line of cases and found that use of the Manual would be inappropriate. The court based this conclusion on the fact that the Bankruptcy Code provision refers only to monthly expense amounts specified under the . . . Standards, and does not expressly incorporate by reference the Manuals instructions or commentary. In doing so, the bankruptcy court rejected the argument that the Manuals explanatory text is implicitly incorporated in the Bankruptcy Code provision. Instead, the bankruptcy court noted that the Manual simply provides informal, flexible guidelines for field agents negotiating with taxpayers and is only an internal agency rule that is not even enforceable against the IRS. *See United States v. Michaud*, 860 F.2d 495, 499 (1st Cir. 1988); *Groder v. United States*, 816 F.2d 139, 142 (4th Cir. 1987). Furthermore, the use of the Manual by the IRS is not similar in the least to its purported use in bankruptcy, nor does the IRS itself use the Standards in a single, uniform manner. Finally, the use of the term applicable, according to the bankruptcy court, indicates intent to disregard the debtors actual circumstances when determining the debtors applicable monthly expense amounts specified under the Standards. In sum, all of these factors weigh against incorporating the Manual into the Bankruptcy Code, a finding which the bankruptcy court believed was consistent with BAPCPAs intended goals:

It is highly unlikely that Congress would elevate a non-mandatory internal IRS guideline, created by an agency with no regulatory authority in bankruptcy, to the status of federal bankruptcy law, and would not do so explicitly but through the obtuse vehicle of the term applicable. . . . Instead, it is much more likely that Congress intended to incorporate only the expressly referenced monthly expense amounts, i.e., the numbers set forth in the Standards, unadorned by any IRS accoutrements.

2008 Bankr. LEXIS 449, at *16.

As to the chapter 13 trustees policy arguments, the bankruptcy court seemed troubled by the fact that, under the trustees reasoning, a debtor would be entitled to take the full amount of the ownership expense deduction for the life of the chapter 13 plan no matter how much or how little was owned on the vehicle, i.e., that the only criteria to be satisfied was that a debtor owed money. As a result, a debtor with only one remaining car payment on the petition date would be entitled to the full deduction for the life of his plan, whereas a debtor who made that car payment one day before the petition date would be entitled to no deduction ever. With this in mind, the bankruptcy court summarily rejected the chapter 13 trustees argument that allowing a debtor with no car payment to deduct the standard ownership allowance would be absurd.

Conclusion. The bankruptcy courts holding in *In re White* is noteworthy in that it systematically analyzes and

limits the extent to which the post-BAPCA Bankruptcy Code has incorporated the IRS's standards and interpretative regulations. In doing so, the bankruptcy court limits the extent of such incorporation to what is expressly contained in section 707(b)(2)(A) and does not allow consideration of the supplemental interpretative guidelines promulgated by the IRS for its own use. As such, the decision in *White* affirms the position of many bankruptcy courts that the reference to and adoption of the IRS's National and Local Standards under section 707(b)(2)(A) does not mean that the camels nose is under the tent. In the words of the court, the most natural reading of the term applicable, in the context of the IRS standard expense tables, is as a directive to the debtor to choose the amounts that correspond to his particular circumstances. 2008 Bankr. LEXIS 449, at *18.

For further discussion related to the determination of applicable deductions under section 707(b)(2)(A), see generally *Collier on Bankruptcy*, 7.05 (Matthew Bender).

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n1 . There is a formula for determining current monthly income under section 101(10A) of the *Bankruptcy Code*, but for purposes of the bankruptcy courts decision in *White* it was unnecessary to discuss this additional computation.

n2 . With all due respect to Congress and apologies to Winston Churchill, discerning the intended function of the IRS expense allowances is like trying to solve a riddle wrapped in a mystery inside an enigma. 2008 Bankr. LEXIS 449, at *6.

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79 of 197 DOCUMENTS

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Mabey on In re Bryan Road

2008 Emerging Issues 2170

Hon. Ralph R. Mabey on In re Bryan Road

By Hon. Ralph R. Mabey

April 17, 2008

SUMMARY: A Florida bankruptcy court enforced a waiver of the automatic stay contained in a prepetition forbearance agreement. While the decision was thoughtfully and cogently considered, the result is questionable for a number of reasons and inflicts unnecessary violence upon the delicate structure of the Bankruptcy Code. Until it is superseded, the decision is a warning signpost for debtors and a guiding signpost for secured creditors.

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Florida Bankruptcy Court Enforces Waiver of the Automatic Stay

Contained in a Prepetition Forbearance Agreement

As creditors lawyers and debtors will attest, the automatic stay is unquestionably among the most important provisions of the Bankruptcy Code. In a recent decision, *In re Bryan Road, LLC, 2008 Bankr. LEXIS 483* (Bankr. S.D. Fla. Feb. 12, 2008), the bankruptcy court endorsed the long-controversial conclusion that a prepetition waiver of the automatic stay may, in at least some circumstances, be enforced in a subsequent bankruptcy case. Given that the recent tumult in the global capital markets--particularly domestic credit markets--is likely to prompt a fresh wave of defaults and possible bankruptcies, many of which will involve similar prepetition forbearance agreements, *Bryan Road* is a warning signpost for debtors, and a guiding signpost for secured creditors.

Framing the Debate. One of the overarching functions of the federal bankruptcy law is to provide forums and mechanisms for collective resolution of debtor-creditor matters. Bankruptcy cases resolve the collective action problems created under traditional, nonbankruptcy grab rules. *See, e.g.,* Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* 7-19 (1986). Toward this end, 11 U.S.C. § 362(a) provides for an automatic stay of various actions against the debtor and the property of its bankruptcy estate, without which creditors would have every incentive to indulge in the value-destroying race to the courthouse that justifies the enactment of a broad federal regime in the first instance.

The automatic stay, of course, is not all-encompassing. Congress has seen fit to codify a list of actions that are

categorically excepted from the stay in section 362(b). Congress periodically expands that list, most recently by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (particularly as to certain financial transactions). Likewise, 11 U.S.C. § 362(d) provides bankruptcy courts with authority to grant relief from the automatic stay on a case-by-case basis, including when cause is present or when the debtor has a filed a single asset real estate case and does not move forward smartly.

Notably, nothing in section 362 provides for the enforcement of a prepetition waiver of the automatic stay. Nevertheless, certain courts have enforced such waivers, particularly when they were executed as part of an earlier bankruptcy case. *Bryan Road* reinvigorates the debate over this issue as to first lien mortgage foreclosures. In parallel, the debate rages as to the permissible impact of intercreditor agreements upon statutory rights in bankruptcy, such as the automatic stay. See, e.g., Ralph R. Mabey, *Enforceability of Intercreditor Provisions: Legal and Practical Considerations*, New York University School of Law, The Lawrence P. King and Charles Seligson Workshop on Bankruptcy and Business Reorganization (2006); Mark Berman, *Second-Lien Financings: Good, Bad and Ugly*, 25-5 Am. Bankr. Inst. J. 1 (June 2006); John C. Murray, *Intercreditor Agreements: Are They Enforceable in Bankruptcy*, SL004 ALI-ABA 3193, 3204 (July 2005); David Line Batty & Jo Ann J. Brighton, *Silent Second Liens--Will Bankruptcy Courts Keep the Peace?*, 9 N.C. Banking Inst. 1, 22 (April 2005).

The Facts and Posture of *Bryan Road*. The debtor (Debtor) in *Bryan Road* was a real estate developer. The Debtors business involved a dry stack boat storage facility in southern Florida, a warehouse-type building containing 210 separate condominiumized storage spaces. In March 2006, the Debtor borrowed nearly \$9 million from Florida Community Bank (the Bank) on a secured basis. Although the relevant security documents were properly executed and filed, the Debtor maintained that the legal description of the storage facility contained in those documents failed to convey a perfected lien to the Bank.

Upon a payment default, the Bank commenced foreclosure proceedings in Florida state court, which resulted in a May 2007 final judgment in the Banks favor. That final judgment scheduled a foreclosure sale for July 25, 2007. Hopeful that it could locate a lender to take the Bank out, the Debtor negotiated a two-month forbearance agreement with the Bank. In that agreement the Debtor agreed that the Bank should be accorded relief from the automatic stay in the event the Debtor filed [sic] for bankruptcy protection as consideration for the Bank entering into the Forbearance Agreement. During negotiations over the forbearance agreement, the Debtor was represented by a very experienced bankruptcy lawyer.

After the Debtor could not locate new financing, it chose to file a chapter 11 bankruptcy petition. The petition was filed the day before the rescheduled foreclosure sale. On the petition date, in addition to the Banks loan, the Debtor also owed approximately \$2 million secured by purported second liens to individuals who had posted CDs as collateral for the Debtors construction lender. General unsecured creditors had further filed proofs of claim totaling approximately \$973,000.

On October 12, 2007, the Bank filed a motion for relief from the automatic stay, arguing, *inter alia*, that the Debtors waiver in the forbearance agreement mandated relief from stay. The Banks motion was opposed by the Debtor, the unsecured creditors committee, and the junior secured creditors.

The *Bryan Road* Opinion. From the considerable case law on the enforceability of prepetition agreements under which a debtor purports to consent to stay relief in the event of a subsequent bankruptcy filing, the court distilled the following general rule:

[P]repetition waivers of stay relief will be given no particular effect as part of initial loan documents; they will be given the greatest effect if entered into during the course of prior (and subsequently aborted) chapter 11 proceedings. Although I agree that stay relief provisions in prior chapter 11 plans are entitled to great respect because they have been

negotiated in a plan context and approved after notice to all parties in interest, I conclude that the existence of a prior confirmed reorganization plan is not a condition precedent to the enforceability of a stay relief agreement.

Bryan Road, 2008 Bankr. LEXIS 483, at *9.

Having concluded that the enforceability of a stay relief agreement does not necessarily turn on the existence of a prior confirmed reorganization plan, the court further adopted the test used in *In re Desai*, 282 B.R. 527, 532 (Bankr. S.D. Ga. 2002). Under that test, four factors should be considered in deciding whether stay relief should be granted pursuant to a prepetition waiver: (1) the sophistication of the party making the waiver; (2) the consideration for the waiver, including the creditors risk and the length of time the waiver covers; (3) whether other parties are affected including unsecured creditors and junior lienholders; and (4) the feasibility of the debtors plan. 2008 Bankr. LEXIS 483, at *10. The *Bryan Road* court noted that these four factors are not necessarily the only factors which might properly be taken into account but did not expressly reference any additional factors. *Id.*

As to the first *Desai* factor, the court thought it weighs heavily in favor of enforcement of the waiver, since the Debtor had present at the signing of the forbearance agreement a very experienced bankruptcy lawyer fully capable of understanding the implications of the Forbearance Agreement. *Id.*

As to the second factor, the court found it more problematic:

What the Debtor got in exchange for the waiver was a two month breathing space, not a very lengthy period. At the time, however, the Debtor was engaged in refinancing efforts and expected to be able to refinance the Banks loan with another lender. It was unable to do so. Although the consideration given to the Debtor in exchange for the Forbearance Agreement was not in retrospect particularly great, it was what the Debtor wanted at the time the Forbearance Agreement was signed. I cannot say that this consideration was *de minimis* in this context.

Id. at *1011.

While the third factor appear[ed]--at least on its face--as militating against stay relief due to the adverse effects that could be suffered by the junior lienholders and unsecured creditors, the court essentially collapsed that factor into the fourth factor via a lengthy critique of the Debtors proposed plan. At bottom, the court was quite skeptical of the Debtors valuation expert and was concerned that the viability of the Debtors Plan from a legal standpoint is premised upon litigation. *See id.* at *15; *see also id.* (the Debtor proposes to engage in massive litigation as the fundamental basis for its Plan). These twin failings led the court to conclude that the Debtors Plan is speculative at best and not sufficiently feasible to pass muster under the third and fourth *Desai* factors. *See id.* at *24.

In summary, the court enforced the waiver contained in the prepetition forbearance agreement, and granted the Banks motion for relief from stay, because the Debtor (1) was represented by sophisticated bankruptcy counsel, (2) received adequate consideration in the form of two months forbearance, and (3) put forth a chapter 11 plan that was little more than a house of cards. *See id.* at *28.

Commentary on *Bryan Road*. Although the court thoughtfully and cogently considered the issues raised in *Bryan Road*, there are several reasons to question whether it reached the proper result.

First, it is fundamental that a chapter 11 filing creates an estate distinct from the debtor, which contains all the debtors legal and equitable property interests as of the petition date. *See, e.g., 11 U.S.C. § 541(a); Hamm v. James (In re James)*, 406 F.3d 1340, 1342 (11th Cir. 2005); *Bell v. Bell (In re Bell)*, 225 F.3d 203, 215 (2d Cir. 2000) (the property of the estate is distinct from the property of the debtor). Although a chapter 11 debtor, as debtor in possession, may enjoy all the rights and powers of a bankruptcy trustee pursuant to 11 U.S.C. § 1107(a), it always does so as a representative of the bankruptcy estate--a separate legal entity that may have interests at odds with the debtor. n1

It is the bankruptcy estate--the corpus of property and other interests essentially held in trust for the collective good of all creditors--that is the beneficiary of the automatic stay. As such, the rights created by the stay generally should be waivable only by the representative of that estate, not by the prepetition debtor. This is particularly so in light of the fact that neither the right nor the estate itself exists prior to the petition date. *Cf. Bank of Am. v. N. LaSalle St. L.P. (In re 203 N. LaSalle St. Pship)*, 246 B.R. 325, 33032 (Bankr. N.D. Ill. 2000) (refusing to allow senior creditor to vote junior creditors claim in bankruptcy since [i]t is generally understood that prebankruptcy agreements do not override contrary provisions of the Bankruptcy Code, and it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply). Indeed, a prepetition contractual waiver of the automatic stay seems dangerously close to a prepetition release of any avoidance actions under 11 U.S.C. §§ 544, 547, 548 or 549, which virtually no court would countenance. In sum, the fundamental remaining rights of the estate, which are unique products of federal bankruptcy law, should not be lightly discarded--particularly since Congress itself has already pruned those rights back to their roots. n2

Second, it is not obvious that the court fully considered the implications of the facts before it. Numerous courts have been reticent to enforce purported contractual waivers of important rights when there is an asymmetrical bargaining relationship between the parties, particularly when one party is in dire financial straits. *See, e.g., First Union Natl Bank v. United States*, 164 F. Supp. 2d 660, 665 (E.D. Pa. 2001) (refusing to enforce waiver of jury rights in a loan agreement where there was evidence of skewed bargaining power and the debtor was in poor financial straits); *OHC Liquidation Trust v. Credit Suisse (In re Oakwood Homes Corp.)*, 378 B.R. 59, 7273 (Bankr. D. Del. 2007) (same). Under the facts of *Bryan Road*, there would appear to be a colorable argument that the Debtor did not willfully agree to the purported waiver of the stay, but rather simply acceded to whatever terms the Bank proposed in order to gain a temporary respite. While the fact that a borrower may be on the brink of insolvency ought not be a reason to invalidate every term of a negotiated forbearance agreement (such as an increase in interest rates or the provision of access to insider information), creditors similarly should not be allowed to use their overwhelming leverage in such situations to extract waivers of fundamental rights, particularly when those rights ultimately inure to the benefit of nonparties to the forbearance agreement (as does the automatic stay).

Third, even assuming that the result reached by the court was the proper one, there were alternative routes, *within the structures of the Bankruptcy Code itself*, that the court could have used to reach that result. For instance, if the courts analysis of the flaws in the Debtors plan and unduly optimistic valuation of the storage facility was correct, then those factors might have constituted cause to grant relief under section 362(d)(1). Furthermore, the storage facility itself appears to have been real property constituting a single property or project that may have met the other elements that Code section 101(51A) provides for the term single asset real estate. If so, the Bank in *Bryan Road* could have asked the court to hold the Debtors feet to the fire pursuant to section 362(d)(3), which may also have resulted in relief from the stay. The important point is that either of these paths would have proceeded under the plain terms of the Bankruptcy Code, and would not have required the court to give effect to the prepetition waiver. Beyond preserving the internal integrity of the statute, these alternative approaches would also have ensured that the Debtors other creditors--the parties in interest who were most affected by the Banks relief from the stay--enjoyed the procedural protections required under *Federal Rule of Bankruptcy Procedure 4001(a)*.

In sum, *Bryan Road* is an important opinion that may inflict unnecessary violence upon the delicate structure codified in the Bankruptcy Code. Until the decision is superseded, attorneys representing lenders seem well advised to request that waivers of the stay be part of all prepetition forbearance agreements; the downside to including such a term seems minimal, and the upside may be significant if a court later enforces the waiver. Debtors attorneys, particularly those likely to be labeled sophisticated, now have a fresh reason to be quite skeptical of requests for these types of waivers. In the meantime, broader debate about the issue will undoubtedly continue.

For further discussion of the automatic stay, see Collier on Bankruptcy, ch. 362 (Matthew Bender).

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Return to Text

n1 . The possibility of the debtor acting in a fashion at odds with the estates interests is highlighted by the presence of 11 U.S.C. § 549, which allows the trustee to avoid an unauthorized post-petition transfer of property of the estate.

n2 . See, e.g., 11 U.S.C. § 362(b)(6), (7), (17), (27); 11 U.S.C. § 546(e), (f), (g), (j); 11 U.S.C. §§ 555, 556, 559, 560, 561. Notwithstanding the extraordinarily broad language of certain of these provisions, courts have rightly attempted to anchor them to underlying policy principles so as to avoid absurd results. See, e.g., *Hutson v. Smithfield Packing Co. (In re Natl Gas Distribs., LLC)*, 369 B.R. 884 (Bankr. E.D.N.C. 2007) (limiting the scope of swap agreement in the context of simple commodity supply agreement); see also, e.g., *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295 (B.A.P. 9th Cir. 2004) (refusing to allow parties to use letter of credit agreements to contract around the section 502(b)(6) cap).

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80 of 197 DOCUMENTS

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Jurs on In re Barfknecht

2008 Emerging Issues 2157

S. Andrew Jurs on In re Barfknecht

By S. Andrew Jurs

April 16, 2008

SUMMARY: In evaluating a trustees objection of a debtors chapter 13 plan, the court is to consider whether all of the debtors projected disposable income is being used to fund the plan. This term is not explicitly defined in the Bankruptcy Code, and in deciding whether it includes Social Security benefits, a bankruptcy court in the Western District of Texas has taken a common-sense approach.

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ARTICLE: Cite as: Jurs, S. Andrew. *In re Barfknecht*. LexisNexis Expert Commentary, (Insert date you accessed the document online).

Social Security Benefits Should Not Be Included When Calculating a Below-Median Debtors Projected Disposable Income under 11 U.S.C. § 1325(b), and Exclusion of Such Benefits from a Plan Is Not Bad Faith *Per Se* under Section 1325(a)(3)

In *In re Barfknecht*, 378 B.R. 154 (Bankr. W.D. Tex. Nov. 7, 2007), the bankruptcy court wrestled with the issue of whether projected disposable income under 11 U.S.C. § 1325(b) includes Social Security benefits, including supplemental security income benefits for a disabled person. In its opinion, the bankruptcy court rejected the chapter 13 trustees effort to include the Social Security benefits as projected disposable income and further held that the debtors were not obligated to include the Social Security benefits; nor was it bad faith *per se* for them to retain the Social Security benefits even though their unsecured creditors would not be paid in full.

Facts and Procedural History. The debtors n1 earned income below the median family income for households of the same size and locality, and received monthly benefits under the Social Security Act. The debtors did not list their monthly Social Security benefits on Form 22C, in accordance with the forms directions and the specific language of section 101(10A) of the Bankruptcy Code. On each debtors Schedule I, though, Social Security benefits were listed as income in light of that official forms directions. In an effort to make sure that the schedules accurately (in the debtors view) reflected the debtors actual disposable income, the debtors in both cases backed out some or all of that income line item as an expense on their Schedule J forms.

More specifically, on the Barfknechts Schedule I, they listed a total of \$1,759 in monthly Social Security benefits.

In their initial Schedule J, the Barfknechts backed out only \$800 of these Social Security benefits as a purported expense with a notation that the Social Security benefits were not considered income. In an amended Schedule J, they voluntarily reduced this figure to \$180, thus providing an even greater amount of their benefits to fund their chapter 13 plan. In his objection to confirmation, the chapter 13 trustee contended that the Bankruptcy Code required the Barfknechts to commit the entire amount of their Social Security benefits to their chapter 13 plan.

In her case, Ms. DeMattios initial Schedule I did not list any Social Security benefits, but she later amended her Schedule I to list monthly Social Security benefits of \$945. In her amended Schedule J, though, Ms. DeMattio backed out all of these Social Security benefits with a notation that they are Not Considered Income. Accordingly, Ms. DeMattio apparently intended to fund her chapter 13 plan with only monthly wages and none of her Social Security benefits.

In each case, the debtors did not offer enough money to pay their unsecured indebtedness in full.

Legal Analysis. Under *Bankruptcy Code* section 1325(b)(1)(B), courts may not approve a proposed chapter 13 plan over a chapter 13 trustee's objection if the plan does not provide for payment of all of the debtors *projected disposable income* to be received during the plan period (emphasis added). Because the Bankruptcy Code, however, does not define projected disposable income, the chapter 13 trustee argued that the forward-looking nature of this term makes it independent of the definitions of current monthly income (CMI) and disposable income which specifically exclude benefits received under the Social Security Act. See 11 U.S.C. §§ 101(10A), 1325(b)(2). According to this argument, Form 22C and its calculation of disposable income from CMI involve only historical figures as of the filing date of the petition without any inquiry into a debtors future ability to pay (which is the debtors projected disposable income).

In contrast, the debtors contended that the language of the statute is clear and cannot be ignored. Even assuming that projected disposable income is forward-looking, the debtors assert that the phrase incorporates disposable income, which is a defined term under the Bankruptcy Code that explicitly excludes Social Security benefits. Thus, according to this argument, the analysis of the debtors ability to pay can be forward-looking while still excluding Social Security benefits from income before the analysis even begins.

A further question before the bankruptcy court involved the trustee's allegation that the debtors refusal to use all of their benefits to pay creditors, who will not receive 100 percent payment, constitutes bad faith. Simply following the Bankruptcy Codes technical requirements does not constitute good faith, the trustee maintained, if the debtors actually retain any form of revenue that could go to the benefit of the unsecured creditors. The debtors countered by asking how it could be bad faith to retain Social Security benefits, which the Bankruptcy Code does not consider income, and to do exactly what the Code permits.

Commentary

Social Security Benefits Are Not Included in Computing Projected Disposable Income. The decision in *In re Barfknecht* is significant in that it uses common sense to analyze how the undefined term projected disposable income is not independent from other definitions and provisions in the Bankruptcy Code.

A minority of bankruptcy courts have used a narrow interpretation of projected disposable income and determined that Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) eliminated bankruptcy courts discretion to assess a debtors changed circumstances. The majority of bankruptcy courts, however, have found that the term projected disposable income is sufficiently forward-looking to allow bankruptcy courts to look beyond the historical figures contained on a debtors Form 22C and consider changes in the debtors circumstances, as reflected on Schedules I and J, in computing the debtors projected disposable income. For example, in *In re Kibbe*, 361 B.R. 302 (B.A.P. 1st Cir. 2007), a debtor calculated a negative disposable income on her Form 22C, so she proposed a plan that provided no payments for the benefit of unsecured creditors. The trustee in *Kibbe* objected because the debtors new job, obtained shortly before the petition date, gave her an actual income nearly \$2,400 more than her expenses. The

bankruptcy court and First Circuit BAP agreed that a bankruptcy court may consider significant changes in circumstances that cause a Form 22Cs monthly disposable income calculation to be an inaccurate projection of a debtors future ability to make plan payments. *See also In re Lanning*, 380 B.R. 17 (B.A.P. 10th Cir. 2007) (projected disposable income under section 1325(b)(1)(B) means more than simply multiplying current disposable income by the anticipated number of monthly payments); *Pak v. eCast Settlement Corp. (In re Pak)*, 378 B.R. 257 (B.A.P. 9th Cir. Nov. 7, 2007) (refusing to confirm plan of below-median debtor whose income increased significantly right before bankruptcy filing but who proposed plan payments well below actual ability to pay).

In *Barfknecht*, the trustee was attempting to push the envelope of this majority position even further by arguing that the bankruptcy court not only is free to ignore prepetition figures in determining projected disposable income, but that the bankruptcy court should rely *only* on forward-looking data.

In rejecting the trustees argument, the court in *Barfknecht* noted that it was unnecessary to read current monthly income (and its limitations as to what constitutes income) out of the statute in order to arrive at a sensible understanding of projected disposable income. Instead, the court found that it could not (and should not) ignore the definition of CMI:

[Considering forward-looking figures to determine projected disposable income] does not mean that § 101(10A)s definition of current monthly income is irrelevant to the calculation of projected disposable income. Section 101(10A) continues to apply *inasmuch as it describes the sources of revenue that constitute income, as well as those that do not*.

378 B.R. 154, 161 (emphasis in original; quoting *In re Hardacre*, 338 B.R. 718, 723 (Bankr. N.D. Tex. 2006)). Thus, the clear directive in section 101(10A) that current monthly income explicitly exclude Social Security benefits is binding as to what constitutes income for purposes of computing projected disposable income. According to Bankruptcy Judge Clark, a plain reading of the statute demands that benefits received under the Social Security Act do not count as income for any purposes. . . . An exclusion is an exclusion, whether looking backward or looking forward. *Id.* at 16162.

It Was Not Bad Faith *Per Se* for the Debtors to Propose Plans in Which Unsecured Creditors Would Not Be Paid In Full and the Debtors Would Retain Some or All of Their Social Security Benefits. Once it determined that the debtors Social Security benefits were not income to be included in the debtors projected disposable income, the bankruptcy court faced the additional question of whether the debtors chapter 13 plans were proposed in bad faith. The trustee based this allegation of bad faith on a small number of decisions holding that, notwithstanding the express exclusion of Social Security benefits from disposable income, debtors engage in bad faith when they accumulate savings over the life of their plans while paying unsecured creditors less than 100 percent. *See, e.g., In re Upton*, 363 B.R. 528, 53637 (Bankr. S.D. Ohio 2006) (requiring debtor to demonstrate that plan was not in bad faith when debtor did not commit \$539 in Social Security benefits).

Bankruptcy Judge Clark rejected the trustees allegation of bad faith, first, on the grounds that the trustee sought to have the bankruptcy court create a *per se* rule that any retention of income must necessarily be bad faith. As the bankruptcy court noted, a *per se* rule would run counter to the Fifth Circuits requirement that bad faith be judged *only* under a totality of the circumstances test. *In re Chaffin*, 816 F.2d 1070, 1074 (5th Cir. 1987). The bankruptcy court also rejected the allegation of bad faith because, according to the court, the explicit treatment of Social Security benefits in the Bankruptcy Code would be swallowed up by a *per se* rule and thus be rendered a nullity.

Applying the totality of circumstances test to the facts at hand, the bankruptcy court observed that the trustee had not alleged any peculiar circumstances, other than the retention of Social Security benefits, demonstrating debtors lack of good faith. There was no allegation that the debtors proposed their plans with intent not to fulfill them, nor did the trustee argue that the debtors had proposed the plans for any purpose not permitted by the Bankruptcy Code. Instead, [i]f anything, the enactment of BAPCPA calls into doubt whether a debtors retention of Social Security benefits may ever be a factor to consider under the good faith standard, 378 B.R. at 164, because the Bankruptcy Code specifically excludes Social Security benefits from income for purposes of satisfying the debtors ability to pay test. [I]t strikes this court at least as an odd reading of the Code indeed to conclude that a debtors *following* the Code, without more, could

constitute abuse of the bankruptcy process. *Id.* at 165 (emphasis in original).

All told, the decision in *Barfknecht* adds another precedent, although on a very limited issue, clarifying what BAPCPA and its new rules and forms have changed regarding the calculation of projected disposable income. By rejecting the trustees attempts to extend BAPCPAs new terms, the bankruptcy court in *Barfknecht* upheld its ability to apply common sense to the Bankruptcy Codes provisions relating to (1) what constitutes disposable income and (2) good faith in retaining money that is not included in disposable income.

For further discussion related to the determination of projected disposable income for purposes of computing necessary chapter 13 plan payments under BAPCPA, see generally Collier on Bankruptcy, ch. 1325 (Matthew Bender).

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Return to Text

n1 . The decision actually covers two bankruptcy cases. In one matter, debtors Joel and Mary Barfknecht filed their bankruptcy case on July 17, 2007. In the other case, Julia DeMattio filed her voluntary chapter 13 petition on June 4, 2007. For simplicity sake, they shall be collectively referred to as debtors unless referenced individually.

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S. Andrew Jurs received his B.A. for both Economics and History in 1991 from Duke University, and his J.D. in 1994 from the Emory University School of Law. For the two years after graduation from law school, Mr. Jurs had the honor of clerking for United States District Court Judge James G. Carr of the Northern District of Ohio. Since 1996, Mr. Jurs has gained substantial experience in bankruptcy, workouts, and creditors rights, and has become a Board Certified Specialist in Consumer and Business Bankruptcy Law. Author of numerous short pieces on bankruptcy law in various publications, including the American Bankruptcy Institute Journal and the Banking Law Journal, Mr. Jurs also has lectured widely on bankruptcy issues. He resides in Gastonia, North Carolina.

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81 of 197 DOCUMENTS

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Glosband on In re Basis Yield Alpha Fund (Master)

2008 Emerging Issues 2158

Daniel M. Glosband on In re Basis Yield Alpha Fund (Master)

By Daniel M. Glosband

April 16, 2008

SUMMARY: May a bankruptcy judge question the presumption that a debtors place of registration is its centre of main interests if the debtor has met the requirements for recognition of a foreign proceeding as a foreign main proceeding under 11 U.S.C. § 1517(a)(2) and (3) and there are no objections to the debtors chapter 15 petition? A bankruptcy judge denied chapter 15 recognition of a foreign-registered hedge fund's Cayman Islands liquidation.

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ARTICLE: A Cold Day in the Caymans: Bankruptcy Court Denies Recognition of Basis Yield Funds Cayman Proceedings Under Chapter 15 of the Bankruptcy Code

In *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37 (Bankr. D.N.Y. 2008), a United States Bankruptcy Judge affirmed his authority to question the presumption that a debtors place of registration is its center of main interests (COMI) even if there are no objections to the chapter 15 petition. In determining a motion for summary judgment on a petition for chapter 15 recognition of the Cayman liquidation proceedings of Basis Yield Alpha Fund (Master) (Basis Yield or the Fund), the bankruptcy court reflected a proper understanding that eligibility for recognition under chapter 15 of the United States Bankruptcy Code (the Code), and the assistance that flows from such recognition, should be reserved for those cases where the debtor has provided evidence that it has a tangible presence in the foreign jurisdiction.

The Facts and Posture of Basis Yield. Basis Yield, which invested in various structured credit securities, was incorporated by Basis Capital Fund Management, an Australian firm based in Sydney, in the Cayman Islands as an exempted limited liability company pursuant to section 193 of the Companies Law and maintains its registered office in the Cayman Islands. Subsequent to the volatility in the global credit markets, in an all too familiar pattern, Basis Yield suffered a significant devaluation of the assets in its portfolio and the Funds trade counterparties made margin calls which Basis Yield was unable to satisfy. Following the issuance of default notices and the exercise by trade counterparties of their contractual rights to seize or sell assets of Basis Yield subject to secured repurchase agreements, Basis Yields shareholders authorized the filing of a voluntary petition to liquidate the Fund in the Cayman Islands. The Grand Court of the Cayman Islands entered an order appointing joint provisional liquidators (the JPLs) of Basis Yield (the Cayman proceeding).

The JPLs filed a petition (the Petition) in the United States Bankruptcy Court for the Southern District of New York (the Court) seeking recognition of the Cayman proceeding as a foreign main proceeding under section 1517(b)(1) n1 of the United States Bankruptcy Code (the Code). n2 In the Petition, the JPLs set forth that Basis Yield was registered in the Cayman Islands pursuant to section 193 of the Companies Law (2004 Revision) and maintained a registered office there. The JPLs also advised the Court that the Funds financial books and records were maintained in the Cayman Islands and provided information regarding Basis Yields investors, administrator, investment manager, attorneys and auditors all of which were also Cayman Island entities.

As noted by the Court, the Petition was, however:

Strikingly silent as to the nature or extent of any business activity Basis Yield conducts (or in the relevant times conducted) in the Cayman Islands. Likewise, it was silent, *inter alia*, as to whether Basis Yield staffed any employees or managers in the Cayman Islands; whether any of its assets were in the Cayman Islands; and the location from which Basis Yields Funds were in fact managed. n3

Subsequent to a hearing on the JPLs Request for Entry of Preliminary Injunction (the Request) to block the continuation of litigation and the seizure of assets, the Court granted the Request and issued an Order re Upcoming Hearing on Motion for Recognition concerning the factual matters that were raised, as well as those factual matters not addressed, in the Petition (the Factual Matters Order). Pursuant to the Factual Matters Order, the JPLs were to use best efforts to introduce evidence sufficient for the Court to make factual findings at an evidentiary hearing regarding recognition of the Cayman proceeding with respect to specified matters relevant to a determination of whether Basis Yield had its COMI or maintained an establishment in the Cayman Islands. n4

Prior to the recognition hearing, the JPLs obtained permission from the Court to file a motion for summary judgment (the Motion) in which they relied solely on the information proffered in the Petition without introducing the evidence called for in the Factual Matters Order. Relying on the facts that Basis Yield is registered in the Cayman Islands and that no objections to recognition had been filed, n5 the JPLs argued in support of the Motion that the Cayman Islands was the COMI of Basis Yield pursuant to section 1516(c) n6 of the Code because in the absence of evidence to the contrary, a debtors COMI is presumed to be the location of its registered office. Accordingly, the JPLs argued, the Court must grant the Motion and recognize the Cayman proceeding as a foreign main proceeding as a matter of law. The Motion sharply focused the issue of the strength of the section 1516(c) presumption and the Courts right to question and require evidence on the debtors COMI in the absence of any objections.

The Basis Yield Opinion. The Court found that there was no question that the JPLs had satisfied two of the three requirements for recognition contained in section 1517(a) of the Code, namely that (i) the JPLs met the definitions of person n7 and foreign representative n8 in satisfaction of section 1517(a)(2) and (ii) that the JPLs fulfilled the application prerequisites of section 1515 n9 in satisfaction of section 1517(a)(3). To prevail on a petition for recognition, however, the Court noted the JPLs must satisfy each of the three requirements of section 1517(a) of the Code n10, *i.e.*, was the foreign proceeding a foreign main proceeding, a foreign non-main proceeding or neither?

Accordingly, the recognition sought by the JPLs on summary judgment turned on whether the JPLs had shown that the Cayman proceeding was a foreign main proceeding as defined in Section 1502 n11 of the Code. The Court framed the issues before it as:

whether, on the evidence before the Court, the [JPLs] have shown the propriety of such as a matter of law, and without regard to any other facts and whether the Court has the right to consider all of the facts when the JPLs elected not to put them forth and instead elected to rely on a statutory presumption embodied in section 1516 of the Code. n12

The Court repeated the array of factors that the bankruptcy court in *In re SPhinX, LTD.*, 351 B.R. 103 (Bankr. D.N.Y. 2006), found probative regarding such determination; n13 in contrast, the Court noted the silence is deafening with respect to such factors or the lack of any other pertinent facts to support the existence of the foreign main

proceeding. n14 Given the insufficiency of facts in the record supporting a foreign main proceeding, the Court turned its inquiry as to whether the presumption embodied in section 1516(c) legally excused the JPLs from proffering such evidence.

Pursuant to section 1516(c), the JPLs argued that so long as they have met the requirements for recognition set forth in sections 1517(a)(2) and (3) summary judgment and recognition of the Cayman proceeding as a foreign main proceeding must be granted by the Court absent any objections or facts before the Court to the contrary. The Court rebuked the JPLs argument and noted that there indeed was evidence to the contrary in the record, namely, that the registration of Basis Yield as an exempted company under sections 193 n15 and 184 n16 of the Cayman Companies Law raised red flags as to whether the Cayman Islands could be Basis Yields COMI. n17 While careful not to rule out circumstances under which Basis Yield could engage in activities in the Cayman Islands sufficient to make a COMI showing and still comply with the requirements applicable to exempted companies, Judge Gerber found that no facts to support such circumstances had been shown by the JPLs to support summary judgment. n18

The Court next examined whether the lack of objection by other parties in interest or section 1516(c) itself bound the Court to close its eyes to the lack of evidentiary support to find that the Cayman proceeding was a foreign main proceeding. n19 Noting that a textual analysis of Code sections 1516 and 1517 was inconclusive as to whether the Court was so bound, the Court looked to the discussion in the *Guide to Enactment of the UNCITRAL Model Law on Insolvency* on the Model Laws corollary provision to section 1516(c) of the Code which affirms the proposition that a court can question the presumption of COMI and call for or assess other evidence. n20 The Court further relied upon Judge Liflands rejection in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007), of the notion that the failure of interested parties to object is binding upon the bankruptcy court in determining whether the requirements of section 1517 have been satisfied. The Court agreed with Judge Lifland that dicta in the *SPhinX* decision to the contrary was not controlling to the extent that it would make the recognition determination by a bankruptcy court a rubber stamp exercise. n21 Finally, the Court turned to the endorsement of commentators, including the author, who have agreed with the view that a bankruptcy court always has the power to make its own determination under section 1517 regardless of the section 1516(c) presumption and the lack of objection by interested parties. n22

In specifically addressing whether the section 1516(c) presumption bound the Courts determination, the Court reiterated the statements contained in the *Guide* and by Judge Lifland in *Bear Stearns*. Furthermore, the Court found that section 1516(c) merely creates a rebuttable presumption and does not shift the burden of proof in supporting a petition for recognition away from the moving party, the JPLs. n23 Lastly, the Court relied on the well established authority of a court to call witnesses, on its own motion, as embodied in *Federal Rule of Evidence 614*. n24

Before reaching his holding on the Motion, Judge Gerber gave helpful examples to practitioners of the simple allegations that a movant can make which would normally be more than sufficient to give a court comfort that reliance on the section 1516 presumption is appropriate n25 and comport with the purposes of the presumption--speed and convenience, and to save stakeholders costs in straightforward cases. n26 Among these simple allegations, *inter alia*, are: (i) location of the debtors headquarters, (ii) primary location of the debtors assets, (iii) when the debtor began transacting business in the asserted COMI, and (iv) the location where the majority of the contracts relating to the debtors business were written. n27 According to the Court, such basic statements will make apparent that the jurisdiction of the debtor is its COMI in most cases and that the section 1516 presumption would be useful, and would rarely, if ever, be second guessed. n28

As such simple allegations were absent from the JPLs Petition and Motion, and in light of the Courts analysis that the Court is not bound in making its recognition determination pursuant to section 1517 by either the failure of interested parties to object or the section 1516(c) presumption where insufficient evidence has been put forth or evidence to the contrary exists, the Court properly denied the Motion upon grounds that genuine issues of material fact existed with respect to Basis Yields COMI and recognition could not be granted as a matter of law. n29

Commentary on *Basis Yield*. While the holding in *Basis Yield* may cause companies registered in foreign countries some concern regarding the prospects for U.S. recognition of their foreign proceeding, the jurisprudence that has emerged from cases like *Basis Yield* and *Bear Stearns*, properly reflects, as the author has previously stated, that there is a U.S. legislative policy to provide the assistance of its bankruptcy courts only to those foreign bankruptcy proceedings that are premised on a tangible presence of the debtor in the foreign jurisdiction. n30 Here, the record is not yet clear on whether the foreign domicile of the debtor is only a technicality or whether the debtor has the requisite economic presence in the Cayman Islands to qualify the foreign proceeding for recognition. The JPLs still have an opportunity to present their case.

What *Basis Yield* correctly makes clear is that the absence of objection by interested parties is irrelevant to the courts duty: (i) under chapter 15 of the Code to determine whether a debtors petition for recognition and other documents on the record satisfy the procedural requirements of section 1515 and the definitional requirements of sections 1501 and 1517, n31 and (ii) to determine if the movant on a motion for summary judgment has met its burden to establish the absence of any genuine issues of material facts. As seen in *Bear Stearns*, a judge may deny recognition subsequent to an evidentiary hearing on recognition where evidence to the contrary exists on the record. n32 Here, Judge Gerber points out that the election of the debtor not to proffer proper evidence may be fatal, even if unopposed, when possibly contradicted by the very foreign statutes under which the debtor is organized.

Off-shore registration may have real benefits to a debtor resulting from foreign tax and regulatory schemes, but if the debtor cannot make even the simple allegations highlighted by Judge Gerber in support of a COMI or an establishment in the foreign domicile, the debtor may be well advised to contact its American lawyers instead of, or in addition to, Cayman liquidators. Indeed, *Basis Yield* is encouraging to those debtors who have a colorable argument to a foreign COMI or establishment and have put forth the basic facts. In such cases, as Judge Gerber notes, a bankruptcy court would be unlikely to second guess the presumption embodied in section 1516(c) absent the objection of an interested party.

For more information on sections 1502, 1515, 1516, 1517 of the Bankruptcy Code, see Collier on Bankruptcy, ch. 1502, 1515, 1516 and 1517 (Matthew Bender).

For more information on Chapter 15 of the Bankruptcy Code in general, see Collier Bankruptcy Practice Guide, ch. 19 (Matthew Bender) and Collier International Business Insolvency Guide, ch. 8, ch. 9 and ch. 10 (Matthew Bender).

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[Return to Text](#)

n1 The provisions of section 1517 relevant to this article provide:

(a) Subject to section 1506, after notice and a hearing, an order recognizing a foreign proceeding shall be entered if--

(1) such foreign proceeding for which recognition is sought is a foreign main proceeding or foreign nonmain proceeding within the meaning of section 1502;

(2) the foreign representative applying for recognition is a person or body; and

(3) the petition meets the requirements of section 1515.

(b) Such foreign proceeding shall be recognized--

(1) as a foreign main proceeding if it is pending in the country where the debtor has the center of its main interests; or

(2) as a foreign nonmain proceeding if the debtor has an establishment within the meaning of section 1502 in the foreign country where the proceeding is pending.

n2 In the alternative, the JPLs sought recognition in the Petition of the Cayman proceeding as a foreign non-main proceeding, but did not seek such relief in the Motion (defined *infra*) subject to the Courts decision.

n3 *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 42 (Bankr. S.D.N.Y. 2008).

n4

[4] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 43 (Bankr. S.D.N.Y. 2008).

n5

[5] One creditor, Citigroup, noted the deficiencies with respect to the evidence proffered by the JPLs in the Petition concerning the establishment of Basis Yields COMI or whether it has an establishment in the Cayman Islands in Citigroups Response to the Request. Citigroup did not, however, object to recognition of the Cayman proceeding as a foreign main proceeding.

n6

[6]. Section 1516 of the Code provides that [i]n the absence of evidence to the contrary, the debtors registered office . . . is presumed to be the center of the debtors main interests.

n7

[7] As such term is defined in section 101(41) of the Code.

n8

[8] As such term is defined in section 101(24) of the Code.

n9

[9] Section 1515 of the Code provides:

(a) A foreign representative applies to the court for recognition of a foreign proceeding in which the foreign representative has been appointed by filing a petition for recognition.

(b) A petition for recognition shall be accompanied by--

(1) a certified copy of the decision commencing such foreign proceeding and appointing the foreign representative;

(2) a certificate from the foreign court affirming the existence of such foreign proceeding and of the appointment of the foreign representative; or

(3) in the absence of evidence referred to in paragraphs (1) and (2), any other evidence acceptable to the court of the existence of such foreign proceeding and of the appointment of the foreign representative.

(c) A petition for recognition shall also be accompanied by a statement identifying all foreign proceedings with respect to the debtor that are known to the foreign representative.

(d) The documents referred to in paragraphs (1) and (2) of subsection (b) shall be translated into English. The court may require a translation into English of additional documents.

n10 *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 46 (Bankr. S.D.N.Y. 2008).

n11

[11] Section 1502(4) of the Code defines a foreign main proceeding as a foreign proceeding pending in the country where the debtor has the center of its main interests.

n12 *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 47 (Bankr. S.D.N.Y. 2008).

n13

[13] Specifically, the Court quoted the factors from the *SPhinX* case:

the location of the debtor's headquarters; the location of those who actually manage the debtor (which, conceivably could be the headquarters of a holding company); the location of the debtor's primary assets; the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case; and/or the jurisdiction whose law would apply to most disputes.

In re Basis Yield Alpha Fund (Master), 381 B.R. 37, 47 (Bankr. S.D.N.Y. 2008) citing *In re SPhinX, LTD.*, 351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006).

n14 *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 48 (Bankr. S.D.N.Y. 2008).

n15

[15] Section 193 of the Cayman Companies Law states:

An exempted company shall not trade in the Islands with any person, firm or corporation except in furtherance of the business of the exempted company carried on outside the Islands:

Provided that nothing in this section shall be construed so as to prevent the exempted company effecting and concluding contracts in the Islands and exercising in the Islands all of its powers necessary for the carrying on of its business outside of the Islands.

n16 Section 184 of the Cayman Companies Law states:

A proposed exempted company applying for registration as an exempted company shall submit to the Registrar a declaration signed by a subscriber to the effect that the operation of the proposed exempted company will be conducted mainly outside the islands.

n17 *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 48 (Bankr. S.D.N.Y. 2008).

n18

[18] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 49 (Bankr. S.D.N.Y. 2008).

n19

[19] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 50 (Bankr. S.D.N.Y. 2008).

n20

[20] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 51 (Bankr. S.D.N.Y. 2008).

n21

[21] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 52 (Bankr. S.D.N.Y. 2008).

n22

[22] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 52 (Bankr. S.D.N.Y. 2008) citing, among others, Daniel Glosband, Sphinx Chapter 15 Opinion Misses the Mark, 25-10 ABIJ 44. As the Motion before the Court was for summary judgment, Judge Gerber noted that the procedural posture was also relevant, as the absence of objections to recognition of Basis Yields COMI neither obviated the burden of proof of the JPLs to establish that no genuine issues of material fact existed nor precluded the Court from concluding that such genuine issues of material fact exist on the record with respect to the recognition of the Cayman proceeding. *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 52 (Bankr. S.D.N.Y. 2008).

n23

[23] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 53 (Bankr. S.D.N.Y. 2008).

n24

[24] *Federal Rule of Evidence 614* states:

Calling and Interrogation of Witnesses by Court

a) Calling by court. The court may, on its own motion or at the suggestion of a party, call witnesses, and all parties are entitled to cross-examine witnesses thus called.

b) Interrogation by court. The court may interrogate witnesses, whether called by itself or by a party.

n25 *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 54 (Bankr. S.D.N.Y. 2008). Albeit, in the absence of any objection or evidence to the contrary. *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 54 (Bankr. S.D.N.Y. 2008).

n26

[26] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 52 (Bankr. S.D.N.Y. 2008).

n27

[27] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 52 (Bankr. S.D.N.Y. 2008).

n28

[28] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 55 (Bankr. S.D.N.Y. 2008).

n29

[29] *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 55 (Bankr. S.D.N.Y. 2008)

n30

[30] Daniel Glosband, Bankruptcy Court Rejects Cayman Proceedings of Bear Stearns Hedge Funds, 26-8 *ABIJ* 38.

n31 See Daniel Glosband, Sphinx Chapter 15 Opinion Misses the Mark, 25-10 *ABIJ* 44.

n32

[32] See *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. D.N.Y. 2007).

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82 of 197 DOCUMENTS

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Lawniczak on Thompson v. Greenwood

2008 Emerging Issues 2151

Lawniczak on Thompson v. Greenwood

By James M. Lawniczak

April 16, 2008

SUMMARY: The Sixth Circuit has become the first circuit court to rule on the issue of whether 28 U.S.C. § 1412 allows a bankruptcy court to retain jurisdiction of an improperly venued case, coming down firmly on the side of strict statutory construction. In *Thompson v. Greenwood*, it holds that in the face of improper venue a bankruptcy court must dismiss the case or transfer it to a district where it originally could have been brought.

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The Sixth Circuit Strictly Interprets the Venue Statute, Holding That 28 U.S.C. § 1406(a) Applies to Cases Where Venue Is Incorrect and Requires Dismissal or Transfer to a District Where the Case Could Have Been Brought

In *Thompson v. Greenwood*, 507 F.3d 416 (6th Cir. 2007), the Court of Appeals for the Sixth Circuit addressed an issue of first impression among the circuit courts of appeals: whether a bankruptcy court faced with a timely motion could retain a bankruptcy case, even though venue was improper, in the interests of justice or for the convenience of the parties. 507 F.3d at 417. The court framed the issue as requiring a determination whether 28 U.S.C. § 1406(a) or § 1412 applied to bankruptcy cases where venue was improper under 28 U.S.C. § 1408. The court stated that § 1406(a) controlled and that a bankruptcy court could only do one of two things once it determined that original venue was improper: dismiss the case or transfer the case to a district where the case could originally have been brought. The court concluded:

(1) the venue requirements of 28 U.S.C. § 1408 are mandatory, not optional; (2) 28 U.S.C. § 1412 applies only to bankruptcy cases filed in a proper venue; (3) 28 U.S.C. § 1406 applies to cases, including bankruptcy cases, filed in an improper venue; and (4) *Federal Rule of Bankruptcy Procedure 1014(a)(2)* must be interpreted as authorizing the transfer of an improperly venued case only to a district in which the case could have originally been brought.

507 F.3d at 424.

Facts and Procedural History. The *Thompson* case arose as a consolidated appeal from two individual chapter 7 bankruptcy cases filed by two sets of debtors, all residents of the northern Mississippi suburbs of Memphis, Tennessee. Both cases were filed by Mississippi residents in the Western District of Tennessee, at Memphis, for reasons of geographic convenience. The United States trustees office for the Northern District of Mississippi moved to transfer both cases to the Northern District of Mississippi.

In one of the two cases, *In re Jordan*, 313 B.R. 242 (Bankr. W.D. Tenn. 2004), Chief Bankruptcy Judge Kennedy denied the United States trustees motion, holding that a bankruptcy court could retain a case filed in an improper district, for the convenience of the parties or in the interest of justice. In contrast, Bankruptcy Judge Latta, in the case of *In re MacDonald*, 356 B.R. 416 (Bankr. W.D. Tenn. 2006), ordered the case transferred to Mississippi, after finding that there was no venue in Tennessee.

Both cases were appealed to the U.S. District Court for the Western District of Tennessee, which held that the United States trustees position was the most coherent reading of the [venue] statute as a whole in conformity with accepted norms of statutory construction. *In re MacDonald*, 356 B.R. 416, 428 (W.D. Tenn. 2006). The appeal to the Sixth Circuit followed.

Statutory Analysis. Section 1408(1) of title 28 provides for venue in title 11 cases, which may be commenced in the district court for the district where an individual has had a domicile or residence for the last 180 days prior to the filing, or if the debtor resided or was domiciled in more than one district, then in the district where the debtor resided or was domiciled for the longer portion of the 180-day period. Therefore, none of the individual Mississippi debtors could argue that venue was proper in Tennessee.

Section 1412 of title 28 allows for a change of venue in title 11 cases. It provides that the court may transfer a bankruptcy case to another district in the interest of justice or for the convenience of the parties. For a case describing § 1412 and the criteria for transferring venue, see, e.g., *In re Dunmore Homes Inc.*, 2008 Bankr. LEXIS 44, at *15-17 (Bankr. S.D.N.Y. Jan. 14, 2008). There is no requirement in § 1412 that the court receiving the transferred case be a court of proper venue. *Aranha v. Winfield (In re Emerson Radio Corp.)*, 52 F.3d 50, 55 (3d Cir. 1995).

In contrast, 28 U.S.C. § 1406(a), which applies to all federal cases, not just title 11 cases, provides that the district court of a district in which venue is improper shall dismiss, or if it be in the interest of justice, transfer such case to any district or division in which it could have been brought.

Sixth Circuits Analysis--Majority Position. The Court of Appeals for the Sixth Circuit first noted that the debtors agreed that venue was improper under the plain language of 28 U.S.C. § 1408. 507 F.3d at 419. The court next turned its attention to the proper interpretation and application of 28 U.S.C. § 1406(a), which governs improperly venued cases. The court began its analysis by observing that, although § 1406 does not specifically mention title 11 bankruptcy cases, it is generally applicable to all district court cases. Because the bankruptcy judges constitute a unit of the district court under 28 U.S.C. § 151, title 11 cases are indeed included within the scope of § 1406. Therefore, the court of appeals found that, where venue is improper and an interested party timely objects, a district court can either (1) dismiss the case or (2) transfer the case to a jurisdiction of proper venue. 507 F.3d at 419-20.

Yet the debtors argued that § 1406 is inapplicable to bankruptcy proceedings and that the more specific title 11 transfer-of-venue section, 28 U.S.C. § 1412, should apply instead. The debtors further argued that the use of the word may in § 1412 indicates that a court considering convenience may retain the case itself in addition to transferring it to another district. 507 F.3d at 420.

The court of appeals disagreed, concluding that the case was governed by the plain text of 28 U.S.C. § 1406. 507 F.3d at 423. The court cited the U.S. Supreme Court case of *Connecticut National Bank v. Germain*, 503 U.S. 249, 112 S. Ct. 1146, 117 L. Ed.2d 391 (1992), for the proposition that a court must give effect to the plain language of

congressional enactments.

The court determined that § 1412 applies only in properly venued cases. To interpret § 1412 as applying to improperly venued cases would nullify, or at least greatly reduce, the venue requirements of 28 U.S.C. § 1408 and permit a debtor to commence a title 11 case in any venue so long as the bankruptcy judge later determined the venue to be convenient. 507 F.3d at 420.

Finally, the court looked at the implications of *Federal Rule of Bankruptcy Procedure 1014* to bolster its holding, although duly noting that the rule does not carry the weight of a statute. 507 F.3d at 420. Rule 1014(a)(1) concerns dismissal and transfer of cases filed in a proper district, while subdivision (a)(2) deals with filings in an improper district, as in *Thompson*. Rule 1014(a)(2) provides that on timely motion the case may n1 be dismissed or transferred to any other district in the interest of justice or for convenience. The court stated in *dictum* that while Rule 1014 supported its decision in the case before it, the rule's broad language allowing an improperly venued case to be transferred to any district, even one where venue did not originally lie, was inconsistent with the statute (§ 1406) and that the statute trumps the rule. 507 F.3d at 422.

In summary, the court focused on 28 U.S.C. § 1406, holding that if a case is brought in an improper venue and an interested party timely objects, n2 a district court has only two options: (1) dismiss the case, or (2) transfer the case to a jurisdiction of proper venue, if it be in the interest of justice. 507 F.3d at 416 (footnote omitted).

Minority Position. In reaching its decision, the Sixth Circuit noted that the *Thompson* decision is the first by a court of appeals on the issue of retention of improper venue. According to the court, its ruling that a bankruptcy court cannot keep an improperly venued case is in agreement with the majority view of the lower courts.

However, a minority of the lower courts have held that under 28 U.S.C. § 1412 a bankruptcy court *can* keep a case filed in an incorrect venue, in the interest of justice or for the convenience of the parties. Generally, courts adopting the minority position rely upon two fairly similar arguments: (1) that § 1412 specifically applies to title 11 cases and permits a bankruptcy court to retain the case; and (2) that bankruptcy courts possess the authority to make independent determinations with regard to motions for transfer of venue.

The proponents of the minority view point out that § 1412 contains no limiting language requiring that a transfer be made only to a district where the action might have been originally brought. *See, e.g., In re Lazaro*, 128 B.R. 168, 173-74 (Bankr. W.D. Texas 1991). These courts favor a practical approach over a strict legislative analysis, commenting that by allowing a court to transfer venue to any district, even one that did not have original venue, § 1412 should logically be read also to allow a court to retain venue. If one federal bankruptcy judge could transfer the case to another district, in the interest of justice or for convenience, then why cannot the judge in that district retain the case, for the same reasons? 128 B.R. at 172.

Alternatively, courts embracing the minority position have held that they possess authority to determine transfer of venue motions in their sound discretion. *See, e.g., In re Brazzle*, 321 B.R. 893, 895-96 (Bankr. W.D. Tenn. 2005). This line of reasoning is supported by cases such as *In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litigation*, 140 B.R. 969 (N.D. Ill. 1992), in which Circuit Judge Easterbrook, sitting by designation, stated that any court has jurisdiction to determine its own jurisdiction, and this court unquestionably has the authority to determine what effect the bankruptcy stay has on [the litigation before it]. 140 B.R. at 972. This adverse affect on a courts judicial independence combined with the ambiguities in §§ 1406 and 1412 result in some courts holding that the express requirements of § 1406 are inapplicable in bankruptcy proceedings.

Pre-1987 minority cases supporting the right of a bankruptcy court to retain an improper venued case are less persuasive, the *Thompson* court explained, because they were decided before the 1987 amendments to Rule 1014(a)(2) and the issuance of an advisory committee note that clearly favors the majority interpretation. 507 F.3d at 418, n.1. For this reason, one bankruptcy judge changed from supporting the minority view to the majority view after 1987. *See In re*

Pick, 95 B.R. 712, 715 (Bankr. D.S.D. 1989).

Application of Thompson Rationale to Corporate Cases. Despite the fact that the underlying cases that gave rise to the Sixth Circuit appeal were individual consumer bankruptcy proceedings, the rationale and decision of the *Thompson* case applies with equal validity to corporate cases. Thus, if a corporation files a bankruptcy case in an improper venue and a party in interest objects, then under the *Thompson* case rationale, the bankruptcy court must either dismiss the case or transfer it to a court where venue lies.

Lower courts addressing improper venue in corporate bankruptcy proceedings have previously adopted both the majority and the minority positions. Compare *In re Columbia Western, Inc.*, 183 B.R. 660, 665 (Bankr. N.D. Mass. 1995) (majority view: holding that under § 1406, transfer or dismissal are the only available options), and *EDP Medical Computer Sys., Inc. v. United States (In re EDP Medical Computer Sys., Inc.)*, 178 B.R. 57, 63 (M.D. Pa. 1995) (majority view), with *In re Capital Hotel Group, Inc.*, 206 B.R. 190, 192 (Bankr. E.D. Mo. 1997) (minority view: stating that the court possessed the ability to retain an improperly venued case in the proper circumstances, but ultimately transferring the case to the proper venue, so that the courts views on the issue were *dictum*), and *United States Aviox Co., Inc. v. Aviox International, Inc. (In re United States Aviox Co., Inc.)*, 96 B.R. 874, 882 (Bankr. N.D. Ind. 1988) (minority view: discussing § 1412 in support of its position). Because the venue analysis of corporate bankruptcy proceedings involves the same bankruptcy statutes and rules as consumer bankruptcy proceedings, the venue statutes applicable to consumer bankruptcy proceedings, and thus the *Thompson* case, should be equally applicable to corporate bankruptcy proceedings.

United States Trustee as Interested Party Entitled to Object and Appeal. In its holding, the *Thompson* court indicated that the bankruptcy case must be dismissed or transferred to a court of proper original venue when an interested party timely objects. 507 F.3d at 420. The court then noted in a footnote that the United States trustee is an interested party under 11 U.S.C. § 307, which allows the United States trustee to raise and appear on any issue in a case or proceeding. *Id.* n.3. Although the court does not cite to its own decision dealing with whether this standing to appear includes the right to appeal, the Sixth Circuit previously held in *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 500 (6th Cir. 1990), that the United States trustee has the right to appeal even though § 307 does not explicitly say so. This is the unanimous view of the courts of appeals that have weighed in on the issue. See *United States Trustee v. Price Waterhouse*, 19 F.3d 138, 141 (3d Cir. 1994); *United States Trustee v. Clark (In re Clark)*, 927 F.2d 793, 796 (4th Cir. 1990).

One related issue that went unmentioned in the case was whether the United States trustee for the Northern District of Mississippi was entitled to go out of its jurisdiction and appear and be heard in cases pending in the Western District of Tennessee. Section 581 of title 28 creates 21 regions, each with its own United States trustee. Section 586(a) of title 28 describes the duties of each United States trustee but prefaces the list of duties with a limitation, within the region for which such United States trustee is appointed. Thus, it appears that an argument could have been made that only the United States trustee with responsibility for Tennessee had the statutory authority to appear in the cases. Cf. *Citicorp North America, Inc. v. Finley (In re Washington Manufacturing Co.)*, 123 B.R. 272, 275 (Bankr. M.D. Tenn. 1991) (pointing out that the right of the United States trustee to appear on any issue in 28 U.S.C. § 307 contrasts with the specificity of the United States trustees duties spelled out in 28 U.S.C. § 586(a)).

Strict Statutory Construction. Ultimately in the *Thompson* case, the Court of Appeals for the Sixth Circuit indicated that it was taking the majority approach because of the plain text of the applicable statutes. 507 F.3d at 423. In doing so, however, the Sixth Circuit did not discuss the most recent U.S. Supreme Court case on statutory interpretation in a bankruptcy context, *Marrama v. Citizens Bank of Massachusetts*, 127 S. Ct. 1105, 166 L. Ed. 2d 956, 2007 U.S. LEXIS 2651 (2007).

In *Marrama*, the Supreme Court appeared to disregard the plain language of 11 U.S.C. § 706(a), which provides an unconditional right for a debtor to convert a chapter 7 case to either chapter 11, 12 or 13 at any time, holding that the debtor had forfeited his right to convert his case to a chapter 13 proceeding due to his prepetition bad faith conduct. In

doing so, the Supreme Court indicated that the broad authority granted to bankruptcy judges is sufficient to allow a judge to deny a motion to convert when the conversion order merely postpones the eventual relief of dismissal of the converted chapter 13 case for bad faith. 2007 U.S. LEXIS 2651, at *18.

This result-oriented decision lends support to the minority view on the venue issue that was before the *Thompson* court. Just as the *Marrama* Court determined that the bankruptcy court did not need to undertake a meaningless exercise--allow conversion of the case to chapter 13, then dismiss that converted case for bad faith--it could be argued that the bankruptcy court need not similarly engage in a circular exercise on the venue issue--first transfer the case to a proper original venue court, then have the case come back to the original court for the convenience of the parties.

On the other hand, before *Marrama*, there were numerous Supreme Court cases on bankruptcy issues where the Court adhered to the plain-meaning method of statutory application. See, for example, *Connecticut National Bank v. Germain*, 503 U.S. 249, 112 S. Ct. 1146, 117 L. Ed.2d 391 (1992), which was cited by the *Thompson* court. The *Thompson* decision certainly signals a reluctance on the part of the court to depart from that prior line of case law, applying instead a strict construction analysis to the question of statutory interpretation.

The Sixth Circuit has spoken on the issue of retaining improper venue and the message is clear: The venue statutes mean what they say and they say what they mean.

For further discussion of venue in bankruptcy cases, see Collier on Bankruptcy, ch. 4 (Matthew Bender).

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Return to Text

n1 . The court went on to discuss whether use of the permissive word may in Rule 1014 rather than must would allow a court authority to retain a case. The court rejected that view, pointing out that it was foreclosed by the 1987 Advisory Committee Note to the rule, which noted that the right to retain a case was intentionally deleted. 507 F.3d at 421.

n2 . The courts comment that its holding is premised on the fact that an interested party has timely objected is *dicta* in that there was a timely objection in the case before the court, so that the court did not consider whether a bankruptcy court can act *sua sponte* to dismiss or transfer a case filed in the wrong venue. In *In re Langston*, 291 B.R. 872, 875-76 (Bankr. N.D. Ala. 2003), the court held that it could transfer the cases to the proper venue, even in the absence of any such motion.

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83 of 197 DOCUMENTS

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Glosband on In re Compaa de Alimentos Fargo, S.A.

2008 Emerging Issues 1937

Glosband on In re Compaa de Alimentos Fargo, S.A.

By Daniel Glosband

February 21, 2008

SUMMARY: A bankruptcy court in the Southern District of New York found that considerations of comity, fairness and efficiency supported dismissal of an involuntary U.S. chapter 11 proceeding in favor of a foreign proceeding. If a foreign debtor chooses to file an insolvency proceeding in a forum which does not provide identical protections of the U.S. Bankruptcy Code, will U.S. bankruptcy courts provide protection? On what grounds can a U.S. bankruptcy court abstain from hearing an insolvency proceeding when there is simultaneous proceeding in a foreign forum?

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ARTICLE: A Bankruptcy Court Finds that Considerations of Comity, Fairness and Efficiency Support Dismissal of an Involuntary Chapter 11 Case Under 11 U.S.C. § 305(a) in Favor of the Foreign Insolvency Proceeding

In today's environment of pervasive global transactions and cross-border relationships, parties should be aware that the doors of the United States bankruptcy courts may not remain open to all debtors that satisfy the eligibility requirements of *section 109 of the Bankruptcy Code* (the Code). Bankruptcy courts have discretion under section 305(a) of the Code to abstain from hearing an insolvency proceeding, by suspending or dismissing the proceeding, based on considerations of comity and other factors including whether a foreign forum is available which will determine the parties' rights fairly, the relative benefits and burdens of exercising the courts' jurisdiction and, in the case of an involuntary petition, the reasons for filing such petition. Recently, the bankruptcy court in *In re Compaa de Alimentos Fargo, S.A. (Fargo)* decided to exercise its discretion to abstain from hearing an involuntary Chapter 11 case and dismissed the case in favor of a reorganization proceeding that was pending in Argentina. n1

The Facts and Posture of Fargo. Following Argentina's delinking of the dollar-to-peso exchange rate in early 2002, the Argentine economy plunged into a recession as the value of the peso fell. Compaa de Alimentos Fargo, S.A. (the Debtor), Argentina's largest commercial producer of bread products, defaulted on interest payments due to holders of unsecured notes (the Noteholders) issued under United States law (the Notes) pursuant to an indenture agreement,

dated July 27, 1998, with Citibank, N.A., as Trustee (the Indenture Trustee). Approximately 65% of the Debtors public debt is held by Argo Capital Investors Fund SPC, Rainbow Global High Yield Fund, Rainmac Fund and the Star Fund (collectively, the Petitioners), off-shore Caribbean investors. In June of 2002, to address its default, the Debtor began a *concurso preventivo* (the *Concurso*) in the National Commercial Court in Buenos Aires. A *concurso preventivo* is a reorganization proceeding under Argentine Insolvency Law that triggers an automatic stay of unsecured creditor actions against the Debtor and its property, wherever located. Secured creditors were exempt from the stay. n2

Upon commencement of the *Concurso*, the Indenture Trustee filed aggregate proofs of claim on behalf of the Noteholders in the full U.S. dollar amount of principal and unpaid pre-petition interest. The Debtor commenced an ancillary proceeding (also apparently in an Argentine court) seeking to limit the Indenture Trustees claim for voting and distribution purposes to the amounts that the Noteholders paid for the Notes in the secondary market. The Debtor also sought to have the liabilities under the Notes converted from dollars to pesos. The Argentine bankruptcy court rejected the Debtors arguments and allowed the proofs of claim in the amounts filed by the Indenture Trustee. n3

On appeal, the National Court of Appeals on Commercial Matters (the Court of Appeals) reversed the bankruptcy courts decision and decided an issue that had been neither argued nor briefed. The Court of Appeals agreed that the claims should be denominated in dollars but limited the Indenture Trustees claim *for voting purposes* to the amount of unpaid pre-petition interest (the Appeals Decision). n4 Therefore, while the Indenture Trustees claim remained fixed at U.S. \$134,000,000 for distribution purposes, the claim was reduced by U.S. \$120,000,000 for voting purposes. According to the Petitioners, the Debtor did not present this argument to the Court of Appeals and the Indenture Trustee did not have the opportunity to be heard on this issue.

The Indenture Trustee appealed the Appeals Decision to the National Supreme Court (the Supreme Court). After letting the matter languish for two years, the Debtor filed a waiver (the Waiver) stating that it would agree to allow the Indenture Trustee to vote the full value of the claims and the issues raised by the Waiver were remanded to the bankruptcy court in August 2007. In the meanwhile, the Petitioners had filed an involuntary chapter 11 petition in the Bankruptcy Court for the Southern District of New York (the Court) in September 2006. The Court ultimately dismissed the involuntary case under section 305(a) of the Code. n5

The Fargo Opinion. In its October 12, 2007 decision, the Court reasoned first that the Argentine insolvency system is procedurally and substantively fair and that the *concurso preventivo* is similar to a chapter 11 case under the Code. n6 A court-appointed trustee supervises debtors in possession, and there is oversight from a creditors committee. Creditors claims are further protected by the automatic stay, judicial remedies which regulate the claims process, avoidance powers and statutory fiduciary duties punishable by criminal penalties.

Practitioners should take notice that, to afforded comity, the foreign proceeding and the foreign forum need not provide *identical* remedies to those available under the Code. For example, according to the Debtors expert testimony, under Argentine insolvency law the automatic stay does not apply to the debtors secured creditors. Additionally, Argentine law does not provide for equitable subordination of claims or broad discovery similar to that of *Federal Rule of Bankruptcy Procedure 2004*. The Petitioners asserted that the Argentine courts were corrupt, emphasized the differences from U.S. law and alleged irregularities in the Appeals Decision to challenge the fairness and efficiency of the Argentine bankruptcy system. The Court found no admissible or convincing evidence of corruption. Further, the Court ruled that the differences from U.S. law did not render the Argentine law in conflict with fundamental notions of fairness. The foreign bankruptcy system must only be substantially similar and not repugnant to United States law. n7 The Court found that the Petitioners were unable to show that the *Concurso* treated their interests unfairly or that the Argentine judicial system was corrupt in any fashion. n8

Petitioners made much out of the Appeals Decision, but the Court noted that there was an appeals process in place and an appeal was underway to address alleged mistakes in the Appeals Decision. n9 The Debtors waiver of the voting limitation resulted in a remand by the Supreme Court to the Argentine bankruptcy court.

The Court also weighed the benefits of a parallel chapter 11 proceeding and determined that it would be inefficient and not beneficial. The Debtors business operations, customers and employees are located in Argentina, and its only assets located in the United States consist of one trademark and three pending trademark applications. While providing a technical basis for debtor eligibility under section 109 of the Code (presence of property in the United States), the Court would likely not have jurisdiction over all creditors unlike the Argentine bankruptcy court. Furthermore, for a chapter 11 plan confirmed in the U.S. to be enforced in Argentina, an Argentine court would have to grant comity. The Argentine court would be unlikely to grant comity for several reasons, including the Petitioners violation of the Argentine automatic stay by filing the chapter 11 petition in the first place and the requirement in the Petitioners proposed plan for equitable subordination, a remedy that Argentine law does not provide. Thus, permitting the chapter 11 case to proceed might be largely futile since the Court would have limited ability to enforce its jurisdiction.

Practitioners should be further aware that courts will look through the involuntary chapter 11 petition to examine the motives behind the filing. In *Fargo*, the Petitioners claimed that they filed the petition in order to expedite a convoluted Argentine process which had been hijacked by a hostile takeover scheme perpetrated by the Debtors competitor. n10 The Court took notice, however, that three of the Petitioners purchased substantial amounts of Notes long after commencement of the *Concurso* and even *after* the supposedly unfair Appeals Decision. It therefore questioned whether the Petitioners were really all that concerned about the fairness of the *Concurso*. n11 Perhaps, the Court reasoned, the Petitioners themselves were trying to hijack the *Concurso* by substantially increasing their negotiating power by triggering the U.S. automatic stay; unlike the Argentine stay, the U.S. stay included secured creditors. n12 The Debtors secured creditor is a Delaware limited liability company subject to the Courts jurisdiction and thus subject to the stay.

Against the backdrop of the Petitioners possibly questionable motives, the Court held that the factors of comity, fairness and efficiency favored abstention and dismissal of the involuntary petition. n13 The lesson for practitioners is that U.S. courts may choose to deny use of the U.S. insolvency system to entities that are eligible to be debtors under the Bankruptcy Code but that are also debtors in foreign proceedings. Factors in the decision will include the fairness and efficiency of the foreign insolvency system, the ability of the U.S. court to enforce its jurisdiction and the motives of the parties.

Applicability of Chapter 15 of the Code. There was no discussion in the *Fargo* opinion of the possible applicability of Chapter 15 of the Bankruptcy Code. Presumably, the issue was not raised by the parties. The decision notes that the debtor continued in possession subject to a supervisory trustee. The *Concurso* appears to be a foreign proceeding as defined in section 101(23) of the Code and either of the Debtor or the trustee might meet the definition of a foreign representative under section 101(24) of the Code. Superficially, at least, it appears that section 1509(c) of the Code would have required the Debtor to file a petition for recognition under chapter 15 and to obtain recognition before seeking comity by way of dismissal of the involuntary chapter 11 petition.

The facts discussed in the *Fargo* decision support recognition as a foreign main proceeding under section 1517. Upon recognition, the more succinct grounds for dismissal under section 305(a)(2) would have applied: the purposes of chapter 15 would be best served by such dismissal. Practitioners should always consider the applicability of chapter 15 when they encounter a cross-border insolvency situation.

For a complete discussion of section 109 and 305 of the Bankruptcy Code, see Collier on Bankruptcy, ch. 109 and ch. 305 (Matthew Bender).

For more information on Chapter 15 of the Bankruptcy Code, see Collier Bankruptcy Practice Guide, ch. 19 (Matthew Bender) and Collier International Business Insolvency Guide, ch. 8, ch. 9 and ch. 10 (Matthew Bender).

For more information on the *concurso preventivo* and Argentine insolvency law, see Collier International Business Insolvency Guide, ch. 13 (Matthew Bender).

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[Return to Text](#)

n1 . *In re Compania de Alimentos Fargo, S.A.*, 376 B.R. 427, 2007 Bankr. LEXIS 3445 (Bankr. S.D.N.Y. 2007).

n2

[2]. 376 B.R. at 430. For information on *concurso preventivo*, see Collier International Business Insolvency Guide, 13.05 (Matthew Bender). For information on insolvency law in Argentina, see Collier International Business Insolvency Guide, ch. 13 (Matthew Bender).

n3

[3]. 376 B.R. at 431.

n4

[4]. 376 B.R. at 431.

n5

[5]. 376 B.R. at 441.

n6

[6]. 376 B.R. at 435, citing *In re Bd. of Dirs. of Compania Gen. De Combustibles S.A.*, 269 B.R. 104 (Bankr. S.D.N.Y. 2001).

n7

[7]. 376 B.R. at 437 (citations omitted).

n8

[8]. 376 B.R. at 437.

n9

[9]. 376 B.R. at 436. The Debtor and its expert conceded that there were procedural irregularities and flaws with the *Appeals Decision*. 376 B.R. at 436.

n10

[10]. 376 B.R. at 440.

n11

[11]. 376 B.R. at 440-441.

n12

[12]. 376 B.R. at 441.

n13

[13]. 376 B.R. at 441.

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84 of 197 DOCUMENTS

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Hon. Ralph R. Mabey on In re Excel Innovations

2008 Emerging Issues 1860

Hon. Ralph R. Mabey on In re Excel Innovations

By Hon. Ralph R. Mabey

February 5, 2008

SUMMARY: The courts of appeals do not agree on the standard for issuing an injunction to stay litigation against a nondebtor party. Many lower courts have followed the lead of the Fourth Circuit in granting a section 105 injunction against litigation that interferes with the reorganization of the debtor. In a case of first impression, *In re Excel Innovations*, however, the Ninth Circuit has rejected this standard, holding that the traditional preliminary injunction standard applies in bankruptcy cases. In this Expert Commentary, the Hon. Ralph R. Mabey speculates as to the reasons for the disconnect between the approaches of the lower courts in this case (which followed the Fourth Circuit) and the Ninth Circuit and concludes that it may simply reflect the fact that appellate judges are far removed from the immediate practical considerations facing bankruptcy court judges as they manage large, complex cases.

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ARTICLE: The Ninth Circuit Holds That the Traditional Injunction Standard Applies for Granting a Section 105(a) Injunction Staying an Action Against a Nondebtor Party

The financial, legal, or liquidity crisis that forces a company to seek protection under the Bankruptcy Code often also spawns litigation by creditors or shareholders against the directors and officers of the debtor. Even when the debtor is not a party to the action or the matter has been automatically stayed against the debtor, litigation against the directors and officers may be disruptive to the debtor, especially during the early stages of a chapter 11 case, or costly to the bankruptcy estate, either due to dissipation of shared insurance coverage between the debtor and the directors and officers or due to the expense and burden of responding to discovery. As a result, it is common for the debtor or the individual directors and officers to request the bankruptcy court to enjoin or stay the litigation against the nondebtor parties.

More than twenty years ago, the Court of Appeals for the Fourth Circuit in two published opinions in the *A.H. Robins* bankruptcy cases established a comprehensive standard for enjoining litigation against nondebtor parties. See *A.H. Robins Co. v. Piccinin*, 788 F.2d 994 (4th Cir.), cert. denied, 479 U.S. 876 (1986); *Oberg v. Aetna Cas. & Sur. Co. (In re A.H. Robins Co.)*, 828 F.2d 1023 (4th Cir. 1987). In the *Piccinin* case, the Fourth Circuit found four independent grounds for staying or enjoining litigation against nondebtor parties, two of which were based on the extension of the

automatic stay under subsections 362(a)(1) and (a)(3) of the Bankruptcy Code and two of which were based on an injunction issued under the authority of *section 105(a) of the Bankruptcy Code* and 28 U.S.C. § 1334. This commentary will focus only on the standards for issuing an injunction under section 105(a) because the Court of Appeals for the Ninth Circuit previously held that extension of the automatic stay under *Bankruptcy Code section 362(a)* is not available to stay nondebtor party litigation. See *Chugach Timber Corp. v. Northern Stevedoring & Handling Corp. (In re Chugach Forest Prods., Inc.)*, 23 F.3d 241, 246-47, 30 C.B.C.2d 1877 (9th Cir. 1994). In addition to the traditional preliminary injunction standard, the Fourth Circuit in *Piccinin and Oberg* held that, pursuant to section 105(a) and 28 U.S.C. § 1334, a bankruptcy court may enjoin a lawsuit against a nondebtor party where such litigation could interfere with the reorganization of the debtor.

Although the Fourth Circuits *A.H. Robins* cases are often cited and followed by many courts, other circuit courts have developed their own standards for staying or enjoining litigation against nondebtor parties. The Second, Third, and Eighth Circuits favor the traditional preliminary injunction standard. See *Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.)*, 801 F.2d 60 (2d Cir. 1986); *Wedgewood Inv. Fund, Ltd. v. Wedgewood Realty Group Ltd. (In re Wedgewood Realty Group Ltd.)*, 878 F.2d 693 (3d Cir. 1989); *NLRB v. Superior Forwarding, Inc.*, 762 F.2d 695 (8th Cir. 1985). The Seventh Circuit, on the other hand, does not require a showing of irreparable harm to the moving party. *Fisher v. Apostolou*, 155 F.3d 876 (7th Cir. 1998).

After canvassing the existing case law from the other circuits, the Ninth Circuit, in a case of first impression in that court, has held that only the traditional preliminary injunction standard applies to enjoin litigation against a nondebtor party. *Solidus Networks, Inc. v. Excel Innovations, Inc. (In re Excel Innovations, Inc.)*, 502 F.3d 1086 (9th Cir. 2007). Having previously rejected the extension of section 362(a) to third parties, the Ninth Circuit in *Excel Innovations* also explicitly rejected the Fourth Circuits interference with reorganization standard and the Seventh Circuits relaxation of the showing of irreparable harm as a requirement for an injunction. As explained further below, the holding in *Excel Innovations* appears to be the product of the Ninth Circuits long-held reluctance to use the Bankruptcy Code to benefit insiders of the debtor.

Facts. Ned Hoffman was the founder and a major shareholder of both Excel Innovations, Inc. and Indivos Corporation. Excel Innovations in turn also separately owned shares of Indivos. In 2000, Hoffman and Indivos entered into a series of agreements for the purpose of removing Hoffman from the management of Indivos. These agreements prohibited Hoffman from directly or indirectly managing Indivos, and both Hoffman and Excel Innovations pledged their Indivos shares in a voting trust as collateral for their obligations to Indivos. The agreements also contained a provision requiring all disputes to be arbitrated before the American Arbitration Association (AAA).

In 2003, Indivos initiated an arbitration before the AAA against Hoffman and Excel Innovations. Indivos alleged that Hoffman and Excel Innovations wrongfully attempted to disrupt a merger between Indivos and Solidus Networks, Inc. by, among other things, initiating multiple shareholder derivative actions, a proxy contest, and a patent infringement lawsuit. In May 2004, the arbitrator granted partial summary judgment for Indivos, finding that Hoffman breached his contracts with Indivos by wrongfully attempting to disrupt the merger and also found Excel Innovations liable as Hoffmans alter ego. Later in the month, Hoffman and Excel Innovations also suffered a serious defeat in the patent infringement litigation when the United States District Court found that Indivos, not Excel Innovations, owned all the disputed patents.

Shortly after these setbacks, Hoffman and Excel Innovations filed bankruptcy petitions under chapters 13 and 11, respectively, which stayed both the arbitration and the patent infringement litigation. After several months, Hoffmans chapter 13 case was dismissed, and he resigned as an officer and director of Excel Innovations. Following the dismissal of Hoffmans chapter 13 case, Indivos recommenced the arbitration proceeding solely against Hoffman, but Hoffman objected, arguing that Indivoss claims against him were so intertwined with claims against Excel Innovations that continuing the arbitration would be inequitable and would violate the automatic stay of Excel Innovations. The arbitrator disagreed and scheduled new briefing deadlines and evidentiary hearings.

Bankruptcy Courts Decision. Unable to persuade the arbitrator, Hoffman initiated an adversary proceeding in the Excel Innovations chapter 11 case to seek declaratory and injunctive relief on the grounds that the arbitration violated the automatic stay. Hoffman, joined by Excel Innovations, argued that the arbitration should be enjoined because (1) Hoffman might reveal information subject to the attorney-client privilege of Excel Innovations and (2) Hoffman would seek indemnification against Excel Innovations for any damages assessed against him. After overcoming certain procedural hurdles, Hoffman convinced the bankruptcy court first to issue a temporary restraining order and then a preliminary injunction under *section 105(a) of the Bankruptcy Code* enjoining the arbitration from proceeding against him. In issuing the preliminary injunction, the bankruptcy court, echoing the Fourth Circuit, stated that a section 105(a) injunction is proper if the arbitration could conceivably have any effect on the administration of the bankruptcy case. *See Excel Innovations, 502 F.3d at 1091-92.* Although the bankruptcy court also held that the preliminary injunction would be granted under the traditional standard, it failed to make any findings on Hoffmans likelihood of success, but merely concluded that a stay would protect Excel Innovations from possible injury while causing no harm to Indivos or Solidus.

Ninth Circuit Bankruptcy Appellate Panels Decision. Indivos and Solidus appealed the bankruptcy courts preliminary injunction order to the Ninth Circuit Bankruptcy Appellate Panel (the BAP), which affirmed the bankruptcy court. The BAP first recognized that the Ninth Circuit had not adopted a standard for granting injunctions under section 105(a). The BAP, after looking for guidance from other circuit courts, followed the Fourth Circuit and held that enjoining actions against nondebtor parties is appropriate where the debtor and nondebtors interests are so intertwined that an action against the nondebtor is in effect a claim against the debtor. *Id. at 1092.* The BAP further held that section 105(a) is the appropriate statutory basis for granting injunctions in matters that are related to the underlying bankruptcy case. The BAP also found that Hoffman satisfied the traditional preliminary injunction standard: the Excel Innovations reorganization had a fair chance of success, and allowing the arbitration to proceed would have caused irreparable harm to Excel Innovations. Although the BAP affirmed the granting of the preliminary injunction on slightly different grounds than the bankruptcy court, both courts reasons appear to be rooted in one of the four grounds for a third-party injunction set forth in the Fourth Circuits *Piccinin* decision. Indivos and Solidus once again appealed, this time to the Ninth Circuit.

Ninth Circuits Decision. Recognizing that the issue on appeal presented a case of first impression in the circuit, the Ninth Circuit took the opportunity to lay out its standard for granting a section 105(a) injunction to enjoin litigation against a nondebtor party. The Ninth Circuit began with a thorough discussion of the standards applied by the other circuit courts and concluded that the majority of the circuits (Second, Third, and Eighth) apply the usual preliminary injunction standard, with the Fourth and the Seventh Circuits being the primary exceptions.

The Ninth Circuit once again explicitly rejected the principle followed in the Fourth Circuit, that section 362(a)s automatic stay could be extended to nondebtor parties. *Excel Innovations, 502 F.3d at 1094-95.* The Ninth Circuit then rejected the standards applied by the BAP and the bankruptcy court. Both the BAP and the bankruptcy court held that a preliminary injunction would be proper whenever an action in another forum could conceivably have any effect on the administration of the bankruptcy estate. In rejecting that approach, the Ninth Circuit found that the standard cited by the BAP and the bankruptcy court is actually the standard for determining subject matter jurisdiction over a motion for preliminary injunction, not the standard for actually issuing the injunction. The Ninth Circuit also criticized the BAPs reliance on the Fourth Circuits *Piccinin* decision, under which a preliminary junction was granted upon a finding that unusual circumstances existed to make the interests of the debtor and the nondebtor inextricably intertwined. Because the automatic stay cannot be extended in the Ninth Circuit, the unusual circumstances doctrine, which has been applied to extend section 362(a), cannot constitute an independent basis for a preliminary injunction.

The Ninth Circuit then held that the traditional preliminary injunction standard applied in bankruptcy cases. That standard requires a showing of (1) a strong likelihood of success on the merits, (2) the possibility of irreparable harm to the plaintiff if the injunction is not granted, (3) a balance of hardships favoring the plaintiff, and (4) advance of the public interest (in certain cases). *Excel Innovations, 502 F.3d at 1093* (citing *Save Our Sonoran, Inc. v. Flowers, 408 F.3d 1113, 1120 (9th Cir. 2005)*). The Ninth Circuit next addressed the application of the traditional preliminary

injunction standard in a bankruptcy context. For the purposes of meeting the first element of the traditional preliminary injunction standard, the plaintiff must show a reasonable likelihood of a successful reorganization, instead of the likelihood of succeeding in the adversary proceeding. *502 F.3d at 1095*.

In applying the traditional preliminary injunction standard, the Ninth Circuit found that the lower courts (1) failed to determine whether Excel Innovations had a reasonable likelihood of successfully reorganizing and (2) ignored the potential harm to Indivos and, as a result, failed to balance the harm between Excel/Hoffman and Indivos. The Ninth Circuit, therefore, vacated the preliminary injunction and remanded the case for further proceedings below.

Commentary. The Ninth Circuit's decision in *Excel Innovations* cannot be viewed in isolation. The opinion reflects, and is a product of, the Ninth Circuit's long-established policy against granting in effect a discharge, extending the automatic stay, or enjoining litigation against nondebtor parties, especially for the benefit of insiders of debtors. See *Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 140102 (9th Cir. 1995), cert. denied, 517 U.S. 1243 (1996) (no discharge for nondebtor parties under a plan of reorganization); *In re American Hardwoods, Inc.*, 885 F.2d 621 (9th Cir. 1989) (holding that the bankruptcy court lacks jurisdiction to issue a section 105(a) injunction for the benefit of a nondebtor party); *Underhill v. Royal*, 769 F.2d 1426 (9th Cir. 1985) (bankruptcy court lacks the power to enjoin litigation against a nondebtor party by another nondebtor party); *Chugach Timber Corp. v. Northern Stevedoring & Handling Corp. (In re Chugach Forest Prods., Inc.)*, 23 F.3d 241, 246, 30 C.B.C.2d 1877 (9th Cir. 1994) (automatic stay cannot be extended to enjoin litigation against a nondebtor party). Similarly, the Ninth Circuit, as shown by *Excel Innovations*, concludes that the traditional preliminary injunction standard must be applied in bankruptcy cases so that injunctions for the benefit of nondebtor parties will not be granted lightly.

Despite the fact that a majority of the circuits, including the Ninth Circuit now, have adopted the narrower, traditional preliminary injunction standard, the Fourth Circuit's broader approach to third-party injunctions set forth in *Piccinin* and *Oberg* are still frequently cited and followed. In fact, it appears that both the bankruptcy court and the BAP in *Excel Innovations* case extensively followed the Fourth Circuit, even though the Ninth Circuit long ago rejected the extension of the automatic stay under the unusual circumstances doctrine. The disconnect between the lower courts and the Ninth Circuit's approach may reflect a more practical approach employed by bankruptcy court judges who are in the trenches dealing with large, complex bankruptcy cases, and the appellate judges in the Ninth Circuit, who are far removed from the underlying bankruptcy cases and only review the issue long after the emergency that may have prompted the request for an injunction.

Although a director or officer of a debtor may succeed in obtaining an injunction before the bankruptcy court, ultimately on appeal, the injunction may become harder to defend. As a result of a lack in uniformity on the standard for issuing a preliminary injunction under *section 105(a) of the Bankruptcy Code*, a debtor with multiple venue options will weigh carefully these differences. By way of example, consider the following: In order to obtain contributions necessary to its plan of reorganization, the *Dow Corning* plan in effect permanently enjoined the claims of some nondebtor parties against other, plan-contributor nondebtor parties. The Court of Appeals for the Sixth Circuit upheld these provisions based upon the unusual circumstances of that mass-tort case, an outcome apparently not available in the Ninth Circuit. *Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002).

For further discussion of injunctions under *Bankruptcy Code* section 105, see *Collier on Bankruptcy*, 105.02 and 105.03 (Matthew Bender).

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Judge Mabey is the past President and Chair of the American College of Bankruptcy. He served as an appointee of the Chief Justice of the United States to the U.S. Judicial Conferences Advisory Committee on the Bankruptcy Rules. He also served as the managing editor of the Norton Bankruptcy Law Adviser and on the Editorial Advisory Board of the American Bankruptcy Law Journal.

He is a member of the National Bankruptcy Conference, the American Law Institute, and the American Bar Associations Select Advisory Committee on Business Reorganization (SABRE).

Judge Mabey's service in complex workout, bankruptcy, reorganization, and litigation matters includes A.H. Robins Company (as examiner with expanded powers); Dow Corning (as counsel for certain bondholders); Columbia Gas System (as equity committee counsel); Federated Department Stores (as counsel for the official pre-merger bondholders committee); TWA (as counsel for the pilots); American Airlines (as counsel for the pilots); Enron (as special counsel for the debtor); Cajun Electric Power Cooperative (as chapter 11 trustee); Boston Chicken (as an expert witness); and At Home/Excite (as an expert witness).

Courts, parties, and the Department of Justice (U.S. Trustee Program) have appointed Judge Mabey to serve as mediator, arbitrator, examiner, or trustee in Alaska, Arizona, California, Louisiana, Michigan, New York, Texas, Utah, Virginia, and Washington, D.C.

Judge Mabey is a member of the New York and Utah Bars.



85 of 197 DOCUMENTS

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Mark Broude and George Royle V on Al Perry Enterprises, Inc.

2008 Emerging Issues 1826

Mark Broude and George Royle V on Al Perry Enterprises, Inc.

By Mark Broude and George Royle V

January 25, 2008

SUMMARY: The scope of Code section 353(f) remains unclear thirty years after its enactment. The section authorizes a trustee to sell estate assets free and clear of any interest in such property, but courts do not agree on whether interests includes non-in rem interests, such as claims against the estate. The Sixth Circuits decision in *Al Perry Enterprises v. Appalachian Fuels* is the latest in a series of cases applying section 363(f) to a debtors prepetition liabilities. In their Expert Commentary, Mark Broude and George Royle V explain that, although the decision muddies the waters, it does offer some lessons that counsel in a section 363(f) sale would do well to keep in mind.

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ARTICLE: Free and Clear Sales Under 11 U.S.C. § 363(f): The Sixth Circuit Muddies the Waters

Sales of substantially all of a debtors assets are increasingly common in Chapter 11 cases. *Section 363(f) of the Bankruptcy Code* permits a trustee to sell estate assets free and clear of any interests in such property, provided certain conditions are met and subject to the interest-holders right to adequate protection. Debtors and their purchasers rely on this Bankruptcy Code section to ensure that the purchaser is not acquiring the debtors liabilities, thereby maximizing the sale price of estate assets.

The Bankruptcy Code, however, does not define the term interests, and now, thirty years after section 363(f) was enacted, it is still unclear just how broad section 363(f) is, and just what liabilities a purchaser of estate assets can be assured it will not have to face. Courts have consistently interpreted interests to include *in rem* interests, such as a liens; however, courts are at odds as to whether interests also encompasses claims against the estate.

In September 2007, the Court of Appeals for the Sixth Circuit issued a decision in *Al Perry Enterprises, Inc. v. Appalachian Fuels, LLC*, 503 F.3d 538 (6th Cir. 2007), the latest in a series of cases from the circuit courts applying section 363(f) to a debtors prepetition liabilities. Unfortunately, *Al Perry* largely fails to resolve the controversy surrounding the scope of section 363(f). It does, however, illustrate the competing concerns that a court faces when a trustee sells estate property and seeks to extinguish a successor liability claim, and it suggests some lessons that counsel to parties in a section 363(f) sale would do well to keep in mind.

Overview and History of Section 363(f) Free and Clear Sales. Bankruptcy Code section 363(f) provides that

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if--

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- (2) such entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Before Congress enacted this provision in 1978, courts had widely interpreted the bankruptcy statutes to mean that bankruptcy courts had the power to extinguish *in rem* interests in estate property. As early as the Bankruptcy Act of 1867, Congress explicitly extended the bankruptcy courts jurisdiction to the ascertainment and *liquidation of the liens and other specific claims* on estate property. ⁿ¹ Interpreting this provision in *Ray v. Norseworthy*, 90 U.S. 128, 23 L. Ed. 116 (1874), a case involving a real estate mortgage, the Supreme Court held that [b]eyond all doubt the property of a bankrupt may, in a proper case, be sold by order of the bankrupt court free of encumbrance upon proper notice to the holder of the encumbrance. 90 U.S. at 135.

The Bankruptcy Act of 1898, which succeeded to the 1867 act, did not contain a similar explicit authorization of sales free and clear. Nonetheless, in *Van Huffel v. Harkelrode*, 284 U.S. 225, 52 S. Ct. 115, 76 L. Ed. 256 (1931), the Supreme Court again recognized the power of bankruptcy courts to make such sales. Noting the absence of an explicit provision in the statute to sell property of the bankruptcy free from encumbrances, Justice Brandeis wrote that, nevertheless, [w]e think it clear that the power was granted by implication. The lower federal courts have consistently held that the bankruptcy court possesses the power, stating that it must be implied from the general equity powers of the court and the duty to collect, reduce to money and distribute the estates of bankrupts, and to determine controversies with relation thereto. 284 U.S. at 227-28. As in *Norseworthy*, the encumbrance at issue--a state tax lien--was an *in rem* interest. *Id.* at 226.

Evolution of Free and Clear Sales to Encompass Claims of Successor Liability. Despite the apparently narrow view taken by the courts of section 363(f)'s predecessor statutes, courts have increasingly read the Bankruptcy Code to authorize more than a sale of estate property free and clear of merely *in rem* interests. Although a minority of courts have asserted the traditional view that the section applies only to specific interests in property, ⁿ² the majority have taken a broader view of the statute and held that some--but not all--claims (as defined by *section 101(5)(A) of the Bankruptcy Code*) are also covered by section 363(f). The Fourth and Third Circuits decisions in *United Mine Workers of America v. Leckie Smokeless Coal Co (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573 (4th Cir. 1996), and *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003), respectively, are among the most often cited cases for this proposition. Both hold that the phrasing of section 363(f), which explicitly mentions liens as but one form of interest in property subject to a free and clear sale, indicates that the term interest must also encompass certain bankruptcy claims that have a relationship with, ⁿ³ or are connected to, or arise from, the estate property being sold. ⁿ⁴ In addition to this textual analysis, courts endorsing a broad reading of section 363(f) have also cited two policy-based reasons for it: (1) maximizing the value of estate property; and (2) adhering to the Bankruptcy Codes priority scheme. ⁿ⁵

In practice, courts have employed this somewhat loose definition of interests to extinguish certain types of claims of successor liability against the purchaser of estate assets. In *Leckie*, for example, the Fourth Circuit found that pension funding liabilities arising under the Coal Industry Retiree Health Benefit Act of 1992, 26 U.S.C. §§ 9701-9722, could be

affected by section 363(f) when the debtor sold its mining assets to a purchaser free and clear. Likewise, in *Trans World*, the Third Circuit held that the debtors former employees successor liability claims of employment discrimination and entitlement to the use of certain travel vouchers had been subject to a section 363(f) sale free and clear. Other courts have concluded that personal injury claims n6 and product liability claims n7 also can be stripped from property sold free and clear pursuant to section 363(f).

That is not to say that the case law supports the transfer of property free and clear of all successor liability claims in a section 363(f) sale. As noted above, some courts, based on an asserted plain reading of the statutory language, reject completely the notion that a sale under section 363(f) conveys assets being sold free and clear of any non-*in rem* interests--and specifically successor liability claims. n8

Other courts have refused to find that successor liability claims are subject to section 363(f) if they did not arise before the free and clear sale. n9 In these cases, the courts have expressed concern that claimants whose successor liability claims arise after a section 363(f) sale would be deprived of due process protections if their claims were covered by the statute because they could not receive the constitutionally requisite notice for deprivation of their property right. n10

Adding to this chorus of disagreement, commentators have staked out opposing viewpoints of the constitutionality of subjecting n11 and not subjecting n12 successor liability claims to a section 363(f) free and clear sale. Moreover, the Bankruptcy Codes guarantee that holders of interests affected by a section 363(f) sale must be afforded adequate production n13 also raises some conceptual questions about how and whether non-*in rem* claims (which may be contingent and unliquidated, and by definition do not attach to specific property) could be adequately protected. n14

Al Perry Enterprises, Inc. v. Appalachian Fuels, LLC. The Sixth Circuits decision in *Al Perry* does little to resolve any of these issues. Although the holding pays lip service to the broad scope of section 363(f), it contains no meaningful discussion of that Bankruptcy Code section. Nonetheless, the case serves as a useful illustration of the competing concerns that courts face as they continue to wrestle with the scope of section 363(f), and of some practical considerations lawyers should keep in mind when representing parties in connection with a free and clear sale of estate assets.

In *Al Perry*, Al Perry Enterprises, Inc. (Perry) entered into a contract with Bowie Resources, Ltd. (Bowie) for Perry to procure coal supply contracts for Bowie on commission (the Commissions Contract). In accordance with their agreement, Perry procured a coal supply contract for Bowie to supply coal to the Tennessee Valley Authority (the TVA Contract). For several years, Bowie paid commissions on the TVA Contract, as agreed. Bowie subsequently filed a petition under chapter 11 of the Bankruptcy Code, assumed the Commissions Contract, and continued to make payments. Perry accordingly did not make a claim against the estate.

Once in bankruptcy, Bowie negotiated to sell substantially all of its assets to JJM Energy, LLC (JJM). The proposed asset purchase agreement provided that the assets were to be delivered free and clear of all Liens except [liabilities JJM agreed to assume] pursuant to *section 363 and 365 of the Bankruptcy Code*. The proposed agreement further provided that JJM would agree to assume all of Bowies liabilities relating to the Purchase Assets or to the Business arising after the Closing Date, including all Liabilities and obligations arising in connection with the Executory Contracts [which included the TVA Contract]. Perry objected to the sale, arguing that the Commissions Contract would be wiped out by this language. Ultimately, JJM and Bowie did not consummate the sale.

Later, however, Bowie found a new buyer in Appalachian Fuels, LLC (Appalachian), which agreed to purchase substantially all of Bowies assets on terms identical to the JJM sale. Perry did not object to this new sale, and the bankruptcy court entered an order authorizing the sale free and clear of all liens, claims, interests and encumbrances, with the exception of any liabilities Appalachian agreed to assume. Once the sale was consummated, Appalachian refused to make any commission payments to Perry on its sales of coal under the TVA Contract. Perry sued for breach of contract. On the parties cross-motions for summary judgment, the district court adopted the bankruptcy courts

recommended decision and rejected Perrys claim.

On appeal, the Sixth Circuit held that Al Perry was not entitled to its commissions under the Commissions Contract. The court wove though its opinion three distinct rationales for denying Perrys claim (with varying degrees of articulation): (1) the broad scope of section 363(f); (2) common law principles of successor liability; and (3) Perrys own failure to file a claim or object to the Appalachian sale.

With respect to section 363(f), the court held that the bankruptcy court has clear power to approve the sale of debtors assets free and clear of any interest or claims that could be brought against the bankrupt estate during bankruptcy pursuant to 11 U.S.C. § 363(f) and that the effect of the bankruptcy courts order [approving the section 363(f) sale] was to extinguish Perrys claim unless it was expressly assumed by Appalachian Fuels as part of the purchase agreement. 503 F.3d at 543. Citing a bankruptcy courts opinion in *Autostyle Plastics, Inc. v. Car-Tec, Inc.*, 227 B.R. 797 (Bankr. W.D. Mich. 1998), which contains a similarly broad statement of a trustees (and courts) section 363(f) powers, the court concluded that because Perry claimed entitlement to commissions for work it had completed prior to the bankruptcy, its claim for payment was a claim as defined by section 101(5)(A) of the Bankruptcy Code, and therefore could not be asserted against Appalachian by virtue of section 363(f). *Al Perry*, 503 F.3d at 543.

Al Perry therefore appears to reflect the degree to which the Sixth Circuit takes for granted the view that section 363(f) may apply to claims that are not *in rem* interests. Indeed, neither party disputed that the court had that authority--and perhaps for that reason, the court did not discuss the issue in depth. As a result, however, it may prove too much to argue that *Al Perry* represents a full-throated rejection of the alternate readings of section 363(f), or an endorsement of the policy rationales articulated in other cases for interpreting the section to include successor liability claims.

Indeed, most of the Sixth Circuits opinion is spent discussing the second and third rationales identified above. Perrys sole argument on appeal was that it was entitled to commissions under the Commissions Contract because Appalachian had expressly assumed that liability in the purchase agreement. Perry pointed to language in the purchase agreement providing that Appalachian would assume liabilities relating to the assets being purchased, including those arising in connection with the TVA contract.

Without specifically discussing the common law doctrine of successor liability, but impliedly adopting its precepts, n15 the Sixth Circuit accepted the premise that Appalachian could be held liable on the Commissions Contract if it had agreed to do so. The court concluded, however, that the obligation to pay commissions to Perry is related to and arising in connection with the [Commissions Contract], and that no language in the purchase agreement constitutes an assumption of the obligation of Bowie relating to and arising in connection with the TVA Contract, which the court described as a totally separate contract on a totally different subject matter. 503 F.3d at 54344.

The Sixth Circuit also repeatedly faulted Perry for not having filed a proof of claim or objected to the Appalachian sale. The court specifically adopted the holding in *Car-Tec* that claims such as Perrys should have been brought forward during the bankruptcy and could not be asserted against Appalachian once Perry failed to do so. *Id.* at 54243. n16 Significantly, the court also noted that Perry had previously objected to the JJM sale but had not objected to the sale to Appalachian. *Id.* at 543 n.4. Lessons of *Al Perry*. Despite its lack of clarity on the issue of the definition of the term interests in section 363(f), *Al Perry* suggests some guidelines for attorneys on all sides of a section 363(f) sale. Counsel representing debtors or purchasers of estate assets should draft purchase agreements in broad terms, n17 and be explicit about what liabilities, if any, are being assumed. Counsel should be mindful that this will not necessarily insulate the purchaser from all successor liability claims (especially claims arising after the sale), but it may reduce litigation risk. On the flip side, lawyers representing creditors with claims at risk of being affected by a sale pursuant to section 363(f) should preserve their claim at every opportunity--by filing a proof of claim (if procedurally proper) and objecting to or otherwise seeking to protect their interest in connection with any proposed sale. Creditors counsel whose clients claims are at risk of being subject to a free and clear sale may also want to consider invoking section 363(e)s guarantee of adequate protection, despite the conceptual difficulties that such a request would entail. Although it is not clear how

adequate protection would be supplied in the context of a non-*in rem* claim, a creditor may contend that the logical extension of treating claims as interests under *section 363(f) of the Bankruptcy Code* is that he is entitled to such relief, a position that may garner more favorable treatment than would otherwise be the case.

For further discussion of *Bankruptcy Code section 363*, see Collier on Bankruptcy, ch. 363 (Matthew Bender).

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Return to Text

n1 . 14 Stat. 517 (1867) (emphasis added). The power to sell estate property free and clear may also be inferred from earlier, short-lived bankruptcy statutes. The Bankruptcy Act of 1800, 2 Stat. 19 (1800) (*repealed 1803*), permitted the bankruptcy assignee (a precursor to the trustee) to dispose of all the bankrupts estate, real and personal, at public auction or venue, without being subject to any tax, duty, imposition or restriction, any law to the contrary notwithstanding. *Id.* at 33, § 44. Likewise, the Bankruptcy Act of 1841 contemplated that district courts could order the assignee to sell estate property, the proceeds of which would be paid into the court. 9 Stat. 447 at § 9 (1841) (*repealed 1843*). Each statute distributed the estate *pro rata* to creditors without regard to their security interests. 2 Stat. at 30, § 31; 9 Stat. at 444, § 5.

n2

[2]. See, e.g., *Fairchild Aircraft Inc. v. Cambell (In re Fairchild Aircraft Corp.)*, 184 B.R. 910 (Bankr. W.D. Tex. 1995) (holding that section 363(f) applies only to *in rem* interests in estate property), *vacated on other grounds*, 220 B.R. 909 (Bankr.W.D.Tex. 1998).

n3

[3]. *Leckie*, 99 F.3d at 582.

n4

[4]. *Trans World*, 322 F.3d at 289. Both also agree, however, that this is not a limitless category. As the Fourth Circuit put it in *Leckie*, an interest subject to extinguishment under section 363(f) does not arise simply [because] one has a right to demand money from the debtor. *Leckie*, 99 F.3d at 581.

n5

[5]. See, e.g., *Ninth Ave. Remedial Group. v. Allis-Chalmers Corp.*, 195 B.R. 716, 731 (N.D. Ind. 1996) (citing cases).

n6

[6]. See *Myers v. United States*, 297 B.R. 774 (S.D. Cal. 2003) (personal injury claim that arose before free and clear sale of estate property was subject to section 363(f), despite lack of notice to the claimant of the sale)

n7

[7]. See *In re All American of Ashburn, Inc.*, 56 B.R. 186 (Bankr. N.D. Ga. 1986) (product liability claim arising before sale of property was subject to section 363(f))

n8

[8]. See, e.g., *Schwinn Cycling & Fitness, Inc. v. Benonis (In re Schwinn Bicycle Co.)*, 210 B.R. 747 (Bankr. N.D. Ill. 1997) (finding that section 363(f) in no way protects the buyer from current or future product liability; it only protects the purchased assets from lien claims against those assets); *Fairchild*, 184 B.R. at 91718 (The sorts of interests impacted by a sale free and clear are *in rem* interests which have attached to the property Section 363(f) is not intended to extinguish *in personam* liabilities.).

n9

[9]. See, e.g. *In re Savage Ind., Inc.*, 43 F.3d 714 (1st Cir. 1994) (holding product liability claims that arose before free and clear sale were *not* covered by section 363(f) where claimant had no notice of sale); *Zerand-Bernal Group v. Cox*, 23 F.3d 159 (7th Cir. 1994) (purchaser was not free and clear of product liability claim arising after section 363(f) sale, although stating in *dicta* that section 363(f) would extinguish claim that could have been brought against the debtor).

n10

[10]. A potential solution to this problem is the appointment of a future claims representative to represent the interests of as-yet unidentified, but anticipated, future plaintiffs.

n11

[11]. See George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235 (2002) (arguing that section 363(f) is limited to *in rem* interests, and criticizing application of section to *in personam* claims on constitutional and policy-based grounds).

n12

[12]. See Hon. William T. Bodoh & Michelle M. Morgan, *Inequality Among Creditors: The Unconstitutional Use of Successor Liability to Create a New Class of Priority Claimants*, 4 Am. Bankr. Inst. L. Rev. 325 (1996) (arguing that permitting successor liability claims to survive a section 363(f) sale is an unconstitutional infringement on the powers granted to Congress under the Bankruptcy Clause); see also Michael H. Reed, *Successor Liability and Bankruptcy Sales Revisited--A New Paradigm*, 61 Bus. Law. 179 (2005).

n13

[13]. 11. U.S.C. § 363(e).

n14

[14]. For instance, *Bankruptcy Code section 361*, which defines the types of adequate protection available under section 363, states that adequate protection is necessary to the extent the use, sale, or lease of estate property results in a decrease in the value of [an interest holders] interest in such property. 11 U.S.C. § 361(1). It may be difficult for courts to value an interest for the purposes of this section where the interest is something other than an *in rem* interest, particularly an unliquidated, future claim against the purchaser of the debtors assets.

n15

[15]. Although successor liability doctrine varies slightly from state to state, the general rule with respect to successor liability is that a purchasing corporation does not accept the liabilities of the selling corporation unless one of four exceptions is present: (1) the purchaser expressly or impliedly agrees to assume such debts or other liabilities; (2) the transaction amounts to a consolidation or merger of the seller and purchaser; (3) the purchasing corporation is merely a continuation of the selling corporation; or (4) the transaction is entered into fraudulently in order to escape liability for such debts. See, e.g., *Parker v. Henry A. Petter Supply Co.*, 165 S.W.3d 474, 479 (Ky. App. 2005).

n16

[16]. As in *Al Perry*, the claimant in *Car-Tec* did not file a proof of claim or object to the asset sale. It is not

clear whether either court would treat failure to file the proof of claim, alone, as a reason for subjecting the claim to a free and clear sale. If section 363(f) is as broad as the Sixth Circuit contends, then Perrys claim would presumably have been affected by the law in any event.

n17

[17]. *But see In re Automationsolutions Intl, LLC*, 274 B.R. 527 (Bankr. N.D. Cal. 2002) (criticizing counsel for overreaching in broadly drafted proposed order).

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Mark Broude is a partner in the New York office of Latham & Watkins, where he is a member of the Insolvency Practice. His practice focuses primarily on business reorganization, creditors' rights, representation of unsecured creditors' committees and bank finance with particular focus on representing prepetition and post-petition lenders in workouts and chapter 11 cases; bondholders, both individually and formal and informal committees; and potential acquirers of assets of companies in chapter 11, both under section 363 and pursuant to plans of reorganization.

Mr. Broude has had extensive experience on a variety of major bankruptcy transactions. He has regularly represented prepetition and post-petition lenders in a substantial number of workouts and chapter 11 cases. Mr. Broude represents bondholders, both individually and formal and informal committees, as well as statutory committees, including most recently the official committee of unsecured creditors of Delphi Corporation, the largest industrial bankruptcy in United States history. He has represented Debtors in complex chapter 11 cases, including Spring Air Partners and Trump Hotels & Casino Resorts. He also represents potential acquirers of assets of companies in chapter 11, both under section 363 and pursuant to plans of reorganization. Mr. Broude has received recognition of his expertise in the bankruptcy field, including his being named one of the leading practitioners in the restructuring and insolvency arena by Chambers USA and Chambers Global.

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86 of 197 DOCUMENTS

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Collier on Remedies for Violation of the Automatic Stay

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Collier on Remedies for Violation of the Automatic Stay

By Collier

December 18, 2007

SUMMARY: This Emerging Issues Analysis covers whether a violation of the automatic stay is void or voidable, the annulment of automatic stays, the punishment for violation of a stay by contempt of court sanctions, and the payment of damages, costs, and attorneys fees under Bankruptcy Code section 362(k) for willful violations of automatic stays.

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ARTICLE: The automatic stay of section 362 is effective immediately upon the filing of the petition, whether voluntary, joint or involuntary. Formal service of process is not required. Because the stay is imposed automatically, and often without notice to parties who may be stayed, a party may violate the stay without realizing that it has taken effect. In other cases, a party may knowingly violate the stay, either in the erroneous belief that the partys action is permitted or in disregard of the stay. At least one court has held that only a party protected by the stay may seek enforcement of the stay. n1

Action Violating the Stay is Void. Most courts have held that actions taken in violation of the stay are void and without effect. n2 However, some courts have found that actions taken in violation of the stay are voidable, not void, permitting an action to take effect if it is not objected to. n3 The cases draw support for this proposition from the fact that one of the alternatives under section 362(d), when a request for relief from the stay is made, is to annul the stay and thus apparently to validate actions otherwise taken in violation of it. n4

The better approach is to view the annulment option as a means of avoiding the effect of the stay, rather than as an indication that acts taken in violation are voidable. If such acts were merely voidable, then the debtor would have the obligation to avoid acts taken in violation. n5 In view of the importance of the stay, it is preferable to treat any such acts as void and of no effect, subject to being given effect by annulment or modification of the stay. n6 Although a court may use the annulment power to give retroactive relief from the stay, relief should be granted sparingly. n7 The breathing room provided by the stay would be limited if debtors feared regular retroactive validation. Debtors would be forced to defend all actions, even those stayed, because the stay might be retroactively annulled and a default by the debtor might become binding. Thus, retroactive relief should be granted only in extraordinary circumstances, such as when a creditor acted without knowledge of the stay, under circumstances in which relief from the stay would have been available, and where the creditor changed its position in reliance on the validity of its action.

Violation of Stay Is Contempt of Court. A violation of the stay is punishable as contempt of court. n8 Most courts will impose contempt sanctions for a knowing and willful violation of a court order, and the automatic stay is considered as equivalent to a court order. n9 If the conduct is willful, even if based upon advice of counsel, contempt is an appropriate remedy. n10 When a violation of the stay is inadvertent, contempt is not an appropriate remedy. n11 Nevertheless, the creditor has a duty to undo actions taken in violation of the automatic stay. n12 Failure to undo a technical violation may elevate the violation to a willful one. n13 In *In re Crysen/Montenay Energy Co.*, n14 the court described the standard governing the imposition of sanctions in contempt proceedings as follows:

[Prior to the enactment of section 362(k)] the standard that governed the imposition of sanctions was that which governed contempt proceedings: a party generally would not have sanctions imposed for its violation of an automatic stay as long as it had acted without maliciousness and had a good faith argument and belief that its actions did not violate the stay.

It should be noted that contempt and other remedies may not be available against states that violate the automatic stay. In *Seminole Tribe of Florida v. Florida*, n15 the Supreme Court held that in the absence of a waiver of sovereign immunity, Congress may waive a states sovereign immunity only through an express waiver pursuant to a valid exercise of power. It has been held that although *Bankruptcy Code section 106* contains an express waiver of sovereign immunity, the waiver may be an invalid and unconstitutional exercise of congressional power. n16

Federal Rule of Bankruptcy Procedure 9020 sets out a procedure for dealing with contempt. In general, it provides that contempt committed in the presence of the bankruptcy judge may be determined summarily by the judge. Other contempt may be determined by the judge after a hearing on notice. An order of contempt has the same force and effect as an order entered by the district court unless, within 10 days after the order, the entity held in contempt serves and files objections, in which case the district court may review the findings and order *de novo*. Thus, contempt matters need not necessarily be referred to the district court; the bankruptcy court retains some power to deal with contempt. n17

In some cases, courts have been persuaded to annul the automatic stay when the filing of the case was in bad faith. In this event, an innocent action in apparent violation of the stay will not be void. n18 In all but the rarest case, it will be prudent for the creditor to undo the effect of its innocent action and thereafter to assert the debtors bad faith as a basis for relief. n19

Recovery of Damages for Willful Violation of the Stay. Section 362(k) provides for a recovery of damages, costs and attorneys fees by an individual damaged by a willful violation of the stay. n20 Under section 362(k)(1), which was designated as section 362(h) prior to the 2005 amendments, in an appropriate case, an individual injured by a stay violation may also recover punitive damages. n21 Once the creditor becomes aware of the filing of the bankruptcy petition and therefore the automatic stay, any intentional act is willful.' n22 The bankruptcy court has exclusive jurisdiction over sanctions for a stay violation. n23

Several amendments to the Bankruptcy Code made in 2005 limit the relief available under section 362(k)(1). Section 362(k)(2) was added as a companion provision to section 362(h), which provides for the termination of the stay as to personal property based on the debtors failure to take certain action related to the statement on intention under section 521(a)(2). n24 If a violation of the stay is based on an action taken by an entity in the good faith belief that the stay had been terminated as to the debtor under section 362(h), section 362(k)(2) provides that the recovery under section 362(k)(1) shall be limited to actual damages. Recovery of actual damages, based on the language of section 362(k)(1), may include an award of attorneys fees and costs. There also appears to be an emerging consensus that emotional distress damages may be recovered in an award of actual damages under section 362(k)(1). n25

In addition, section 342(g)(2), added in 2005, provides that a monetary penalty may not be imposed on a creditor under section 362(k) for violation of the stay unless the conduct that is the basis for the violation occurs after the creditor has received effective notice as provided under section 342 of the order for relief. n26 Since actual damages

are typically viewed as compensatory in nature, and generally do not serve as a penalty, this provision appears to preclude only the recovery of punitive damages under section 362(k)(1). This limitation on the award of punitive damages applies only to the creditor who has not received effective notice under section 342, not others who have violated the stay.

Several courts have considered whether section 362(k) provides all debtors with a remedy against stay violators or whether its scope is limited by the reference in section 362(k) to an individual injured by a stay violation. The question is of some importance because, although a stay violation may be punished as contempt, the imposition of a remedy under a civil contempt procedure may be subject to a stricter standard than is imposed by section 362(k) and does not afford the availability of punitive, in addition to compensatory, damages. Moreover, the power of a bankruptcy court to impose a civil contempt sanction is subject to more extensive procedural requirements than are present in affording a remedy under section 362(k).ⁿ²⁷ In particular, an action seeking a remedy under section 362(k) is a core proceeding that may be decided by the bankruptcy court. Under Bankruptcy Rule 9020, contempt is treated as similar to a noncore proceeding, the result of which may be subject to *de novo* review by the district court.

Some courts have held that the section 362(k) remedy is available only to natural persons.ⁿ²⁸ For example, in *In re Chateaugay Corp.*,ⁿ²⁹ the Court of Appeals for the Second Circuit held that the remedy under section 362(k) is not available to corporate debtors and instead is limited to debtors who are natural persons. The court suggested that the context in which the term individual is used generally suggests a natural person, not a partnership or a corporation. For example, only an individual with regular income may file a chapter 13 petition. Apparently, Congress intended that only natural persons could use chapter 13 and that partnerships and corporations must generally reorganize under chapter 11. The court also pointed to section 101, which defines relative as an individual related by affinity or consanguinity within the third degree. The court dryly observed that corporations and partnerships are not related by affinity or consanguinity; thus, individual must be limited to a natural person. The court also found that there was no legislative history to suggest that the term individual was intended to refer to a person. Thus, there was no reason to believe that rejection of the broader interpretation would defeat the legislative intent.

Other courts have permitted corporate debtors to take advantage of section 362(k). The leading case in this respect is *Budget Serv. Co. v. Better Homes of Virginia, Inc.*ⁿ³⁰ The court stated that it seems unlikely that Congress meant to give a remedy only to individual debtors against those who willfully violate the automatic stay provisions of the Code as opposed to debtors which are corporations or other like entities. Such a narrow construction of the term would defeat much of the purpose of the section.ⁿ³¹ Thus, the court held that the term individual as used in section 362(k) includes corporate debtors and that the provision gave the bankruptcy court the authority to impose the sanctions.

There is also a split of authority over whether a bankruptcy trustee is an individual for purposes of section 362(k). In *In re Pace*,ⁿ³² the Court of Appeals for the Ninth Circuit read individual narrowly to exclude a trustee because, while the trustee was a natural person, the interest the trustee represented was that of the bankruptcy estate, not a natural person. In *In re Garofalos Finer Foods, Inc.*, the district court rejected the Ninth Circuit's narrow reading of the term individual in favor of a broader definition that would assure that the estate, through the trustee, could recover costs and attorneys fees incurred by the trustee in, among other things, recovering property in the possession of a recalcitrant third party.ⁿ³³

Although the automatic stay is of critical importance in bankruptcy cases, the better approach is to recognize that section 362(k) provides a remedy only for natural persons. The provision was enacted in 1984 as part of a package of consumer amendments intended to deal with individual bankruptcy.ⁿ³⁴ If Congress had intended to provide a damage remedy for all debtors, it could easily have chosen a word other than individual to denominate the beneficiaries of the remedy. In fact, although the standards and procedures for contempt may be slightly more demanding, courts have had little difficulty dealing with and punishing stay violations even without the availability of section 362(k).ⁿ³⁵ There is little reason to adopt a tortured reading of the statute in order to provide corporate or partnership debtors or trustees with a remedy for stay violations.

For a complete discussion of the automatic stay, see Collier on Bankruptcy ch. 362.

Return to Text

n1 1. *In re New Era, Inc.*, 135 F.3d 1206 (7th Cir. 1998) (debtor may not enforce automatic stay to protect estate).

n2

2. *Kalb v. Feuerstein*, 308 U.S. 433, 60 S. Ct. 343, 84 L. Ed. 370 (1940); *Soares v. Brockton Credit Union (In re Soares)*, 107 F.3d 969 (1st Cir. 1997); *In re Schwartz*, 954 F.2d 569, 26 C.B.C.2d 649 (9th Cir. 1992); *Smith v. First America Bank, N.A. (In re Smith)*, 876 F.2d 524 (6th Cir. 1989); *In re 48th Street Steakhouse, Inc.*, 835 F.2d 427, 17 C.B.C.2d 1415 (2d Cir. 1987), cert. denied, 485 U.S. 1035, 108 S. Ct. 1596, 99 L. Ed. 2d 910 (1989); *Morgan Guaranty Trust Co. of New York v. American Sav. & Loan Ass'n*, 804 F.2d 1487 (9th Cir. 1986), cert. denied, 482 U.S. 929, 107 S. Ct. 3213, 96 L. Ed. 2d 700 (1987); *In re Advent Corp.*, 24 B.R. 612 (Bankr. 1st Cir. 1982). An exception may exist in rare cases on equitable grounds. *Matthews v. Rosene*, 739 F.2d 249 (7th Cir. 1989); *In re Albany Partners, Ltd.*, 749 F.2d 670, 12 C.B.C.2d 244 (11th Cir. 1984) (dictum); *In re Smith Corset Shops, Inc.*, 696 F.2d 971, 7 C.B.C.2d 1009 (1st Cir. 1982); *Borg-Warner Acceptance Corp. v. Hall*, 685 F.2d 1306, 7 C.B.C.2d 209 (11th Cir. 1982).

n3

3. *In re Jones*, 63 F.3d 411 (5th Cir. 1995); *Bronson v. United States*, 46 F.3d 1573 (Fed. Cir. 1995); *Easley v. Pettibone Michigan Corp.*, 990 F.2d 905, 911, 28 C.B.C.2d 1002, 1008 (6th Cir. 1993) (actions taken in violation of the stay are invalid and voidable and shall be voided absent limited equitable circumstances); *Job v. Calder (In re Calder)*, 907 F.2d 953, 23 C.B.C.2d 677 (10th Cir. 1990); *Sikes v. Global Marine, Inc.*, 881 F.2d 176 (5th Cir. 1989).

n4

4. *In re Siciliano*, 13 F.3d 748, 30 C.B.C.2d 667 (3d Cir. 1994).

n5

5. *Soares v. Brockton Credit Union (In re Soares)*, 107 F.3d 969 (1st Cir. 1997); *In re Schwartz*, 954 F.2d 569, 26 C.B.C.2d 649 (9th Cir. 1992).

n6

6. *In re Schwartz*, 954 F.2d 569, 26 C.B.C.2d 649 (9th Cir. 1992).

n7

7. *Soares v. Brockton Credit Union (In re Soares)*, 107 F.3d 969 (1st Cir. 1997).

n8

8. *Jove Eng'g, Inc. v. IRS*, 92 F.3d 1539 (11th Cir. 1996); *Mountain Am. Credit Union v. Skinner (In re Skinner)*, 917 F.2d 444 (10th Cir. 1990) (stay violations may be punishable under this subsection, if applicable, or as contempt under 11 U.S.C. § 105).

n9

9. See, e.g., *Hubbard v. Fleet Mortgage Co.*, 810 F.2d 778 (8th Cir. 1987); *In re Xavier's of Beville*, 172 B.R. 667 (Bankr. M.D. Fla. 1994); *In re Fry*, 122 B.R. 427 (Bankr. N.D. Okla. 1990); see also *Fidelity Mortgage Investors v. Camelia Builders, Inc.*, 550 F.2d 47 (2d Cir. 1976), cert. denied, 429 U.S. 1093, 97 S. Ct., 1107, 51 L. Ed. 2d 540, reh'g denied, 430 U.S. 976, 97 S. Ct. 1670, 52 L. Ed. 2d 372 (1977).

n10

10. See *Homer Nat'l Bank v. Namie*, 96 B.R. 652, 654 (W.D. La. 1989); see also *Fidelity Mortgage Investors v. Camelia Builders, Inc.*, 550 F.2d 47 (2d Cir. 1976), cert. denied, 429 U.S. 1093, 97 S. Ct., 1107, 51 L. Ed. 2d 540, reh'g denied, 430 U.S. 976, 97 S. Ct. 1670, 52 L. Ed. 2d 372 (1977).

n11

11. *Vahlsing v. Commercial Union Ins. Co.* 928 F.2d 486, 489 (1st Cir. 1991) (Violation of the stay, is not a strict liability tort.); see also *Smith v. First America Bank, N.A. (In re Smith)*, 876 F.2d 524 (6th Cir. 1989); *In re Smith Corset Shops, Inc.*, 696 F.2d 971, 7 C.B.C.2d 1009 (1st Cir. 1982); *Foreston Coal Int'l, Inc. v. Red Ash Coal & Coke Corp.*, 18 C.B.C.2d 1414, 83 B.R. 399 (W.D. Va. 1988).

n12

12. *In re Wright*, 75 B.R. 414 (M.D. Fla. 1987).

n13

13. See *In re Taylor*, 190 B.R. 459 (Bankr. S.D. Fla. 1995); *Mitchell Constr. Co. v. Smith (In re Smith)*, 180 B.R. 311 (Bankr. N.D. Ga. 1995).

n14

14. 902 F.2d 1098, 1104, 22 C.B.C.2d 1385, 1392-93 (2d Cir. 1990).

n15

15. 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252 (1996).

n16

16. See *Collier on Bankruptcy*, 106.02[2][b].

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17. See *Brown v. Ramsey (In re Ragar)*, 3 F.3d 1174, 29 C.B.C.2d 1005 (8th Cir. 1993) (collecting cases on divergent views of bankruptcy court's contempt power). The Advisory Committee Notes to the 1987 amendments state that the amended *Fed. R. Bankr. P. 9020* recognizes that bankruptcy judges may not have the power to punish for contempt. See also *In re Just Brakes Corporate Sys., Inc.*, 108 F.3d 881 (8th Cir. 1997) (Congress has conferred no power to punish for a violation of § 362(a), other than the punitive damage authority in § 362(h); the court found that the bankruptcy court retains the power to remedy, but not to punish, stay violations).

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18. *Mataya v. Kissinger (In re Kissinger)*, 72 F.3d 107 (9th Cir. 1995); *Mutual Benefit Life Ins. Co. v. Pinetree, Ltd.*, 876 F.2d 34 (5th Cir. 1989); *In re Washtenaw/Huron Inv. Corp. No. 8*, 160 B.R. 74 (E.D. Mich. 1993).

n19

19. See *Collier on Bankruptcy*, 362.07[6][a].

n20

20. 11 U.S.C. § 362(k) has been held to create a private right of action for one damaged by a willful violation of the stay. *Pettitt v. Baker*, 876 F.2d 456 (5th Cir. 1989). An award of damages under 11 U.S.C. §362(k) must have a sufficient factual foundation. *Goichman v. Bloom (In re Bloom)*, 875 F.2d 224 (9th Cir. 1989); *Archer v. Macomb County Bank*, 853 F.2d 497, 19 C.B.C.2d 1279 (6th Cir. 1988) (award of compensatory damages not supported by evidence).

n21

21. *Promower, Inc. v. Scuderi (In re Promower, Inc.)*, 74 B.R. 49 (D. Md. 1987).

n22

22. *Fleet Mortgage Group, Inc. v. Kaneb*, 196 F.3d 265 (1st Cir. 1999); *In re Lansdale Family Restaurants, Inc.*, 977 F.2d 826, 829 (3d Cir. 1992) (act done intentionally with knowledge that bankruptcy petition has been filed is willful violation of stay).

n23

23. *Halas v. Platek*, 239 B.R. 784 (N.D. Ill. 1999) (state court denial of section 362(b) was not *res judicata*).

n24

24. See *Collier on Bankruptcy*, 362.10A.

n25

25. *In re Dawson*, 390 F.3d 1139, 1148 (9th Cir. 2004); *Fleet Mortgage Group, Inc. v. Kaneb*, 196 F.3d 265 (1st Cir. 1999). But see *Aiello v. Providian Fin. Corp.*, 239 F.3d 876 (7th Cir. 2001).

n26

26. 11 U.S.C. § 342(g)(2), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n27

27. See *Mountain Am. Credit Union v. Skinner (In re Skinner)*, 917 F.2d 444 (10th Cir. 1990). It appears that assessment of damages under 11 U.S.C. § 362(k) is a core proceeding. See, e.g., *Budget Serv. Co. v. Better Homes of Virginia, Inc.*, 804 F.2d 289, 15 C.B.C.2d 1025 (4th Cir. 1986).

n28

28. See, e.g., *In re Just Brakes Corporate Sys., Inc.*, 108 F.3d 881 (8th Cir. 1997); *Jove Eng'g, Inc. v. IRS*, 92 F.3d 1539, 36 C.B.C.2d 1270 (11th Cir. 1996); *Environmental Corp. v. Knight (In re Goodman)*, 991 F.2d 613 (9th Cir. 1993).

n29

29. 920 F.2d 183 (2d Cir. 1990).

n30

30. 804 F.2d 289, 15 C.B.C.2d 1025 (4th Cir. 1986); see also *In re Atlantic Business and Community Corp.*, 901 F.2d 325, 22 C.B.C.2d 1176 (3d Cir. 1990).

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31. 804 F.2d 289, 292, 15 C.B.C.2d 1025, 1028.

n32

32. 67 F.3d 187 (9th Cir. 1995) (trustee not an individual).

n33

33. 186 B.R. 414 (E.D. Ill. 1995) (trustee is an individual).

n34

34. Pub. L. No. 98-353, § 304 (1984), *reprinted in* Collier on Bankruptcy, App. Pt. 6(a).

n35

35. *See, e.g., In re Pace*, 67 F.3d 187 (9th Cir. 1995) (although trustee could not recover costs under section 362(h), trustee could recover similarly upon a finding of contempt); *In re Ormond Beach Assocs. Ltd. Partnership*, 185 B.R. 408 (Bankr. D. Conn. 1995).

ABOUT THE AUTHOR(S):

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87 of 197 DOCUMENTS

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Collier on the Disallowance of Interest as of the Petition Date

2008 Emerging Issues 1619

Collier on the Disallowance of Interest as of the Petition Date

By Collier

December 18, 2007

SUMMARY: This Emerging Issues Analysis covers prepaid interest that represents an original discounting of a claim, the operation of section 502(b)(2) as a bankruptcy rule of liquidation, the effect on interest when a debt is found to be nondischargeable, and the operation of section 502(b)(2) as to solvent debtors, secured creditors, and tax claims.

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ARTICLE: *Bankruptcy Code section 502(b)(2)* states the general rule that there is a suspension of the accrual of interest on claims as of the date of the filing of the petition. Section 502(b)(2) provides that a claim is disallowed to the extent that such claim is for unmatured interest. n1 Thus, section 502(b)(2) prohibits payment of postpetition interest on prepetition unsecured claims, including claims for prepetition taxes. n2 Although different methods of considering and computing interest in bankruptcy cases are conceivable, fixing the cutoff point for the accrual of interest as of the date of the filing of the petition is a rule of convenience providing for equity in distribution. This rule combines the advantage of practicability with equality of distribution. To take into account contractual interest would not only entail considerable administrative inconvenience but also violate the equitable principle that the delay in liquidation and subsequent distribution necessitated by the bankruptcy process should result in neither gain nor loss for similarly situated creditors. n3 Interest on debts is to be computed as of the date of the filing of the petition. n4 This policy is clear not only from the sparse, unambiguous statement expressed in section 502(b)(2), but also from the identical comments made by both the House and the Senate Judiciary Committees in the legislative histories of this section. n5

Effect of Disallowance of Interest as of Petition Date. The disallowance of interest as of the petition date has several implications. First, section 502(b) does not provide a mechanism for a creditor to receive postpetition interest at the post-default rate. n6 Additionally, whether interest is considered to be matured or unmatured for the purpose of this section is to be determined without reference to any *ipso facto* bankruptcy clause in the agreement creating the claim. Thus, the mere filing of the petition serves to accelerate the unpaid portion of the debt on the date of the petition. n7 It does not, however, accelerate or allow the accrual of interest that is unmatured as of the date of the filing. Simply stated, the filing of a petition accelerates the principal amount of all unmatured claims against the debtor, whether or not a clause in a prepetition agreement provides that a bankruptcy filing accelerates the maturity date.

Original Issue Discount. Section 502(b)(2) disallows not only postpetition interest not yet due and payable as of the date of the filing, but also prepaid interest representing an original discounting of the claim that was not fully earned on the petition date. Courts, in analyzing these transactions, have considered evidence outside the terms of the document in order to focus on substance over form. n8 Prepaid interest must be prorated and then disallowed to the extent not accrued as of the petition date. Unamortized original issue discount (OID) is unmatured interest within the meaning of section 502(b)(2). n9 However, because unamortized OID on new debt that results from a face value debt-for-debt exchange consists only of the discount carried over from the old debt at the time of the exchange, it is not subject to section 502(b)(2), for that section affects only the old OID. n10 A debt-to-debt face value exchange does not generate original issue discount, and the full face amount of a debt instrument is the proper amount of claim in a bankruptcy case which may not be reduced on the ground that the discount is unmatured interest. n11 The leading and most cited case for the method used to calculate unamortized OID is *In re Chateaugay Corp.*, n12 The *Chateaugay* court found that interest should be calculated under a constant interest method that allows for compounding and is closer to the economic realities of the transaction. n13 The *Chateaugay* court also considered a straight line method for calculating interest that had been adopted by an earlier court, n14 but criticized that court for its lack of analysis on how to prorate interest. n15

Operation of Section 502(b)(2) as Bankruptcy Rule of Liquidation. The principle that interest stops running from the date of the filing of the petition can be viewed as a bankruptcy rule of liquidation rather than as a rule of substantive law. n16 In the overwhelming majority of cases, a final distribution to creditors is far less than even the principal amount owed, let alone the interest thereon. Therefore, disputes over interest are often academic. n17 In liquidating interest-bearing claims, the computation of interest must be made as of some fixed date. Bankruptcy law selects the petition date and disregards, for purposes of the liquidation of the debtors assets, interest accruing beyond that date. This is primarily a technical policy device to cope with the debtors insolvency in the most convenient, equitable and economical way. n18

Interest Continues to Accrue Even If Not Allowable Against Estate. Most courts find that interest continues to accrue on all prepetition debt even if such interest cannot be charged against the estate. This is important in instances where a debt becomes nondischargeable. The effect of the intervening bankruptcy case was merely to delay payment of the interest on the nondischargeable debt and not to relieve that payment. n19 In such a circumstance, since interest continues to accrue, it is unavailing for a codebtor or a guarantor of debtors debt to assert that the debtor's bankruptcy case might relieve them from the obligation of payment of interest on the codebt or guarantee.

Allowance of Interest Where Debtor Is Solvent. In rare cases, estate assets are sufficient to pay interest accrued after the filing date. In these cases, it would seem inappropriate for the trustee to return the surplus assets, after accommodating all creditor claims but without distributing any amount for postpetition interest, to the debtor. n20 Therefore, in these cases, the Code does require that postpetition interest be paid to creditors before distributing the excess assets to the debtor.

Section 726(a), in listing the order of priority of payment from the debtors estate, provides in paragraph (5) for the payment of interest at the legal rate from the date of the filing of the petition on any claim paid under the preceding paragraphs of that section, before any surplus will be returned to the debtor. Thus, under section 726(a), n21 distribution of the property of the estate is first made to the kinds of claims described in section 507 (claims entitled to priority) and then, in order, to timely filed unsecured claims other than priority claims, to tardily filed unsecured claims, to claims for fines, penalties or forfeiture, and finally to creditors for postpetition interest. Only following full

application of this distributive scheme of section 726(a) may any payment at all be made to the debtor under section 726(a)(6). This scheme illustrates that the disallowance of claims for unmatured interest as of the petition date is based on policy and convenience as much as on substantive law. n22

Interest does not survive the debt from which it stemmed; if the debt was extinguished, so was any interest relating to it. n23 Also, when interest is payable because a debtor proves to be solvent, the proper rate of interest is the statutory or legal rate. n24 The purpose for this rule is because allowing a contractual rate over the statutory rate would benefit some creditors over others.

Allowance of Interest to Secured Creditors. Secured creditors are no less affected by the cessation of interest after the filing date than are unsecured creditors. Yet, in some respects they enjoy, by reason of their security, a superior position. A secured creditor whose security is insufficient to cover both the debt and interest may not increase its deficiency claim by applying the proceeds realized from the sale of the security first against interest accrued after the filing date. To that extent, its rights remain similar to those of the unsecured creditor. n25 It has always been a fundamental principle of bankruptcy law, however, that valid liens are not impaired in the administration of the estate. n26 This principle is reflected in section 506(b) of the Code. Consequently, the payment of interest that accrues after the date of the petition is permitted when the security for the debt is sufficient. This is true because the collateral is security for the payment of interest as much as for the payment of the principal debt. n27 When a secured creditor is thus oversecured, however, courts may adjust the interest rate for postpetition interest if the contractual rate is viewed as excessive. n28

There is another historical exception to the rule against allowance of interest, which has not been recognized by all courts and is not explicitly set out in the Code. If a secured creditor possesses collateral of a kind that yields interest, dividends, or other income in the interval between the date of the filing of the petition and the liquidation of the collateral, this income may be applied to the payment of interest on the debt accruing after the date of the filing of the petition. n29

The Bankruptcy Code was amended by the Bankruptcy Reform Act of 1994 to prevent the award of interest on interest (unless contained in the agreement or provided by nonbankruptcy law) and the attendant court contrived windfall to secured creditors at the expense of unsecured creditors in cases in which the debtor's plan proposed to cure a default. n30

Disallowance of Interest on Tax Claims. There is no indication that tax claims, with respect to unmatured interest, are to be treated differently from other claims under the Bankruptcy Code. n31 Thus, interest does not continue to accrue on tax claims.

Tax Claims Not Accorded Distinct Treatment. Before 1949, the custom of treating tax claims differently from the standpoint of interest was accepted by some courts but repudiated by others. In 1949, the matter was settled by the United States Supreme in *City of New York v. Saper*. n32 The Court observed that no section of the 1898 Act even obliquely suggested that postpetition interest would be permitted on tax claims but, rather, that the Bankruptcy Act specifically provided that claims by taxing authorities were to be treated no differently than other claims except for the fact that tax claims were given a priority under Section 64a(4). In thus equating tax claims to other claims on the question of whether postpetition interest would be authorized, the *Saper* case dealt only with an unsecured tax claim. It in no way dealt with or altered the rule giving secured creditors interest to the date of payment when the security was sufficient to cover both principal and interest. n33 As there is nothing in the Code to suggest a rule contrary to that announced by the Supreme Court in *Saper*, it follows that the mere fact that a tax claim is involved does not presuppose the claim will be allowable to the extent it is for unmatured interest, nor that the rule is altered that stops interest from accruing as of the date of the filing of the petition.

Nonconsensual Liens Not Treated Differently from Consensual Liens. Before 1989, some courts drew a distinction between claims secured by a statutory lien and claims involving a specific piece of property given as collateral to secure a debt. n34 Those cases equated lien tax claims with non-lien tax claims and disallowed postpetition interest. n35 Other courts permitted recovery of postpetition interest where the government had a perfected statutory lien on all of the property. n36 The controversy ended with *United States v. Ron Pair Enterprises, Inc.* n37 The Supreme Court, addressing primarily section 506(b), held that there was no significant reason why Congress would have intended, nor any policy reason which would compel, that consensual and nonconsensual liens be treated differently with respect to postpetition interest. n38 Therefore, it is now settled that secured creditors are entitled to receive postpetition interest on oversecured statutory liens as well as on oversecured consensual liens. n39

This principle was further discussed and analyzed in *Rake v. Wade*. n40 In *Rake*, the Supreme Court further held that an oversecured creditor was due both pre- and postconfirmation interest arrearages in a chapter 13 plan.

For a complete discussion of Code chapter 502, see Collier on Bankruptcy, ch. 502.

Return to Text

n1 1. See *In re Republic Fin. Corp.*, 12 C.B.C.2d 646, 47 B.R. 766 (Bankr. N.D. Okla. 1985); *In re Christian*, 8 C.B.C.2d 14, 25 B.R. 438 (Bankr. D.N.M. 1982); *In re Standard Furniture Co.*, 2 C.B.C.2d 274, 3 B.R. 527 (Bankr. S.D. Cal. 1980); see also Blum, *Treatment of Interest on Debtor Obligations in Reorganizations Under the Bankruptcy Code*, 50 U. Chi. L. Rev. 430 (1983); Fortgang & King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. Rev. 1148 (1981). But see *In re Kentucky Lumber Co.*, 860 F.2d 674, 676-77 (6th Cir. 1988) (discussing cases which recognize three nonexclusive exceptions: (1) where the debtor proves solvent; (2) where the collateral produces income postpetition; and (3) where the collateral is sufficient to pay interest as well as the principal of the claim); *In re Twin Parks, Ltd.*, 720 F.2d 1374, 10 C.B.C.2d 564 (4th Cir. 1983) (allowance of interest accruing after the commencement of the case is permissible when the debtor is solvent, the debtors property continues to earn money, or the debt is nondischargeable) (decided under the former Bankruptcy Act).

n2

2. *In re Del Mission Ltd.*, 998 F.2d 756, 29 C.B.C.2d 347 (9th Cir. 1993); *In re Fullmer*, 962 F.2d 1463, 27 C.B.C.2d 92 (10th Cir. 1992) (unmatured interest, including interest accruing postpetition on prepetition tax debt, not allowable); see also *In re Fesco Plastics Corp. Inc.*, 996 F.2d 152, 28 C.B.C.2d 1503 (7th Cir. 1993).

n3

3. *In re Fesco Plastics Corp Inc.*, 996 F.2d 152, 155, 28 C.B.C.2d 1503 (7th Cir. 1993).

n4

4. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 67 S. Ct. 237, 91 L. Ed. 162 (1946), in which the Court said:

Accrual of simple interest on unsecured claims in bankruptcy was prohibited in order that the administrative inconvenience of continuous recomputation of claims could be avoided. The bases for disallowing unmatured interest are concerns pertaining to administrative convenience and fairness to creditors, and collateral estoppel should not apply to prevent actions attempting to enforce such claims.

See also In re Hanna, 872 F.2d 829, 20 C.B.C.2d 1452 (8th Cir. 1989).

n5 5. The relevant legislative history reads as follows:

Paragraph (2) requires disallowance to the extent that the claim is for unmatured interest as of the date of the petition. Whether interest is matured or unmatured on the date of bankruptcy is to be determined without reference to any ipso facto or bankruptcy clause in the agreement creating the claim. Interest disallowed under this paragraph includes postpetition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy. For example, a claim on a \$1,000 note issued the day before bankruptcy would only be allowed to the extent of the cash actually advanced. If the original discount was 10% so that the cash advanced was only \$900, then notwithstanding the face amount of note, only \$900 would be allowed. If \$900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be pro-rated and disallowed to the extent it was for interest after the commencement of the case.

See S. Rep. No. 989, 95th Cong., 2d Sess. 62 (1978), *reprinted in* Collier on Bankruptcy, App. Pt. 4(e)(i); H.R. Rep. No. 595, 95th Cong., 1st Sess. 352 (1977), *reprinted in* Collier on Bankruptcy, App. Pt. 4(d)(i).

n6

6. *In re Southeast Co.*, 868 F.2d 335, 20 C.B.C.2d 1348 (9th Cir. 1989). *See In re Christian*, 8 C.B.C.2d 14, 25 B.R. 438 (Bankr. D.N.M. 1982). *But see In re Moore*, 9 B.C.D. 1246, (Bankr. N.D. Tex. 1982) (the provisions of 11 U.S.C. § 1129(a)(9)(C) should prevail over the general prohibition of 11 U.S.C. § 502(b)(2)). Computation of finance charge rebates using the Rule of 78s method may result in higher interest rates, however, it does not result in an unallowable claim for unmatured interest. *In re Watson*, 9 C.B.C.2d 345, 32 B.R. 491 (Bankr. W.D. Wis. 1983).

n7

7. *In re Allegheny Intl, Inc.*, 100 B.R. 247 (Bankr. W.D. Pa. 1989); *In re Manville Forest Prods. Corp.*, 11 C.B.C.2d 735, 43 B.R. 293 (Bankr. S.D.N.Y. 1984) (long-term debt was automatically accelerated by the filing of the bankruptcy petition regardless of any contractual clause requiring notice to the debtor that acceleration was to occur).

n8

8. *Thrifty Oil Co. v. Bank of Am. Nat'l Trust Sav. Ass'n*, 322 F.3d 1039, 1047 (9th Cir. 2003).

n9

9. *In re Allegheny Int'l, Inc.*, 23 C.B.C.2d 71, 100 B.R. 247 (Bankr. W.D. Pa. 1989).

n10

10. *In re Chateaugay Corp.*, 961 F.2d 378, 26 C.B.C.2d 1174 (2d Cir. 1992); see also *Brown v. Sayyah (In re I.C.H. Corp.)*, 230 B.R. 88 (N.D. Tex. 1999).

n11

11. *In re Pengo Indus., Inc.*, 962 F.2d 543, 27 C.B.C.2d 119 (5th Cir. 1992).

n12

12. 961 F.2d 378, 26 C.B.C.2d 1174 (2d Cir. 1992).

n13

13. 961 F.2d 378, 383.

n14

14. See *In re Allegheny Intl Inc.*, 23 C.B.C.2d 71, 100 B.R. 247 (Bankr. W.D. Pa. 1989).

n15

15. 961 F.2d 378, 384.

n16

16. *Bursch v. Beardsley & Piper*, 971 F.2d 108 (8th Cir. 1992); *In re Hanna*, 872 F.2d 829, 20 C.B.C.2d 1452 (8th Cir. 1989) (because the general rule disallowing unmatured interest is a rule of administrative convenience and fairness to all creditors, when concerns for such convenience and fairness are not present, postpetition interest will be allowed).

n17

17. *Bruning v. United States*, 376 U.S. 358, 84 S. Ct. 906, 11 L. Ed. 2d 772 (1964); *In re John Osbornes Sons & Co., Inc.*, 177 F. 184 (2d Cir. 1910).

n18

18. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 67 S. Ct. 237, 91 L. Ed. 162 (1946).

n19

19. *In re Fullmer*, 962 F.2d 1463, 27 C.B.C.2d 92 (10th Cir. 1992), *revd on other grounds*, *Raleigh v. Illinois Dept of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 43 C.B.C.2d 869 (2000) (interest on prepetition debt nondischargeable, but continues to accrue postpetition and survives as personal obligation of debtor); *Kitrosser v. CIT Group/Factoring, Inc.*, 177 B.R. 458 (S.D.N.Y. 1995); *In re Dow Corning Corp.*, 270 B.R. 393 (Bankr. E.D. Mich. 2001).

n20

20. *See In re Kentucky Lumber Co.*, 860 F.2d 674, 677, 19 C.B.C.2d 1292, 1295 (6th Cir. 1988) ([t]his exception to the general rule helps to prevent [solvent] debtors from abusing the bankruptcy process by merely using it to delay payments and avoid interest penalties); *In re Manville Forest Prods. Corp.*, 11 C.B.C.2d 735, 43 B.R. 293 (Bankr. S.D.N.Y. 1984).

n21

21. As amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), *reprinted in* Collier on Bankruptcy, App. Pt. 9(a).

n22 22. See *Collier on Bankruptcy*, 726.02[5] .

n23

23. See *In re Chiapetta*, 159 B.R. 152 (Bankr. E.D. Pa. 1993) (award of claim is prerequisite to award interest); *In re Churchill*, 109 B.R. 863 (Bankr. S.D. Ill. 1990) (interest must arise from legal basis which gives rise to claim); *In re Nite Lite Inns*, 5 C.B.C.2d 1, 13 B.R. 900 (Bankr. S.D. Cal. 1981) (an allegedly secured creditor was found not to be secured and therefore not entitled to postpetition interest; accordingly, its claim was disallowed under section 502(b)(2)).

n24

24. *Debentureholders Protective Comm. v. Continental Inv. Corp.*, 679 F.2d 264, 271 (1st Cir. 1982).

n25

25. *Sexton v. Dreyfus*, 219 U.S. 339, 31 S. Ct. 256, 55 L. Ed. 244 (1911); *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860 (4th Cir. 1994) (general rule is if creditor is not oversecured, interest stops running on creditor's claim upon bankruptcy filing).

n26

26. *Oppenheimer v. Oldham*, 178 F.2d 386 (5th Cir. 1949); see also *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.* (*In re Timbers of Inwood Forest Assocs., Ltd.*), 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988).

n27

27. *In re Laguna*, 944 F.2d 542, 25 C.B.C.2d 727 (9th Cir. 1991), cert. denied sub nom. *Shearson Lehman Mortgage Corp. v. Laguna*, 503 U.S. 966, 112 S. Ct. 1577, 118 L. Ed. 2d 219 (1992); *Littleton v. Kincaid*, 179 F.2d 386 (4th Cir. 1950).

n28

28. See generally *Collier on Bankruptcy*, 506.05. See, e.g., *Invex Holdings, N.V. v. Equitable Life Ins.* (*In re Invex Holdings, N.V.*), 179 B.R. 111 (N.D. Ind. 1993), aff'd, 27 F.3d 241 (7th Cir.), cert. denied, 513 U.S. 948, 115 S. Ct. 360, 430 L. Ed. 2d (1994) (court did not err in considering all factors relevant to proper interest rate

on mortgagee's notes).

n29

29. See *Sexton v. Dreyfus*, 219 U.S. 339, 31 S. Ct. 256, 55 L. Ed. 244 (1911); see also *In re Jenson*, 980 F.2d 1254, 1259 (9th Cir. 1992) (a secured claim which included postpetition interest earned on funds held pursuant to a prejudgment writ of attachment represented allowable postpetition appreciation of the collateral rather than unmatured interest); *In re Chiapetta*, 159 B.R. 152 (Bankr. E.D. Pa. 1993) (recognizing that interest may be allowable where collateral securing debt produces income after filing of petition). But see *In re Fesco Plastics Corp., Inc.*, 966 F.2d 152, 28 C.B.C.2d 1503 (5th Cir. 1993) (recognizing only two instances in which postpetition interest is paid on prepetition claims: when estate is solvent, permissible under section 726(a)(5), and when secured creditor is oversecured, permissible under section 506(b)).

n30

30. See 11 U.S.C. §§ 1123(d), 1222(d), 1322(e), added by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994, and applicable to agreements entered into after the date of enactment), reprinted in *Collier on Bankruptcy*, App. Pt. 9(a) (legislatively overruling *Rake v. Wade*, 508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424 (1993)); see also Section-by-Section Description of H.R. 5116, 140 Cong. Rec. H10,770 (daily ed. October 4, 1994), reprinted in *Collier on Bankruptcy*, App. Pt. 9(b).

n31

31. 11 U.S.C. § 502(b)(2); *United States v. Victor*, 121 F.3d 1383 (10th Cir. 1997).

n32

32. 336 U.S. 328, 69 S. Ct. 554, 93 L. Ed. 710 (1949).

n33

33. 11 U.S.C. § 502(b); see *Collier on Bankruptcy*, 506.03.

n34

34. Section 101 of the Code defines statutory lien and security interest. See *Collier on Bankruptcy*, ch. 101; see also *United States v. Harrington*, 269 F.2d 719 (4th Cir. 1959); *In re Cameron*, 166 F. Supp. 400 (S.D. Cal.

1958), *aff'd sub nom. United States v. Bass*, 271 F.2d 129 (9th Cir. 1959) (a tax lien was not a specific encumbrance on a specific piece of property in the same sense as a mortgage or a deed of trust); *In re Lykens Hosiery Mills, Inc.*, 141 F. Supp. 895 (S.D.N.Y. 1956). For discussion of the difference between a tax lien and a consensual lien from the standpoint of the allowance of interest, see C. Seligson, *Creditors Rights*, 1958 *Ann. Surv. Am. L.* 426-31 and C. Seligson, *Creditors Rights*, 1959 *Ann. Surv. Am. L.* 375-83.

n35

35. *In re Cameron*, 166 F. Supp. 400-06 (S.D. Cal. 1958).

n36

36. *In re Parchem*, 166 F. Supp. 724 (D. Minn.), *appeal dismissed an stipulation sub nom. United States v. Mussman*, 261 F.2d 839 (8th Cir. 1958).

n37

37. 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 20 C.B.C.2d 267 (1989).

n38

38. 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 20 C.B.C.2d 267 (1989).

n39

39. *In re Schreiber*, 30 C.B.C.2d 1105, 163 B.R. 327 (Bankr. N.D. Ill. 1994) (right of holder (IRS) of unsecured claim to postpetition interest was unqualified).

n40

40. 508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424, 28 C.B.C.2d 983 (1993). The holding in *Rake* was legislatively overruled by Congress with the enactment of section 1322(e). See *Collier on Bankruptcy*, ch. 1322.

ABOUT THE AUTHOR(S):

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88 of 197 DOCUMENTS

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Administrative Expense Priority of Certain Wages, Salaries & Commissions

2008 Emerging Issues 1620

Collier on the Administrative Expense Priority of Certain Wages, Salaries and Commissions

By Collier

December 18, 2007

SUMMARY: This Emerging Issues Analysis covers the priorities that are accorded for postpetition and prepetition wages, wages for employees that are hired by the trustee or the debtor in possession to preserve the estate, and the impact of section 503(b)(1)(A) on vacation pay, severance pay, back pay awards, pension plan obligations, and obligations to indemnify corporate officials.

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ARTICLE: *Bankruptcy Code section 503(b)(1)(A)* makes clear that among the actual necessary costs and expenses of preserving an estate are wages, salaries or commissions for services rendered after the commencement of the case.

The Different Priority Accorded Postpetition and Prepetition Wages. The distinction between prepetition and postpetition wages should be kept in mind. Those expenses for wages, salaries or commissions incurred postpetition in an effort to preserve the estate or operate the debtors business can qualify as administrative expenses. Those incurred prior to the filing of the petition are not. Courts have emphasized that for employment compensation to receive administrative priority, the services must be rendered *after* commencement of the bankruptcy case. n1

Wage claims are entitled to a second priority by section 507(a)(2) to the extent they are administrative expense claims. A different priority is given by section 507 to prepetition unsecured claims for wages, salaries or commissions earned within 180 days before the filing of the petition. Such prepetition claims are accorded a fourth priority under section 507(a)(4). n2 Section 507(a)(4) of the Code grants a fourth priority to allowed unsecured claims for wages, salaries, or commissions, including vacation, severance, and sick leave pay¹ earned within 180 days before the petition, but limits such priority claims to \$10,950. n3 Wage claims not falling in one of these priorities are general unsecured claims against the debtor.

Employees Hired by Trustee or Debtor in Possession. If necessary to preserve the estate, the trustee or debtor in possession may hire employees to operate and manage the debtors business. Employees may include the debtors former personnel or the individual debtor. In the case of a sole proprietorship operating under chapter 11, the individual debtor may draw a salary in the ordinary course of business, subject to the general requirements of section 503(b)(1)(A). n4 The expenses for the compensation to such employees are expressly entitled to priority under section 503(b)(1)(A) as an actual, necessary cost and expense of preserving the estate. The employment of people by a trustee or debtor in

possession may prove a necessary step even in the process of a liquidation under chapter 7. But such employment will be subject to extensive scrutiny. It should be borne in mind that although a prepetition wage claim entitled to priority is limited in amount, there is no inherent restriction on compensation for services of employees rendered to a trustee after the institution of the proceedings by the filing of a petition, and therefore compensation obligations should be incurred carefully. In one case, the court denied administrative claims for bonuses asserted by certain of the debtors postpetition employees because, although the services were rendered postpetition, the employees did not meet their burden of proving that their bonus payments were necessary to preserve the estate.ⁿ⁵ In particular, the court stated that there should have been testimony to support findings as to whether the Employees would have rendered the necessary services without the bonuses, and, if not, whether others could have been found to do the work at a lesser cost.ⁿ⁶

Vacation Pay. Among the most difficult questions relating to the reach of the priority given by section 503(b)(1)(A) are those involving claims for vacation and severance pay by employees of the debtor who were discharged at some point during the administration of the case. The courts seem to have had less difficulty with the rules regarding vacation pay. The general rule seems to be that originally set forth by the Second Circuit under the Bankruptcy Act in *Straus-Duparquet, Inc. v. International Brotherhood of Electrical Workers*.ⁿ⁷ In that case, the debtors employees were employed for about a month after the bankruptcy petition was filed and were then discharged. The employees asserted claims for the Bankruptcy Act equivalent of an administrative priority expense for vacation pay in accordance with the terms of a collective bargaining agreement. The court allowed an administrative expense priority but only to the extent of the proportionate part of total vacation pay earned during the period from the beginning of the bankruptcy case to the date of termination of employment. This approach has generally been followed in cases under the Bankruptcy Code.ⁿ⁸

Severance Pay. A business enterprise operating after bankruptcy may find it necessary to offer severance pay or another form of employee retention program to keep employees from leaving the business. Payments under a severance program established after the commencement of the case ought certainly to qualify as administrative expenses. Because such a program is unlikely to be in the ordinary course of the companys postpetition business, adoption would require court approval,ⁿ⁹ or at least notice and a hearing under section 363(b).

Whether severance pay based on a prepetition severance program qualifies as an administrative expense has been the subject of many cases. In *Lines v. Syustem Board (In re Health Maintenance Foundation)*,ⁿ¹⁰ the Ninth Circuit Court of Appeals noted that there are two general types of severance pay. The first is a payment at termination in lieu of advance notice of termination.ⁿ¹¹ The second is a payment at termination based on length of employment. The first type of severance is generally accorded administrative priority status. The latter, at issue in *Health Maintenance Foundation*, was considered by the Ninth Circuit as not qualifying for administrative expense status. Such benefits, it reasoned, were earned prior to the bankruptcy filing. The only benefits that could receive administrative expense status are those, if any, earned after the commencement of the case. The Ninth Circuit view seems to be the majority view.ⁿ¹² There have, however, been other approaches adopted by various courts.ⁿ¹³ In particular, the Second Circuit Court of Appeals has held that severance pay is compensation for termination and is entitled to administrative expense status in full.ⁿ¹⁴

Back Pay Awards. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act) added clause (ii) to section 503(b)(1)(A) to provide that certain back pay awards qualify as administrative expenses.ⁿ¹⁵ To qualify, the award must consist of wages or benefits awarded pursuant to a judicial proceeding or a proceeding of the National Labor Relations Board. The back pay must be attributable to a period of time occurring after the commencement of the case as a result of a violation of federal or state law by the debtor. It does not matter when the conduct on which the award is based began or whether any services were rendered. Accordingly, if a judicial or NLRB award of back pay spans a period covering conduct occurring both prepetition and postpetition based on employer conduct commencing during the prepetition period, the postpetition portion would qualify as an administrative expense. The language added by the 2005 Act contains a qualification that mitigates the impact of such an award that will be primarily applicable in chapter 11 cases. In order for the back pay claim to be accorded administrative priority, the court must find that payment of such wages and benefits will not substantially increase the probability of layoff or termination

of current employees or of nonpayment of domestic support obligations. This process probably will often involve a two-stage process. A court may be asked to make such a finding at the time that the back pay award is granted. If the outcome of the case is too uncertain for the court to make such a finding, it should not mean that administrative expense status should be denied. Rather, the court should defer the matter until plan confirmation at which time a final determination can be made in light of the outcome of the chapter 11 case.

Pension Plan Obligations. A priority wage issue involving the termination of employees arises from claims for withdrawal liability from a multiemployer pension plan established pursuant to the Employees Retirement Income Security Act of 1974 (ERISA), as amended by the Multiemployer Pension Plan Amendments Act of 1980. Under ERISA, when an employer withdraws from a multiemployer plan, its withdrawal liability is based on its allocable portion of the unfunded vested benefits for the plan. n16 The issue of whether and to what extent withdrawal liability should be accorded an administrative priority has been answered differently in the cases, but most cases allow administrative status for only that portion of the withdrawal liability which relates to the postpetition labor of the debtors employees. In *In re Cott Corp.*, n17 the court devised a method of dividing the withdrawal liability into prepetition and postpetition amounts and then accorded the postpetition withdrawal liability priority status under section 503(b)(1)(A). n18 In the case of *In re United Department Stores, Inc.* n19 the court held that withdrawal liability would not be given administrative expense priority because that would have the undesirable effect of benefitting other employer-participants in the plan who are not creditors of the debtor ahead of the debtors bona fide creditors. n20

A related issue is the extent to which claims arising from the postpetition termination of a pension plan give rise to an administrative expense claim in favor of the Pension Benefit Guaranty Corporation (PBGC). In *Pension Benefit Guaranty Corp. v. Skeen (In re Bayly Corp.)*, the Court of Appeals for the Tenth Circuit held that a claim by the PBGC for unfunded benefit liabilities based on benefits accrued by employees prior to filing a case was not incurred by the bankruptcy estate and not entitled to administrative priority. n21 In *Pension Benefit Guaranty Corp. v. Sunarhauserman, Inc. (In re Sunarhauserman, Inc.)*, n22 the PBGC argued that all ERISA minimum funding contributions accrued after commencement of the case ought to be entitled to administrative priority status. It reasoned that such contributions were a requirement of continuing to do business and thus were like other regulatory costs of continuing to operate a business. The Sixth Circuit Court of Appeals disagreed. It limited administrative expense priority to that portion of the minimum funding contribution attributable to pension benefits actually earned by the debtors employees who worked after commencement of the case. n23

Obligations to Indemnify Corporate Officials. Pursuant to corporate bylaws or contractual provisions, corporate officials may be entitled to indemnity from a debtor corporation for costs incurred in acting for the corporation, such as by personally defending a lawsuit. Courts have treated these rights as similar to administrative expense claims for wages. For example, courts have denied administrative expense priority to corporate officials seeking indemnification under the corporate bylaws when the acts or services which gave rise to the claims occurred prepetition. In contrast, when the acts or services requiring indemnification occurred postpetition, indemnification has been granted administrative expense status. n24 One court held that section 503(b)(1)(A) does not permit corporate debtors to advance, as administrative expenses, attorneys fees of their former officers and directors for the defense of actions against them alleging misconduct, even though indemnification provisions are contained in the debtors bylaws. n25 Section 503(b)(1)(A) may permit corporate debtors to advance such fees to current directors on a sufficient showing that the current directors services are necessary and beneficial to the estate and that the directors willingness to serve is expressly contingent upon payment of such fees. n26

For a complete discussion of Code section 503, see Collier on Bankruptcy, ch. 503.

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Return to Text

n1 1. See *In re Continental Airlines, Inc.*, 148 B.R. 207 (D. Del. 1992) (court denied administrative expense status for award of back pay under National Labor Relations Act constructively earned postpetition, because unlike with general administrative claims, Congress was quite specific about which wage claims were to receive administrative priority and made it clear that the only wages which were to be given priority under section 503(b)(1)(A) were those for services rendered post-petition); *In re Palau Corp.*, 139 B.R. 942 (B.A.P. 9th Cir. 1992), *aff'd*, 18 F.3d 746, 30 C.B.C.2d 1204 (9th Cir. 1994) (same); see also *In re La Electronica, Inc.*, 995 F.2d 320 (1st Cir. 1993); *In re Beverage Enters., Inc.*, 225 B.R. 111 (Bankr. E.D. Pa. 1998) (WARN Act claims entitled to administrative expense priority).

n2

2. See *Collier on Bankruptcy*, 507.05.

n3

3. This dollar amount is effective for cases commenced on or after April 1, 2007. The 2005 Act had set the amount at \$10,000, effective in cases commenced on or after April 20, 2005, the enactment date of the 2005 Act. Pub. L. No. 109-8, §§ 1401(2), 1406 (2005). Pursuant to 11 U.S.C. § 104(b), the amount is adjusted every three years to account for changes in the cost of living. See *Collier on Bankruptcy*, 104.03. For cases commenced between April 1, 2004, and April 19, 2005, the dollar amount was \$4,925. For cases commenced during the three-year period beginning April 1, 2001, the amount was \$4,650. The amount for the three-year period beginning April 1, 1998, was \$4,300. For cases commenced before April 1, 1998, the amount in effect was \$4,000.

n4

4. *In re Herberman*, 24 C.B.C.2d 1105, 122 B.R. 273 (Bankr. W.D. Tex. 1990).

n5

5. *In re Regensteiner Printing Co.*, 122 B.R. 323, 326 (N.D. Ill. 1990).

n6

6. *In re Regensteiner Printing Co.*, 122 B.R. 323, 326; see also *In re Bartley Lindsay Co.*, 137 B.R. 305 (D. Minn. 1991) (consultants fee for postpetition service, which totaled over \$244,000 according to a prepetition agreement, was reduced to \$60,000 because the consultant was entitled to compensation only for the actual and necessary services he provided); *In re Baldwin-United Corp.*, 13 C.B.C.2d 709, 52 B.R. 549 (Bankr. S.D. Ohio 1985) (claims based on prepetition stock option plan are not analogous to wages or severance pay and are thus not allowable as administrative claims).

n7

7. 386 F.2d 649 (2d Cir. 1967).

n8

8. *In re Schatz Fed. Bearings Co.*, 2 C.B.C.2d 624, 5 B.R. 549 (Bankr. S.D.N.Y. 1980).

n9

9. See *Bagus v. Clark (In re Buyer's Club Markets, Inc.)*, 5 F.3d 455, 29 C.B.C.2d 1295 (10th Cir. 1993) (denying administrative expense status to severance pay claims based on a severance program adopted by a chapter 11 debtor without court approval).

n10

10. 680 F.2d 619 (9th Cir. 1982).

n11

11. See *In re Tucson Yellow Cab Co.*, 789 F.2d 701 (9th Cir. 1986) (collective bargaining agreement required employer to provide either two weeks notice of layoffs of two weeks severance pay; severance pay upheld as administrative expense).

n12

12. The same reasoning has been used in *Lasky v. Phones for All, Inc. (In re Phones for All, Inc.)*, 288 F.3d 730 (5th Cir. 2002); *In re Commercial Fin. Servs.*, 246 F.3d 1291 (10th Cir. 2001); *In re Roth American, Inc.*, 975 F.2d 957 (3d Cir. 1992); *In re Mammoth Mart, Inc.*, 536 F.2d 950 (1st Cir. 1976); *Rawson Food Servs. Inc. v. Creditors Committee*, 67 B.R. 351 (M.D. Fla. 1986); *In re Public Ledger, Inc.*, 161 F.2d 762 (3d Cir. 1947);

In re M Group, Inc., 268 B.R. 896 (Bankr. D. Del. 2001) (denying priority for severance provision not falling into either category, but due in fixed amount whenever employment contract terminated); *In re Yarn Liquidation, Inc.*, 217 B.R. 544 (Bankr. E.D. Tenn. 1997); *In re Northwest Eng'g Co.*, 11 C.B.C.2d 831, 43 B.R. 603 (Bankr. E.D. Wis. 1984).

n13

13. *In re Uly-Pak, Inc.*, 24 C.B.C.2d 1989, 128 B.R. 763 (Bankr. S.D. Ill. 1991) (there are more than simply two categories of severance pay and rather than forcing a claim into one category or another, court should focus on whether the severance claim arises from a postpetition transaction with, or is beneficial to, the estate).

n14

14. *Straus-Duparquet, Inc. v. Local Union No. 3, Int'l Bd. of Elec. Workers*, 386 F.2d 649 (2d Cir. 1967) (full amount of severance pay due as administrative expense upon termination). The Second Circuit reiterated this holding in *Rodman v. Rinier (In re W.T. Grant Co.)*, 620 F.2d 319 (2d Cir.), cert. denied, 446 U.S. 983, 100 S. Ct. 2963, 64 L. Ed. 2d 839 (1980). See also *In re Campo Electronics, Inc.*, 247 B.R. 646 (E.D. La. 1998) (severance pay is an administrative expense where persons employment contract was entered into shortly before bankruptcy and as an inducement to continue employment with debtor).

n15

15. Pub. L. No. 109-8, § 329 (2005), effective in cases commenced on or after October 17, 2005.

n16

16. 29 U.S.C. §§ 1381, 1391.

n17

17. 12 C.B.C.2d 735, 47 B.R. 487 (Bankr. D. Conn. 1984).

n18

18. 12 C.B.C.2d 735, 743-45.

n19

19. 12 C.B.C.2d 1424, 1429, 49 B.R. 462, 466 (Bankr. S.D.N.Y. 1985).

n20

20. See *In re Kessler*, 23 B.R. 722 (Bankr. S.D.N.Y. 1982).

n21

21. 163 F.3d 1205 (10th Cir. 1998).

n22

22. 126 F.3d 811 (6th Cir. 1997).

n23

23. See also *Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc.*, 789 F.2d 98 (2d Cir. 1986) (the consideration supporting employers lump sum payment in satisfaction of its withdrawal liability was the past labor of the employees; thus, administrative priority was denied); *LTV Corp. v. PBGC (In re Chateaugay Corp.)*, 130 B.R. 690 (S.D.N.Y. 1991), vacated, 1993 WL 388809 (rejecting argument that statutory obligations arising from postpetition termination of pension plan were entitled to administrative status, and holding that retirees were not induced to provide postpetition services by the promise of pension benefits; only pension liabilities arising from postpetition labor of employees were entitled to administrative priority); *Columbia Packing Co. v. PBGC*, 81 B.R. 205 (D. Mass. 1988) (debtors obligation for contributions to employee pension fund entitled to administrative priority to the extent it arises from services rendered after the commencement of the case); *In re Pulaski Highway Express, Inc.*, 14 C.B.C.2d 417, 57 B.R. 502 (Bankr. M.D. Tenn. 1986); *In re Silver Wheel Freightlines, Inc.*, 14 C.B.C.2d 328, 57 B.R. 476 (Bankr. D. Or. 1985).

n24

24. See *In re Mid-American Waste Systems, Inc.*, 228 B.R. 816 (Bankr. D. Del. 1999) (denying administrative expense to indemnification claim of former officers and directors incurred in litigation arising out of prepetition activities); *In re Hecks Properties, Inc.*, 151 B.R. 739 (S.D. W. Va. 1992) (citing cases).

n25

25. *In re Baldwin-United Corp.*, 11 C.B.C.2d 1391, 43 B.R. 443 (S.D. Ohio 1984).

n26

26. See *In re Hecks Properties, Inc.*, 151 B.R. 739 (S.D. W. Va. 1992) (section 503(b)(1)(A) priority allowed for costs of indemnifying current officers and directors); *In re Consolidated Oil & Gas, Inc.*, 22 C.B.C.2d 1423 (Bankr. D. Colo. 1990).

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89 of 197 DOCUMENTS

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Collier on the Limitation of Key Employee Retention Plans

2008 Emerging Issues 1621

Collier on the Limitation of Key Employee Retention Plans

By Collier

December 18, 2007

SUMMARY: This Emerging Issues Analysis covers the scope of section 503(c), the test for the narrow exception to the operation of section 503(c), the limitation on severance payments, the limitation on payments outside the ordinary course of business, and the likely consequences of section 503(b) on employment contracts and business cases.

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ARTICLE: *Bankruptcy Code section 503(c)* was enacted in 2005. n1 Its purpose was to limit the scope of key employee retention plans and other programs providing incentives to management of the debtor as a means of inducing management to remain employed by the debtor. Section 503(c) covers three general areas. First, it prohibits payments to insiders to induce those insiders to remain with the debtors business. Second, it limits severance payments to insiders. Finally, it limits any transaction outside the ordinary course of business, especially those that benefit officers, managers, and consultants hired after the date of the filing of the petition. The language of section 503(c) is not well drafted, and it is difficult to discern the scope of the exceptions to the restrictions placed on insider retention and severance payments. Those exceptions seem to be so narrowly drawn, however, that very few insider retention or severance plans will meet the necessary qualifications. The result is that these plans are likely to be eliminated as a common feature of chapter 11 cases.

Limitation on Retention Payments. Section 503(c)(1) limits transfers made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtors business. A narrow exception can arise if the court finds, based on evidence in the record, that three tests have been satisfied.

The first test is that the transfer or obligation is necessary to retain the insider because the insider has a bona fide job offer from another business at the same or a greater rate of compensation. The test will not be met if the person merely threatens to quit or to retire. The person must have received a legitimate job offer at an equal or higher rate of compensation. The reference is to compensation rather than salary and so all components of compensation can be taken into account, including benefits and the potential for incentive compensation. The latter point might be important if a large portion of the compensation consists of commissions, incentive pay, stock options or other contingent forms of compensation.

The second test is that the services provided by the insider are essential to the survival of the business. Unlike the

other two tests, this one is largely subjective. The reference to survival suggests, however, that the person seeking to justify such a payment will have a heavy burden. The moving party will not merely need to show that the insiders continued retention is valuable or beneficial to creditors. Rather, the moving party must show that continued employment is necessary for the business to survive. As a practical matter, this will be a nearly impossible standard to meet for companies that are not founder dominated and that are run by professional managers.

The third test sets a limit on the amount of the payment or obligation. The amount of the transfer or obligation cannot be greater than 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation incurred. If no such similar transfers were made or obligations incurred regarding nonmanagement employees during such calendar year, the amount of the transfer or obligation cannot be greater than 25 percent of the amount of any similar transfer made or obligation incurred for the benefit of such insider for any purpose during the previous calendar year. The reference to a similar kind and any similar transfers suggests that the transfers or obligations against which the proposed award is to be measured are earlier awards that are in the nature of retention payments. The reference to for any purpose probably refers to all programs regarding retention of employees, even though it is not likely that any company would have more than one such program in effect during any year. The language of section 503(c)(1)(C) can probably be simplified as follows: If a retention program is put in place during a calendar year that covers nonmanagement employees, the amount awarded to the insider cannot be greater than 10 times the mean award to nonmanagement employees. If no such program for nonmanagement employees is in effect, the award to the insider cannot exceed 25 percent of any retention award granted to the insider during the previous year. If no retention program existed during such previous calendar year, then the third test cannot be satisfied. Every clause of section 503(c)(1)(C) awkwardly refers to both the making of a transfer and the incurring of an obligation. Since a transfer will not be made unless an obligation has previously been incurred, this could be interpreted to mean that the tests have to be met at both the time that the obligation is incurred and then again at the time that the transfer is made. This would lead to an absurd result, however. In the unlikely event that a retention program for an insider ever qualified under section 503(c)(1)(C), it would be unfair to the insider to eliminate the retention award after it has been earned because it then failed to meet a subsequent application of the same test. Also, the first two portions of the test can be fulfilled at the time a retention program is enacted but they seemingly could never be met at the time that the retention payment would become due to the insider.

Limitation on Severance Payments. Section 503(c)(2) prohibits severance payments to an insider of the debtor unless two tests are satisfied. First, the payment must be part of a program that is generally applicable to all full-time employees. This requirement at first appears extremely difficult to fulfill in a debtor of any size. It is a rare severance plan that will apply to all full-time employees of a large company. For example, employees covered by collective bargaining agreements are likely to be covered by a different severance plan than management employees. The purpose of the limitation, however, is to ensure that the insider severance is not specially created for those insiders and that a severance program is in effect for all full-time employees. Accordingly, it would make sense to interpret the reference to a severance program to mean a series of plans so long as the series covers all full-time employees of the debtor. The second requirement is that the amount of the payment to the insider is not greater than ten times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made. If read literally, the requirement would preclude any payment of severance to an insider until the end of the calendar year in which the insiders employment is terminated. Only at the end of the year would it be possible to know the mean severance pay given to nonmanagement employees during the year. Courts may perhaps interpret the language to mean the period then elapsed during the calendar year. This could lead to anomalies, however, if the layoffs occur during the early part of the year. The language also makes no distinction between the period before and the period after filing of the petition. Accordingly, both prebankruptcy and postbankruptcy layoffs will need to be taken into account if the payment to the insider is proposed to be made during the year in which the petition is filed. It should also be noted that the language refers to the amount given to nonmanagement employees. This indicates that the calculation will be made with respect to the actual amount paid as severance to such employees as opposed to a calculation based on the mean payment for which employees are eligible. If the layoffs on which the calculation is based involves low salaried employees, the cap on insider severance will be quite small.

Section 503(c)(2) does not distinguish between severance programs enacted before bankruptcy and those enacted after the commencement of the case. Therefore, it would probably limit severance payments to insiders under programs that are in place before bankruptcy and either assumed or followed during the bankruptcy case. It is not clear, however, whether it would apply to a payment that is in the nature of severance but that arises under an employment contract rather than a severance plan. If a corporate officer is entitled to a payment upon the officer's departure based on a clause in the officer's employment contract, such a payment can be viewed as severance but it can also be viewed as a damages claim for the debtor's failure to fulfill the contract. When assumption of a prepetition employment contract is under consideration, the impact of section 503(c)(2) on any severance provisions will need to be considered.

Limitation on Payments Outside the Ordinary Course of Business. Section 503(c)(3) prohibits transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition. Section 503(c)(3) is a catch all provision but one that is much narrower than would first appear. It prohibits administrative expense status to any obligation that is both outside the ordinary course of business and not justified by the facts and circumstances of the case. If a transaction is entered into in the ordinary course of the debtor's business, it would not be proscribed by section 503(c). If it is outside the ordinary course of business, but is nonetheless justified by the facts and circumstances of the case, it would likewise not be proscribed by section 503(c)(3). Section 503(c)(3) will thus have limited applicability. This test does not seem any narrower than the test that already exists under section 503(b)(1) which requires that administrative expenses be actual, necessary costs and expenses of preserving the estate. A transaction qualifying under that test is likely to also qualify under the test imposed by section 503(c)(3). The reference in section 503(c)(3) to officers, managers, or consultants hired after the date of the filing of the petition is largely surplusage. The rules of construction in section 102(c) indicate that the term including is not a limitation. Accordingly, section 503(c)(3) is not limited to such persons and is a general restriction on postpetition transactions. If a transaction with any such person is within the ordinary course of business, such transaction is not implicated by the beginning language of section 503(c)(3). If any such transaction is outside the scope of the ordinary course of business, court approval would be necessary in any event and the standard for approval to be employed under section 503(c)(3) is unlikely to be much different than the standard for approval that would otherwise be applied by the court. If the intent behind section 503(c)(3) was to provide special limitations on postpetition employment of officers, managers and consultants, that intent may not have been achieved.

The Effect of Section 503(c) on Business Cases. The narrow scope of subsections 503(c)(1) and (c)(2) will basically result in the elimination of programs that provide compensation to officers for remaining employed with the debtor or that provide severance when such persons leave. The elimination of such programs will have consequences that are difficult to predict. In order to prevent the loss of managers that are necessary to deliver a successful outcome, different methods of inducing those managers to remain with the debtor will need to be found. One likely consequence is that employment contracts will get richer. Nothing in section 503(c) limits the amount of salary, bonus or incentive compensation to be paid to managers unless such compensation is both outside the ordinary course of business and not justified by the facts and circumstances of the case. The latter language is subjective and allows the court to approve all manner of compensation arrangements deemed to be justified. Thus, while severance payments and retention payments to insiders are likely to disappear from chapter 11 cases, they will probably be replaced by richer employment contracts that are designed to achieve the same goals as retention and severance programs but award compensation through different mechanisms. Another likely consequence is that the key individuals will serve as consultants or advisors rather than officers and thus avoid fitting within the definition of insider.

For a complete discussion of Code section 503, see Collier on Bankruptcy, ch. 503.

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n1 1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 331 (2005), effective in cases commenced on or after October 17, 2005.

ABOUT THE AUTHOR(S):

Collier on Bankruptcy. This Emerging Issues Analysis was adapted from material appearing in *Collier on Bankruptcy* (Matthew Bender). Written and edited by leading scholars and practitioners, *Collier on Bankruptcy* is the preeminent treatise in the bankruptcy field. Long recognized as the most authoritative and comprehensive single source of bankruptcy law information, and available both in print and online, *Collier* is an indispensable resource for any firm with a substantial bankruptcy practice. Cited in hundreds of opinions each year, *Collier* is a benchmark authority. For more information on *Collier on Bankruptcy*, consult the online LexisNexis bookstore.

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90 of 197 DOCUMENTS

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Priority Status for Wages Earned Within 180 Days Before Filing the Petition

2008 Emerging Issues 1622

Collier on the Priority Status for Wages Earned Within 180 Days Before Filing the Petition

By Collier

December 18, 2007

SUMMARY: This Emerging Issues Analysis covers the purpose of this fourth priority, the scope of the fourth priority, who may assert the fourth priority, when fourth priority claims may be assigned, the applicable time period for the operation of the fourth priority, and the impact of section 507(a)(4) on vacation pay, severance benefits, and payments due as a result of the Worker Adjustment and Retraining Notification Act.

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ARTICLE: A fourth priority is available under *Bankruptcy Code section 507(a)(4)* for allowed unsecured claims for wages, salaries and commissions, including vacation, severance and sick leave pay earned by an individual. n1 It is also available for sales commissions earned by an individual, or a corporation with only one employee, acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the debtors business if, and only if, during the 12 months preceding that date at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the debtor. The third priority is available only for wages, salaries and commissions earned within 180 days before the earlier of the date of the filing of the petition or the date the debtor ceased business. n2 The maximum dollar limit on the priority is \$10,950 for each individual and corporation. n3 Any excess claim for wages, salaries and commissions will be a general unsecured claim.

Purpose of the Fourth Priority. A priority for wages was included as part of the Bankruptcy Act upon its original enactment in 1898 and has been a feature of the bankruptcy law since that time. The purpose of allowing a priority for wages is to alleviate hardship on workers who lose their jobs or part of their salary by bankruptcy. Employees are usually the hardest hit financially by a bankruptcy because the debtor/employer is typically the only source of income for the employees. When a debtor fails to pay debts to its other creditors, those creditors presumably have other sources of income and do not rely on the debtor as their sole source of income. Another distinction is that other creditors presumably knowingly extended credit to the debtor. Employees do not typically view themselves as extending credit by waiting for their paychecks. One additional purpose of the wage priority is to encourage employees to stand by an employer in financial difficulty. Still another advantage of the wage priority is one not cited by the legislative history or explicitly recognized by cases in which the scope of the priority has been litigated. Because wages are priority claims, courts have often permitted debtors to pay prepetition wage claims in the ordinary course in response to a motion filed by a debtor in possession at the commencement of a chapter 11 case. The ability to ensure that the employees receive

their unpaid prepetition salary and do not miss a paycheck is critical to obtaining the stability necessary for the transition to operating as a debtor in possession. If wage claims were not entitled to priority, it would be difficult to justify first day orders approving payment of prepetition wages. There is no clear statutory authority for such first day orders, although a court with some confidence in the debtors ability to satisfy claims through the third priority could justify the order under section 105.

Scope of Fourth Priority. The fourth priority is available for wages, salaries and commissions earned by an employee within the applicable 180-day period. n4 The scope of the priority covers all types of wages, however they may be denominated in the contract between the debtor and the employee. It includes regular salaries, whether the employee is paid by the hour, the week or the month. It covers bonuses so long as the bonus is in the nature of compensation for work performed. n5 It also extends to piecework for employees who are paid by what they produce rather than by the time spent working. The priority also encompasses all types of commissions, however they may be calculated. In addition to salary and commissions, the priority under section 507(a)(4) also extends to certain benefits that are considered akin to compensation, such as vacation, severance and sick leave pay. n6 It does not extend to other fringe benefits or other perks of employment. It also does not extend to obligations that may be related to employment, but that are not referred to in the language of section 507(a)(4). n7 Most notable among these are payments owed with regard to workers compensation benefits. These have uniformly been held to be outside the scope of section 507(a)(4). n8

Who May Assert Fourth Priority. By its terms, the priority under section 507(a)(4) is, with one exception, available only to individuals. It may not be asserted for wages, salaries or commissions owed to a corporation, partnership or association. n9 The one exception is that a corporation with only one employee may be eligible to receive a priority for commissions if it qualifies as an independent contractor under the language of section 507(a)(4)(B).

Employees of Debtors. The priority may be asserted by any individual who is an employee of the debtor. It is not limited to subordinate employees and may be asserted by employees who also happen to be officers, directors, stockholders or partners. n10 An employee seeking a priority for wages or salary must be a direct employee of the debtor and have a direct claim against the debtor arising from such employment. n11 In determining whether an individual is an employee of the debtor, the court should look to state law. n12

Independent Contractor Commissions. Prior to the Bankruptcy Reform Act of 1994, there was a split among the courts as to whether commissions owed to an independent contractor working for the debtor qualified for a section 507(a)(4) priority. n13 The Bankruptcy Reform Act of 1994 ended the dispute by creating a new clause (B) to section 507(a)(4) providing that commissions owed to independent contractors are eligible for priority if certain conditions are met. For commissions owed to independent contractors to qualify for priority, the independent contractor must have been acting as such for the debtor with regard to the sale of goods or services in the ordinary course of the debtors business. In addition, during the 12 months preceding the earlier of the date of the filing of the petition or the cessation of the debtors business, the independent contractor must have earned from the debtor at least 75 percent of the total amount earned by such independent contractor from the sale of goods or services. Commissions owed to independent contractors are also subject to the general rules governing priority under section 507(a)(4). They must be earned within the applicable 180-day period n14 and cannot exceed the maximum dollar limitation.

Assigned Fourth Priority Claims. There is nothing that prohibits an employee from assigning a fourth priority claim to another person, and an assignee may assert a priority claim obtained from an employee. n15 Only an assigned claim may be asserted, however. If an entity succeeds to the rights of the debtor through subrogation, section 507(d) prohibits the subrogee from obtaining the benefit of the priority claim. n16 It has been held that a grocery store that cashed payroll checks of the debtor that were subsequently dishonored is an assignee of the employees wage priority claims and entitled to assert the priority. n17 The same result did not apply when the debtors bank cashed payroll checks that the debtor had insufficient funds to cover; rather than being an assignee of the employees, the bank was held to have extended credit to the debtor by honoring the overdraft. n18

Numerous attempts have been made on behalf of employment agencies to assert priority claims for wages paid to individuals furnished to the debtor by the employment agencies. While each situation needs to be evaluated on its own merits, these assertions typically fail. n19 If the individual is working for the debtor and receives payment directly from the debtor, wages owed to the individual obviously qualify for priority and there is no issue. If the individual receives payment from the agency, however, and the agency collects from the debtor, the employees do not belong to the debtor and the agency's status is the same as any other contractual vendor of services to the debtor.

Applicable 180-Day Period. A claim is entitled to priority under section 507(a)(4) only if earned during the 180 days prior to the earlier of the filing of the petition or the cessation of the debtors business. n20 The reason that cessation of the business is used as an alternative measuring date is to protect the wage priority of employees if the debtor shuts down its business but delays the filing of a bankruptcy case. The 180-day priority period is the same as the 180-day priority period provided under the fifth priority for contributions to employee benefit plans.

In order for cessation of the business to be used as a measuring date, the debtor must cease business altogether. It is not enough that the debtor shut down the division or line of business that employed a particular employee. n21 The standard for determining when to use cessation of the business as the measuring date is the same as under the fifth priority for contributions to employee benefit plans. Cases under the fifth priority analyzing when cessation is considered to have occurred are relevant to the same issue under the fourth priority. n22

Extent to Which a Claim Has Been Earned. For a claim to be eligible for priority, it must have been earned within the applicable 180-day period. The general rule is that wages, salaries and commissions are earned when the employee obtains a right to payment under the employment contract rather than at the time that payment is to be made. n23 If the employee's right to receive a salary payment is absolute at a particular point in time but payment is deferred until a later date, the salary is earned when the right to receive payment occurred. If a bonus is awarded in December, but not payable until the following March, the bonus was earned in December. If a commission was earned for sales during the month of December, but is not payable to an independent contractor until the following March, it likewise was earned in December. n24 Determining when wages, salaries and commissions were earned is usually relatively straightforward. It is often much more difficult to determine when vacation pay and severance pay have been earned. Nothing in the Code sheds any light on how to calculate when vacation or severance pay have been earned. n25

Vacation Pay. If the employment contract or collective bargaining agreement between the debtor and its employees provide that an employee earns a pro rata share of the employees annual vacation each day during a year that the employee works, determining the amount of the vacation pay earned within the 180-day period is a relatively simple endeavor. For an employee employed during all of the relevant 180-day period, the employee will be entitled to a percentage of the employees annual vacation pay equal to 180 divided by whatever denominator, 360 or 365 days, is used in the employment contract or collective bargaining agreement to calculate vacation pay.

The calculation becomes more difficult when the contract provides for vacation pay to vest in a different manner. For example, if an employee first vests in a right to vacation pay after the conclusion of a calendar year, and the employee is dismissed prior to the end of the year, the employee may not have a contractual right to receive any vacation pay at all. If that is so, there is no claim for which priority needs to be determined. Upon the date of vesting, however, the employee may vest all at once with an entire years worth of vacation pay. It would seem anomalous to allow an employee to assert a priority for an entire years vacation pay merely because the annual vesting occurred during the 180-day measuring period. The Court of Appeals for the Seventh Circuit has held that vacation pay will be deemed to have been earned continuously throughout the year and that, so long as the employee has a valid contractual claim for the vacation pay, 180 days worth will be considered to have been earned during the 180-day period regardless of the vesting schedule. n26

Severance Benefits. Severance benefits are also entitled to priority under section 507(a)(4), and are specifically

mentioned in the statutory language. Severance benefits are payments due to an employee as a result of the termination of the employee's employment or some other significant adjustment to or change in the employee's circumstances. Only those severance payments earned within the appropriate 180-day period are eligible for priority. If the employee is terminated before the 180-day period, any severance benefits due to the employee will not qualify for priority under section 507(a)(4) because the benefits were not earned within the 180-day period. This is so even if the severance benefits were by contract payable during the 180-day period. n27 As with wages, it is the date that the severance benefits are earned--not the date on which they are payable--that is important.

If the employee is terminated within the 180-day period, or if the employee is terminated after the filing of the bankruptcy case, then some or all of the severance benefits owed to the employee may qualify for priority treatment under section 507(a)(4). The extent to which the benefits qualify for priority will depend in part upon the nature of the particular severance program. There are three general types of severance benefits that may be payable to an employee. The first and most common are severance benefits in compensation for job loss, where the amount of benefits is calculated by a formula usually based on the employee's number of years of service. These benefits are typically payable at termination regardless of the extent to which the employee had prior notice of the termination. The second are severance benefits that are provided to the employee in lieu of notice of termination. These benefits are typically payable only if the employee is terminated without receipt of sufficient notice. The third are severance benefits payable under an employment contract that arise automatically upon termination. An employee typically becomes entitled to this type of severance benefit if the employee is terminated without cause before expiration of the contract period.

Severance Benefits in Compensation for Loss of Employment. If a severance program provides benefits to employees in compensation for termination of employment, those severance benefits are typically payable either in a lump sum at termination or over a period of time. The amount of benefits typically varies depending upon the number of years of employment. The question arises as to when the severance pay is considered to be earned for purposes of section 507(a)(4). Employees will contend that the severance benefits are earned at the time of termination on the theory that no right to severance exists until an employee is involuntarily terminated. If this reasoning is adopted, as it has been by some courts, the full amount of severance owed to an employee terminated during the 180-day period would be considered earned during the 180-day period and would be eligible for priority. If the employee were terminated after the filing of the petition, the severance pay obligation would constitute an administrative expense and the employee would not need the wage priority at all. n28 Courts rejecting that argument have determined that severance benefits are earned pro rata over the period of the employee's employment. Such courts hold that administrative priority will be granted for that portion of the severance benefits earned after the filing of the petition, a priority claim will be granted for that portion of the severance benefits earned during the 180 days prior to bankruptcy, and a general unsecured claim will be granted for the balance. n29 In determining what portion was earned during the 180 days prior to the filing, the typical approach is to take a fraction of the total severance benefits payable and multiply the total by a fraction, the numerator of which is 180 and the denominator is the total period over which severance benefits vested in the employee. n30

Severance Benefits in Lieu of Notice of Termination. Where the agreement between the employer and the employee provides that the employee is entitled to severance only if the employer fails to give advance notice to the employee of termination of employment, the analysis is different. Severance of this type is payable only if the employee is terminated without the prescribed notice. If the notice is given, no severance benefits are due. The employee has continued employment for a specified period in lieu of severance pay. If the employee is summarily terminated, the employee is entitled to either payment of wages for the prescribed period or a lump sum of an equal amount. This payment is considered to be earned at the time that the employee is terminated since no right to any type of severance benefit exists unless the summary termination occurs. If termination occurs within the 180-day period, then the full amount of termination, up to the maximum dollar limitation, is eligible for priority treatment. n31

Contractual Severance Benefits. A third category of severance claims are those that arise under employment contracts and are based neither on length of service nor lack of notice. Under many employment contracts, an employee is entitled to a specified payment if the employee is terminated without cause before expiration of the employment

period under the contract. This type of severance payment is most commonly found in employment contracts for managers and other senior employees. Most cases involve a termination after commencement of the case, and the courts have held that the severance benefits were earned when the contract was executed rather than during the 180 days preceding the bankruptcy filing. n32 Any such claim is subject to the limitation on damages for breach of an employment contract found in section 502(b)(7).

Worker Adjustment and Retraining Notification (WARN) Act. An analogous situation arises under the Worker Adjustment and Retraining Notification (WARN) Act. That statute requires that payments are owed by an employer to certain employees who are terminated without the notice prescribed by the WARN Act. Those payments are very similar to payments due to employees under severance contracts in which benefits become payable only if termination occurs without notice. These payments have been considered earned at the time of termination and the full amount of WARN Act payments are eligible for priority if termination occurs during the 90-day period. n33

For a complete discussion of Code section 507, see Collier on Bankruptcy, ch. 507.

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Return to Text

n1 1. This section was renumbered from 507(a)(3) to 507(a)(4) by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 212 (2005), effective in cases commenced on or after October 17, 2005. Decisions in cases filed before the effective date will thus refer to what was then section 507(a)(3).

n2

2. This time period was increased from 90 days to 180 days by Pub. L. No. 109-8, § 1401(1) (2005), effective in cases commenced on or after April 20, 2005. For cases commenced before April 20, 2005, the 90-day limit will be applicable.

n3

3. This dollar amount is effective for cases commenced on or after April 1, 2007. Pursuant to 11 U.S.C. § 104(b), the amount is adjusted every three years to account for changes in the cost of living. See Collier on Bankruptcy, 104.03. The 2005 Act had set the amount at \$10,000, effective in cases commenced on or after April 20, 2005. For cases commenced between April 1, 2004, and April 19, 2005, the dollar amount was \$4,925. For cases commenced during the three-year period beginning April 1, 2001, the amount was \$4,650. The amount for the three-year period beginning April 1, 1998, was \$4,300. For cases commenced before April 1, 1998, the amount was \$4,000.

n4

4. See *Collier on Bankruptcy*, 507.06[5], regarding when benefits are earned, and *Collier on Bankruptcy*, 507.06[4], regarding calculation of the 180-day period.

n5

5. *In re Cardinal Indus. Inc.*, 160 B.R. 83 (Bankr. S.D. Ohio 1993) (bonus considered within scope of section 507(a)(4) (which at the time was numbered 507(a)(3))).

n6

6. See *Collier on Bankruptcy*, 503.05.

n7

7. See *In re Baldwin-United Corp.*, 13 C.B.C.2d 709, 52 B.R. 549 (Bankr. S.D. Ohio 1985) (cash guarantee related to stock option plan not eligible for priority; more akin to a perk rather than compensation); *Keim v. Growers Seed Assn*, 49 B.R. 17 (Bankr. N.D. Tex. 1985) (claim for reimbursement of moving expenses outside scope of the priority). But see *In re Columbia Packing Co.*, 35 B.R. 447 (Bankr. D. Mass. 1983) (claim for expense reimbursement considered close enough to salary and wages to be included within priority).

n8

8. See *In re Bersaglia*, 254 B.R. 376 (Bankr. E.D. Ky. 2000) (workers compensation benefits outside the scope of wage priority); *In re Lull Corp.*, 30 C.B.C.2d 927, 162 B.R. 234 (Bankr. D. Minn. 1993) (same); *In re Webster*, 126 B.R. 4 (Bankr. D. Me. 1991) (same); *In re Redford Roofing Co.*, 54 B.R. 254 (Bankr. N.D. Ill. 1985) (same).

n9

9. *In re Wang Lab., Inc.*, 164 B.R. 404 (Bankr. D. Mass. 1994); *In re Dahlman Truck Lines, Inc.*, 59 B.R. 218 (Bankr. W.D. Wis. 1986).

n10

10. See *In re Jade West Corp.*, 13 C.B.C.2d 680, 53 B.R. 16 (Bankr. D. Or. 1985) (officers and directors of

corporate debtor entitled to assert wage priority). *In re Comtec Indus. Inc.*, 91 B.R. 344 (Bankr. E.D. Pa. 1988), is to the contrary, but is incorrect. See also *In re Hutchison*, 223 B.R. 586 (Bankr. M.D. Fla. 1998) (claim of debtor's attorney not entitled to wage priority status because the attorney was not an employee of the debtor).

n11

11. *In re Alroco, Inc.*, 92 B.R. 523 (Bankr. M.D. Fla. 1988) (employee must be direct employee of the debtor to qualify for priority). But see *In re Konidaris*, 87 B.R. 846 (Bankr. E.D. Pa. 1988) (when state statute makes debtor liable for wages of employees of corporation owned/managed by debtor, such wages entitled to priority).

n12

12. *In re Dahlman Truck Lines, Inc.*, 59 B.R. 218 (Bankr. W.D. Wis. 1986); see also *In re Kasson, Inc.*, 109 B.R. 352 (Bankr. E.D. Wis. 1989) (milk suppliers not employees under state law).

n13

13. At the time, the wage priority was numbered section 507(a)(3). It was renumbered as section 507(a)(4) by Pub. L. No. 109-8, § 212 (2005), effective in cases commenced on or after October 17, 2005. See *In re Wang Lab., Inc.*, 164 B.R. 404 (Bankr. D. Mass. 1994) (commissions owed to independent contractors qualified for priority); *In re Lynnwear Corp.*, 28 B.R. 532 (Bankr. S.D.N.Y. 1983) (same); *In re American Shelter Sys., Inc.*, 40 B.R. 793 (Bankr. W.D. La. 1984) (commissions owed to independent contractors did not qualify for priority); *In re St. Josephs Hosp.*, 126 B.R. 37 (Bankr. E.D. Pa. 1991) (same).

n14

14. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1401(1) (2005), effective in cases commenced on or after April 20, 2005, increased the number of days from 90 to 180. In *In re Myer*, 197 B.R. 875 (Bankr. W.D. Mo. 1996), the court held that a claim for lost commissions (commissions the creditor never had a chance to earn) due to the debtor's breach of sales agreement was not entitled to priority status because it was not earned within the applicable period. *In re Myer* sets forth the inexplicable assertion that a claim reduced to judgment prior to the bankruptcy loses its eligibility for priority. There is no justification in the Code, however, for a claim otherwise entitled to priority to lose its priority status because it was reduced to judgment.

n15

15. *Wilson v. Brooks Supermarket, Inc. (In re Missionary Baptist Found.)*, 667 F.2d 1244, 5 C.B.C.2d 1442

(5th Cir. 1982); *In re Paris Indus. Corp.*, 95 B.R. 258 (Bankr. D. Me. 1989) (entity that purchased assignment of right to vacation pay eligible to assert priority); *In re Dahlman Truck Lines*, 59 B.R. 218 (Bankr. W.D. Wis. 1986); *Peninsula Nat'l Bank v. Allen Carpet Shops, Inc. (In re Allen Carpet Shops, Inc.)*, 8 C.B.C.2d 671, 27 B.R. 354 (Bankr. E.D.N.Y. 1983).

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16. See *Collier on Bankruptcy*, 507.14.

n17

17. *Wilson v. Brooks Supermarket, Inc. (In re Missionary Baptist Found.)*, 667 F.2d 1244 (5th Cir. 1982).

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18. *Peninsula Nat'l Bank v. Allen Carpet Shops, Inc. (In re Allen Carpet Shops, Inc.)*, 8 C.B.C.2d 671, 27 B.R. 354 (Bankr. E.D.N.Y. 1983) (debtors bank that cashed payroll checks not an assignee of wage claims; in cashing checks, bank was extending credit to debtor by making an overdraft available).

n19

19. See *In re Mel-Hart Prods., Inc.*, 156 B.R. 606 (Bankr. E.D. Ark.1993) (company that made employees available to debtor and then billed debtor for employment costs plus markup not an assignee of wage claims, but held its own contract claim); *In re Alroco, Inc.*, 92 B.R. 523 (Bankr. M.D. Fla. 1988) (same); *In re Grant Indus., Inc.*, 133 B.R. 514 (Bankr. W.D. Mo. 1991) (firm supplying debtor with temporary employees not entitled to wage priority); *In re Dahlman Truck Lines*, 59 B.R. 218 (Bankr. W.D. Wis. 1986) (no wage priority for company whose employees are on loan to debtor); see also *In re Aurora Graphics, Inc.*, 255 B.R. 612 (Bankr. D.N.H. 2000) (denying priority to co-employer because co-employer had legal obligation to pay the wage claims).

n20

20. The time period was increased from 90 days to 180 days by Pub. L. No. 109-8, § 1401(1) (2005), effective in cases commenced on or after April 20, 2005. For cases commenced before April 20, 2005, the 90-day limit will be applicable.

n21

21. See *Davidson Transfer & Storage Co. v. Teamsters Pension Trust Fund*, 817 F.2d 1121, 17 C.B.C.2d 76 (4th Cir. 1987) (cessation of business means ceasing all business operations and not merely shutting down major operations); *Plaintiff's Class Claimants v. Elsinore Corp. (In re Elsinore Corp.)*, 228 B.R. 731 (B.A.P. 9th Cir. 1998) (a debtor that remained in business as a holding company for several years after ceasing active operations was held not to have ceased business); *Boatwright v. Rau (In re Rau)*, 113 B.R. 619 (B.A.P. 9th Cir. 1990) (cessation of business did not occur when debtor shut down mining business, even though debtor's only remaining business was a restaurant having no connection to the mining business); *In re Sullivan Sales Corp.*, 146 B.R. 623 (Bankr. W.D.N.Y. 1992) (cessation did not occur where subsidiary shut down, but transferred all its assets to parent which continued in business).

n22

22. See *Collier on Bankruptcy*, 507.06[2].

n23

23. See *In re Murray Indus. Inc.*, 114 B.R. 749 (Bankr. M.D. Fla. 1990) (claim for damages/lost wages due to employer's breach of employment contract accrues at time of termination and claim not entitled to priority where termination occurred prior to the applicable period).

n24

24. See *In re Cardinal Indus. Inc.*, 160 B.R. 83 (Bankr. S.D. Ohio 1993) (bonus earned when right to bonus established, even though bonus not payable until later date).

n25

25. Where collective bargaining agreements are involved, there is a tension between the language of section 1113 and the priority requirements of section 507. Unions have maintained that section 1113 requires vacation and severance benefits under collective bargaining agreements to be treated as postpetition claims, rather than as prepetition priority claims, absent a proper rejection of the collective bargaining agreement. See, e.g., *Air Line Pilots Assn Intl v. Shugrue (In re Ionosphere Clubs, Inc.)*, 22 F.3d 403, 30 C.B.C.2d 1627 (2d Cir. 1994) (section 1113 does not preclude prepetition claims for vacation pay arising under collective bargaining agreement from being classified in chapter 11 plan as unsecured claims entitled to wage priority); *In re Roth Am., Inc.*, 975 F.2d 949, 27 C.B.C.2d 1125 (3d Cir. 1992) (same); *In re Spirit Holding Co.*, 157 B.R. 879 (Bankr. E.D. Mo. 1993) (same).

n26

26. *Northwest Engg Co. v. United Steelworkers*, 863 F.2d 1313 (7th Cir. 1988). This approach was also followed in *Roeder v. United Steelworkers (In re Old Electralloy Corp.)*, 167 B.R. 786 (Bankr. W.D. Pa. 1994); *In re Crouthamel Potato Chip Co.*, 52 B.R. 960 (E.D. Pa. 1985), *rev'd on other grounds*, 786 F.2d 141, 14 C.B.C.2d 502 (3d Cir. 1986) (union contract provided that union members vested in holiday pay 45 days prior to holiday; no priority where debtor filed bankruptcy and shut down prior to holiday since pay could not have been earned in advance of holiday).

n27

27. See *In re General Info. Servs., Inc.*, 68 B.R. 419 (Bankr. E.D. Pa. 1986) (no priority for severance benefits payable within applicable period because employee terminated prior to applicable period and employee's right to payments earned at that time).

n28

28. See, e.g., *In re Golden Distribs., Ltd.*, 134 B.R. 760 (Bankr. S.D.N.Y. 1991), *aff'd*, 152 B.R. 35 (S.D.N.Y. 1992) (full amount of severance pay for employees discharged after bankruptcy entitled to administrative priority).

n29

29. *In re Roth Am., Inc.*, 975 F.2d 949, 27 C.B.C.2d 1125 (3d Cir. 1992); *In re Russell Cave Co, Inc.*, 44 C.B.C.2d 131, 248 B.R. 301 (Bankr. E.D. Ky. 2000); *In re Lykes Bros. Steamship Co.*, 213 B.R. 401 (Bankr. M.D. Fla. 1997); *Barto Tech. Servs., Inc. v. Named Persons (In re Wean, Inc.)*, 171 B.R. 528 (Bankr. W.D. Pa. 1994); *Roeder v. United Steelworkers (In re Old Electralloy Corp.)*, 167 B.R. 786 (Bankr. W.D. Pa. 1994); *Jeannette Corp. v. Gilardi (In re Jeanette Corp.)*, 23 C.B.C.2d 1075, 118 B.R. 327 (Bankr. W.D. Pa. 1990).

n30

30. This calculation was undertaken in *Roeder v. United Steelworkers (In re Old Electralloy Corp.)*, 167 B.R. 786 (Bankr. W.D. Pa. 1994). A variation of this method was employed in *In re Yarn Liquidation, Inc.*, 217 B.R. 544 (Bankr. E.D. Tenn. 1997), where the employees vested in additional severance benefits each six months.

n31

31. See *In re Guardianship Trust & Home Program, Inc.*, 80 B.R. 268 (Bankr. D.N.H. 1987) (full amount of severance owed to employee due to failure to give advance notice of termination occurring in applicable period entitled to wage priority); *McCloskey v. Division of Labor*, 200 F.2d 402 (9th Cir. 1952) (under Bankruptcy Act,

severance owed due to failure to give notice of termination earned at termination); *In re Public Ledger, Inc.*, 161 F.2d 762 (3d Cir. 1947) (same).

n32

32. See, e.g., *Dullanty v. Selectors, Inc. (In re Selectors, Inc.)*, 19 C.B.C.2d 157, 85 B.R. 843 (B.A.P. 9th Cir. 1988); *In re M Group, Inc.*, 268 B.R. 896 (Bankr. D. Del. 2001); *In re Uly-Pak, Inc.*, 24 C.B.C.2d 1989, 128 B.R. 763 (Bankr. S.D. Ill. 1991).

n33

33. *International Brotherhood of Teamsters v. Kitty Hawk Intl, Inc. (In re Kitty Hawk, Inc.)*, 255 B.R. 428 (Bankr. N.D. Tex. 2000); *In re Riker Indus. Inc.*, 151 B.R. 823 (Bankr. N.D. Ohio 1993); *In re Cargo, Inc.*, 138 B.R. 923 (Bankr. N.D. Iowa 1992).

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91 of 197 DOCUMENTS

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Collier on Reaffirmation Agreements and Discharge Hearings

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Collier on Reaffirmation Agreements and Discharge Hearings

By Collier

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SUMMARY: This Emerging Issues Analysis covers the requirements for an enforceable reaffirmation agreement, the disclosure statement required by Bankruptcy Code subsection 524(k), the rescission of a reaffirmation agreement by a debtor, and whether voluntary payments by a debtor pursuant to Bankruptcy Code subsection 524(f) constitute a reaffirmation of a discharged debt.

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ARTICLE: Subsections (c) and (d) of *Bankruptcy Code section 524* prohibit enforcement of the reaffirmation of a discharged debt unless specific requirements have been met. n1 If an agreement to pay a discharged or dischargeable debt does not meet the requirements of subsections (c) and (d), it is without legal effect. These subsections grew out of a long history of coercive and deceptive actions by creditors to secure reaffirmation of discharged debts. n2 The subsections have been applied strictly by the courts to carry out their remedial purposes and to ensure that they are not evaded by agreements which, though not labeled as reaffirmations, have the effect of waiving the protections of the discharge. n3 The debtor cannot enter into an agreement, other than a valid reaffirmation agreement, that would create personal liability for the discharged debt. For example, a postdischarge agreement to pay a secured debt after bankruptcy in exchange for the creditors forbearance in repossessing the collateral is an agreement that recreates the debtors personal liability for the debt and is not valid notwithstanding the creditors claim that the agreement is for the new consideration of the creditors forbearance. n4

The Court of Appeals for the Eighth Circuit misinterpreted the requirements of subsections (c) and (d) in *DuBois v. Ford Motor Credit Co.*, n5 holding that debtors who, after bankruptcy, had continued to make payments on an automobile lease did not enter into a reaffirmation agreement when they thereafter entered into a new lease that included charges still owing from the prior lease. The court held that the new agreement was voluntary and that it was therefore permitted by subsection 524(f), which permits a creditor to accept voluntary payments on a discharged debt. n6 In doing so, the court equated a payment with an agreement to pay, despite the fact that the statute treats them very differently. Although a voluntary payment of a discharged debt is allowed by subsection 524(f), any agreement to pay a discharged debt is a reaffirmation agreement subject to the requirements of subsection (c). If an agreement to pay a discharged debt were permitted simply because it is voluntary, the reaffirmation requirements of the Code would be eviscerated.

The debtor may rescind a reaffirmation within 60 days after the reaffirmation agreement is filed. n7 Additionally, before reaffirmation becomes effective as to an individual debtor, if the debtor is not represented by an attorney who has negotiated and certified the agreement as voluntary, informed and manageable for the debtor, the court must advise the debtor of the effects of reaffirmation and approve the reaffirmation as not imposing a hardship on the debtor and as being in the debtors best interest. n8 Typically, an allowable reaffirmation agreement yields a concrete benefit to the debtor, such as the right to retain collateral. n9 Only the debtor, not the creditor, may apply for court approval of a reaffirmation agreement. n10 However, if the debt is a consumer debt secured by real property, court approval is not required, even in cases of individuals not represented by an attorney during the course of negotiating the reaffirmation agreement. n11

Requisites of an Enforceable Reaffirmation Agreement. Subsections 524(c) and (d), except under very limited circumstances, render unenforceable reaffirmation agreements based upon dischargeable debts. To be enforceable, a reaffirmation must be made before the granting of a discharge, n12 and the debtor may rescind a reaffirmation agreement at any time up to 60 days after the agreement is filed in court, n13 in which case any monies paid by the debtor pursuant to the agreement must be returned by the creditor. n14 Of course, to be an enforceable agreement, the reaffirmation agreement must also be one to which both the debtor and creditor agree. n15 Applying this general principle, the Court of Appeals for the First Circuit, in *Jamo v. Katahdin Fed. Credit Union (in Re Jamo)*, n16 held that a creditor is permitted to refuse to enter into a reaffirmation agreement of one debt if the debtor refuses to reaffirm another debt. It is unclear how far courts will allow creditors to extend this concept, which in theory could allow creditors to demand additional charges and other concessions in exchange for a reaffirmation demanded under a threat of repossession or foreclosure. Notably, the court in *Jamo* held that creditors may not engage in coercive or harassing tactics and that threats of foreclosure could violate this rule. n17

Section 524(c)(2), as amended in 2005, n18 provides that a reaffirmation agreement is not enforceable unless the debtor received the disclosures described in section 524(k), enacted by the same legislation, at or before the time the debtor signed the reaffirmation agreement. Section 524(k)(2) requires the disclosures to be made clearly and conspicuously and in writing. The terms Amount Reaffirmed and Annual Percentage Rate must be disclosed more conspicuously than other terms or information, except that the phrases Before agreeing to reaffirm a debt, review these important disclosures and Summary of Reaffirmation Agreement may be equally conspicuous.

Courts have differed regarding what is required to make language clear and conspicuous. In *American General Finance, Inc. v. Bassett*, n19 the Court of Appeals for the Ninth Circuit reversed a decision of the bankruptcy appellate panel n20 that had found that a creditors notice of the right to rescind was not clear and conspicuous because it was in lower-case letters and was located very near another statement in upper-case letters. The court of appeals held that the statement was conspicuous because it was the first sentence of an agreement that took up less than one side of a page and no aspect of formatting or appearance of the statement made it difficult or less visible to read. n21 These conflicting interpretations of the word conspicuous suggest that creditors should be careful to emphasize in some way the language that is required to be conspicuous.

The disclosures that must be given in connection with a reaffirmation agreement are set forth in section 524(k), enacted by the 2005 amendments. n22 According to section 524(k)(1), the disclosures consist of a combination of the disclosure statement described in section 524(k)(3), completed as required by that paragraph, and the agreement, statement, declaration, motion and order described in section 524(k)(4)(8). Thus, unless all of these documents conform to the statutory requirements, the disclosures required by section 524(c)(2) have not been given. Section 524(k)(1) also provides that these are the only disclosures that are required. The disclosures required by section 524(k)(3), designated as Part A, are in some ways similar to those required for consumer credit transactions under the Truth In Lending Act, and incorporate certain concepts from that law. n23 They require the use of particular terms and phrases, including Amount Reaffirmed and Annual Percentage Rate, as well as standard statements. The required disclosures are far more lengthy and confusing than the form promulgated by the Administrative Office of the United States Courts that was previously used in many courts. It is likely that many debtors will not understand them, and it is also likely that many

law firms will be hired to draft forms that comply with these complicated new provisions. There is also a potential for much litigation, similar to that under the Truth in Lending Act, if creditors do not strictly comply with the disclosure requirements. The form of the reaffirmation agreement, designated as Part B, is dictated by section 524(k)(4). It must include a brief description of the credit agreement, a task that may not be easy in light of the complicated agreements utilized by consumer creditors. The creditor and the debtor(s) must both sign and date the agreement. If an attorney represents the debtor in negotiating the agreement, Part C, required by section 524(k)(5), is the attorneys declaration, discussed below. Under section 524(k)(6), the debtor must also sign a form statement, designated Part D. The statement requires the debtor to compute whether the debtor has sufficient disposable income to make the payments required under the reaffirmation agreement and, if not, to explain how the debtor can afford to make the payments. However, this computation and explanation is not required if the debtor is represented by an attorney and the creditor is a credit union. n24 Section 524(k)(7), Part E, sets forth the form of a motion that may be used to obtain court approval of a reaffirmation agreement that must be approved by the court. Such approval is necessary if the debtor is not represented by an attorney with respect to the reaffirmation, unless the debt is secured by real property. n25 Lastly, section 524(k)(8) sets out a form of order that may be used to grant court approval of a reaffirmation agreement.

The agreement must be filed with the court, within 30 days after entry of an order granting a discharge or confirming a chapter 11 plan of an individual debtor. n26 If applicable, the agreement must be accompanied by a declaration or affidavit of the attorney who represented the debtor during the course of negotiating the agreement. The declaration or affidavit must state that the agreement represents a fully informed and voluntary agreement by the debtor and does not impose a hardship on the debtor or a dependent of the debtor. n27 The declaration or affidavit must also state that the attorney fully advised the debtor of the legal effect and consequences of the reaffirmation agreement and of any default under that agreement. n28 And, if the debtors budget as reflected in Part D does not demonstrate adequate income to make the payments required by the reaffirmation agreement, the declaration must also state that in the attorneys opinion the debtor is able to make those payments. n29 Courts are likely to continue to scrutinize reaffirmation agreements, especially when the debtors budget appears inadequate, due to concerns that attorneys signing them have not adequately investigated the debtors situation and have misrepresented whether the agreement would cause hardship to the debtor or the debtors dependents. n30

Court Approval Required for Certain Reaffirmation Agreements. If the debtor is an individual who was not represented by an attorney in the course of negotiating a reaffirmation agreement, subsection (d) requires the court to hold a discharge hearing, which the debtor must attend, at which the court must explain reaffirmation to the debtor. Normally, such a hearing is triggered by the debtors filing a motion for approval of the reaffirmation agreement. Courts have held that only the debtor has standing to seek approval of a reaffirmation agreement, n31 but any party may file a reaffirmation agreement with the court.

Section 524(c)(6)(A) requires the court to determine at the discharge hearing whether the agreement imposes an undue hardship on the debtor or a dependent of the debtor, and whether it is in the best interest of the debtor. The court must also make such a determination if the debtor is represented by an attorney but the attorney did not negotiate the reaffirmation agreement. In either case, the court may approve the reaffirmation agreement only if it does not impose a hardship. Section 524(c)(6)(A) does not apply, however, to the extent that the debt is a consumer debt secured by real property.

Under section 524(m), added by the 2005 amendments to the Bankruptcy Code, n32 the court may also disapprove certain reaffirmation agreements in cases in which the debtor is represented by an attorney, although a hearing is not required in every such case. If the debtors declaration shows a budget insufficient to make payments under the agreement, a presumption arises that the reaffirmation agreement is an undue hardship, and the court is required to review the matter. n33 In support of the reaffirmation, the debtor may submit a written explanation of how additional funds will be obtained to make the payments in order to rebut the presumption. If the presumption is not rebutted, the court may disapprove the agreement after notice to the debtor and creditor and a hearing concluded before the

discharge. n34 However, the standard for approval of a reaffirmation agreement remains unchanged in section 524(c)(6)(A). The agreement must not impose an undue hardship on the debtor and must be in the debtors best interest, which suggests that the court should never approve an agreement when the presumption of undue hardship has not been satisfactorily rebutted. In order to fully review all agreements in which the presumption arises, courts may have to delay the discharge in many cases. But these presumption of hardship provisions do not apply if the creditor is a credit union and in such cases court review is required only if the debtor is not represented by an attorney. n35

In past cases in which court approval has been required, courts have looked to a number of factors to decide whether a reaffirmation agreement is in the best interest of the debtor. n36 When it is doubtful that a debtor can make the payments called for by the agreement, the agreement is normally disapproved. n37 If an agreement is intended to prevent repossession of property subject to a nonavoidable lien, and the debtor could better accomplish the purpose of the agreement in some other manner, the agreement is also unlikely to win court approval. n38 For example, if the security agreement is invalid, the court may decline to approve such a reaffirmation agreement. n39 Some courts refuse to permit reaffirmation of a secured debt in an amount in excess of the value of the collateral. n40 A reaffirmation agreement not in the debtors best interest may not be coerced by threats to embroil the debtor in costly foreclosure proceedings. n41 A bankruptcy court should not permit reaffirmation of a debt in exchange for the creditors forbearing to press criminal bad check charges, because the customary practice of collecting debts through such criminal proceedings should not be abetted. n42

In many courts, it has been held that property securing a discharged debt cannot be repossessed as long as the debtor remains current in payments on the debt, n43 so in those courts it is unnecessary to reaffirm a secured debt to retain the property if the debtor is current on payments. n44 Similarly, if the agreement purports to be one entered into to avoid dischargeability litigation, and the creditor has not timely filed a dischargeability complaint, the agreement will not be approved. n45 Reaffirmation should rarely, if ever, be recommended by an attorney or approved by the court if the sole reason for it is the debtors desire to pay the discharged debt, n46 since the debtor already has the absolute right to pay the debt without giving up the protections of the discharge. n47 Courts will likely look to similar considerations in determining whether an agreement will pose an undue hardship for the debtor in deciding whether to approve agreements with respect to which a presumption of undue hardship arises under section 524(m)(1). n48

In order to fully assess the circumstances surrounding a reaffirmation, some courts have required a good deal of information about the debtors circumstances, including the nature of any security for the debt and its value. To facilitate the reaffirmation process, the Administrative Office of the United States Courts promulgated a form of reaffirmation agreement requiring such information. n49 It is unclear whether courts will still require this information in every reaffirmation agreement, now that the statute provides a different form for the agreement. n50 However, nothing prevents a court from requiring such additional information in order to evaluate whether an agreement should be approved.

Once a court has entered an order approving a reaffirmation agreement, relief from that order, beyond the statutory right to rescind the agreement, is governed by normal rules of procedure. n51

Reaffirmation Agreements and Federal Rule of Bankruptcy Procedure 4004(c). Federal Rule of Bankruptcy Procedure 4004(c)(2) n52 provides that on motion of the debtor, the court may defer the entry of an order granting a discharge for 30 days and, on motion within this period, the court may further defer entry of the order to a date certain. The purpose of this rule is to give the debtor the opportunity to obtain automatically an additional 30 days to conclude a reaffirmation agreement. n53 In explaining the provision, the 1983 Advisory Committee Note to Bankruptcy Rule 4004 states, in part:

The last sentence of subdivision (c) takes cognizance of § 524(c) of the Code which authorizes a debtor to enter into enforceable reaffirmation agreements only prior to entry of the order of discharge. Immediate entry of that order after expiration of the time fixed for filing complaints objecting to discharge may render it more difficult for a debtor to settle pending litigation to determine the dischargeability of a debt and execute a reaffirmation agreement as part of a

settlement.

The Discharge Hearing. In a case concerning an individual who seeks to reaffirm a debt, there must be compliance with the provisions of subsection (d). n54 However, in many cases subsection (d) requires nothing.

Subsection (d) provides that if the court has decided to grant a discharge, the court may hold a discharge hearing. n55 If the court holds such a hearing, the debtor must appear in person. However, the court is not required to hold a discharge hearing unless the debtor desires to reaffirm a debt and was not represented by an attorney in negotiating the reaffirmation agreement. n56

Most courts do not hold discharge hearings in cases in which there are no reaffirmation agreements. However, bankruptcy courts may still wish to exercise their discretion to hold discharge hearings in all cases in which the debtor agrees to reaffirm a debt. Many courts have found that even debtors who have been represented by counsel have made unwise reaffirmation agreements and benefit greatly from an explanation of the risks of such agreements. n57

In cases in which the court does hold a discharge hearing, the court must inform the debtor that a discharge has been granted, that a reaffirmation agreement is not required by any applicable law, and of the legal consequences and effects of a reaffirmation agreement and of a default under it. n58

Unless the debtor has been represented by an attorney in negotiating a reaffirmation agreement, the court must also decide whether to approve the agreement. n59 This determination is not required to the extent the agreement is secured by real property. The agreement can be approved only if the court finds that it is in the best interest of the debtor and that it will not impose an undue hardship on the debtor or the debtors dependents, as discussed above. n60

If a discharge hearing is required, n61 and the court does not hold a discharge hearing at which the debtor receives the admonitions described in section 524(d), the language of section 524(c) leaves no doubt that the reaffirmation agreement is not enforceable. Section 524(c)(5) requires compliance with section 524(d), and section 524(d) requires the court to hold a hearing in certain specified cases at which the debtor must appear in person. Therefore, in *Arnhold v. Kyrus*, n62 a case in which the debtor failed to bring a reaffirmation agreement to the attention of the court and never received the admonitions about reaffirmation, the Court of Appeals for the Fourth Circuit held that the reaffirmation agreement was invalid. n63

As to the time at which the reaffirmation and discharge hearing under section 524(d) must be held, *Federal Rule of Bankruptcy Procedure 4008* provides that it be held not more than 30 days following the entry of an order granting or denying a discharge, or confirming a plan in a chapter 11 reorganization case concerning an individual debtor, and on not less than 10 days notice to the debtor and trustee. The rule also provides that a motion by the debtor for approval of a reaffirmation agreement must be filed before or at the hearing. n64

For a complete discussion of Code section 524, see Collier on Bankruptcy, ch. 524.

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Return to Text

n1 1. 11 U.S.C. § 524(c), (d). *In re Johnson*, 148 B.R. 532 (Bankr. N.D. Ill. 1992); *Lindale Natl Bank v.*

Artzt (In re Artzt), 145 B.R. 866 (Bankr. E.D. Tex. 1992). 11 U.S.C. § 524(c) was amended by Pub. L. No. 109-8 (enacted on April 20, 2005, and effective in cases commenced on or after October 17, 2005).

n2

2. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 162-164 (1977), *reprinted in* Collier on Bankruptcy, App. Pt. 4(d)(i); Report of the Bankruptcy Commission, H.R. Doc. 137, 93d Cong., 1st Sess., Part I, 177.

n3

3. *Renwick v. Bennett (In re Bennett)*, 298 F.3d 1059 (9th Cir. 2002) (creditors offer of new consideration for repayment of the discharged debt was inconsequential); *Republic Bank California, N.A. v. Getzoff (In re Getzoff)*, 33 C.B.C.2d 1281, 180 B.R. 572 (B.A.P. 9th Cir. 1995) (fact that additional consideration may have been given was irrelevant when consideration given by debtor included promise to pay discharged debt); *Chilcoat v. Minor (In re Minor)*, 115 B.R. 690 (D. Colo. 1990) (agreement to settle dischargeability by repaying prepetition debt could not be characterized as waiver of discharge under section 727(a)(10) to avoid reaffirmation requirements); *In re Zarro*, 47 C.B.C.2d 203, 268 B.R. 715 (Bankr. S.D.N.Y. 2001) (agreement is reaffirmation if any part of consideration given by debtor involves promise to pay discharged debt); *In re Lowery*, 187 B.R. 761 (Bankr. M.D. Fla. 1995) (new postbankruptcy note which included discharged debt was disguised reaffirmation agreement); *Light v. Adkins (In re Adkins)*, 151 B.R. 458 (Bankr. M.D. Tenn. 1992) (divorce agreement clause purporting to make certain obligations nondischargeable in bankruptcy held invalid); *In re Bowling*, 116 B.R. 659 (Bankr. S.D. Ind. 1990) (transaction in which part of postpetition loan proceeds, in amount of discharged debt, were immediately paid back to lender to pay that debt, and debtors were then again liable for amount of discharged debt they had just borrowed, constituted prohibited reaffirmation); *see also In re Barnes*, 969 F.2d 526 (7th Cir. 1992) (predischARGE oral promise to pay unscheduled creditor who had notice of the bankruptcy was not enforceable, even if fraudulent); *In re Johnson*, 114 B.R. 799 (Bankr. D.D.C. 1990) (statement of intention to reaffirm did not constitute reaffirmation agreement if valid reaffirmation agreement was never made). *But see Rein v. Providian Fin. Corp. (In re Rein)*, 270 F.3d 895 (9th Cir. 2001) (settlement of adversary proceeding approved by court order stipulating that portion of debt not discharged precluded claim that actions to collect debt violated discharge injunction).

n4

4. *Bankruptcy Receivables Mgmt. v. Lopez (In re Lopez)*, 345 F.3d 701 (9th Cir. 2003) (postdischarge asset retention agreement was reaffirmation despite creditors claim that forbearance from repossession was new consideration, because part of consideration from debtor was agreement to repay discharged debt); *In re Brown*, 220 B.R. 101 (Bankr. C.D. Cal. 1998); *cf. Arruda v. Sears, Roebuck & Co.*, 310 F.3d 13 (1st Cir. 2002) (redemption agreement providing that creditor would not repossess if debtor paid agreed value of collateral and clearly providing that no personal liability existed did not violate statute); *Gordon v. Hines (In re Hines)*, 147 F.3d 1185, 40 C.B.C.2d 684 (9th Cir. 1998) (suggesting that postpetition services of a chapter 7 debtors attorney could be consideration for new postpetition debt).

n5

5. 276 F.3d 1019 (8th Cir. 2002).

n6

6. 276 F.3d at 1023.

n7

7. 11 U.S.C. § 524(c)(2), as amended to include disclosure of the right to rescind in section 524(k) by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n8

8. 11 U.S.C. §524(c)(3), (6).

n9

9. See, e.g., *Green v. National Cash Register Co. (In re Green)*, 5 C.B.C. 2d 733, 15 B.R. 75 (Bankr. S.D. Ohio 1981); *Bank v. Sholos (In re Sholos)*, 11 B.R. 782 (Bankr. W.D. Pa. 1981).

n10

10. *Peoples Bank of Pound v. Newsome (In re Newsome)*, 1 C.B.C.2d 1000, 3 B.R. 626 (Bankr. W.D. Va. 1980).

n11

11. 11 U.S.C. § 524(c)(6)(B).

n12

12. 11 U.S.C. § 524(c)(1); *Chase Auto. Fin., Inc. v. Kinion (In re Kinion)*, 207 F.3d 751 (5th Cir. 2000); *In re Collins*, 243 B.R. 217 (Bankr. D. Conn. 2000); *In re Brinkman*, 123 B.R. 611 (Bankr. N.D. Ind. 1991). A

bankruptcy court should not vacate a discharge that has already been entered so that a reaffirmation agreement may then be filed before the granting of the discharge. *Winters Natl Bank and Trust Co. v. McQuality (In re McQuality)*, 2 C.B.C.2d 723, 5 B.R. 302 (Bankr. S.D. Ohio 1980).

n13

13. 11 U.S.C. § 524(c)(4).

n14

14. *McAuliffe v. GMAC Mtg. Corp. (In re McAuliffe)*, 180 B.R. 336 (Bankr. D. Me. 1995).

n15

15. *In re Turner*, 156 F.3d 713, 40 C.B.C.2d 1105 (7th Cir. 1998).

n16

16. 283 F.3d 392, 48 C.B.C.2d 70 (1st Cir. 2002).

n17

17. 283 F.3d 392, 399-402.

n18

18. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n19

19. 285 F.3d 882 (9th Cir. 2002) (9th Cir. 2002), cert. denied, 537 U.S. 1002, 123 S. Ct. 496, 154 L. Ed. 2d 398 (2002).

n20

20. *Bassett v. Am. Gen Fin., Inc. (In re Bassett)*, 255 B.R. 747 (B.A.P. 9th Cir. 2000).

n21

21. 285 F.3d 882, 887.

n22

22. 11 U.S.C. § 524(k), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n23

23. 15 U.S.C. § 1601 *et seq.*

n24

24. 11 U.S.C. § 524(k)(6)(B). The statute refers to a creditor defined in section 19(b)(1)(a)(iv) of the Federal Reserve Act, which defines credit unions.

n25

25. *See Collier on Bankruptcy*, 524.04[2] (Matthew Bender).

n26

26. *Fed. R. Bankr. P. 4008*, as amended by the 2005 amendments to the Federal Rules of Bankruptcy Procedure; *Vazquez v. Sears, Roebuck & Co. (In re Vazquez)*, 221 B.R. 222 (Bankr. N.D. Ill. 1998) (unfiled reaffirmation agreements are void); *In re Latanowich*, 207 B.R. 326 (Bankr. D. Mass. 1997); *see also In re Davis*, 273 B.R. 152 (Bankr. S.D. Ohio 2001) (bankruptcy could be reopened to permit filing of reaffirmation agreement because Code does not require agreement to be filed before discharge).

n27

27. 11 U.S.C. § 524(c)(3).

n28

28. *Id.* The form for such a certification is set forth in 11 U.S.C. § 524(k)(5), added by Pub. L. No. 109-8 (enacted on April 20, 2005, effective in cases commenced on or after October 17, 2005).

n29

29. 11 U.S.C. § 524(k)(5)(B), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. This statement is not required if the creditor is a credit union exempted from the presumption of undue hardship provision by section 524(m)(2), enacted by the same legislation.

n30

30. *See, e.g., In re Melendez*, 224 B.R. 252 (Bankr. D. Mass. 1998) (attorney declaration subject to Rule 9011 requirement of reasonable inquiry under the circumstances); *In re Bruzzese*, 214 B.R. 444 (Bankr. E.D.N.Y. 1997); *In re Izzo*, 197 B.R. 11 (Bankr. D.R.I. 1996).

n31

31. *See* 2005 Advisory Committee Note to *Fed. R. Bankr. P. 4008*; *In re Carlos*, 215 B.R. 52 (Bankr. C.D. Cal. 1997) (citing *Fed. R. Bankr. P. 4008*). *But see McClellan Fed. Credit Union v. Parker (In re Parker)*, 139 F.3d 668, 670-71 (9th Cir. 1998), *cert. denied*, 525 U.S. 1041, 119 S. Ct. 592, 142 L. Ed. 2d 535 (1998) (creditor has standing to appeal denial of reaffirmation approval); *BankBoston, N.A. v. Claflin (In re Claflin)*, 44 C.B.C.2d 676, 249 B.R. 840 (B.A.P. 1st Cir. 2000) (same).

n32

32. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n33 33. 11 U.S.C. § 524(m)(1), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n34

34. *Id.*

n35

35. 11 U.S.C. § 524(m)(2), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n36

36. *See BankBoston, N.A. v. Claflin (In re Claflin)*, 44 C.B.C.2d 676, 249 B.R. 840 (B.A.P. 1st Cir. 2000) (listing factors to be considered and holding that schedules indication of inability to pay is only *prima facie* evidence that reaffirmation will impose undue hardship, which may be rebutted).

n37

37. *See In re Melendez*, 224 B.R. 252 (Bankr. D. Mass. 1998); *In re Bryant*, 43 B.R. 189 (Bankr. E.D. Mich. 1984).

n38

38. *In re Sampson*, 51 B.R. 13 (Bankr. D.D.C. 1984) (debtor might have better options through converting case or redeeming property).

n39

39. *E.g., In re Carlos*, 215 B.R. 52 (Bankr. C.D. Cal. 1997).

n40

40. *In re Delano*, 3 C.B.C.2d 259, 7 B.R. 72 (Bankr. D. Me. 1980); *In re Jenkins*, 2 C.B.C.2d 307, 4 B.R. 651 (Bankr. E.D. Va. 1980). However, a court may not, by local rule, preemptively preclude all reaffirmations of unsecured debts. *Chase Auto. Fin., Inc. v. Kinion (In re Kinion)*, 207 F.3d 751 (5th Cir. 2000).

n41

41. *In re Farmer*, 4 C.B.C.2d 1461, 13 B.R. 319 (Bankr. M.D. Fla. 1981).

n42

42. *American Express Co. v. Griffin (In re Griffin)*, 4 C.B.C.2d 1507, 13 B.R. 591 (Bankr. S.D. Ohio 1981).

n43

43. See *Collier on Bankruptcy*, 521.10[2] (Matthew Bender).

n44

44. E.g., *In re McDaniel*, 129 B.R. 301 (Bankr. M.D. Fla. 1991).

n45

45. *In re Hirte*, 71 B.R. 249 (Bankr. D. Or. 1986).

n46

46. *In re Berkich*, 7 B.R. 483 (Bankr. E.D. Pa. 1980); *In re Long*, 2 C.B.C.2d 23, 3 B.R. 656 (Bankr. E.D. Va. 1980).

n47

47. 11 U.S.C. § 524(f); see *Collier on Bankruptcy*, 524.07 (Matthew Bender).

n48

48. 11 U.S.C. § 524(m)(1), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n49

49. See Collier on Bankruptcy, Form CS20.13-7; *In re Brown*, 248 B.R. 784 (Bankr. N.D. Ohio 2000) (use of form strongly recommended; court could not approve reaffirmation without information required by form or attachment of underlying contract to be reaffirmed).

n50

50. See Collier on Bankruptcy, 524.04[1] (Matthew Bender).

n51

51. *Missoula Fed. Credit Union v. Reinertson (In re Reinertson)*, 43 C.B.C.2d 130, 241 B.R. 451 (B.A.P. 9th Cir. 1999) (reversing order granting relief from order approving reaffirmation agreement because relief was not sought within one year as required by *Fed. R. Civ. P. 60(b)*, incorporated in *Fed. R. Bankr. P. 9024*).

n52

52. *Fed. R. Bankr. P. 4004(c)*, as amended in 2000.

n53

53. See *In re Long*, 6 C.B.C.2d 1370, 1373, 22 B.R. 152, 154 (Bankr. D. Me. 1982) (Judicious use of that rule [Local Rule 4002: the forerunner of Rule 4004] by debtors counsel largely should obviate the need for future motions to vacate a discharge.).

n54

54. 11 U.S.C. § 524(c)(5).

n55

55. 11 U.S.C. § 524(d).

n56

56. 11 U.S.C. § 524(d).

n57

57. See *In re Melendez*, 224 B.R. 252 (Bankr. D. Mass. 1998).

n58

58. See *In re Garber*, 2 C.B.C.2d 390, 4 B.R. 684 (Bankr. C.D. Cal. 1980); *In re Keefe*, 3 C.B.C.2d 385, 7 B.R. 270 (Bankr. E.D. Va. 1980).

n59

59. 11 U.S.C. § 524(d)(2).

n60

60. See *Collier on Bankruptcy*, 524.04[2] (Matthew Bender).

n61

61. A discharge hearing was required in all cases filed prior to Oct. 22, 1994, in which there was a reaffirmation agreement, and is required in cases filed after that date in which the debtor reaffirms a debt without being represented by an attorney in the course of negotiating the reaffirmation agreement. 11 U.S.C. § 524(d), as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994 and effective with respect to cases filed on or after that date).

n62

62. 851 F.2d 738 (4th Cir. 1988).

n63

63. See also *Midlothian State Bank v. Roth (In re Roth)*, 12 C.B.C.2d 53, 43 B.R. 484 (N.D. Ill. 1984); *In re Marletter*, 236 B.R. 281 (Bankr. M.D. Fla. 1999) (although reaffirmation of debt secured by real estate need not be approved by court, lack of discharge hearing rendered reaffirmation unenforceable); *Bankers Trust Co. v. Hunt (In re Hunt)*, 124 B.R. 200 (Bankr. N.D. Tex. 1991). But see *Sweet v. Bank of Oklahoma (In re Sweet)*, 954 F.2d 610 (10th Cir. 1992) (debtors failure to attend reaffirmation hearing did not render reaffirmation agreement unenforceable); cf. *In re Mensch*, 7 B.R. 804 (Bankr. S.D.N.Y. 1980) (debtor may be excused from attending discharge hearing if there is good cause presented at time of hearing).

n64

64. See *Collier on Bankruptcy*, 4008.05 (Matthew Bender). The 1991 amendments to the Bankruptcy Rules and Official Forms amended Rule 4008 to conform to 524(d) of the Code as amended in 1984. A hearing under section 524(d) is not mandatory unless the debtor desires to enter into a reaffirmation agreement. 1991 Advisory Committee Note to Rule 4004. The Advisory Committee Note to *Fed. R. Bankr. P. 4008* states that the notice of the section 524(d) hearing may be combined with the notice of the meeting of creditors or entered as a separate order.

ABOUT THE AUTHOR(S):

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92 of 197 DOCUMENTS

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Collier on Appointment of An Attorney for a Special Purpose

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Collier on Appointment of An Attorney for a Special Purpose

By Collier

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SUMMARY: This Emerging Issues Analysis discusses 11 U.S.C. § 327(e), which provides that, when it is in the best interest of the estate, the trustee may employ an attorney who has represented the debtor for a "specified purpose" other than to represent the trustee in conducting the bankruptcy case. It also reviews the split in opinion as to whether section 327(e) is limited to situations in which an attorney has previously represented the debtor.

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ARTICLE: Employment for Specified Special Purpose of Attorney Who Represented the Debtor; 11 U.S.C. § 327(e). Although an attorney's lack of disinterestedness may preclude employment by the estate for general purposes in conducting a bankruptcy case, the attorney may still be retained by the estate for a special purpose. Thus, *Bankruptcy Code section 327(e)* provides that, when it is in the best interest of the estate, the trustee may employ, for a specified purpose, other than to represent the trustee in conducting the case, an attorney who has represented the debtor. Such attorney need not be disinterested, n1 as is otherwise required by section 327(a), provided that the attorney represents or holds no interest adverse to the debtor or to the estate in respect of the matter upon which the attorney is to be engaged. n2 Indeed, one court has stated:

The Court believes where employment is sought only for specific limited purposes, that subsection (e) of § 327 not only eliminates the disinterestedness requirement for a professional who has formerly represented the debtor, but also narrows the conflict of interest issue to one of factual evaluation of actual or potential conflicts only as related to the particular matters for which representation is sought. n3

Special Purpose Retention Limited to Attorneys. The exception for the retention of special purpose services applies exclusively to attorneys. n4 The plain language of section 327(e) dictates such an explicit limitation, which may not be expanded by a bankruptcy court's equitable powers. n5 While § 105(a) does allow the Bankruptcy Court some latitude in interpreting the Bankruptcy Code, it cannot be used to ignore specific and unambiguous provisions of the Code. n6 Thus, while a court may find it equitable to include a nonattorney professional within the parameters of section 327(e), it may not broaden language that is otherwise unambiguous. n7

In *In re Andover Togs, Inc.*, the District Court for the Southern District of New York ruled that section 327(e) does

not contemplate the appointment of an accountant for specified special purposes. n8 While the court acknowledged the sound reasoning of the bankruptcy court in its extension of section 327(e) to encompass a debtor's accountant, the court rejected any application of the statute other than to attorneys. n9 This position also has been adopted by the Bankruptcy Court for the Southern District of Texas, n10 which dismissed the appointment of consultants under section 327(e). Section 327 (e) is inapplicable to the case at bar. The plain language of the statute limits its application to attorneys. n11 These rulings illustrate the relatively straightforward and literal approach that has been adopted by courts in interpreting this and other requirements of section 327.

Requirement That Attorney Previously Have Represented the Debtor. Courts are split with regard to whether section 327(e) is limited to situations in which the attorneys previously represented the debtor. n12 Consistent with the literal approach that most courts have adopted in interpreting section 327, the majority approach imposes an express requirement of prior representation of the debtor. n13 This is also consistent with the legislative history of section 327(e), which recognizes that section 327(e) will most likely be used when the debtor is involved in complex litigation, and changing attorneys in the middle of the case after the bankruptcy case has commenced would be detrimental to the progress of that litigation. n14 Yet some courts have ruled otherwise, and have permitted retention of counsel under section 327(e) where such counsel had not been retained by the debtor previously. n15 Other courts have reasoned by analogy to section 327(e) to permit attorneys who have represented creditors to be retained for special purposes under section 327(c). These courts are persuaded that the attorneys can be retained as long as their representation of the creditor does not create a conflict with the limited purpose for which they are being retained. n16

Section 327(e) has been examined in light of its statutory counterpart, section 327(a). The two sections address the retention of professionals, and each sets forth a distinct conflict-of-interests standard. One court has reconciled the requirement of prior representation of the debtor by explaining that a lack of prior representation does not automatically disqualify such an attorney. Instead, section 327 offers an alternative subsection in section 327(a) for the retention of professionals generally. n17 A debtor may retain an attorney who has not previously represented the debtor if such attorney meets the stricter standards of disinterestedness in section 327(a). n18

The courts that have not enforced the prior representation language in section 327(e) have reasoned that the language purporting to strictly require that an attorney have previously represented the debtor requires only that the attorney have no actual conflict of interest with the estate and that the attorney's services are in the best interest of the estate. n19 Such an interpretation seems to focus on the best interest of the estate language of section 327(e), and infers that the prior representation language merely serves as guidance to further this general goal. n20

Attorney Retained as Special Counsel Compensated for Limited Duties. The reference to conducting the case in section 327(e) includes those matters that form a part of the administration of the case under the Code. In a reorganization case, these matters include assisting in formulating a plan n21 and assisting the trustee in carrying out required investigations; in a liquidation case, these matters may include examining the validity of liens and claims n22 and collecting the assets of the estate when legal action is required. Thus, an attorney retained as special counsel may receive compensation only for those services directly related to the limited scope of retention and not for services rendered generally to the debtor in connection with its bankruptcy case. n23 Attorneys who render services beyond the specified scope of their retention risk denial of compensation for such unauthorized services.

Definition of Specified Special Purpose. An example of the specified special purpose referred to in section 327(e) is a situation where it is advisable to retain an attorney who has been employed by the debtor to handle a specific legal action for which that attorney may be particularly suited (e.g., securities litigation, personal injury lawsuits, labor negotiations). The special purpose must be unrelated to the reorganization of the debtor and must be explicitly defined or described in the application seeking approval of the attorney's employment. n24 As noted, the disinterested test of section 327(a) does not apply to section 327(e) because the attorney may, in fact, be a creditor of the debtor for fees related to such prepetition representation of the debtor. n25

Subsection (e) does not authorize the employment of the debtor's attorney to represent the estate generally or to

represent the trustee in the conduct of the case. n26 Instead, the subsection authorizes employment of an attorney in certain cases, notwithstanding the attorney's prior connection with the debtor, in order to permit the estate to take advantage of that attorney's special knowledge and experience if it may substantially benefit the estate. n27 Subsection (e) will most likely be used when the debtor is involved in complex litigation, and changing attorneys in the middle of the case after the bankruptcy case has commenced would be detrimental to the progress of that other litigation. n28

When an attorney is not disinterested but purports to act under the exception of section 327(e), approval by the court must be explicit; it cannot take the form of silent acquiescence by the court. n29 In addition, local rules may establish supplementary requirements. n30

A court may look at the totality of the circumstances, including the role of counsel prior to the filing and the actual services performed by counsel during the case, to determine whether the scope of its work will be (or has been) limited to a specified purpose under section 327(e). For example, if counsel assisted in the preparation of a prepackaged plan of reorganization prior to the filing, the court should take those services into consideration in determining whether retention under section 327(e) is appropriate. n31

For a complete discussion of Code section 327, see Collier on Bankruptcy, ch. 327.

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Return to Text

n1 1. *In re EBW Laser, Inc.*, 333 B.R. 351, 359 (Bankr. M.D.N.C. 2005) (counsel not disqualified under section 327(e) because it holds prepetition claim); *In re Albert*, 206 B.R. 636, 644 (Bankr. D. Mass. 1997) (distinguishing the disinterested requirement in subsection 327(a) from the adverse interest requirement of subsections 327(c) and (e)); *In re Black & White Cab Co.*, 175 B.R. 24, 25 (Bankr. E.D. Ark. 1994); *In re Hub Business Forms, Inc.*, 146 B.R. 315 (Bankr. D. Mass. 1992) (because of limited scope of employment, special counsel need not be disinterested; however, special counsel may not hold or represent an interest adverse to the estate); *In re G & H Steel Serv., Inc.*, 76 B.R. 508 (Bankr. E.D. Pa. 1987). For a discussion of the concept of disinterestedness, see *Collier on Bankruptcy*, 327.04[3].

n2

2. *I.G. Petroleum, L.L.C. v. Fenasci (In re West Delta Oil Co., Inc.)*, 432 F.3d 347 (5th Cir. 2005) (counsel with financial interest in bidder for estate's assets had disqualifying potential conflict when part of its services to estate included threatening litigation against competing bidder); *In re Bolton-Emerson, Inc.*, 200 B.R. 725, 732 (D. Mass. 1996); *DeVlieg-Bullard, Inc. v. Natale (In re DeVlieg, Inc.)*, 174 B.R. 497, 503 (N.D. Ill. 1994); *In re Lease-A-Fleet, Inc.*, 1992 U.S. Dist. LEXIS 407 (E.D. Pa. Jan. 15, 1992) (rejecting argument that section 327(e) requires disqualification whenever a potential conflict exists.); *Schwartz v. Prudential Ins. Co. (In re Kridlow)*, 233 B.R. 334 (Bankr. E.D. Pa. 1999) (finding no actual conflict of interest due to special counsel's prior representation of a creditor against debtor.); *Buckley v. TransAmerica Inv. Corp. (In re Southern Kitchens)*, 216 B.R. 819 (Bankr. D. Minn. 1998) (special counsels prior representation of one of the members of debtor's board

of directors is in violation of section 327(e)); *In re Imperial Corp. of Am.*, 181 B.R. 501, 506-07 (Bankr. S.D. Cal. 1995); *In re Black & White Cab Co.*, 175 B.R. 24, 25-27 (Bankr. E.D. Ark. 1994); *In re Servico, Inc.*, 149 B.R. 1009 (Bankr. S.D. Fla. 1993) (no violation of section 327(e) because receipt of the alleged preferential payment did not cause the law firm to hold any interest adverse to the debtor or the estate on the matter on which it was employed); *In re Hub Business Forms, Inc.*, 146 B.R. 315 (Bankr. D. Mass. 1992).

n3

3. *In re Statewide Pools, Inc.*, 79 B.R. 312, 314 (Bankr. S.D. Ohio 1987).

n4

4. *In re Andover Togs, Inc.*, 45 C.B.C.2d 1258 (S.D.N.Y. 2001) (only attorneys may qualify for the section 327(e) exception). *But see In re South Shore Golf Club Holding Co.*, 182 B.R. 94, 95 (Bankr. W.D.N.Y. 1995) (suggesting that there may be circumstances in which an accountant may be appointed under section 327(e)). The district court in *In re Andover Togs, Inc.*, however, held that its narrow reading of section 327(e) is in accord with *In re South Shore Golf Club*.

n5

5. *In re Federated Dep't Stores, Inc.*, 44 F.3d 1310, 1318 (6th Cir. 1995); *United States Trustee v. Price Waterhouse (In re Sharon Steel Corp.)*, 19 F.3d 138, 142 (3d Cir. 1994); *In re Andover Togs*, 45 C.B.C.2d 1258, 2001 U.S. Dist. LEXIS 2690, at *13-14 (S.D.N.Y. 2001); *In re Johns-Manville Corp.*, 26 B.R. 405, 414 (Bankr. S.D.N.Y. 1983), *aff'd*, 40 B.R. 219 (S.D.N.Y. 1984).

n6

6. *In re Andover Togs*, 45 C.B.C.2d 1258, 2001 U.S. Dist. LEXIS 2690, at *13 (S.D.N.Y. 2001) (citing *In re Johns-Manville Corp.*, 26 B.R. 405, 414 (Bankr. S.D.N.Y. 1983), and *In re Federated Dep't Stores, Inc.*, 44 F.3d 1310, 1318 (6th Cir. 1995)).

n7

7. see note 6, *supra*.

n8

8. 45 C.B.C.2d 1258, 2001 U.S. Dist. LEXIS 2690, at *13-14 (S.D.N.Y. 2001).

n9

9. *Id.*

n10

10. *In re Quality Beverage Co., Inc.*, 216 B.R. 592 (Bankr. S.D. Tex. 1995).

n11

11. 216 B.R. 592, 594.

n12

12. Compare *In re Abrass*, 250 B.R. 432, 435-36 (Bankr. M.D. Fla. 2002), *In re Black & White Cab. Co.*, 175 B.R. 24, 26 (Bankr. E.D. Ark. 1994), and *In re Genco, Inc.*, 105 B.R. 620, 621 (Bank. D. Colo. 1988), with *In re Covenant Fin. Group of Am., Inc.*, 243 B.R. 450, 457 (Bankr. N.D. Ala. 1999) (illustrating the diverging interpretations of the prior representation language in section 327(e)), and *Schwartz v. Prudential Ins. Co. of Am. (In re Kridlow)*, 233 B.R. 334 (Bankr. E.D. Pa. 1999).

n13

13. *Meespierson, Inc. v. Strategic Telecom, Inc.*, 202 B.R. 845, 848-49 (D. Del. 1996) (representing shareholder and creditor is conflict under section 327(a) and not allowed under section 327(e)); *In re Abrass*, 250 B.R. 432, 436 (Bankr. M.D. Fla. 2002); *In re Black & White Cab Co.*, 175 B.R. 24, 26 (Bankr. E.D. Ark. 1994); *In re French*, 139 B.R. 485, 489 (Bankr. D.S.D. 1992).

n14

14. *In re Abrass*, 250 B.R. 432, 436 (Bankr. M.D. Fla. 2002).

n15

15. *In re Scranton Electric Constr. Co.*, 105 B.R. 1 (Bankr. M.D. Pa. 1989).

n16

16. *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*, 176 F.3d 610, 622 (2d Cir. 1999) (subsection (e) limited to prior representation of debtor but supports analyzing adverse interest with respect to the limited role for which counsel engaged); *Stoumbos v. Kilimnik*, 988 F.2d 949, 964-65 (9th Cir. 1993) (under section 327(c), conflict may not exist with respect to the matter for which special counsel retained by analogy to section 327(e)); *In re Peters Contracting, Inc.*, 301 B.R. 857 (Bankr. M.D. Tenn. 2003) (same); *In re Development Corp. of Plymouth, Inc.*, 283 B.R. 464 (Bankr. E.D. Mich. 2002) (same).

n17

17. *Colorado National Bank of Denver v. Genco Inc.*, 105 B.R. 620, 621 (Bankr. D. Colo. 1988).

n18

18. *Id.*

n19

19. See *Schwartz v. Prudential Ins. Co. of Am. (In re Kridlow)*, 1999 Bankr. LEXIS 126 (Bankr. E.D. Pa. Feb. 19, 1999); see also *In re Covenant Fin. Group of Am., Inc.*, 243 B.R. 450, 457 (Bankr. N.D. Ala. 1999) (stating that the prior representation language of section 327(e) is not a prerequisite for representation.); *In re Scranton Elec. Constr. Co.*, 105 B.R. 1, 3 (Bankr. M.D. Pa. 1989) (only the no adverse interest requirement need be satisfied under section 327(e)) (citations omitted).

n20

20. See *Schwartz v. Prudential Ins. Co. of Am. (In re Kridlow)*, 1999 Bankr. LEXIS 126 (Bankr. E.D. Pa. Feb. 19, 1999).

n21

21. See *In re Tidewater Mem. Hosp., Inc.*, 22 C.B.C.2d 793, 802, 110 B.R. 221, 228 (Bankr. E.D. Va. 1989) (special purpose to be served by counsel appointed under § 327(e) must not be related to the debtor's reorganization since this is tantamount to representing the debtor in the conduct of the case).

n22

22. *In re Neuman*, 138 B.R. 683 (S.D.N.Y. 1992) (appointment of special counsel to advise and assist trustee in determining allowability of government claims was improper since investigating validity of government claims was a large part of conducting the case.).

n23

23. See *In re Imperial Corp. of Am.*, 181 B.R. 501 (Bankr. S.D. Cal. 1995); *In re B-T Productions, Inc.* 104 B.R. 599 (Bankr. W.D.N.Y. 1989); *In re Vladic Corp.*, 103 B.R. 802 (Bankr. N.D. Tex. 1989).

n24

24. See *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*, 176 F.3d 610 (2d Cir. 1999) (trustee retained special counsel to pursue a related litigation against a creditor); *In re Geilsinger*, 2000 U.S. Dist. LEXIS 1026 (E.D. Pa. Feb. 4, 2000) (affirming the bankruptcy court's approval of the retention of special counsel to litigate a products liability claim.); *In re Warner*, 141 B.R. 762 (M.D. Fla 1992) (debtor retained special counsel to represent him in various civil matters and in appealing criminal convictions for securities fraud); *In re McGrath Mfg. Co.*, 95 F. Supp. 825 (D. Neb. 1951) (attorney denied any compensation for services on behalf of trustees because a large part of such services concerned the administration of the reorganization case, a purpose for which the attorney had not been appointed); *In re Statewide Pools, Inc.*, 17 C.B.C.2D 927, 79 B.R. 312 (Bankr. S.D. Ohio 1987) (trustee sought to appoint attorney as special counsel specifically to collect certain of the debtor's accounts receivable and for the continued representation of the debtor in a lawsuit.); *In re Macon Prestressed Concrete Co.*, 61 B.R. 375 (Bankr. M.D. Ga. 1986) (former partner of law firm representing the debtor, and currently representing the creditors' committee, was authorized to act as debtor's special litigation counsel); *In re Iorizzo*, 35 B.R. 465 (Bankr. E.D.N.Y. 1983) (appropriate for the trustees of separate affiliated debtors to engage the same special counsel for the purpose of conducting a limited investigation); cf. *In re Mortgage Guar. Co.*, 40 F Supp. 226 (D. Md. 1941).

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25. *DeVlieg-Bullard, Inc. v. Natale (In re DeVlieg, Inc.)*, 174 B.R. 497, 503 (N.D. Ill. 1994), appeal dismissed, 56 F.3d 32 (7th Cir. 1995); *In re G & H Steel Serv., Inc.*, 76 B.R. 508 (Bankr. E.D. Pa. 1987).

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26. *In re NRG Resources, Inc.*, 64 B.R. 643, 647 (W.D. La. 1986); H.R. Rep. No. 595, 95th Cong., 1st Sess. 328; S. Rep. No. 989, 95th Cong., 2d Sess. 38; see *In re Neuman*, 138 B.R. 683, 686 (S.D.N.Y. 1992).

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27. See *In re Statewide Pools, Inc.*, 17 C.B.C.2D 927, 930-31, 79 B.R. 312, 315 (Bankr. S.D. Ohio 1987).

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28. H.R. Rep. No. 595, 95th Cong., 1st Sess. 328; S. Rep. No. 989, 95th Cong., 2d Sess. 38-39. *But see Stapleton v. Woodworking Warehouse, Inc. (In re Woodworkers Warehouse, Inc.)*, 323 B.R. 403 (D. Del. 2005) (counsel unable to be retained under section 327(a) may be retained under section 327(e) when services included approval of financing, sale of assets and key employee retention program).

n29

29. See *In re Progress Lektro Shave Corp.*, 117 F.2d 602, 604 (2d Cir.), *reh'g denied*, 118 F.2d 751 (2d Cir. 1941); see also *In re D.L. Enterprises*, 89 B.R. 107 (Bankr. C.D. Cal. 1988) (court reduced fee award to special counsel for nondisclosure of dual representation of debtor partnership and nondebtor general partner in action against limited partner).

n30

30. For example, Local Bankruptcy Rule 2014-1 of the Southern District of New York provides: An application for the employment of a professional person pursuant to §§ 327 and 328 of the *Bankruptcy Code* shall state the specific facts showing the reasonableness of the terms and conditions of the employment, including the terms of any retainer, hourly fee, or contingent fee arrangement. In addition, Delaware's Local Bankruptcy Rule 2014-1 sets forth the procedural requirements that are necessary for court approval of any professional employed by the debtor. See *Collier Bankruptcy Practice Guide Local Rules Pamphlet: Second Circuit* (Matthew Bender).

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31. *Century Indem. Co. v. Congoleum Corp. (In re Congoleum Corp.)*, 426 F.3d 675 (3d Cir. 2005).

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93 of 197 DOCUMENTS

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Employment of a Disinterested Professional With No Adverse Interest

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Collier on the Employment of a Disinterested Professional With No Adverse Interest

By Collier

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SUMMARY: Under Bankruptcy Code section 327(a), a trustee may employ only attorneys, accountants, appraisers and other professional persons not holding or representing an interest adverse to the estate. Additionally, a trustee may employ only professional persons who are disinterested persons. Courts have recognized that there is an overlap in the two prongs of section 327(a). This article discusses the Courts disagreement as to the rigidity of the application of these tests.

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ARTICLE: Under *Bankruptcy Code section 327(a)*, the trustee may employ only attorneys, accountants, appraisers and other professional persons not holding or representing an interest adverse to the estate. n1 In addition, a trustee may employ only professional persons who are disinterested persons.

Courts have recognized that there is an overlap in the two prongs of section 327(a), persons holding or representing an interest adverse to the estate and persons who are not disinterested, n2 and observe that they form one hallmark with which to evaluate whether professionals seeking court-approved retention (or to remain retained by the estate) meet the absence of adversity requirements embodied in the Bankruptcy Code. n3

The Disinterestedness Prong: When a Person Is Not Disinterested; 11 U.S.C. §101. Disinterested person is defined in section 101 of the Code, which sets forth the affiliations, connections and interests that disqualify professional persons from being employed by trustees. n4 Numerous cases have construed section 101's definition of disinterested. n5 These and other courts tend to analyze aspects of disinterestedness (e.g., the professionals status as a creditor of the estate) in the context of conflicts of interest. n6

Section 101 and the Definition of Disinterested Person. Section 101 prescribes three tests that, if satisfied by a person under consideration, renders that person disinterested. Otherwise, that person, except as provided in section 327(c), 327(e), or 1107(b), is ineligible for employment by a trustee. The section provides that a person is a disinterested person if the person:

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason. n7

Note that for cases commenced prior to October 17, 2005, there is still an additional category of those who are not disinterested, certain investment bankers and their advisers. n8

Courts disagree as to the rigidity of the application of these tests. The majority of courts demand *per se* application of the statute; lack of disinterestedness results in automatic disqualification, including situations in which a law firm represents the debtor in bankruptcy proceedings while also acting for creditors in nonbankruptcy proceedings. n9 But some courts have held that judges have latitude to depart from *per se* application of the statute and make case-by-case decisions looking to the totality of the circumstances. n10

In *In re Pierce*, n11 the Court of Appeals for the Eighth Circuit rejected a rule that would allow a case-by-case analysis in favor of a *per se* rule in disqualifying an attorney for the debtor simply because the attorney had a mortgage on the debtors property securing a claim for prepetition bankruptcy services rendered to the debtor. The court reasoned that the intent of the Code is clear; if a professional is a creditor, then that person is not disinterested under [section 101] and is subject to disqualification under Section 327(a). n12 The Third Circuit has disqualified counsel when a facially plausible claim of a substantial preference existed. n13 Similarly, the Court of Appeals for the Sixth Circuit held that [b]y forbidding employment of all interested persons, section 327 prevents individual bankruptcy courts from having to make determinations as to the best interest of the debtors in these situations. n14

The Court of Appeals for the Fourth Circuit has followed the Sixth Circuit in holding that the bankruptcy court may only approve the employment of a professional who has represented a creditor of the estate if that person no longer represents the creditor in connection with the bankruptcy case, § 327(c). These are congressionally established *per se* rules that a bankruptcy court must apply in exercising its approval power over the appointment of professionals. n15

In contrast, the Court of Appeals for the First Circuit has held that there is no *per se* rule mandating disqualification of a professional who fails the disinterested test. n16 The court identified a nonexhaustive list of 10 factors to consider in determining whether a relationship with the debtor, such as the holding of a security interest in the debtors property, renders a professional disinterested:

- (1) the reasonableness of the arrangement and whether it was negotiated in good faith;
- (2) whether the security demanded was commensurate with the predictable magnitude and value of the foreseeable services;
- (3) whether it was a needed means of ensuring the engagement of competent counsel;
- (4) whether there are telltale signs of overreaching;
- (5) the nature and extent of any conflict arising from the taking of a security interest as well as the likelihood that a potential conflict might turn into an actual one;
- (6) the influence the putative conflict may have in subsequent decision-making;
- (7) how the matter likely appears to creditors and to other parties in legitimate interest, given the importance of perceptions by the creditor body and the problem at large;
- (8) whether the existence of the security interest threatens to hinder or to delay the effectuation of a plan;

(9) whether the security interest granted is (or could be perceived as) an impediment to reorganization; and

(10) whether the fundamental fairness of the proceedings might be unduly jeopardized either by the actuality of the arrangement or by the reasonable public perception of it. n17

Other bankruptcy courts also have held that there is no *per se* rule mandating disqualification. n18 Similar to determinations of disinterestedness concerning other professional persons, some courts have rejected a vigorous application of the section 101 definition of disinterested. n19 Indeed, the court in *In re Pacific Express* rejected a literal application of the disinterested standard set forth in section 101 as incorporated into sections 327(a) and 328(c) of the Code. n20 The court found that the application of the standard of disinterestedness is not to be prophylactic but must be judged in the perspective of the particular case and the facts presented. Given the incidence of public corporations resorting to protection under chapter 11, this more pragmatic construction of the definition may be justified.

Section 1104 and the Requirement of Disinterestedness. The Code requires the same degree of disinterestedness on the part of an attorney or other professional person employed by the trustee that is required of the trustee in a reorganization case under section 1104(d) of the Code. Section 1104(d) provides that the United States trustee, after consultation with parties in interest, and subject to court approval, shall appoint a disinterested person to serve as trustee or examiner (if one is ordered in a reorganization case). n21 It would be anomalous to require a trustee to be aloof from all connection with the debtor or its management, yet permit the trustee's attorney, who necessarily would be active in furthering the trustee's duties of investigation, management, prosecution, development of plans and the like, to have a close relationship with the debtor, its management or associates. n22

Who Is Not Disinterested as Defined by Section 101?

Creditor of the Debtor. Section 101 provides that a person is not disinterested if the person is a creditor of the debtor. n23 Creditor is defined in section 101 and includes holders of prepetition claims.

Equity Security and Equity Security Holder. Under section 101, a person is not disinterested if the person is an equity security holder of the debtor. n24 Equity security is defined in section 101 and includes shares or stock in a corporation, a limited partner's interest in a limited partnership, and warrants or rights to subscribe in an equity security. The term does not include securities, such as convertible debentures, that are convertible into equity securities, but that have not been converted. n25 Equity security holder is the holder of an equity security of the debtor.

Insider. An insider of the debtor also is not a disinterested person. n26 Although section 101 defines insider, the definition is open-ended because the term is not precise. An insider is one who has a sufficiently close relationship with the debtor that his or her conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.

If the debtor is a corporation, then a controlling person, a relative of a controlling person, a partnership in which the debtor is a general partner and a general partner of the debtor are all insiders. If the debtor is a partnership, then a general partner of or in the debtor, a relative of a general partner in the debtor and a person in control are all insiders. If the debtor is a municipality, then an elected official of the debtor is an insider. In addition, affiliates of the debtor and managing agents are insiders. n27

Section 101 might be construed to preclude persons who are acting as trustees of a parent corporation from appointment as trustees of the parent's wholly owned subsidiary, since they are not disinterested. However, this would be contrary to considerations of judicial economy. It would result in unwieldy administration of large reorganization cases involving many affiliated entities. Courts, therefore, generally evaluate each case on its facts and permit trustees to jointly administer parent and subsidiary companies. n28

It is presumed by the statute that a person who is a creditor, equity security holder or insider is incapable of the impartial judgment required of a professional in the conduct of a case under the Code. n29 This reasoning is equally applicable to the employment of professional persons by the trustee.

Person Holding an Interest Materially Adverse to Interest of the Estate or Class of Creditors or Equity Security Holders. Section 101 provides that a person is not disinterested if the person has an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor *or for any other reason*. [Emphasis added.] This subsection of section 101 is adopted from former Rule 10-202(c)(2)(D), which has been described as a catch-all clause. n30 It appears broad enough to include anyone who in the slightest degree might have some interest or relationship that would color the independent and impartial attitude required by the Code. n31 The purpose of the catch-all clause is to prevent a conflict even if the professional person under consideration promises to report such conflict if it arises. n32 Examples of such materially adverse interests include

- a prepetition claim against the debtor; n33
- representation of a shareholder; n34
- representation of an adversary; n35
- representation of certain investors of the debtors; n36 and
- performance of services for an entity whose subsidiary is a member of the creditors committee. n37

Although these representations have been considered by courts to render the professional person not disinterested, the more correct analysis is to conclude that, as a result of such representations, the person represents an interest adverse to the estate, which is the second prong of the analysis under section 327(a). n38

Caution must be exercised to avoid the application of the catch-all provision to the detriment of the case. Relationships remote from the pending case that do not involve confidential information should not serve as the basis for disqualifying competent professional persons. For example, in *In re Allegheny Int'l, Inc.*, n39 the possibility that a conflict could arise was an insufficient basis to deny the retention of an otherwise qualified professional to act as an independent special advisor to assist the debtor in its business operations. The court stated that the possibility that [the advisor] may eventually play a managerial role in an as-yet speculative reorganization plan does not mean that [the advisor] would fall prey to conflicting loyalties while employed under the special advisor agreement, or that his interest would be materially adverse to those of the estate, creditors or equity security holders. n40 In *In re Wingspread Corp.*, n41 the court considered a successor parents objection to the continued representation by the chapter 7 trustees law firm in an adversary proceeding against the successor-parents subsidiary. The bankruptcy court approved the continued employment of the law firm, based in part on the lack of evidence demonstrating that the law firms prior representation of the second subsidiary provided it with confidential information related to the trustees action against the other subsidiary. n42

In *In re Marvel Entertainment Group, Inc.*, n43 the Court of Appeals for the Third Circuit clarified that the catch-all provision for any other reason does not sanction disqualification of a professional merely upon the basis of an appearance of a conflict. Instead, the court adopted the following tests for disqualification: (1) section 327 imposes a *per se* disqualification of any professional who has an actual conflict of interest; (2) the court may, within its discretion, disqualify a professional who has a potential conflict of interest; and (3) the court may not disqualify a professional solely on the basis of an appearance of conflict.

The Adverse Interest Prong: Persons Must Not Hold or Represent an Interest Adverse to the Estate. Section

327(a) requires that, in addition to being disinterested, the professional retained by the trustee not hold or represent an interest adverse to the estate. An interest adverse to the estate has been defined as any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute, n44 or a predisposition under circumstances that render such bias against the estate. n45

The Court of Appeals for the Second Circuit has held that the distinction between the interest adverse and disinterested prongs of section 327(a) is that the interest adverse prong forbids persons who represent interests adverse to the estate from also being employed by the trustee under section 327(a); in contrast, the disinterestedness prong does *not* forbid persons who represent interests adverse to creditors or equity security holders from also representing the estate. n46 Thus the interest adverse prong adds to the disinterestedness prong the requirement that the person to be employed not represent an interest adverse to the estate.

Adverse interests have been found in instances where the professional person represented the debtor corporations officers, n47 served as an officer and director of the debtor, n48 was a prepetition creditor of the debtors estate, n49 was actually acting on behalf of a major equity holder of the estate, n50 co-owned land with the debtor n51 and offered financing to one of the bidders for estate assets. n52

A provision similar to section 327(a) of the Code with respect to the disqualifying effect of holding or representing an interest adverse to the estate was found in former Bankruptcy Rule 215(a). Former Rule 215(a) also contained the requirement that the employment of the attorney or accountant be in the best interest of the estate. This requirement is not found in section 327(a), but appears in section 327(d) when the court may authorize the trustee to act as attorney or accountant for the estate and section 327(e) when the trustee may, for a specified special purpose, employ an attorney who has previously represented the debtor.

Nevertheless, courts may conclude there is no materially adverse interests even in instances in which the professional is a mortgagee of the debtors estate, n53 a special advisor involved in the postconfirmation management of the debtor n54 or has provided prior services to the debtors competitor n55 or has asserted prior legal positions inapposite to positions in the current representation of the debtor. n56 The reasons supporting these conclusions are the same, of course, as those previously recounted.

Indirect or remote associations or affiliations, as well as direct, may engender conflicting loyalties. n57 Thus, a debtors attorney is not eligible for employment as a disinterested attorney for the trustee. n58 However, section 327(e) authorizes the trustee to employ for a special purpose, other than representation of the trustee in the overall bankruptcy case, an attorney that has represented the debtor if such attorney does not represent or hold any adverse interest to the estate and if the appointment is in the best interest of the estate. n59

For a complete discussion of Code section 327, see Collier on Bankruptcy, ch. 327.

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n1 1. See *Miller v. United States Trustee (In re Independent Engg Co.)*, 197 F.3d 13, 17 (1st Cir. 1999); *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*, 176 F.3d 610, 621 (2d Cir. 1999); *In re Martin*, 817

F.2d 175, 179, 16 C.B.C.2d 672 (1st Cir. 1987); *In re Tauber on Broadway, Inc.*, 271 F.2d 766 (7th Cir. 1959); *In re Kendavis Indus. Intl, Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988); *Sholer v. Bank of Albuquerque (In re Gallegos)*, 68 B.R. 584 (Bankr. D.N.M. 1986); *In re Gray*, 64 B.R. 505 (Bankr. E.D. Mich. 1986); *In re Patterson*, 53 B.R. 366 (Bankr. D. Neb. 1985); *In re Wells Benrus Corp.*, 48 B.R. 196 (Bankr. D. Conn. 1985); see also *In re Pacific Express Inc.*, 14 C.B.C.2d 157, 56 B.R. 859 (Bankr. E.D. Cal. 1985) (investment in debtor by partners of law firm, service as corporate officer and director by a partner and participation of law firm partners with debtor in a business venture did not constitute an interest adverse to debtors or their estates).

n2

2. *In re Vebeliunas*, 231 B.R. 181, 189 (Bankr. S.D.N.Y. 1999); see also *In re Envirodyne Indus., Inc.*, 150 B.R. 1008, 1017 (Bankr. N.D. Ill. 1993); *In re Tinley Plaza Assocs., L.P.*, 142 B.R. 272, 277 (Bankr. N.D. Ill. 1992).

n3

3. *In re Vebeliunas*, 231 B.R. 181, 189 (Bankr. S.D.N.Y. 1999); see also *In re Martin*, 817 F.2d 175, 179 n.6 (1st Cir. 1987) (with respect to the requirement of no adverse interest the two prongs of this test are duplicative); *In re Mercury*, 280 B.R. 35, 53 (Bankr. S.D.N.Y. 2002) (quoting from *In re Martin*); *In re Roberts*, 46 B.R. 815, 828 (Bankr. D. Utah 1985); *In re Cropper Company, Inc.*, 35 B.R. 625, 631 (Bankr. M.D. Ga. 1983) (either prong requires an attorney employed by a debtor in possession to be free of conflicts of interest).

n4

4. For a case involving several obvious grounds for disqualification, see *In re McGrath Mfg. Co.*, 95 F. Supp. 825 (D. Neb. 1951).

n5

5. See, e.g., *In re Federated Dept Stores, Inc.*, 44 F.3d 1310, 32 C.B.C.2d 1391 (6th Cir. 1995); *In re Martin*, 817 F.2d 175, 16 C.B.C.2d 672 (1st Cir. 1987); *Pierce v. Aetna Life Ins. Co.*, 809 F.2d 1356 (8th Cir. 1987); *Merrimac Assocs., Inc. v. Daig Corp. (In re Daig Corp.)*, 799 F.2d 1251 (8th Cir. 1986); *Smith v. Marshall (In re Hot Tin Roof, Inc.)*, 205 B.R. 1000 (B.A.P. 1st Cir. 1997); *In re Roberts*, 75 B.R. 402 (D. Utah 1987); *In re Gulf Coast Orthopedic Ctr.*, 265 B.R. 318 (Bankr. M.D. Fla. 2001); *In re LKM Indus., Inc.*, 252 B.R. 589 (Bankr. D. Mass. 2000); *In re Princeton Med. Mgmt., Inc.*, 249 B.R. 813 (Bankr. M.D. Fla. 2000); *In re Amdura Corp.*, 121 B.R. 862 (Bankr. D. Colo. 1990); *In re Flying E Ranch Co.*, 81 B.R. 633 (Bankr. D. Colo. 1988); *In re Kendavis Indus. Intl, Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988); *In re Viking Ranches, Inc.*, 19 C.B.C.2d 354, 89 B.R. 113 (Bankr. C.D. Cal. 1988); *In re Sixth Ave. Car Care Ctr.*, 81 B.R. 628 (Bankr. D. Colo. 1988); *In re Global Marine, Inc.*, 108 B.R. 998 (Bankr. S.D. Tex. 1987); *In re Michigan General Corp.*, 17 C.B.C.2d 846, 78 B.R. 479 (Bankr. N.D. Tex. 1987), *affd in part, revd in part, sub nom. Diamond Lumber, Inc. v. Unsecured Creditors Comm. of Diamond*, 88 B.R. 773 (N.D. Tex. 1988); *In re Gray*, 64 B.R. 505 (Bankr. E.D.

Mich. 1986); *In re Estes*, 14 C.B.C.2d 58, 57 B.R. 158 (Bankr. N.D. Ala. 1986); *In re Pacific Express, Inc.*, 14 C.B.C.2d 157, 56 B.R. 859 (Bankr. E.D. Cal. 1985); *In re OConnor*, 52 B.R. 892 (Bankr. W.D. Okla. 1985); *In re Wells Benrus Corp.*, 48 B.R. 196 (Bankr. D. Conn. 1985).

n6

6. *In re Bolton-Emerson, Inc.*, 200 B.R. 725, 732 (D. Mass. 1996); *In re Southern Kitchens, Inc.*, 216 B.R. 819, 826 (Bankr. D. Minn. 1998); *In re Roberts*, 46 B.R. 815, 827 (Bankr. D. Utah 1985).

n7

7. 11 U.S.C. § 101(14); see *Collier on Bankruptcy*, 101.14.

n8

8. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 414 (2005), effective in cases commenced on or after October 17, 2005, deleted from those who were disinterested a person that (1) is not and was not an investment banker for any outstanding security of the debtor, (2) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor, and (3) is not and was not, within two years before the date of the filing of the petition, a director, officer or employee of the debtor or of an investment banker of the type described in clauses (1) and (2) above. See *Collier on Bankruptcy*, 101.14 and *Collier on Bankruptcy*, 327.LH[9].

n9

9. *In re Consolidated Bancshares, Inc.*, 785 F.2d 1249, 1256 n.6 (5th Cir. 1986); *In re Envirodyne Indus., Inc.*, 28 C.B.C.2d 747, 150 B.R. 1008 (Bankr. N.D. Ill. 1993); *In re American Printers & Lithographers, Inc.*, 28 C.B.C.2d 242, 245, 148 B.R. 862, 864 (Bankr. N.D. Ill. 1992). Although these courts state the issue in such situations as one of disinterestedness, representation of an entity adverse to the debtor is more appropriately analyzed under the adverse interest prong of section 327(a). See *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*, 176 F.3d 610 (2d Cir. 1999).

n10

10. *In re Martin*, 817 F.2d 175, 180-83, 16 C.B.C.2d 672 (1st Cir. 1987); *In re Pacific Express, Inc.*, 14 C.B.C.2d 157, 56 B.R. 859 (Bankr. E.D. Cal. 1985); *In re OConnor*, 52 B.R. 892, 899 (Bankr. W.D. Okla. 1985).

n11

11. 809 F.2d 1356 (8th Cir. 1987).

n12

12. 809 F.2d 1356, 1362.

n13

13. *Staiano v. Pillowtex, Inc. (In re Pillowtex, Inc.)*, 304 F.3d 246 (3d Cir. 2002) (even if firm agrees to waive claim if transfer is avoided, the conditional waiver does not resolve conflict); *see also Movitz v. Baker (In re Triple Star Welding, Inc.)*, 324 B.R. 778, 795 (B.A.P. 9th Cir. 2005) (facially plausible preference claim must be resolved before proposed counsel can be employed (or compensated)).

n14

14. *In re Middleton Arms, L.P.*, 934 F.2d 723, 725 (6th Cir. 1991).

n15

15. *In re Harold & Williams Dev. Co.*, 977 F.2d 906, 909 (4th Cir. 1992).

n16

16. *In re Martin*, 817 F.2d 175, 16 C.B.C.2d 672 (1st Cir. 1987).

n17

17. *In re Martin*, 817 F.2d 175, 182, 16 C.B.C.2d 672 (1st Cir. 1987) (allowing professional with retainer to be retained).

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18. *See, e.g., In re Leypoldt*, 95 I.B.C.R. 220 (Bankr. D. Idaho 1995) (security for retainer does not

disqualify in absence of evidence of overreaching although additional safeguards needed when retainer in form of security interest in estate property); *In re Quincy Air Cargo, Inc.*, 155 B.R. 193 (Bankr. C.D. Ill. 1993).

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19. *In re GHR Energy Corp.*, 60 B.R. 52 (Bankr. S.D. Tex. 1985); *In re Pacific Express, Inc.*, 14 C.B.C.2d 157, 56 B.R. 859 (Bankr. E.D. Cal. 1985).

n20

20. 14 C.B.C.2d 157, 56 B.R. 859 (Bankr. E.D. Cal. 1985).

n21

21. *In re Marvel Entertainment Group*, 140 F.3d 463, 39 C.B.C.2d 1315 (3d Cir. 1998).

n22

22. *In re McGrath Mfg. Co.*, 95 F. Supp 825, 834 (D. Neb. 1951).

n23 23. See *United States Trustee v. Price Waterhouse*, 19 F.3d 138, 30 C.B.C.2d 1522, (3d Cir. 1994); *In re Martin*, 817 F.2d 175, 16 C.B.C.2d 672 (1st Cir. 1987); *In re Siliconix, Inc.*, 135 B.R. 378 (N.D. Cal. 1991); *In re Roberts*, 75 B.R. 402 (D. Utah 1987); *In re LKM Indus., Inc.*, 252 B.R. 589 (Bankr. D. Mass. 2000); *In re Princeton Med. Mgmt., Inc.*, 249 B.R. 813 (Bankr. M.D. Fla. 2000); *In re Hub Business Forms, Inc.*, 146 B.R. 315 (Bankr. D. Mass. 1992); *In re Viking Ranches, Inc.*, 19 C.B.C.2d 354, 89 B.R. 113 (Bankr. C.D. Cal. 1988); *In re Flying E Ranch Co.*, 81 B.R. 633 (Bankr. D. Colo. 1988); *In re Boro Recycling, Inc.*, 67 B.R. 3 (Bankr. E.D.N.Y. 1986); *In re Gray*, 64 B.R. 505 (Bankr. E.D. Mich. 1986); *In re Estes*, 14 C.B.C.2d 58, 57 B.R. 158 (Bankr. N.D. Ala. 1986); *In re Nashville Union Stockyard Restaurant, Co.*, 54 B.R. 391 (Bankr. M.D. Tenn. 1985); *In re Patterson*, 53 B.R. 366 (Bankr. D. Neb. 1985); *In re Codesco, Inc.*, 18 B.R. 997 (Bankr. S.D.N.Y. 1982).

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24. See *In re Anver Corp.*, 11 C.B.C.2d 1171, 44 B.R. 615 (Bankr. D. Mass. 1984); *In re The Cropper Co.*, 35 B.R. 625 (Bankr. M.D. Ga. 1983); see also *Merrimac Assocs., Inc. v. Daig Corp. (In re Daig Corp.)*, 799 F.2d 1251 (8th Cir. 1986) (holder of stock purchase warrant held not to be disinterested); *In re Ocean City Auto.*

Bridge Co., 184 F.2d 726, 729 (3d Cir. 1950) (trustee who was a stockholder of the debtor was found to be not disinterested under former section 158 of the Act). *But see In re Pacific Express, Inc.*, 14 C.B.C.2d 157, 56 B.R. 859 (Bankr. E.D. Cal. 1985); *In re OConnor*, 52 B.R. 892 (Bankr. W.D. Okla. 1985) (attorney holding only 1,000 out of 12 million outstanding shares of debtor corporation satisfied the disinterestedness test).

n25

25. H.R. Rep. No. 595, 95th Cong., 1st Sess. 311; S. Rep. No. 989, 95th Cong., 2d Sess. 24.

n26

26. *See In re Prado Verde Ranch, Inc.*, 250 B.R. 126 (Bankr. D.N.M. 2000); *In re Hub Business Forms, Inc.*, 146 B.R. 315 (Bankr. D. Mass. 1992) (court denied employment of law firm *nunc pro tunc* because a member of the firm was on the debtors board of trustees); *In re Patterson*, 53 B.R. 366 (Bankr. D. Neb. 1985) (attorneys co-ownership of real estate with debtor could be viewed as a partnership, and thus attorney was an insider under section 101); *In re Wells Benrus Corp.*, 48 B.R. 196 (Bankr. D. Conn. 1985) (member of law firm served as officer and director of debtor for 17 years); *In re Roger J. Au & Son, Inc.*, 65 B.R. 322 (Bankr. N.D. Ohio 1984), *aff'd*, 64 B.R. 600 (N.D. Ohio 1986) (attorney who was director and secretary to the debtor and its affiliates was disqualified as debtors attorney); *see also United States Trustee v. S.S. Retail Stores Corp. (In re S.S. Retail Stores Corp.)*, 211 B.R. 699, 704 (B.A.P. 9th Cir. 1997) (member of firm who was corporate secretary did not disqualify law firm); *cf. In re Middleton Arms, L.P.*, 934 F.2d 723 (6th Cir. 1991). *But see In re All Seasons Indus., Inc.*, 121 B.R. 822 (Bankr. N.D. Ind. 1990) (disinterestedness requirement under section 327 does not apply to a debtors inside management because debtors management is, by definition, an insider and not disinterested); *In re GHR Energy Corp.*, 60 B.R. 52 (Bankr. S.D. Tex. 1985) (sole fact that two of debtors lawyers served as officers of debtor purely for ministerial functions should not serve as basis for reducing compensation of debtors attorneys due to conflict of interest); *In re Pacific Express, Inc.*, 14 C.B.C.2d 157, 56 B.R. 859 (Bankr. E.D. Cal. 1985) (court did not question law firms purportedly disinterested status under section 101 despite service by one of its members on debtors board of directors and as debtors corporate secretary).

n27

27. *See note 35 infra*; H.R. Rep. No. 595, 95th Cong., 1st Sess. 312; S. Rep. No. 989, 95th Cong., 2d Sess. 25.

n28

28. *See In re International Oil Co.*, 427 F.2d 186 (2d Cir. 1970); *In re G.E.C. Sec., Inc.*, 331 F.2d 655 (2d Cir. 1964); *Katz v. Kilsheimer*, 327 F.2d 633 (2d Cir. 1964); *In re National Pub. Serv. Corp.*, 68 F.2d 859 (2d Cir.), *cert. denied*, 292 U.S. 641, 54 S. Ct. 774, 78 L. Ed. 1492 (1934); *In re Covenant Fin. Group of Am.*, 243 B.R. 450 (Bankr. N.D. Ala. 1999); *In re Ben Franklin Retail Stores*, 214 B.R. 852 (Bankr. N.D. Ill. 1997); *In re Global Marine, Inc.*, 108 B.R. 998 (Bankr. S.D. Tex. 1987); *see also In re H&S Transportation Co.*, 55 B.R. 786,

791 (Bankr. M.D. Tenn. 1982); *Hassett v. McColley (In re O.P.M. Leasing Servs., Inc.)*, 5 C.B.C.2d 1503, 16 B.R. 932, 937-40 (Bankr. S.D.N.Y. 1982); cf. *Grubbs v. Pettit*, 282 F.2d 557 (2d Cir. 1960) (two trustees of parent appointed as trustees of subsidiary and third trustee appointed for both parent and subsidiary). Note, however, that the Code permits only single trustees. See 11 U.S.C. §§ 701, 702, 1104(c).

n29

29. In a Securities and Exchange report, it was noted: A trustee who is a stockholder or a creditor can hardly be expected to take action which may result in invalidating or impairing the worth of his own stock in the debtor or of his own claim against it, regardless of the advantage of such action to the estate as a whole. Securities & Exchange Commn, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees*, pt. VIII, at 110 (1937-1940) [hereinafter *SEC Report*].

n30

30. Note, *Bankruptcy: Corporate Reorganization: Survey of Chapter X in Operation*, 18 N.Y.U.L.Q. Rev. 399, 436 (1941).

n31

31. See *In re Pierce*, 809 F.2d 1356 (8th Cir. 1987); *Smith v. Marshall (In re Hot Tin Roof, Inc.)*, 205 B.R. 1000 (B.A.P. 1st Cir. 1997); *Beal Bank, S.S.B. v. Waters Edge Ltd. Pship*, 248 B.R. 668 (D. Mass. 2000); *In re Temp-Way Corp.*, 95 B.R. 343 (E.D. Pa. 1989); *In re Vebeliunas*, 231 B.R. 181 (Bankr. S.D.N.Y. 1999); *In re Envirodyne Indus.*, 28 C.B.C.2d 747, 150 B.R. 1008 (Bankr. N.D. Ill. 1993); *In re Hub Business Forms, Inc.*, 146 B.R. 315 (Bankr. D. Mass. 1992); *In re Carrousel Motels, Inc.*, 97 B.R. 898 (Bankr. S.D. Ohio 1989); *Sholer v. Bank of Albuquerque (In re Gallegos)*, 68 B.R. 584 (Bankr. D.N.M. 1986); *In re Hoffman*, 53 B.R. 564, 845 (Bankr. W.D. Ark. 1985). But see *In re Martin*, 817 F.2d 175, 180-83, 16 C.B.C.2d 672 (1st Cir. 1987); *In re Film Ventures Intl*, 75 B.R. 250 (B.A.P. 9th Cir. 1987); *In re Allegheny Intl, Inc.*, 117 B.R. 171 (W.D. Pa. 1990); *In re Roberts*, 75 B.R. 402 (D. Utah 1987); *In re Aircraft Instrument & Dev., Inc.*, 151 B.R. 939 (Bankr. D. Kan. 1993); *In re Maddox*, 92 B.R. 707 (Bankr. W.D. Tex. 1988).

n32

32. *Meredith v. Thralls*, 144 F.2d 473, 475 (2d Cir.), cert. denied, 323 U.S. 758, 64 S. Ct. 92, 89 L. Ed. 607 (1944).

n33

33. *Sholer v. Bank of Albuquerque (In re Gallegos)*, 68 B.R. 584 (Bankr. D.N.M. 1986). Of course, this is

already expressly covered in the definition of disinterested under section 101.

n34

34. *In re Temp-Way Corp.*, 95 B.R. 343 (E.D. Pa. 1989); *In re Carrousel Motels, Inc.*, 97 B.R. 898 (Bankr. S.D. Ohio 1989); *In re Hoffman*, 53 B.R. 564 (Bankr. W.D. Ark. 1985).

n35

35. *In re Johore Inv. Co.*, 49 B.R. 710 (Bankr. D. Haw. 1985).

n36

36. *In re Envirodyne Indus.*, 28 C.B.C.2d 747, 150 B.R. 1008 (Bankr. N.D. Il. 1993).

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37. *In re Hub Business Forms, Inc.*, 146 B.R. 315 (Bankr. D. Mass. 1992).

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38. See also *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*, 176 F.3d 610 (2d Cir. 1999).

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39. 117 B.R. 171 (W.D. Pa. 1990).

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40. 117 B.R. 171, 179.

n41

41. 28 C.B.C.2d 1050, 152 B.R. 861 (*Bankr. S.D.N.Y. 1993*).

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42. 28 C.B.C.2d 1050, 152 B.R. 861, 865.

n43

43. 140 F.3d 463, 39 C.B.C.2d 1315 (3d Cir. 1998).

n44

44. *In re American Printers & Lithographers, Inc.*, 28 C.B.C.2d 242, 245, 148 B.R. 862, 864 (*Bankr. N.D. Ill. 1992*).

n45

45. *Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831, 835 (7th Cir. 1998) (quoting from *In re Roberts*, 46 B.R. 815, 827 (*Bankr. D. Utah 1985*)).

n46

46. *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*, 176 F.3d 610 (2d Cir. 1999); *In re Huntco Inc.*, 288 B.R. 229 (*Bankr. E.D. Mo. 2002*) (following Second Circuit approach).

n47

47. See, e.g., *In re Tauber on Broadway, Inc.*, 271 F.2d 766 (7th Cir. 1959).

n48

48. See, e.g., *In re Wells Benrus Corp.*, 48 B.R. 196 (*Bankr. D. Conn. 1985*).

n49

49. See, e.g., *Sholer v. Bank of Albuquerque (In re Gallegos)*, 68 B.R. 584 (Bankr. D.N.M. 1986); *In re Gray*, 64 B.R. 505 (Bankr. E.D. Mich. 1986).

n50

50. See, e.g., *In re Kendavis Indus. Intl, Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988).

n51

51. See, e.g., *In re Patterson*, 53 B.R. 366 (Bankr. D. Neb. 1985).

n52

52. *I.G. Petroleum, L.L.C. v. Fenasci (In re West Delta Oil Co., Inc.)*, 432 F.3d 347 (5th Cir. 2005).

n53

53. *In re Martin*, 817 F.2d 175, 16 C.B.C.2d 672 (1st Cir. 1987) (mortgage taken as retainer for postpetition services); *In re Film Ventures Intl*, 75 B.R. 250 (B.A.P. 9th Cir. 1987); *In re Advanced Imaging Technologies, Inc.*, 306 B.R. 677, 682 (Bankr. W.D. Wash. 2003) (lien for postpetition services does not disqualify counsel *per se*).

n54

54. *In re Allegheny Intl, Inc.*, 117 B.R. 171 (W.D. Pa. 1990).

n55

55. *In re Aircraft Instrument & Dev., Inc.*, 151 B.R. 939 (Bankr. D. Kan. 1993).

n56

56. *In re Westside Creek Ltd. Pship*, 93 B.R. 177 (Bankr. E.D. Ark. 1988).

n57

57. See *In re Progress Lektro Shave Corp.*, 117 F.2d 602 (2d Cir. 1941); *In re Chicago Rapid Transit Co.*, 93 F.2d 832 (7th Cir. 1937); *In re Envirodyne Indus.*, 28 C.B.C.2d 747, 758, 150 B.R. 1008, 1017 (Bankr. N.D. Ill. 1993).

n58

58. See *In re Progress Lektro Shave Corp.*, 117 F.2d 602 (2d Cir. 1941).

n59

59. See 11 U.S.C. § 327(e).

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94 of 197 DOCUMENTS

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Collier on the Exception to the Automatic Stay Arising From a Prior Bankr. Case

2008 Emerging Issues 1536

Collier on the Exception to the Automatic Stay Arising From a Prior Bankruptcy Case

By Collier

December 15, 2007

SUMMARY: In some situations, the automatic stay might not apply by reason of a prior case under the Bankruptcy Code. This Emerging Issues Analysis covers the requirements and procedure for and duration of an *in rem* order under Bankruptcy Code section 362(d)(4), and the exemption from the stay after a bankruptcy filing by an ineligible debtor or in violation of court order.

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ARTICLE: In some situations, the automatic stay might not apply by reason of a prior case under the Bankruptcy Code. For example, if a prior case is dismissed under *Bankruptcy Code section 349(a)* n1 with prejudice to the filing of a petition under any chapter of the Bankruptcy Code for a period of twelve months, a petition commencing a subsequent case within the prohibition period will not operate as an automatic stay of actions against the debtor. n2 Courts have also dealt with abusive serial filings that attempt to gain the benefit of the automatic stay to protect a piece of real property from foreclosure by granting relief from the stay in the case and *in rem* against the property for a fixed period of time. n3

The 2005 amendments to section 362(b) added subsections (20) and (21), which expressly delineate the particular acts or actions in connection with serial filings that will result in an exception to the automatic stay with respect to the enforcement of a real property security interest. Sections 362(c)(3) and (c)(4), added in 2005, also limit the duration of the stay or prevent its application when there have been repeat bankruptcy filings by an individual debtor. n4

In Rem Orders; 11 U.S.C. § 362(b)(20) & (d)(4). Section 362(b)(20) creates an exception for the enforcement of a lien against or security interest in real property following the entry of an order in a prior bankruptcy case prohibiting the application of the automatic stay as to that property. n5 An *in rem* order of this kind must be entered in accordance with section 362(d)(4). Unless relief from the order is granted in a subsequent case, the order shall remain in effect for a period of two years after the date of entry.

Section 362(d)(4) provides that upon the request of a creditor whose claim is secured by an interest in real property, and after notice and hearing, the court may grant relief from the stay with respect to an act against the property if the court finds that the filing of the petition was part of a scheme to delay, hinder and defraud creditors that involved either (1) the transfer of all or part ownership of or interest in the property without the consent of the secured creditor or court

approval; or (2) multiple bankruptcy filings affecting the property. n6 The stay exception provided in section 362(b)(20) is limited to acts to enforce a lien or security interest in real property and the relief under section 362(d)(4) is available only to a creditor whose claim is secured by an interest in real property. Therefore, these provisions generally will not apply to proceedings involving the enforcement of a rental agreement. n7

While courts may be inclined to look to case law construing the hinder, delay or defraud language found in sections 548(a)(1) and 727(a)(2) for guidance in applying section 362(d)(4), these other provisions are substantively different, as the words in the pertinent phrase in section 362(d)(4)--delay, hinder and defraud--are joined by the conjunction and rather than or. Significantly, at the same time that Congress added section 362(d)(4) as part of the 2005 amendments, it also enacted two other provisions in which the disjunctive form of the hinder, delay or defraud phrase was used, in sections 522(o) and 548(e). This clearly suggests that, since Congress used the non-exclusive disjunctive form in the other provisions, n8 the language in section 362(d)(4) was deliberately chosen to impose a substantial burden of proof on secured creditors before an *in rem* order may issue. n9 Given the extraordinary nature of *in rem* relief, extending for a period of two years, it is reasonable that Congress purposely selected this language so that *in rem* orders would be entered only in the rare case in which a creditor can prove that the debtor's filing of the petition was part of a scheme not only to hinder and delay, but also to defraud the creditor. n10 This view is consistent with the apparent purpose of this provision, which is to provide a remedy for addressing the abusive practices of certain mortgage consultants and foreclosure specialists involving serial bankruptcy filings to delay home foreclosures and whose intent is to defraud creditors. n11

By requiring that the scheme to hinder, delay and defraud a creditor must involve either an unauthorized transfer of the property or multiple bankruptcy filings affecting the property, section 362(d)(4) addresses conduct that could be indicative of an abusive filing in relation to a real property foreclosure. For example, a court may find that the transfer of a fractional interest of property to a bankruptcy debtor by a property owner facing foreclosure, done for the purpose of gaining the automatic stay, was part of a scheme to hinder, delay and defraud a foreclosing creditor. However, an innocent transfer of the property, such as the court ordered transfer of a former spouses property interest to the debtor as part of a domestic court proceeding, should not by itself form the basis for an *in rem* order under section 362(d)(20). Similarly, the filing of multiple bankruptcy cases by the debtor or others holding an interest in the property for the purpose of delaying a foreclosure could be part of the requisite scheme. But a single case, or even several cases filed over an extended period of time or which do not all affect the property, may fail to support the findings required for the entry of an *in rem* order.

In any event, while the circumstances described in section 362(d)(4) are not exhaustive of the conduct that could be deemed abusive, n12 section 362(d)(20) applies only when the particular circumstances described therein exist. If an order entered under section 362(d)(4) is recorded in compliance with applicable state law governing the recordation of real property documents, n13 it shall be binding in all future bankruptcy cases that might affect the subject property for a period of two years after the date of the entry of the order. Section 362(d)(4) does not appear to limit the scope of the *in rem* order to the secured creditor who obtained the order or to the debtor in whose case the order entered, though the court should be free to impose restrictions on the order's application that do not conflict with section 362(b)(20) and 362(d)(4). In any event, by conditioning the binding effect of an *in rem* order on its proper recordation, an innocent purchaser of the property should have notice that the property is subject to an such an order and that a stay in regard to the property will not be obtained for the two year period should that the purchaser file bankruptcy. Moreover, section 362(d)(4) provides that a debtor may move in a subsequent case for relief from an *in rem* order based upon changed circumstances or for good cause shown, after notice and a hearing. Presumably, this provision would apply to any purchaser or transferee of the property affected by the order.

Filing by Ineligible Debtor or in Violation of Court Order; 11 U.S.C. § 362(b)(21). Section 362(b)(21) exempts from the stay the enforcement of a lien against or security interest in real property in a case filed by a debtor who is ineligible to be a debtor under section 109(g), or if the case is filed in violation of a bankruptcy court order in a prior case prohibiting the debtor from being a debtor in another case. n14 In a joint case, this provision would apply as to property jointly held by both debtors only if both debtors are ineligible under section 109(g) or subject to the prior court

order. n15

An individual debtor is not eligible to file a petition under section 109(g) if the debtor, within 180 days preceding the filing of the petition, was the debtor in a bankruptcy case dismissed for willful failure to abide by orders of the court or to appear before the court in proper prosecution of the case, or the debtor requested and obtained the voluntary dismissal of a bankruptcy case following the filing of a request for relief from the automatic stay. n16

It remains to be seen what practical effect this provision will have because the question of whether section 109(g) is applicable is not always clear, and often is not resolved until a motion to dismiss is filed in the subsequent case. This is because the court rarely makes express findings, in dismissing the prior case, that the debtor willfully failed to prosecute the case or willfully failed to obey a court order. And the clerk will normally accept the petition filed in the later case because no determination has been made that the debtor is ineligible under section 109(g). Thus, secured creditors may be reluctant to enforce a real property security interest in reliance upon section 362(b)(21) when no section 109(g) findings have been made, and therefore may instead seek relief from the stay under section 362(d). This is because a creditor who mistakenly relies upon section 362(b)(21), believing that the debtor was ineligible under section 109(g), may be subject to sanctions under section 362(k), and there is no applicable good faith belief exception limiting damages recoverable by the debtor as is found in section 362(k)(2).

Section 362(b)(21) is also applicable if the debtor files a case in violation of a bankruptcy court order in a prior case prohibiting the debtor from being a debtor in another case. Unlike an order entered under section 349(a) dismissing a bankruptcy case with prejudice, which precludes the debtor from obtaining a discharge of debts that could have been discharged in the dismissed case, n17 section 362(b)(21) is applicable when the prior order specifically bars the filing of a new case.

For a complete discussion of Code section 362, see Collier on Bankruptcy, ch. 362.

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n1 1. See *Collier on Bankruptcy*, 349.02[2].

n2

2. In *FDIC v. Cortez*, 96 F.3d 50 (2d Cir. 1996), the subsequent petition was an involuntary petition. The bar was held applicable because the debtor colluded in the filing of the petition.

n3

3. In *Great Western Bank v. Snow (In re Snow)*, 201 B.R. 968 (Bankr. C.D. Cal. 1996), the order ran for 180

days, enough time to permit the benefitted secured lender to complete foreclosure against the property.

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4. *See Collier on Bankruptcy*, 362.06[3] and [4].

n5

5. 11 U.S.C. § 362(b)(20), added by Pub. L. No. 109-8, effective in cases commenced on or after October 17, 2005.

n6

6. 11 U.S.C. § 362(d)(4), added by Pub. L. No. 109-8, (2005), effective in cases commenced on or after October 17, 2005.

n7

7. *See In re McCray*, 342 B.R. 668 (Bankr. D.D.C. 2006).

n8

8. 11 U.S.C. § 102(5).

n9

9. Perhaps it is noteworthy that Congress changed the order of the words, leading with delay in section 362(d)(4) and hinder in the other sections, suggesting that Congress intended the phrase to have a different meaning.

n10

10. *See In re Muhaimin*, 343 B.R. 159, 17071 (Bankr. D. Md. 2006) (creditor satisfied burden of proving scheme to hinder, but failed to prove fraud).

n11

11. See *Final Report of the Bankruptcy Foreclosure Scam Task Force*, 32 *Loyola L.A. L. Rev.* 1063 (1999).

n12

12. See, e.g., *Final Report Of The Bankruptcy Foreclosure Scam Task Force*, 32 *Loyola L.A. L. Rev.* 1063 (1999).

n13

13. Section 362(d)(4) provides that federal, state, or local governmental units that accept notices of interests or liens in real property shall accept for indexing and recording any certified copy of an order entered under the subsection.

n14

14. 11 U.S.C. § 362(b)(21), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n15

15. Section 362(b)(21) should be compared with the refiling provision in section 362(c)(3), which expressly states that the provision is applicable in a single or joint case filed by an individual debtor. See *Collier on Bankruptcy*, 362.06[3].

n16

16. See *Collier on Bankruptcy*, 109.08.

n17

17. *Frieouf v. United States (In re Frieouf)*, 938 F.2d 1099, 1103 (10th Cir. 1991). But see *In re Casse*, 198 F.3d 327 (2d Cir. 1999); see also *Collier on Bankruptcy*, 109.08.

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Collier on the Admin. Expense Priority Afforded to Taxes Incurred by the Estate

2008 Emerging Issues 1537

Collier on the Admin. Expense Priority Afforded to Taxes Incurred by the Estate

By Collier

December 15, 2007

SUMMARY: Bankruptcy Code section 503(b)(1)(B) provides that all taxes "incurred by the estate" are administrative expenses entitled to second priority under section 507(a)(2), excepting only the kind of taxes specified as eighth-priority claims under section 507(a)(8). This Emerging Issues Analysis covers when taxes are determined to have been "incurred by the estate".

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ARTICLE: *Bankruptcy Code section 503(b)(1)(B)* provides that all taxes incurred by the estate are administrative expenses entitled to second priority under section 507(a)(2), excepting only the kind of taxes specified as eighth-priority claims under section 507(a)(8), n1 which are to be treated under that provision and are denied administrative priority under section 503(b)(1)(B) even if incurred by the estate. n2 Taxes entitled to priority can be secured or unsecured and includes property taxes for which liability is in rem, in personam, or both. n3 Administrative priority under section 503(b)(1)(B) is also extended to certain tax claims relating to tentative carryback adjustments.

Determining When Tax Is Incurred. Only taxes incurred by the estate can be administrative expenses. Therefore, first priority for tax claims extends only to postpetition taxes because before the petition is filed, there is no estate. n4 Whether a particular tax has been incurred by the estate is not always easy to determine. The time of assessment or payment may not necessarily be equivalent to the time the tax is incurred for the purpose of establishing priority under section 503(b)(1)(B). Rather, the significant event is the date the tax accrues and becomes a fixed obligation. n5

For instance, in *Costello Bros. v. Pawtucket Institution for Savings (In re Melino Cigar & Cando Co.)*, n6 the question was whether a guarantors postpetition payment on a surety bond for cigarette tax stamp liability that was incurred prepetition constituted a priority administrative expense pursuant to section 503(b)(1)(B). The bankruptcy court held that the claim did not qualify under section 503(b)(1)(B) because the tax was deemed paid when the stamps were affixed prepetition and therefore there never was a liability of the estate. n7 (Alternatively, the court held the tax was an excise tax on a transaction occurring within three years of the filing of the petition as then specified in section 507(a)(6) [now section 507(a)(8)] and thus was excluded under section 503(b)(1)(B)(i).)

The question of whether the bankruptcy estate survives after plan confirmation in a chapter 11 or chapter 13 case presents an obstacle to any administrative expense claim for taxes incurred after confirmation. For instance, in *In re*

Westholt Manufacturing, Inc.,ⁿ⁸ the debtors case had been converted after confirmation from chapter 11 to chapter 7, and the IRS filed an administrative expense claim for taxes incurred postconfirmation but preconversion. The court held that taxes incurred after confirmation were not incurred by the estate and, accordingly, would be treated as prepetition claims with sixth priority under then section 507(a)(6) (now eighth priority under section 507(a)(8)).ⁿ⁹ In other words, a tax claim incurred after confirmation of a chapter 11 plan but prior to conversion of the case to chapter 7 may be entitled to priority under section 507(a)(8), but not administrative priority in the superseding chapter 7 case.ⁿ¹⁰

No Administrative Priority for Taxes Described in Section 507(a)(8). To determine whether taxes are entitled to administrative expense status requires not only a finding that the taxes were incurred by the estate postpetition, but also a finding that the taxes do not fit within any of the categories specified in section 507(a)(8). Thus, the reference in section 503(a)(1)(B)(i) to section 507(a)(8) means that, to the extent a debtors prepetition liability becomes a tax claim after the petition, it is not for that reason alone to be given administrative expense status.ⁿ¹¹

The interaction among section 507(a)(8), section 502(i) and section 503(b)(1)(B) is somewhat confusing.ⁿ¹² Pursuant to section 502(b), the amount of a claim is determined as of the date the petition is filed, suggesting that all claims described in section 507(a)(8) must have arisen prepetition. Section 502(i) further clouds matters by providing that [a] claim that does not arise until after the commencement of the case for a tax entitled to priority under section 507(a)(8) shall be allowed or disallowed the same as if such claim had arisen before the date of the filing of the petition.

Categories of taxes enumerated in section 507(a)(8), which must be considered in determining whether a tax is entitled to administrative priority under section 503(b)(1)(B), include income taxes, property taxes, withholding taxes, employment taxes, excise taxes and custom duties.

Income Taxes. Whether income taxes are entitled to administrative expense status may depend on whether the tax was measured on income earned prepetition or postpetition, whether the debtor is an individual, a partnership or a corporation, and the chapter under which a case is filed. It is clear that any taxes measured by income earned postpetition will be administrative expenses. However, it is unclear whether income taxes measured by income earned prepetition when the close of the taxable year occurs postpetition will be allowed as administrative expenses.

Section 507(a)(8)(A) appears to limit income taxes entitled to eighth priority to those measured by income for a taxable year ending on or before the date of the filing of the petition. Because the taxable year ends on the petition date for an individual filing under chapter 7 or 11--under sections 728(a) and 1146(a)--any tax on income earned by the debtor prepetition should be entitled to allowance as an eighth priority claim under section 507(a)(8)(A), but not as an administrative expense. However, pursuant to section 346(c)(1), the taxable year of a corporation or partnership remains unchanged. The same result appears to follow in the case of an individual filing under chapter 13 pursuant to section 346(d). In those instances, then, taxes on income earned prepetition might be entitled to administrative expense status if the taxable year closes postpetition and the court determines that the taxes were incurred at the close of the taxable year.ⁿ¹³

Two cases decided in 1995 addressed whether a claim for income tax for the tax year that straddles the petition date qualifies for first priority as an administrative expense or then seventh (now eighth) priority as a prepetition tax claim. While both courts stated that the full amount of income tax for a tax year which ends postpetition is incurred by the estate, they split on whether the entire claim would qualify for administrative priority. The Eighth Circuit held that the portion of the tax which related to postpetition income was not of the kind given priority under section 507, and therefore it was entitled to administrative priority.ⁿ¹⁴ The Ninth Circuit held that the tax for the entire tax year was within the scope of section 507(a)(7)(A)(iii) that that, therefore, no portion of it was entitled to administrative priority.ⁿ¹⁵ The Eighth Circuit approach has been adopted by the Eleventh Circuit as well.ⁿ¹⁶

Property Taxes. Property taxes covering a period that straddles a bankruptcy filing raise issues similar to those arising with respect to income taxes as to whether some of the tax qualifies for administrative priority. Section 507(a)(8)(B) grants priority to property taxes for a tax that is incurred before commencement of the case. The word

incurred was inserted by the 2005 Act in place of the word assessed, which had been part of the Code since enactment. Before the amendment, numerous cases considered the issue of whether a property tax was assessed before the commencement of the case. n17 Because there was no necessary correlation between when a property tax is assessed and when the payment obligation arises, the cases tended to be inconsistent in outcome and varied considerably from jurisdiction to jurisdiction.

Changing the focus from when a tax is assessed to when it is incurred ought to make the determination easier and the outcome more consistent. A property tax is presumably incurred at the time that the debtor becomes obligated to pay the tax.

The 2005 Act also clarified that all types of property taxes can qualify for administrative expense priority. The 2005 Act added language to section 503(b)(1)(B) making it clear that secured and unsecured *ad valorem* property taxes are entitled to administrative expense priority. n18 This is true whether the tax liability is *in rem*, *in personam*, or both.

Withholding Taxes. Withholding taxes attributable to postpetition administrative expense wages or to sales made after the filing of the petition are entitled to an administrative expense priority. Where withholding taxes are attributable to wages earned prepetition, the taxes are not entitled to administrative expense status, even if paid postpetition. The Supreme Court's decision in *Otte v. United States (In re Freedomland, Inc.)* n19 leaves no room for doubt that a bankruptcy trustee is the equivalent to a wage claimant's employer for both the employee and employer taxes. That case also made plain that the so-called employee taxes, i.e., the portion withheld from the dividend given the priority wage claimant, was given the same Bankruptcy Act priority as the dividend from which the withholding was made. Section 64a(2) of the Bankruptcy Act gave employee claims priority to the extent described therein. In the *Otte* case, the Supreme Court ruled that federal taxes withheld from priority wage claim dividends were to be given the same priority treatment as the underlying wage claims, rather than general administrative priority under Section 64a(1) or administrative tax priority under Section 64a(4).

Employment Taxes. Employment taxes, which are those taxes imposed on an employer based on wages or salaries paid, are entitled to administrative expense status only when the wages or salaries to which the taxes relate are earned by employees postpetition. n20 When employment taxes relate to wages or salaries earned prepetition but not paid until after the filing in bankruptcy, they are specifically excluded from administrative expense status by virtue of sections 503(b)(1)(B)(i) and 507(a)(8)(D). Thus, these taxes are only entitled to an eighth priority. The specific intended purpose of section 503(b)(1)(B) may have been to ensure that claims for employment taxes based upon postpetition payment of wages that were earned prepetition will receive an eighth, rather than a first priority. By making such taxes an eighth priority, section 503(b)(1)(B) negates the argument that payment of a general or, at most, a third-priority claim (prepetition wages) could give rise to a first-priority claim (taxes on such wages).

Excise Taxes. An excise tax will be entitled to administrative expense status if the transaction, event or occurrence on which the tax is based occurs postpetition and the tax is thus incurred by the estate. In 1996, the Supreme Court held that characterization of an assessment as an excise tax under the Internal Revenue Code is not necessarily determinative for purposes of determining priority under the Bankruptcy Code. n21 Examples of covered excise taxes under *Bankruptcy Code section 507(a)(8)(E)* are sales taxes, estate and gift taxes, gasoline and special fuel taxes, wagering and truck taxes, and stamp and transfer taxes. n22 In addition, the Court of Appeals for the Ninth Circuit determined that the debt of an employer to a state fund for workers compensation benefits is an eighth priority excise tax. n23

In *LTV Corp. v. United States (In re Chateaugay Corp.)*, n24 the court held an exaction labeled as an excise tax under the Internal Revenue Code, but which was in reality a penalty imposed for pension plan underfunding, was not entitled to priority under section 503(b) even though it arose postpetition because it provided no benefit to the estate. The district court attempted to distinguish a decision of the Second Circuit in a related proceeding, *In re Chateaugay Corp.*, n25 in which the Second Circuit had found that cleanup costs assessed postpetition for a prepetition release or threatened release of hazardous substances were necessary to preserve the estate in the sense that they enable the estate to maintain itself in compliance with applicable environmental laws. n26 Rather than distinguishing the two cases, the

district court summarily stated: The same concerns do not apply here. The IRS 1986 excise tax claim is in no way necessary to preserve the estate. In fact, if anything, imposition of the 1986 excise tax would make more difficult the successful implementation of a reorganization plan. n27 But the same was true of the administrative expense for hazardous waste cleanup that the Second Circuit allowed. The district court did not acknowledge the *Reading* line of cases which does not require a benefit to the estate in all circumstances. n28

Custom Duties. Although a customs duty is not technically a tax, its inclusion in section 507(a)(8) would probably entitle it to administrative expense status as a tax if goods were imported postpetition. In any case, it would seem that customs duties would be an administrative expense as an actual and necessary cost of preserving the estate.

Tax Carryback Adjustments. Section 503(b)(1)(B)(ii) allows as an administrative claim a tax which is attributable to an excess allowance by the Internal Revenue Service of a tentative carryback adjustment that the trustee has received. This is regardless of whether the taxable year to which that adjustment relates ended before or after the filing of the petition commencing the case under the Bankruptcy Code. This is the so-called quickie refund. n29

To measure the priority period from the earlier year to which the loss was carried back would cost the taxing authority its right to an administrative expense claim even though the government did not have adequate opportunity to audit the claimed loss before it granted the refund adjustment. Accordingly, section 503(b)(1)(B)(ii) confers administrative expense status to an excessive allowance of a carryback adjustment received by the estate regardless of the taxable year in which the loss occurred and to which the adjustment related. Whether the taxable year ended before or after the commencement of the case is irrelevant.

For a complete discussion of Code section 503, see Collier on Bankruptcy, ch. 503.

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[Return to Text](#)

n1 1. The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353 (1984), redesignated former section 507(a)(6) as section 507(a)(7). Section 507(a)(7), as redesignated in 1984, was redesignated again as section 507(a)(8) by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994). A governmental unit is not required to file a request for payment of an administrative expense for tax-related fines, penalties, and interest subject to section 503(b)(1)(C) as a condition to being allowed an administrative expense. *See Collier on Bankruptcy*, 503.02[3].

n2

2. *In re Burlington Motor Holdings, Inc.*, 235 B.R. 741 (Bankr. D. Del. 1999) (holding that registration in licensing fees of a motor carrier paid postpetition in connection with an international registration plan for carrier is not a tax under section 503(b)(1)(B) but is an administrative expense allowable under section 503(b)(1)(A)).

n3

3. The 2005 Act added language to clause (i) of section 503(b)(1)(B) to clarify that all such taxes are entitled to administrative expense priority. Pub. L. No. 109-8, § 712(b) (2005), effective in cases commenced on or after October 17, 2005.

n4

4. See *United States v. Friendship College, Inc. (In re Friendship College, Inc.)*, 737 F.2d 430, 10 C.B.C.2d 1151 (4th Cir. 1984); *Still v. United States (In re W.L. Jackson Mfg. Co.)*, 12 C.B.C.2d 1365, 50 B.R. 498 (Bankr. E.D. Tenn. 1985); see also *In re Chateaugay Corp.*, 21 C.B.C.2d 135, 102 B.R. 335 (Bankr. S.D.N.Y. 1989) (claim for indemnification on a Tax Benefit Transfer not entitled to administrative priority when agreement arose prepetition and did not benefit estate).

n5

5. See, e.g., *In re Bondis Valu-King, Inc.*, 126 B.R. 47 (N.D. Ohio 1991) (tax is incurred for § 503(b)(1)(B) purposes when all the acts necessary to create the tax liability have occurred). But see *United Mine Workers v. Rushton (In re Sunnyside Coal Co.)*, 146 F.3d 1273 (10th Cir. 1998) (premiums assessed against coal mining operators under Coal Industry Retiree Health Benefit Act are considered newly assessed during each statutory period, even after debtor has ceased operations and converted to chapter 7); *In re Soltan*, 234 B.R. 260 (Bankr. E.D.N.Y. 1999) (holding that real property taxes accrued postpetition even though secured by operation of law can be an administrative expense under section 503(b)(1)(B)).

n6

6. 7 C.B.C.2d 71, 22 B.R. 703 (Bankr. D.R.I. 1982).

n7

7. See also *In re Higgins*, 8 C.B.C.2d 500, 29 B.R. 196 (Bankr. N.D. Iowa 1983) (investment credit recapture tax assessed postpetition was not incurred by the estate because it was a revival of a prepetition tax liability); *In re Scrap Disposal, Inc.*, 7 C.B.C.2d 822, 24 B.R. 178 (Bankr. S.D. Cal. 1982), *affd*, 38 B.R. 765 (B.A.P. 9th Cir. 1984) (tax incurred prepetition but only correctly assessed postpetition was denied administrative expense status on the ground that it was not incurred by the estate). But see *Perpetual Am. Bank, FSB v. District of Columbia (In re Carlisle Court)*, 10 C.B.C.2d 77, 36 B.R. 209 (Bankr. D.D.C. 1983) (property tax that accrued prepetition was treated as administration expense).

n8

8. 6 C.B.C.2d 1068, 20 B.R. 368 (Bankr. D. Kan. 1982), *affd sub nom United States v. Redmond*, 10 C.B.C.2d 1428, 36 B.R. 932 (D. Kan. 1984).

n9

9. *See also In re Johnson*, 901 F.2d 513 (6th Cir. 1990) (upon conversion of a chapter 11 case to a chapter 7 case, administrative expense claims for taxes incurred postpetition but preconversion must comply with the chapter 7 bar date); *In re Bondis Valu-King, Inc.*, 126 B.R. 47 (N.D. Ohio 1991) (tax liability incurred during chapter 11 case cannot be an administrative expense in a superseding chapter 7 case).

n10

10. *See, e.g., In re Hirsch-Franklin Enterprises, Inc.*, 15 C.B.C.2d 672, 63 B.R. 864 (Bankr. M.D. Ga. 1986).

n11

11. *See, e.g., United States v. Friendship College, Inc. (In re Friendship College, Inc.)*, 737 F.2d 430, 10 C.B.C.2d 1151 (4th Cir. 1984) (FICA and income taxes withheld from the colleges employees, as well as the colleges own share of FICA, were administrative expenses); *see also In re Lumara Foods of Am., Inc.*, 13 B.C.D. 409 (Bankr. N.D. Ohio 1985) (examining the former Act and the legislative history of the Code and concluding that postpetition withholding and sales taxes are administrative expenses); *In re Carlisle Court, Inc.*, 10 C.B.C.2d 77, 36 B.R. 209 (Bankr. D.D.C. 1983) (real estate taxes incurred by the estate were administrative expenses); *Waldschmidt v. Commissioner*, 9 C.B.C.2d 673, 33 B.R. 11 (Bankr. M.D. Tenn. 1983) (capital gains taxes incurred by the trustees sale of the estates assets were administrative expenses).

n12

12. *See In re Carlisle Court, Inc.*, 10 C.B.C.2d 77, 84-87, 36 B.R. 209, 218-20 (Bankr. D.D.C. 1983) (discussing the conflicts among section 502(i), section 503(b)(1)(B)(i) and section 507(a)(7) [now section 507(a)(8)]).

n13 13. *But see In re Higgins*, 8 C.B.C.2d 500, 29 B.R. 196 (Bankr. N.D. Iowa 1983).

n14

14. *In re L.J. O'Neill Shoe Co.*, 64 F.3d 1146 (8th Cir. 1995).

n15

15. *In re Pacific-Atlantic Trading Co.*, 64 F.3d 1292 (9th Cir. 1995).

n16

16. *United States v. Hillsborough Holdings Corp. (In re Hillsborough Holdings Corp.)*, 116 F. 3d 1391 (11th Cir. 1997).

n17

17. See, e.g., *City of White Plains v. A&S Galleria Real Estate, Inc. (In re Federated Department Stores, Inc.)*, 270 F.3d 994 (6th Cir. 2001); *Marion County Treasurer v. Blue Lustre Products, Inc. (In re Blue Lustre Products, Inc.)*, 214 B.R. 188 (S.D. Ind. 1997); *In re Mansfield Tire & Rubber Co.*, 18 C.B.C.2d 1138, 85 B.R. 437 (Bankr. N.D. Ohio 1987); *In re Kamstra*, 13 C.B.C.2d 266, 51 B.R. 560 (Bankr. W.D. Mich. 1985); see also *Bachman v. Commercial Fin. Servs., Inc. (In re Commercial Fin. Servs., Inc.)*, 246 F.3d 1291 (10th Cir. 2001) (A debt is not entitled to priority simply because the right to payment arises after the debtor in possession has begun managing the estate.) (quoting *Isaac v. Temex Energy, Inc. (In re Amarex, Inc.)*, 853 F.2d 1526, 1530 (10th Cir. 1988)).

n18

18. Pub. L. No. 109-8, § 712(b) (2005), effective in cases commenced on or after October 17, 2005.

n19

19. 419 U.S. 43, 95 S. Ct. 247, 42 L. Ed. 2d 212 (1974).

n20

20. *In re Friendship College*, 34 B.R. 126 (Bankr. W.D.N.C. 1983), *rev'd on other grounds sub nom. United States v. Friendship College*, 737 F.2d 430, 10 C.B.C.2d 1151 (4th Cir. 1984).

n21

21. *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463, 29 B.C.D. 2d 271 (1996); see also *In re Wheeling-Pittsburgh Steel Corp.*, 103 B.R. 672 (W.D. Pa. 1989) (characterizing the liability imposed under section 4971 of the Internal Revenue Code for an employers failure to make pension plan contributions for prepetition tax periods as a penalty in the employer/debtors bankruptcy case, thus denying administrative priority despite fact that tax returns and payments were due postpetition and that the liability is designated a tax in the tax code). One case, *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (6th Cir. 1991) reached the opposite conclusion, but was effectively overruled by the Supreme Courts decision in *CF&I Fabricators*, *supra*.

n22

22. 124 Cong. Rec. H11,113 (daily ed. Sept. 28, 1978); see also *United Mine Workers v. Rushton (In re Sunnyside Coal Co.)*, 146 F.3d 1273 (10th Cir. 1998) (premiums assessed against coal mining operators under Coal Industry Retiree Health Benefit Act constitute excise taxes and continue to accrue during each new statutory period, even after debtor has ceased operations and converted to chapter 7).

n23

23. *Industrial Commn of Ariz. v. Camilli (In re Camilli)*, 94 F.3d 1330, 36 C.B.C.2d 833 (9th Cir. 1996). The court relied on the decision in *County Sanitation Dist. No. 2 of Los Angeles County v. Lorber Indus. of California (In re Lorber Indus. of California)*, 675 F.2d 1062 (9th Cir. 1982), for the definition of a tax. For a contrary view, see *Ohio Bureau of Workers Compensation v. Yoder (In re Suburban Motor Freight, Inc.)*, 36 F.3d 484 (6th Cir. 1994).

n24

24. 146 B.R. 626 (S.D.N.Y. 1992) (granting the IRSs motion to vacate the judgment and dismiss the complaint on the ground that settlement made the underlying controversy moot).

n25

25. 944 F.2d 997, 25 C.B.C.2d 620 (2d Cir. 1991).

n26

26. 944 F.2d 997, 1009, 25 C.B.C.2d 620, 635.

n27

27. 146 B.R. 626, 633.

n28

28. See *Collier on Bankruptcy*, 503.06[3].

n29

29. See S. Rep. No. 1106, 95th Cong., 2d Sess. 20 (1978).

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96 of 197 DOCUMENTS

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Collier on New Confirmation Requirements for Individual Debtors in a Ch. 11 Case

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Collier on New Confirmation Requirements for Individual Debtors in a Chapter 11 Case

By Collier

December 14, 2007

SUMMARY: This Emerging Issues Analysis covers the section 1129(a) requirements that the individual debtor must be current on all domestic support obligations that accrue postpetition, that the individual debtor must pay five years worth of disposable income to unsecured creditors, and that the individual debtor must file all requested tax documents.

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ARTICLE: Substantive Requirements of Section 1129(a) of the Bankruptcy Code; Consensual Confirmation. The 13 requirements of *Bankruptcy Code* section 1129(a) are the focus of all confirmation hearings. The plan proponent, as indicated above, n1 bears the burden of proof of establishing that each of these requirements have been satisfied. When these requirements are satisfied, the court will confirm the plan. n2

Individual Debtor Must Pay Postpetition Domestic Support Obligations in Full; 11 U.S.C. § 1129(a)(14).

Congress added section 1129(a)(14) in 2005. n3 It applies to individual chapter 11 debtors n4 who are required by a judicial or administrative order, or by statute, to pay a domestic support obligation n5 If so, then the debtor must, as a condition of confirmation, pay all amounts payable under such order or such statute for such obligation that first become payable after the date of the filing of the petition. n6

The key term here is domestic support obligation, a defined term also added by the 2005 legislation. n7 Its essence is that it be a debt that is in the nature of alimony, maintenance, or support of [a] spouse, former spouse, or child of the debtor or such child's parent, without regard to whether such debt is expressly so designated. n8

Section 1129(a)(14) thus requires the individual debtor to be current on all domestic support obligations that accrue postpetition. Prepetition arrearages may be paid over the term of the plan in accordance with section 1129(a)(9)(B).

Individual Debtor Must Pay Five Years Worth of Disposable Income to Unsecured Creditors; 11 U.S.C. § 1129 (a)(15). Section 1129(a)(15), also added in 2005, n9 requires either that the individual chapter 11 debtor pay all unsecured claims in full n10 or that the debtors plan devote an amount equal to five years worth of the debtors projected disposable income to unsecured creditors. n11 As with the best interest of creditors test found in section 1129(a)(7), standing to object on this ground is given to any single unsecured creditor; it is irrelevant that the plan proponent obtained the consent of the class of unsecured creditors of which the objecting unsecured creditor is a

member.

Central to the application of paragraph (15) is the concept of disposable income, and the amounts of such disposable income that must be devoted to the implementation of the plan.

Disposable Income. Disposable income is a concept borrowed from chapter 13. Indeed, section 1129(a)(15) itself refers to section 1325(b)(2) for a definition of the concept. n12 Reference to a fuller discussion of that section is appropriate, n13 but the following can serve as a rough guide.

Disposable income is essentially the difference between a debtors income and the debtors reasonably necessary necessary expenses. The Code, as amended by the 2005 Act, which added section 1129(a)(15), however, defines such income, and possibly such expenses, in nonintuitive ways.

Under section 1325(b)(2), income and expenses are determined on a monthly basis. The income side is determined by a generally applicable definition, current monthly income. n14 It is basically the debtors average income or receipts from any source (including income that would not be taxed) for the last six full months preceding the commencement of the case. Section 1325(b)(2) then alters this sweeping definition by specifically providing that income for purposes of that section, and derivatively for purposes of section 1129(a)(15), does not include any funds received by way of child support, foster care or disability payments for a dependent child. n15

Expenses differ depending on whether the debtor is in business. If the debtor is not in business, expenses are those amounts reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor or for any postpetition domestic support obligation. n16 Such expenses also may include charitable contributions so long as the contributions do not exceed 15 percent of the debtors gross income for the year in which such contributions are made. n17

If the debtor is in business, expenses are those amounts reasonably necessary to be expended for the payment of expenditures necessary for the continuation, preservation, and operation of such business. n18 As section 1129(a)(15) incorporates section 1325(b)(2), cases construing that section will be relevant in determining whether what expenses may be used to calculate disposable income under chapter 11.

An argument might be made that the cross-reference in section 1129(a)(15) to section 1325(b)(2) also makes section 1325(b)(3) applicable in construing permissible expenses under section 1129(a)(15). This would make calculation of such expenses conform to the chapter 13 method of expense calculations, in which debtors whose annualized current monthly income exceed the debtors state median income would have to calculate expenses with reference not to actual expenses, but to expense categories established by the Internal Revenue Service. n19 In short, under this construction the cross-reference to section 1325(b)(2) would implicitly incorporate paragraph (3) of section 1325(b) and treat that paragraph as a necessary rule of construction rather than a separate paragraph. n20

This reading is flawed, however, as the reference in section 1129(a)(15) is explicitly to, and only to, paragraph (2) of section 1325(b). Congress had it within its power to draft the cross-reference more broadly, but did not. It presumably took into account the business orientation of most chapter 11s, as well as the increased levels of creditor involvement in a chapter 11 cases. These factors, together with the requirement that the debtor obtain the consent of all unsecured creditor classes under section 1129(a)(8), would tend to indicate that individual creditor insistence on the artificial expenses standards found in chapter 7 are neither necessary nor appropriate in chapter 11 cases.

Amounts and Timing. The confirmation requirement is that the debtors plan distribute property equal in value to the debtors projected disposable income over the five-year period commencing with the date that the first payment is due under the plan. The confirmation requirement thus specifies the amount and the timing of all payments.

Although based on chapter 13 practice, this confirmation requirement differs from that practice in several respects. First, it differs as to time. Under chapter 13, a debtors plan must extend for three years (in some cases five years) unless

the plan provides for payment in full of all unsecured claims sooner. n21 Section 1129(a)(15) does not specify a minimum period, but does specify that the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor to be received during the 5-year period commencing with the start of plan payments. n22 Thus, if property from any other source such as loans or gifts, or from exempt property is used to supplement the payments to unsecured creditors, the plan may be shorter than five years. n23

Chapter 13 also limits the maximum plan length to five years. n24 Section 1129(a)(15) explicitly permits longer plans by making the provision of five years worth of disposable income the minimum amount. If any unsecured creditor objects to the plan, the statute conditions confirmation on the continued payment of disposable income over a five-year period, or the period for which the plan provides payments, whichever is longer. n25

Finally, chapter 13 requires payments to begin within 30 days of the commencement of the case, regardless of whether the plan is confirmed, n26 and then measures the plan period from the first scheduled payment to unsecured creditors. n27 Under section 1129(a)(15)(B), however, the minimum five year period commences on the date that the first payment is due under the plan, n28 which usually will be after confirmation, which will almost certainly be longer than 15 days.

Restrictions on Transfers of Property of Nonprofit Entities; 11 U.S.C. §1129(a)(16). Congress added section 1129(a)(16) in 2005. n29 It conditions confirmation of a plan on the fact that all transfers under the plan will be made in accordance with applicable nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust. n30 Although the wording is not felicitous, in that a plausible reading can be put forward that the provision seems to apply to all transfers, and then imposes on all such transfers the same restrictions place on transfers by nonprofit entities, Congress was clear that this provision was meant to restrict the authority of a trustee to use, sell, or lease property by a nonprofit corporation or trust. n31

This provisions limits the permissible transfers by any nonprofit entity, and this could be significant in some hospital or other similar reorganizations. It keeps in place the state law restrictions on such nonprofit entities, and buttresses this rule by giving standing to state attorneys general to raise this issue. n32

Another uncodified portion of the 2005 Act states that, notwithstanding the prominent place state law has in such determinations, [n]othing in this section shall be construed to require the court in which a case under chapter 11 of title 11, United States Code, is pending to remand or refer any proceeding, issue, or controversy to any other court or to require the approval of any other court for the transfer of property. n33

Individual Debtor Must File All Requested Tax Documents. Section 1228(b) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, n34 which is uncodified, provides: The court shall not confirm a plan of reorganization in the case of an individual under chapter 11 or 13 of title 11, United States Code, unless requested tax documents have been filed with the court. n35 Neither section 1228(b) nor its legislative history n36 indicates whether the request that triggers this requirement is a simple request, backed by nothing other than the curiosity of the person making the request, a request made pursuant to some process (such as in a request for production of documents or a request made pursuant to subpoena), or a request made pursuant to a statutory right. It also does not define the scope of documents; for example, it is unclear whether copies of the return, without accompanying work papers, would suffice.

The 2005 Act, however, amended several parts of section 521 of the Code to require the provision of tax information, n37 and it is likely that this new confirmation requirement relates to duties added concurrently with the new requirement. There are at least two such requirements. Section 521(e)(2)(A)(ii), for example, requires a debtor to furnish his or her latest federal tax return to any creditor who requests it so long as such request is timely made. In this context timely means made before the debtor is required to furnish the same information to the trustee, which is not later than 7 days before the date first set of the first meeting of creditors. n38 It may be, however, that provision of this tax information is not the information to which section 1129(a)(16) refers. The confirmation requirement is that the

requested tax documents must be filed with the court, and not provided to creditors. This mismatch between the confirmation requirement of filing with the court and the statutory requirement to provide the same information directly to creditors likely eliminates section 521(e)(2) as a candidate for the applicable request.

It is more likely that this uncodified confirmation requirement refers to the duties, newly added in 2005, n39 specified in section 521(f). n40 This section requires an individual debtor to file federal income tax returns, and any amendments thereto, with the court [a]t the request of the court, the United States trustee, or any party in interest in a case under chapter 7, 11, or 13. n41 The duty extends to all returns, and amended returns, filed during the pendency of the case, and which relate to: (i) the three tax years immediately preceding the commencement of the case; n42 and (ii) all tax years which elapse during the pendency of the case. n4343 Since section 521(f) refers to the same delivery location as does the confirmation requirement--the courts docket--it is the most likely source of the triggering request under section 1228(b) of the 2005 Act.

For further discussion of Code section 1129, see Collier on Bankruptcy, ch. 1129.

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n1 See *Collier on Bankruptcy*, 1129.02[3].

n2 See *United States ex rel. Farmers Home Admin. v. Arnold & Baker Farms (In re Arnold & Baker Farms)*, 177 B.R. 648, 33 C.B.C.2d 31 (B.A.P. 9th Cir. 1994).

n3 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 213(1) (2005). This provision is effective in all cases commenced on or after October 17, 2005. *Id.* § 1501(b)(1).

n4 Although the paragraph does not use the term individual debtor, the nature of domestic support obligations are such that it will be the rare case when a non-individual (such as a corporation or partnership) will be liable for such a debt.

n5 11 U.S.C. § 1129(a)(14).

n6 *11 U.S.C. § 1129(a)(14)*.

n7 *11 U.S.C. § 101(14A)*, added by Pub. L. No. 109-8, § 211(2) (2005), effective in cases commenced on or after October 17, 2005.

n8 *11 U.S.C. § 101(14A)*.

n9 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 321(c)(1) (2005), effective in cases commenced on or after October 17, 2005.

n10 *11 U.S.C. § 1129(a)(15)(A)*.

n11 *11 U.S.C. § 1129(a)(15)(B)*. This requirement is buttressed by section 1123(a)(8) which requires individual debtors to devote all earnings from personal services performed by the debtor after commencement of the case or other future income of the debtor as is necessary for the execution of the plan. *11 U.S.C. § 1123(a)(8)*; *see also 11 U.S.C. § 1115*, which classifies such postpetition earnings as property of the estate.

n12 Section 1129(a)(15)(B) specifically provides that disposable income of the debtor is used as defined in section 1325(b)(2).

n13 *See Collier on Bankruptcy*, ch. 1325.

n14 *11 U.S.C. § 101(10A)*.

n15 *11 U.S.C. § 1325(b)(2)*.

n16 11 U.S.C. § 1325(b)(2)(A)(i).

n17 11 U.S.C. § 1325(b)(2)(A)(ii).

n18 11 U.S.C. § 1325(b)(2)(B).

n19 Section 1325(b)(3) incorporates the means test expense standard found in subparagraphs (A) and (B) of section 707(b)(2), which in turn incorporates the expenses standards developed by the Internal Revenue Service.

n20 The strongest argument for this reading is that section 1325(b)(3) states that [a]mounts reasonably necessary to be expended under paragraph (2) shall be determined in accordance with section 707(b)(2) if the debtors annualized current monthly income exceeds certain median income levels in the state in which the debtor resides.

n21 11 USCS § 1325(b)(4).

n22 11 U.S.C. § 1129(a)(15)(B).

n23 This view is supported by section 1123(a)(8), which requires an individual debtor's plan to include all postpetition earnings from services, but without specification of any minimum period.

n24 11 U.S.C. §§ 1322(d), 1325(b)(4)(A)(i)(ii).

n25 11 U.S.C. § 1129(a)(15)(B).

n26 11 U.S.C. § 1326(a)(1). The plan must be filed within 15 days of the commencement of the case. *Fed.*

R. Bankr. P. 3015(b).

n27 *11 U.S.C. § 1325(b)(1)(B).*

n28 *11 U.S.C. § 1129(a)(15)(B).*

n29 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1221(b) (2005). It is applicable to all cases regardless of the date the case commenced. *Id.* § 1221(d). With respect to cases pending on the date of enactment, April 20, 2005, the statute provides that the court shall not confirm a plan under chapter 11 of title 11, United States Code, without considering whether this section would substantially affect the rights of a party in interest who first acquired rights with respect to the debtor after the date of the filing of the petition. Section 1129(a)(16) was added as a package of similar amendments to sections 363 and 541. *Id.*

n30 *11 U.S.C. § 1129(a)(16).*

n31 H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 145 (2005).

n32 Pub. L. No. 109-8, § 1221(d) (2005).

n33 Pub. L. No. 109-8, § 1221(e) (2005).

n34 Pub. L. No. 109-8, § 1228(b) (2005).

n35 Pub. L. No. 109-8, § 1228(b), *119 Stat. 23, 183 (2005).*

n36 See, e.g., H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 146-47 (2005).

n37 Pub. L. No. 109-8, § 315 (2005).

n38 11 U.S.C. § 521(e)(2)(A)(ii).

n39 Pub. L. No. 109-8, § 315(b)(2) (2005).

n40 11 U.S.C. § 521(f)(1)(3).

n41 11 U.S.C. § 521(f).

n42 11 U.S.C. § 521(f)(2).

n43 11 U.S.C. § 521(f)(1).

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97 of 197 DOCUMENTS

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Collier on Duration of a Chapter 13 Plan

2008 Emerging Issues 1498

Collier on Duration of a Chapter 13 Plan

By Collier

December 14, 2007

SUMMARY: This Emerging Issues Analysis covers when Chapter 13 debtors may be required to propose a five-year plan, when Chapter 13 debtors who have current monthly income that is less than the applicable state median income may propose a five-year plan, and when three-year and five-year plans commence and conclude.

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ARTICLE:

Bankruptcy Code Section 1322(d), formerly section 1322(c) and amended substantially in 2005, n1 was an innovation of the Bankruptcy Reform Act of 1978. n2 Under Chapter XIII of the former Bankruptcy Act, n3 there was no limit placed on the duration of a Chapter XIII plan, but the practice of proposing extension wage earner plans of not less than three years' duration became widespread and many extended much longer. n4

Plan May Propose Payments Up to Three Years, or Up to Five Years, Depending on Circumstances.

Cases Filed Prior to Effective Date of 2005 Amendments. For cases filed prior to October 17, 2005, the effective date of the 2005 amendments to the Bankruptcy Code, n5 section 1322(d) provides that no plan, including subsequent modifications, n6 may propose payments over a period of more than three years, unless the court, for cause shown, authorizes the debtor to propose a plan, including any modifications, n7 calling for payments extending up to five years. n8 No chapter 13 plan may propose payments over a period of more than five years under any circumstances. n9 The rationale underlying section 1322(d) is clearly expressed in the House Judiciary Committee Report.

On the other hand in certain areas of the country, inadequate supervision of debtors attempting to perform under wage earner plans have (sic) made them a way of life for certain debtors. Extensions on plans, new cases, and newly incurred debts put some debtors under court supervised repayment plans for seven to ten years. This has become the closest thing there is to involuntary servitude n10

The usual reason for extension of plan payments beyond three years is the debtor's inability to cure a default under section 1322(b)(5) n11 or to pay priority or allowed secured claims in a shorter time. n12 Extensions up to the

five-year maximum should be allowed without difficulty in these circumstances, since without them the debtor may be unable to obtain effective relief under chapter 13. They may also be allowed in cases in which the debtor wishes to pay a somewhat higher dividend to unsecured creditors. n13

However, a court considering confirmation of such a plan must ensure that the extension beyond three years is completely voluntary, and not imposed on the debtor by creditors or the chapter 13 trustee. n14 To require plans longer than three years when they are not required by the statute would be renewing the very practices to which Congress objected and would be contrary to section 1325(b), which for all cases filed before the effective date of the 2005 amendments and for most cases thereafter, n15 requires only three years of payments to assure plan confirmation. n16

Cases Filed after Effective Date of 2005 Amendments for Debtors with Current Monthly Income at or Above Applicable State Median Income; 11 U.S.C. § 1322(d)(1). Because the 2005 legislation amended section 1325(b) to require an applicable commitment period of five years for certain chapter 13 debtors, n17 it was necessary to also amend the maximum plan length provisions of section 1322(d). For a debtor who could be subject to a five-year commitment period if the trustee or unsecured creditor files an objection under section 1325(b), the maximum plan length was changed from three years to five years.

Section 1322(d)(1) describes those debtors, using the same language as section 1325(b)(4)(A)(ii), which requires a five-year commitment period if (1) the trustee or the holder of an allowed unsecured claim objects to confirmation, (2) the plan does not provide for payment in full of all allowed unsecured claims over a shorter period and (3) the current monthly income n18 of the debtor and the debtor's spouse combined is over specified state median family income n19 thresholds. The issues of interpretation regarding these income thresholds are the same for both sections. n20

Cases Filed after Effective Date of 2005 Amendments for Debtors with Current Monthly Income Below Applicable State Median Income; 11 U.S.C. § 1322(d)(2). For debtors whose current monthly income n21 is below the applicable state median family income n22 threshold set forth in section 1322(d)(2), the law remains the same as it was for all debtors prior to the 2005 amendments. n23 These debtors must obtain court approval of a plan that proposes payments over a period in excess of three years, and the plan may not propose payments over a period in excess of five years. n24

Commencement and Conclusion of Three- or Five-Year Period. Finally, there is some doubt as to when the three-year and five-year periods begin and end. Although section 1326(a)(1) requires plan payments to begin within 30 days of when the plan is filed, unless the court orders otherwise, n25 at least one court of appeals has held that the five-year maximum period for plan payments does not commence until confirmation of the plan. n26 In most cases there will not be a large difference between these two dates and, in any event, it is clear that payment periods under plans in prior chapter 13 cases are not counted. n27

In addition, the fact that a debtor does not actually conclude the payments within the stated period does not constitute a violation of section 1322(d). n28 The subsection focuses on the payments *provided for* by the plan. If payments are late, but the debtor is substantially complying with the plan, the court should allow the plan to be completed within a reasonable time after the stated term.

For further discussion of Code section 1322, see Collier on Bankruptcy, ch. 1322.

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n1 The subsection was redesignated in connection with the enactment of current section 1322(c) by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to cases filed on or after October 22, 1994). It was amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n2 Pub. L. No. 95-598 (1978).

n3 See Hearings on H.R. 8046 Before the Subcomm. on the Judiciary, House of Representatives, 75th Cong., 1st Sess. 53 (1937) (statement of Referee Charles True Adams) (I think we have something that was not in the others. We do not want to make wage slaves out of these men, we do not want them bound for life when they are under this plan.).

n4 See Hearings on H.R. 8046 Before the Subcomm. on the Judiciary, House of Representatives, 75th Cong., 1st Sess. 53 (1937).

n5 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n6 See 11 U.S.C. §§ 1323(a), 1329(c); *Collier on Bankruptcy*, 1323.02, *Collier on Bankruptcy*, 1329.04.

n7 See 11 U.S.C. §§ 1323(a), 1329(c); *Collier on Bankruptcy*, 1323.02, , *Collier on Bankruptcy*, 1329.04[1].

n8 11 U.S.C. § 1322(d).

n9 11 U.S.C. §§ 1322(d), 1323(a), 1329(c) as in effect for cases filed prior to October 17, 2005; see *Christensen v. Black (In re Black)*, 292 B.R. 693 (B.A.P. 10th Cir. 2003) (reversing modification of plan which deemed debtors first 28 monthly payments to be a lump sum contribution made on the date of plan modification, thereby extending period from actual first payment date well beyond sixty months).

n10 H.R. Rep. No. 595, 95th Cong., 1st Sess. 117 (1977).

n11 11 U.S.C. § 1322(b)(5); see *Collier on Bankruptcy*, 1322.09.

n12 11 U.S.C. §§ 1322(a)(2) and 1325(a)(5), both before and after the effective date of Pub. L. No. 109-8 (2005) require certain minimum payments to particular creditors; see *Collier on Bankruptcy*, 1322.03 and *Collier on Bankruptcy*, 1325.06.

n13 See, e.g., *In re Fries*, 68 B.R. 676 (Bankr. E.D. Pa. 1986).

n14 See *In re Porter*, 102 B.R. 773 (B.A.P. 9th Cir. 1989); *In re Burris*, 208 B.R. 171 (Bankr. W.D. Mo. 1997).

n15 See *Collier on Bankruptcy*, 1322.17[1][b], [c].

n16 *In re Greer*, 60 B.R. 547 (Bankr. C.D. Cal. 1986); see also 11 U.S.C. § 1325(b); *Collier on Bankruptcy*, 1325.08[4].

n17 11 U.S.C. § 1325(b)(4), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 1325.08.

n18 Current monthly income is defined in section 101, as amended by Pub. L. No. 109-8, § 102(b) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 101.10A.

n19 Median family income" is defined in section 101, as amended by Pub. L. No. 109-8, § 102(k) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 101.39A.

n20 See *Collier on Bankruptcy*, 1325.08.

n21 Current monthly income is defined in § 101, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 101.

n22 Median family income is defined in § 101, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 101.

n23 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n24 See *Collier on Bankruptcy*, 1322.17[1][a].

n25 11 U.S.C. § 1326(a)(1); see *Collier on Bankruptcy*, 1326.02[1].

n26 *West v. Costen*, 826 F.2d 1376 (4th Cir. 1987); see also *In re Martin*, 156 B.R. 47 (B.A.P. 9th Cir. 1993).

n27 *In re Martin*, 156 B.R. 47 (B.A.P. 9th Cir. 1993).

n28 See *In re Henry*, 343 B.R. 190 (Bankr. N.D. Ill. 2006) (debtor allowed to complete plan payments beyond 60-month period to accommodate unexpected secured claim); *Aubain v. LaSalle Natl Bank (In re Aubain)*, 296 B.R. 624 (Bankr. E.D.N.Y. 2003) (case reinstated so debtor could complete payments even though 60 months had run); *In re Brown*, 296 B.R. 20 (Bankr. N.D. Cal. 2003) (fact that debtor would not complete payments in 60 months did not require dismissal of case); *In re Black*, 17 C.B.C.2d 602, 78 B.R. 840 (Bankr. S.D. Ohio 1987) (construing former section 1322(c)).

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Collier on Permissible Modifications of a Chapter 13 Plan After Confirmation

2008 Emerging Issues 1500

Collier on Permissible Modifications of a Chapter 13 Plan After Confirmation

By Collier

December 14, 2007

SUMMARY: After confirmation and before completion of all payments under the confirmed plan, a chapter 13 debtor, the trustee, or the holder of an unsecured claim may propose to modify the confirmed plan pursuant to Bankruptcy Code section 1329, usually in response to altered circumstances following confirmation.

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ARTICLE: After confirmation and before completion of all payments under the confirmed plan, a chapter 13 debtor, trustee or holder of an unsecured claim may propose to modify the confirmed plan, n1 usually in response to altered circumstances following confirmation. *Bankruptcy Code section 1329(a)* identifies the kinds of modifications permitted following confirmation, while sections 1329(b) and (c) impose many of the same requirements respecting plan duration, contents and acceptance as are applicable *ab initio*.

Alteration of Amount of Payments; 11 U.S.C. § 1329(a)(1). Section 1329(a)(1) provides that the chapter 13 debtor, trustee or holder of an unsecured claim may propose to increase or decrease the aggregate amount of the payments, that is, the percentage payable, on claims belonging to one or more classes designated by the confirmed plan. n2 Section 1329 does not authorize the debtor to designate classes of claims different from the classifications defined by the confirmed plan. n3

The Court of Appeals for the Sixth Circuit n4 and some bankruptcy courts n5 have held that section 1329(a)(1) does not permit a debtor to surrender collateral to a secured creditor and modify the plan to reduce cash payments to that creditor. The Sixth Circuit in *Chrysler Finance Corp v. Nolan* held that such a modification would change the amount of an allowed claim or the classification of a claim, and that such modifications are not permitted. The court also found it unfair, and contrary to the intent of section 1327, that the secured creditor would be put at risk of the collaterals depreciation after confirmation. The same court extended its holding, in *In re Adkins*, n6 to cover the situation in which property is repossessed and the debtor seeks to have the remaining claim deemed unsecured.

Other courts have held to the contrary, based on a more careful and complete reading of the Code. n7 Typically, a secured claim is in a separate class from other claims, and section 1329(a)(1) specifically permits a modification to decrease the payments on claims in a particular class, i.e., to the amount already paid. Section 1329(a)(3), which the *Nolan* court did not consider, provides that the amount of the distribution to a creditor may be modified to take into

account any payment of such claim other than under the plan. Thus, a reduction of the amount owed to a creditor may be the basis for a modification that has the effect of changing the amount or classification of a claim after confirmation. Further, section 502(j) permits a court to reconsider a claim for cause, n8 and under *Federal Rule of Bankruptcy Procedure 3008*, the court may allow or disallow a claim, increase or decrease the amount of a prior allowance, accord the claim a different priority or enter any other appropriate order. n9 Contrary to the *Nolan* court's conclusion, a claim may be altered after confirmation, a secured claim may be reclassified as unsecured and section 1329 permits modification of the amount of payments on such a claim. n10 If there were no way to modify a plan to take into account such a reconsideration, the debtor could be required to make payments on a claim in excess of the amount of the claim or in excess of the percentage paid to other similar claims.

Moreover, section 1329(b) specifically makes applicable to postconfirmation modifications the provisions of section 1325(a), including subsection (a)(5). If there were no possibility under section 1329(a)(1) of altering the amount paid to a secured creditor or the debtors choice to retain the collateral, there would be no need to import the standards of section 1325(a)(5), which govern only those issues. With respect to the *Nolan* courts citation of the binding effect of a plan under section 1327(a), the ability to modify under section 1329 is obviously a limited exception; otherwise, no plan could ever be modified and section 1329 would be rendered meaningless. n11 And a creditor would normally be harmed by depreciation of the collateral only if the creditor did not exercise its right to demand adequate protection under section 363. n12 A creditor's failure to exercise remedies available to it should not preclude a debtor from utilizing other Code provisions.

The 2005 amendments to section 1325(a)(5) support these conclusions. Section 1325(a)(5), as amended, states that, when the debtor does not surrender the property and the creditor does not accept the plan, the plan is entitled to confirmation only if the plan provides certain protections for the creditor. n13 These protections include adequate protection, n14 ameliorating the concern of the *Nolan* court about harm from depreciation during the plan. And the plan is to provide that the holder of the allowed secured claim retains its lien until the claim is paid in full under applicable nonbankruptcy law or until the discharge. n15 These protections indicate the extent to which Congress wished to restrict the debtor's flexibility in dealing with secured claims in chapter 13. They do not prevent a debtor from surrendering collateral at some point in the case through a plan modification. The creditor, which would have had the specifically granted right to demand adequate protection, would through such a surrender realize the benefit of the lien that Congress protected. The amendments also do not prevent the value of the collateral from being credited as payment on the debt, providing cause for reconsideration of the claim. In fact, applicable nonbankruptcy law, to which section 1325(a)(5), as amended, would look, almost always would require such value to be credited toward the debt. Congress, which enacted numerous provisions sought by creditors to resolve conflicting case law, including those described above, could easily have adopted the holding in the *Nolan* case; it chose not to do so.

Alteration of Time of Payments; 11 U.S.C. § 1329(a)(2). Section 1329(a)(2) provides that the confirmed plan may be modified so as to extend or shorten the time within which payments on one or more classes of claims were to have been made under the previously confirmed plan, n16 but any protraction of the extension period during which distributions were to have been made to creditors may not extend the period over which the debtor is required to make payments under the plan in contravention of section 1329(c). n17 Thus, for example, the court may suspend payments temporarily due to unanticipated medical expenses necessary for the debtor's well-being. n18

One situation in which the time of payments may be reduced is when the debtor seeks to refinance a mortgage, often at a lower rate, and complete plan payments in a shorter time. As the Bankruptcy Appellate Panel for the Ninth Circuit held in *Sunahara v. Burchard* (In re *Sunahara*), n19 there is no reason such a modification should not be allowed. If the refinancing proceeds are used to pay creditors the amount to which they are entitled under the plan more quickly than originally contemplated, the creditors benefit from the earlier payment and the elimination of the risk the plan will fail. Such a modification is therefore proper, even if it does not comport with a district's form plan provision that a plan must extend for at least 36 months. The provisions of a form plan are no less modifiable than any other provisions of a plan. n20

The *Sunahara* court found that the section 1325(b) disposable income test does not apply to a modification under section 1329. But even if the court looks to the debtor's disposable income, the proceeds of a refinancing should not be considered income, but rather transformation of an asset into cash, with a corresponding increase in the debtor's mortgage liability, and therefore should not be considered to increase the debtor's ability to pay creditors. n21

Alteration of Distribution to Particular Holder; 11 U.S.C. § 1329(a)(3). Under Section 1329(a)(3), the debtor may modify the confirmed plan to alter the amount of any distribution to the holder of a particular claim as required to reflect proper credit for any payment received by the holder outside of the chapter 13 plan. n22 Sources of outside payment include codebtors, sureties, guarantors and the reclamation or disposition of collateral.

Modification of Plan in Order to Purchase Health Insurance; 11 U.S.C. § 1329(a)(4). Section 1329(a)(4), added by the 2005 amendments to the Bankruptcy Code, n23 provides for the situation in which the debtor desires to purchase health insurance. Presumably in recognition of the social policy favoring families purchasing health insurance, Congress made clear the right of a debtor to modify the plan and reduce plan payments by the amounts expended to purchase health insurance for the debtor and for any dependent of the debtor without insurance. The debtor may wish to purchase such insurance during a plan for any of several reasons. The debtors previous insurance through an employer may have been terminated. The debtor's income may have increased to enable the debtor to purchase insurance the debtor could not previously afford. The debtors employer may have begun demanding employee contributions for health insurance. Or the debtor may have decided for other reasons to purchase health insurance.

Whatever the reason, the debtor may take advantage of section 1329(a)(4) provided certain requirements are met.

-- The debtor must document the cost of the insurance. n24

-- The debtor must demonstrate that the expenses are reasonable and necessary. n25 In light of the specific provision for health insurance in section 707(b)(2)(A)(ii)(I), it is hard to conceive of a case where this could not be demonstrated other than a case in which the debtor already had adequate insurance. Thus, this test should require the debtor only to demonstrate the lack of other insurance.

-- If the debtor previously had insurance, the cost of insurance is not materially larger than the cost the debtor previously paid or the cost necessary to maintain the lapsed policy. n26

-- If the debtor did not previously have health insurance, the cost is not materially larger than the amount that would be incurred by a debtor with similar income, expenses, geographic location, health status, and number of dependents who do not otherwise have health insurance. n27

-- The amount is not otherwise allowed for the purposes of determining disposable income under section 1325(b). n28 Presumably, this requirement is simply a recognition that the court will usually consider health insurance expenses to be reasonable and necessary expenses even without the operation of this provision, and that section 1329(a)(4) is designed to supplement the debtor's rights but not to permit double-counting of insurance expenses. A debtor cannot modify the plan to reduce plan payments to purchase insurance if amounts were already allowed in the debtors budget for that purpose.

-- If a party in interest requests, the debtor must provide proof that a health insurance policy was actually purchased. n29

The provision allowing modification of a plan to purchase health insurance recognizes the importance of health insurance to the stability of a family's budget. Like the requirements of credit counseling and credit education, n30 it is designed to encourage debtors to begin sound personal financial practices during the chapter 13 case, in this case practices that will reduce the risk that future medical expenses will once more force them into financial difficulties and possibly another bankruptcy.

For a complete discussion of Code section 1329, see Collier on Bankruptcy, ch. 1329.

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n1 11 USCS § 1329(a).

n2 11 USCS § 1329(a)(1); cf. former Rule 13-214(a).

n3 See *In re White*, 169 B.R. 526 (Bankr. W.D.N.Y. 1994) (even if modified plan may not reclassify allowed secured claim as unsecured, amount of secured claim may be reduced to zero to reflect creditor's decreased security interest after repossession of collateral); *In re Powell*, 5 C.B.C.2d 775, 15 B.R. 465 (Bankr. N.D. Ga. 1981) (provision for discount and lien retention for rejecting secured creditor permissible under section 1329(a)(1)).

n4 *Chrysler Fin. Corp. v. Nolan (In re Nolan)*, 232 F.3d 528 (6th Cir. 2000).

n5 E.g., *In re Dunlap*, 39 C.B.C.2d 13, 215 B.R. 867 (Bankr. E.D. Ark. 1997); *In re Banks*, 161 B.R. 375 (Bankr. S.D. Miss. 1993).

n6 *Ruskin v. DaimlerChrysler Servs. N. Am. (In re Adkins)*, 425 F.3d 296, 55 C.B.C.2d 10 (6th Cir. 2005).

n7 *Bank One, NA v. Leuellen (In re Leuellen)*, 322 B.R. 648 (S.D. Ind. 2005); *In re Knappen*, 281 B.R. 714 (Bankr. D.N.M. 2002); *In re Townley*, 256 B.R. 697 (Bankr. D.N.J. 2000); *Day v. Systems & Servs. Techs., Inc. (In re Day)* 247 B.R. 898 (Bankr. M.D. Ga. 2000); see also *In re Zieder*, 263 B.R. 114 (Bankr. D. Ariz. 2001) (granting modification in light of reconsideration of claim that reduced allowed secured claim to zero).

n8 See *Collier on Bankruptcy*, 502.11; see also *In re Morris*, 289 B.R. 783 (Bankr. S.D. Ga. 2002) (announcing policy that relief from stay for repossession of vehicles would include provision that creditor's

claim deemed satisfied unless amended claim filed). However, a trustee may not unilaterally alter a creditor's claim or the payments to a creditor based upon a repossession without a court order. *System & Servs. Techs., Inc. v. Davis* (*In re Davis*), 314 F.3d 567 (11th Cir. 2002).

n9 Advisory Committee Note to *Fed. R. Bankr. P.* 3008.

n10 See *In re Zieder*, 263 B.R. 114 (Bankr. D. Ariz. 2001); *In re Williams*, 108 B.R. 119 (Bankr. N.D. Miss. 1989) (surrender of collateral can be payment other than under the plan justifying modification).

n11 *Day v. Systems & Servs. Techs., Inc. (In re Day)*, 247 B.R. 898 (Bankr. M.D. Ga. 2000).

n12 *In re Townley*, 256 B.R. 697 (Bankr. D.N.J. 2000).

n13 11 U.S.C. § 1325(a)(5)(B), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n14 11 U.S.C. § 1325(a)(5)(B)(ii)(II).

n15 11 U.S.C. § 1325(a)(5)(B)(i)(I).

n16 11 U.S.C. § 1329(a)(2); cf. former Rule 13-214(a).

n17 See 11 U.S.C. §§ 1322(d), 1329(c), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. Section 1322(d), formerly section 1322(c), was redesignated by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394. See *Collier on Bankruptcy*, 1329.07.

n18 *In re Kapp*, 52 C.B.C.2d 1433, 315 B.R. 87 (Bankr. W.D. Mo. 2004).

n19 54 C.B.C.2d 1048, 326 B.R. 768 (B.A.P. 9th Cir. 2005). The court noted that a debtor who refinances can often simply complete payments on a plan early, without modification, but that in this case the debtor could not obtain the refinancing without an order that the plan would be completed. 326 B.R. 768, 773 n.5; see *Collier on Bankruptcy*, 1329.08.

n20 326 B.R. 768, 783-84.

n21 *In re Brown*, 332 B.R. 562 (Bankr. N.D. Ill. 2005); *Miller v. Loan Star Mortg., Inc. (In re Miller)*, 54 C.B.C.2d 433, 325 B.R. 539 (Bankr. W.D. Pa. 2005).

n22 *In re Tucker*, 35 B.R. 35 (Bankr. M.D. Tenn. 1983); cf. former Rule 13-214(a).

n23 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 102(i) (2005), effective in cases commenced on or after October 17, 2005.

n24 11 U.S.C. § 1329(a)(4).

n25 11 U.S.C. § 1329(a)(4)(A).

n26 11 U.S.C. § 1329(a)(4)(B)(i).

n27 11 U.S.C. § 1329(a)(4)(B)(ii).

n28 11 U.S.C. § 1329(a)(4)(C).

n29 11 U.S.C. § 1329(a)(4).

n30 11 U.S.C. §§ 109(h), 1328(g); see *Collier on Bankruptcy*, 109.09 and *Collier on Bankruptcy*, 1328.08.

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99 of 197 DOCUMENTS

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Collier on the Appointment and Role of a Consumer Privacy Ombudsman

2008 Emerging Issues 1513

Collier on the Appointment and Role of a Consumer Privacy Ombudsman

By Collier

December 14, 2007

SUMMARY: This Emerging Issues Analysis covers the expansion of this appointment authority by bankruptcy courts that seek assistance even when the trustee is able to comply with the debtors privacy policy, the qualifications of and fees for a consumer privacy ombudsman, and the role of the ombudsman under section 332 and as read in conjunction with section 363(b)(1)(B) of the Bankruptcy Code, which governs the use, sale, or lease of property.

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ARTICLE: *Bankruptcy Code section 332* of the Bankruptcy Code provides for the appointment of a consumer privacy ombudsman in cases in which the trustee (or debtor in possession) proposes to sell personally identifiable information in a manner inconsistent with the debtors privacy policy. n1 If so, the court must order the United States trustee to appoint one disinterested person to serve as the ombudsman, whose role is to appear and be heard on the proposed sale in order to provide the court information about the debtors privacy policy in connection with the sale of the information. Consistent with the privacy protection policy of the section, the ombudsman is prohibited from disclosing any personally identifiable information that the ombudsman receives in connection with the case. The ombudsmans fees may be paid in the same manner as the fees of other professionals in the case.

Appointment of Ombudsman. *Section 332(a) of the Bankruptcy Code* requires the court to order the United States trustee to appoint one disinterested person to serve as a consumer privacy ombudsman if a hearing is required under section 363(b)(1)(B). n2 Section 363(b)(1) authorizes the trustee to use, sell or lease property of the estate, after notice and a hearing. It contains a limitation, however, if the property is personally identifiable information. Personally identifiable information is defined in section 101(41A). n3 Generally speaking, it is identifying information that a business debtor gathers from an individual consumer in connection with the individuals purchase of consumer goods or services that can identify the individual. In short, it is the debtors consumer customer list.

Under section 363(b)(1)(B), the trustee may sell or lease the debtors consumer customer list or any of the information contained in the list if the sale or lease complies with the debtors privacy policy that was in effect as of the commencement of the case. If the sale or lease does not comply, then trustee may sell only if the court approves the sale after appointment of a consumer privacy ombudsman under section 332 and after making certain other findings unrelated to any privacy issue. n4 Section 332 requires the court to order the United States trustee to appoint an ombudsman in such a circumstance. The order must require the United States trustee to make the appointment not later

than five days before the commencement of the hearing under section 363(b)(1)(B). The appointee must be a disinterested person and may not be the United States trustee. n5 The order must require that notice of the hearing on the sale of the personally identifiable information be timely given to the ombudsman.

Although the statute authorizes the appointment of a consumer privacy ombudsman when a trustee proposes to sell or lease of personally identifiable information in a manner that is not consistent with the debtors privacy policy, it does not expressly authorize it only in that circumstance or prohibit the appointment in other circumstances. If courts interpret the statute as authorizing the appointment only in the circumstance stated in section 363(b)(1)(B), appointments are likely to be rare, because in most cases, the trustee will be able to comply with the privacy policy. Bankruptcy courts often expand upon a statutory authorization such as section 332 to order the appointment of officers or professionals at the expense of the estate when the court feels that it could benefit from the additional information or assistance that a neutral third party might provide. Appointment in this context for the purposes of assisting the court, when the statutory prerequisite is not present, seems inconsistent with the statute, would impose additional costs on an estate, and, although the statute does not expressly prohibit it, should not be the favored interpretation.

Section 332 does not appear to contain any limits on whom the United States trustee may appoint as the consumer privacy ombudsman, other than the disinterestedness requirement. Common sense suggests that a candidate with knowledge of and experience with consumer privacy laws would be preferred. If the facts and circumstances of a particular case require the appointment of a consumer privacy ombudsman on more than one occasion, it would also seem to make sense to appoint the same individual, who would, by the time of the second or later occasion, already have familiarity with the debtors privacy policy and practices. These matters are committed, however, to the sound discretion of the United State trustee. The statute does not contemplate court approval of the appointment.

The consumer privacy ombudsman will be somewhat of an independent agent in the case, similar to an examiner. The ombudsman does not have a client and does not appear to be required to take direction from any of the parties in interest. Of course, the ombudsman will be subject to the courts orders, but the statute does not appear to contemplate supervision or control of the ombudsman either by the court or the United States trustee. The ombudsmans fees will be subject to court approval, and the United States trustee may object to a fee request. n6 There is no other statutory mechanism, however, for supervision or for court ordered limitations on the ombudsmans duties or activities.

Role of Ombudsman. *Section 332(b) of the Bankruptcy Code*, when read with section 363(b)(1)(B), describes a consumer privacy ombudsmans role. An ombudsman is to be appointed when a trustee proposes to sell or lease personally identifiable information in a way that is not consistent with the debtors privacy policy. In that situation, the court must give due consideration to the facts, circumstances, and conditions of such sale or such lease. and may approve the sale or lease if no showing was made that such sale or such lease would violate applicable nonbankruptcy law. n7 It is apparent that the ombudsmans role is to inform the court of the relevant facts, circumstances and conditions.

Section 332(b) makes that role explicit. It requires the ombudsman to provide to the court information to assist the court in its consideration of the facts, circumstances, and conditions of the proposed sale or lease of personally identifiable information. Section 332(b) provides examples of the kind of such information, including (1) the debtors privacy policy; (2) the potential losses or gains of privacy to consumers if such sale or such lease is approved by the court; (3) the potential costs or benefits to consumers if such sale or such lease is approved by the court; and (4) the potential alternatives that would mitigate privacy losses or potential costs to consumers. Also, the section provides that the ombudsman may appear and be heard at the hearing on the proposed sale or lease. Because the ombudsman is required to provide the court with information but is not expressly required to appear and be heard, the ombudsman may file a written report and not attend the hearing on the proposed sale or lease.

It seems clear that the ombudsman, both from the officers title itself n8 as well as from the tasks described, is to protect the interests of consumers in the privacy of their personally identifiable information. It is not clear, however, how the functioning of this provision adds to the achievement of that goal. Section 363(b)(1)(B) requires that the trustee

comply with the debtors privacy policy in selling or leasing personally identifiable information or that the court find that no showing was made that the sale would violate applicable nonbankruptcy law. If there is such a showing, then the sale may not be approved, and it should not matter what the facts, circumstances and conditions of the sale or lease are nor the effects on the debtors privacy policy, on privacy gains or losses, potential costs or benefits, or potential alternatives to mitigate privacy losses or consumer costs. Even if there are no material privacy losses and no material consumer costs, the sale or lease may not be approved.

The examples of matters of the kinds of matters on which the ombudsman is to report add something substantive to the analysis only if the provision in section 363(b)(1)(B)(ii) is read very narrowly, not as requiring a finding that applicable nonbankruptcy law is not violated, but only that there is no showing that it would be violated. Read as such, it could be viewed as an evidentiary analysis alone: the court should consider the matters on which the consumer privacy ombudsman is to report only if no party in interest offers any evidence of a privacy law violation. That is, the court need not find that the proposed sale or lease does not violate such laws, only that no one offered anything to show that it would. Conversely, if a party in interest makes any showing to that effect, then the sale or lease may not be approved, even if the court ultimately determines that the law would not be violated. That reading could give the ombudsman or other parties in interest in the case an effective veto over a proposed sale or lease, even if it did not actually violate any consumer privacy law. Alternatively, there may be situations in which there is no applicable law. In such a situation, there would be no showing of a violation.

Unfortunately, this reading seems as crabbed as the alternative, which could effectively read section 332(b) out the statute. Congress has simply not provided adequate guidance on how the ombudsmans duties should be read consistent with the statutory requirement in section 363(b)(1)(B)(ii) for the approval of a proposed sale or lease. Particular cases in the future may tease out meaning from these seemingly contradictory or procedurally awkward provisions.

For a complete discussion of Code section 332, see Collier on Bankruptcy, ch. 332.

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n1 Section 332 was added to the Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 232(a) (2005), effective in cases commenced on or after October 17, 2005.

n2 11 U.S.C. § 363(b), as amended by Pub. L. No. 109-8, § 231(a) (2005), effective in cases commenced on or after October 17, 2005.

n3 11 U.S.C. § 101(41A), added by Pub. L. No. 109-8, § 231(b), effective in cases commenced on or after October 17, 2005.

n4 See Collier on Bankruptcy, ch. 363.

n5 For the definition of disinterested person, *see* 11 U.S.C. § 101(14), as amended by Pub. L. No. 109-8, § 414 (2005).

n6 *See* Collier on Bankruptcy, ch. 330.

n7 11 U.S.C. § 363(b), as amended by Pub. L. No. 109-8, § 231(a) (2005), effective in cases commenced on or after October 17, 2005.

n8 An appointed official whose duty is to investigate complaints, generally on behalf of individuals such as consumers or taxpayers, against institutions such as companies and government departments. Wiktionary, definition of ombudsman, *at* <http://en.wiktionary.org/wiki/Ombudsman> (last visited July 25, 2005).

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Collier on the Effect of a Conversion of a Chapter 13 Case

2008 Emerging Issues 1514

Collier on the Effect of a Conversion of a Chapter 13 Case

By Collier

December 14, 2007

SUMMARY: Section 348 of the Bankruptcy Code governs the effect of conversion of a case from one chapter of the Code to another chapter. It provides, in general, that conversion of a case constitutes a new order for relief under the chapter to which the case is converted, but, except as specifically provided in section 348, conversion does not change the date the petition is considered to have been filed.

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ARTICLE: Overview of Section 348. Conversion *Section 348 of the Bankruptcy Code* governs the effect of conversion of a case from one chapter of the Code to another chapter. It provides, in general, that conversion of a case constitutes a new order for relief under the chapter to which the case is converted, but, except as specifically provided in section 348, conversion does not change the date the petition is considered to have been filed. n1

A claim against the estate or the debtor that arose after the original order for relief but before conversion is treated as a prepetition claim in a case converted from chapter 11, 12 or 13, except that it may be entitled to priority as an administrative expense under section 503(b). n2 Conversion also terminates the service of any trustee or examiner who was serving in the case before conversion. n3

When a debtor converts from chapter 13 to chapter 7, the property of the estate will consist of the property the debtor had on the date the original chapter 13 petition was filed, to the extent that the property is still in the debtor's possession. n4 But this rule does not apply if the debtor converted from chapter 13 in bad faith: if the conversion was in bad faith, the property of the estate will consist of the property of the chapter 13 estate as of the date of conversion. n5 In any event, after conversion from chapter 13 to chapter 11 or chapter 12, valuations of property and allowed secured claims are preserved from the chapter 13 case, and allowed secured claims are reduced to the extent that they have already been paid during the chapter 13 case. n6 In cases converted from chapter 13 to chapter 7, the claim of a creditor holding security continues to be secured unless the full amount of the claim, as determined under applicable nonbankruptcy law, has been paid as of the date of conversion. In addition, prebankruptcy defaults are given the effect that they have under applicable nonbankruptcy law unless they have been fully cured under the chapter 13 plan prior to conversion. n7

Except for cases under chapter 9, a case under any chapter may be converted. There may be conversion of a

liquidation case under section 706, n8 conversion of a reorganization case under section 1112, n9 conversion of a chapter 12 case under section 1208 n10 or conversion of a chapter 13 case under section 1307. n11. These four sections set forth the grounds for converting a case from one chapter to another. The one limitation on conversion common to all four is that a case may not be converted to a case under another chapter unless the debtor may be a debtor under such chapter. Section 109 sets forth the qualifications for those who may be debtors under chapters 7, 11, 12 and 13. n12

Section 706 provides that the debtor may convert a case under chapter 7 to a case under chapter 11, 12 or 13 at any time if the case has not previously been converted under section 1112, 1208 or 1307. n13 Thus, except for this restriction, the debtor is given one absolute right of conversion of a liquidation case to a reorganization or individual or family farmer debt adjustment plan case. The policy underlying this provision is that the debtor should have the right to repay his or her debts. n14 In addition, the court may convert a chapter 7 case to a chapter 11 reorganization case, after notice and hearing, upon request of any party in interest. In contrast, conversion to a chapter 12 or 13 case is conditioned upon the debtor's request. This condition follows from the requirement that a chapter 12 or 13 case must be initiated by the debtor. n15

A debtor may convert a chapter 11 reorganization case to a chapter 7 liquidation case under section 1112 unless a trustee has been appointed, the case was commenced by an involuntary petition, or the case was previously converted from another chapter on the request of a party other than the debtor. n16 Upon the request of a party in interest the court may, in some cases, convert a chapter 11 case to a chapter 7 case. n17 Conversion from chapter 11 to chapter 12 or 13 is conditioned upon request by the debtor. It may occur only when the debtor has not been discharged under section 1141(d) and, in the case of conversion to chapter 12, when conversion is equitable. n18

Under section 1208, n19 a debtor may convert a chapter 12 case to a chapter 7 liquidation case at any time. Any waiver of the right to convert is unenforceable. The case may not be converted at the request of any other party unless the debtor has committed fraud in connection with the case. n20

Under section 1307, the debtor may convert a chapter 13 case to a chapter 7 case at any time. n21 A waiver of the right to convert is unenforceable. The court may convert a chapter 13 case to a chapter 7 case upon request of a party in interest or the United States trustee after notice and a hearing. n22 Before confirmation of a plan, the court may also convert the case to a case under chapter 11 or chapter 12, upon the request of a party in interest or the United States trustee. n23 But if the debtor is a farmer, a chapter 13 case may not be involuntarily converted to another chapter. n24

Rules for Conversion of a Chapter 13 Case; 11 U.S.C. § 348(f). The Bankruptcy Reform Act of 1994 added new subsection (f) to section 348. n25 The amendment was intended to clarify the Code to resolve a split in the law about what property is in the bankruptcy estate when a debtor converts from chapter 13 to chapter 7. n26 Substantial amendments were made to section 348(f) in 2005. n27

General Rule Regarding Property of the Estate after Conversion to Chapter 7; § 348(f)(1)(A). Subsection (f)(1)(A) provides that when a chapter 13 case is converted to another chapter, property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.

The addition of this subsection clarified that Congress had intended the result reached by cases that had not included in the postconversion chapter 7 estate the property acquired by the debtor during the preconversion chapter 13 case. n28 As the House Report on the amendment pointed out, this result was in accord with the statute's language, since section 1306, which makes such property property of the estate in chapter 13 cases, is inapplicable to chapter 7 cases. n29 The Report further explained that the Committee was concerned that the contrary rule would create a serious disincentive to chapter 13 filings because debtors would fear that property attained after filing, including equity created

by payment of secured debts, could be lost if the case were converted. n30 The legislative history also states that equity created during the chapter 13 case is not

property of the estate. n31

In accordance with section 348(f)(1), the Court of Appeals for the Fifth Circuit held, in *In re Stamm*, n32 that postpetition wages in the hands of the chapter 13 trustee should be returned to the debtors because they were not a part of the chapter 7 estate. n33 Other courts have also held that property acquired during the pendency of the chapter 13 case does not, absent bad faith, become property of the chapter 7 estate after conversion. n34

Exception for Bad Faith Filing; 11 U.S.C. § 348(f)(2). Under section 348(f)(2), n35 there is an exception to the general rule about property of the estate after conversion from chapter 13 to chapter 7 if conversion is in bad faith. If conversion is in bad faith, property of the chapter 7 estate is the property of the estate as of the date of conversion.

It is unclear what would constitute bad faith such as to trigger this exception. One situation in which bad faith might be found would be if the debtor never really intended to proceed with a chapter 13 case and had filed it simply to protect assets the debtor knew would soon be acquired. Courts are also likely to find bad faith under an all of the circumstances test when the debtor has been repeatedly dishonest and has manipulated the system unfairly. n36 Courts clearly should not find bad faith if the debtor is unable to complete a plan due to a change in circumstances or financial hardship. Moreover, simply taking advantage of the statute's provisions excluding property acquired during the chapter 13 case from the chapter 7 estate after conversion is not bad faith. n37

Valuation of Property after Conversion from Chapter 13; 11 U.S.C. § 348(f)(1)(B) & (C). Section 348(f)(1)(B), also enacted by the Bankruptcy Reform Act of 1994, n38 clarified the law with respect to valuation of property after conversion from chapter 13: valuations of property and of allowed secured claims in the chapter 13 case shall apply in the converted case. However, this paragraph was amended in 2005 to apply only to conversions to chapter 11 or to chapter 12 and not to conversions to chapter 7. n39 The amended subsection clearly applies to the valuations used in determining allowed secured claims in such cases. Once the value of an item of property is established for that purpose, whether by court order, agreement or otherwise, it will not be changed after the case is converted to chapter 11 or chapter 12.

The 2005 amendments to section 348(f) n40 added a new paragraph 348(f)(1)(C), applicable to conversions from chapter 13. Subdivision (i) of this paragraph provides that, with respect to cases converted from chapter 13, the claim of any creditor holding security n41 shall continue to be secured by that security unless the full amount of such claim determined under applicable nonbankruptcy law has been paid in full as of the date of conversion, notwithstanding any valuation or determination of the amount of the allowed secured claim made for purposes of the case under chapter 13. This language raises a number of questions. First, although it appears to contradict section 348(f)(1)(B) in at least some instances, n42 it is not limited to chapter 7 cases. On its face it, seems to apply to all cases converted from chapter 13. The language does not conflict with the first portion of section 348(f)(1)(B), since it contains no dictate concerning the valuation of property. However, for chapter 7 cases this means that valuation of property must be determined by reference to some other source, since section 348(f)(1)(B) is made explicitly inapplicable to cases converted to chapter 7. This may be advantageous to debtors who have converted to chapter 7 because, at least with respect to personal property, the property's value is likely to have gone down during the pendency of the chapter 13 case. n43

In any event, subsections 348(f)(1)(B) and (C) have no applicability with respect to valuation of property for exemption purposes, since exemption values are determined as of the date the petition is filed n44 (which does not change upon conversion). n45 Paragraphs (B) and (C) concern valuations of and treatment of secured claims after conversion. Exemption valuations should be determined consistent with section 348(f)(1)(A), which provides that increases in value during the chapter 13 case do not become property of the chapter 7 estate after conversion. n46 The subsection serves judicial efficiency, by preventing relitigation of valuation issues.

Reduction of Allowed Secured Claims to the Extent Paid Prior to Conversion from Chapter 13; 11 U.S.C. § 348(f)(1)(B) & (C). Subsections 348(f)(1)(B) and (C) also control at least to some degree the treatment of allowed secured claims that have been paid, in part or in full, in chapter 13 cases prior to conversion. In cases converted from chapter 13 to chapter 11 or chapter 12, secured claims are reduced to the extent that they have been paid in the chapter 13 case. This provision too, as originally enacted, resolved a split in the case law.

Some courts had held that debtors seeking to redeem under section 722 n47 in a converted case had to pay the full value of the property even though they had made payments on the allowed secured claim in the chapter 13 case. n48 That result was rejected by the 1994 amendments. Instead, Congress agreed with those courts that had held that the payments on the allowed secured claim made during the chapter 13 case should be credited in the chapter 7 case to reduce the redemption amount so that the debtor does not pay a total that is greater than the value of the property. n49 Therefore, if the debtor had paid a portion of the allowed secured claim through the chapter 13 plan, the debtor could redeem by paying the remainder of the allowed secured claim. n50 If the full allowed secured claim had been paid before conversion, it did not spring back into existence simply because the case has been converted to chapter 7. n51

In 2005 Congress muddled the waters it had cleared by enacting amendments to section 348(f)(1) that create new confusion. The amendments retained the language of the 1994 amendments for cases converted to chapter 11 and chapter 12, but not for cases converted to chapter 7. Section 348(f)(1)(C)(i), added by those amendments, n52 provides that with respect to cases converted from chapter 13, the claim of any creditor holding security n53 shall continue to be secured by that security unless the full amount of such claim determined under applicable nonbankruptcy law has been paid in full as of the date of conversion, notwithstanding any valuation or determination of the amount of the allowed secured claim made for purposes of the case under chapter 13.

There is a potential conflict with section 348(f)(1)(B) for cases converted to chapter 11 and chapter 12 to the extent that subparagraph provides that allowed secured claims are to be reduced to the extent they were paid in chapter 13, because section 348(f)(1)(C)(i) provides that, at least in some cases, even if an allowed secured claim has been paid in full in a chapter 13 case, the creditor continues to be secured by its security. Moreover, the new language does not describe how any reduction in the amount of the creditor's allowed secured claim is to be determined in such cases, either in cases where there is a conflict with section 348(f)(1)(B) or in other cases. Courts may decide that in cases converted to chapter 11 or chapter 12 the more specific provisions of section 348(f)(1)(B) apply. The two sections can be reconciled, by reasoning that even if a creditor continues to be secured by its security, a chapter 7 debtor may still redeem the property by paying the remainder of the allowed secured claim.

In cases in which section 348(f)(1)(B) does not apply, courts will have to look to other sources to decide the amount of the allowed secured claim in the converted case. The amendment of the 1994 provision with respect to conversion of chapter 13 cases to chapter 7 means that the pre-1994 situation is re-created and courts will probably take positions similar to those they had taken prior to the 1994 amendments. The amendment should not be read as creating a negative implication that the allowed secured claim should not be reduced by payments in a chapter 13 plan, because Congress clearly could have stated that rule if it had desired that result. Instead, Congress has said nothing about how the allowed secured claim after conversion is determined in such cases.

The language full amount of such claim determined under applicable nonbankruptcy law also may be a source of disputes. At what point in time is the full amount of the claim determined? Normally claims are determined as of the petition date. Does the reference to nonbankruptcy law concern only possible reductions in the claim under particular provisions of the Bankruptcy Code, such as section 502(b)(6) n54 or 502(d)? n55 Does the provision require that there have been some prior determination under nonbankruptcy law? As with so much of the 2005 legislation, the language is simply unclear.

Cure of Prebankruptcy Defaults; 11 U.S.C. § 348(f)(1)(C)(ii). Paragraph 348(f)(1)(C)(ii), added in 2005, n56

provides that unless a prebankruptcy default has been fully cured under a chapter 13 plan at the time of conversion, in any proceeding under title 11 or otherwise, the default will have the effect it has under applicable nonbankruptcy law. Again, the import of this provision is not entirely clear. With what effects is it concerned? It does not state.

What does seem clear from the language is that the determination of whether the default has been cured is made by reference to the chapter 13 plan. If the terms of the plan provide that a default is cured upon certain payments, then a debtor who has made those payments has cured the default. Under the language of the provision the debtor may have cured otherwise as well, perhaps under a foreclosure loss mitigation agreement with the lender independent of the bankruptcy. When a debtor has not made such payments or otherwise cured, under the law prior to the 2005 amendments, no one would have argued that a default had been cured, so this provision seems to make no significant change, except perhaps to clarify that a cure under a chapter 13 plan continues to be effective even if the plan is not completed.

For a complete discussion of Code section 348, see Collier on Bankruptcy, ch. 348.

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[Return to Text](#)

n1 11 U.S.C. § 348(a)(c); see *Collier on Bankruptcy*, 348.02 *Collier on Bankruptcy*, 348.04 *infra*.

n2 11 U.S.C. § 348(d); see *Collier on Bankruptcy*, 348.05.

n3 11 U.S.C. § 348(e); see *Collier on Bankruptcy*, 348.06.

n4 11 U.S.C. § 348(f)(1)(A); see *Collier on Bankruptcy*, 348.07[1].

n5 11 U.S.C. § 348(f)(2), as amended by a technical amendment in Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 348.07[2].

n6 11 U.S.C. § 348(f)(1)(B), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n7 11 U.S.C. § 348(f)(1)(C), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n8 See Collier on Bankruptcy, ch. 706.

n9 See Collier on Bankruptcy, ch. 1112.

n10 See Collier on Bankruptcy, 1208.01.

n11 See Collier on Bankruptcy, ch. 1307.

n12 See Collier on Bankruptcy, ch. 109.

n13 11 U.S.C. § 706; see Collier on Bankruptcy, 706.02[1].

n14 H.R. Rep. No. 595, 95th Cong., 1st Sess. 380 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 94 (1978).

n15 H.R. Rep. No. 595, 95th Cong., 1st Sess. 428 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 141 (1978).

n16 11 U.S.C. § 1112, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, 1112.02.

n17 11 U.S.C. § 1112(b), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, (c); see Collier on Bankruptcy, 1112.02.

n18 11 U.S.C. § 1112(d); *see Collier on Bankruptcy*, 1112.02.

n19 11 U.S.C. § 1208(a); *see Collier on Bankruptcy*, ch. 1208.

n20 11 U.S.C. § 1208(d); *see Collier on Bankruptcy*, 1208.04.

n21 11 U.S.C. § 1307(a); *see Collier on Bankruptcy*, 1307.02.

n22 11 U.S.C. § 1307(c), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, gives the court discretion either to convert a chapter 13 case into a chapter 7 case or dismiss the chapter 13 case. *See Collier on Bankruptcy*, 1307.04.

n23 11 USCS § 1307(d); *see Collier on Bankruptcy*, 1307.05.

n24 11 USCS § 1307(f), formerly § 1307(e), as redesignated by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 1307.06; *see also* 11 U.S.C. § 303(a).

n25 Pub. L. No. 103-394 (enacted on October 22, 1994, effective in cases commenced on or after the date of enactment).

n26 *See* Section-by-Section Description of H.R. 5116, 140 Cong. Rec. H10,770 (daily ed. Oct. 4, 1994); *see also Collier on Bankruptcy*, 348.02.

n27 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n28 *E.g., In re Bobroff*, 766 F.2d 797, 12 C.B.C.2d 1491 (3d Cir. 1985); see also *In re Young*, 66 F.3d 376 (1st Cir. 1995) (following *Bobroff* in case not governed by amendment because Congress had since clarified the statute).

n29 H.R. Rep. No. 835, 103d Cong., 2d Sess. 57 (1994).

n30 H.R. Rep. No. 835, 103d Cong., 2d Sess. 57 (1994).

n31 H.R. Rep. No. 835, 103d Cong., 2d Sess. 57 (1994).

n32 222 F.3d 216 (5th Cir. 2000).

n33 See *In re Zamora*, 274 B.R. 268 (Bankr. W.D. Tex. 2002) (because funds remaining in trustees hands upon conversion belonged to debtor, debtor had power to assign funds to debtor's attorney and trustee required to honor assignment).

n34 *E.g., Farmer v. Taco Bell Corp.*, 242 B.R. 435 (W.D. Tenn. 1999) (personal injury cause of action which accrued after chapter 13 petition belonged to debtors, not estate, absent bad faith).

n35 A technical amendment to section 348(f)(2), adding the words of the estate after property, the first time it appears, was made by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n36 *In re Siegfried*, 39 C.B.C.2d 1449, 219 B.R. 581 (Bankr. D. Colo. 1998).

n37 *In re Wiczek-Spaulding*, 223 B.R. 538 (Bankr. D. Minn. 1998).

n38 Pub. L. No. 103-394 (1994).

n39 11 U.S.C. § 348(f)(1)(B), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n40 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n41 Security is defined in section 101; *see Collier on Bankruptcy*, ch. 101. In light of the definition of security, it is not clear what claims would be affected by the new language.

n42 *See Collier on Bankruptcy*, 348.07[4].

n43 *See also 11 U.S.C. § 506(a)(2)*, which provides that with respect to property acquired for personal, family, or household purposes replacement value shall be determined *considering the age and condition of the property at the time value is determined*. [emphasis supplied]

n44 11 U.S.C. § 522(a)(2); *see Collier on Bankruptcy*, 522.03[2]; *see also Collier on Bankruptcy*, 348.02[5].

n45 11 U.S.C. § 348(a); *see Collier on Bankruptcy*, 348.02.

n46 *See In re Slack*, 290 B.R. 282 (Bankr. D.N.J. 2003) (value of property stated in schedules, which was not challenged and was therefore implicitly accepted in confirmation of chapter 13 plan, was value of property after conversion to chapter 7); *In re Page*, 250 B.R. 465 (Bankr. D.N.H. 2000) (confirmation of chapter 13 plan was implicit valuation, which was binding for exemption purposes after conversion to chapter 7); *Collier on Bankruptcy*, 348.07[1]. *But see In re Kuhlman*, 254 B.R. 755 (Bankr. N.D. Cal. 2000) (when property was partially nonexempt in chapter 13 case and no plan was confirmed, appreciation in value was appreciation of nonexempt portion that was property of estate as of petition date and belonged to chapter 7 estate because there had been no contrary valuation in chapter 13 case).

n47 See Collier on Bankruptcy, ch. 722.

n48 E.g., *In re Gammon*, 155 B.R. 15 (W.D. Okla. 1993).

n49 E.g., *In re Stoddard*, 167 B.R. 98 (Bankr. S.D. Ohio 1994); *In re Tluscik*, 122 B.R. 728 (Bankr. W.D. Mo. 1991).

n50 *In re Dean*, 281 B.R. 912 (Bankr. W.D. Tenn. 2002); *In re Rodgers*, 273 B.R. 186 (Bankr. C.D. Ill. 2002).

n51 See *In re Archie*, 240 B.R. 425 (Bankr. S.D. Ala. 1999) (debtors who had paid full allowed secured claim on car loan before conversion permitted to redeem vehicle postconversion for \$0.00); *In re Pickett*, 151 B.R. 471 (Bankr. M.D. Tenn. 1992).

n52 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n53 Security is defined in section 101; see Collier on Bankruptcy, ch. 101. In light of the definition of security, it is not clear what claims would be affected by the new language.

n54 Section 506(b)(6) caps the claim of a landlord against the debtor. See *Collier on Bankruptcy*, 502.03[7].

n55 Section 502(d) bars the claim of a transferee of an avoidable transfer unless the transferee has turned over property for which it is liable. See *Collier on Bankruptcy*, 502.05.

n56 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

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101 of 197 DOCUMENTS

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Collier on Reopening a Case Under Title 11

2008 Emerging Issues 1515

Collier on Reopening a Case Under Title 11

By Collier

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SUMMARY: Bankruptcy Code section 350(b) permits the bankruptcy court to reopen a case under title 11 to administer assets, to accord relief to the debtor, or for other cause. However, the case must be reopened in the court in which it was closed. The Court of Appeals for the Ninth Circuit and other courts have held that a case cannot be reopened unless it was closed pursuant to section 350(a) after it has been administered.

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ARTICLE: *Bankruptcy Code section 350(b)* permits the bankruptcy court to reopen a case under title 11 to administer assets, to accord relief to the debtor, or for other cause. However, the case must be reopened in the court in which it was closed. n1 The Court of Appeals for the Ninth Circuit and other courts have held that a case cannot be reopened unless it was closed pursuant to section 350(a) after it has been administered. Therefore , a dismissed case could not be reopened under section 350(b). n2 A dismissal could be undone only through an appeal or a motion under *Federal Rule of Bankruptcy Procedure 9023* or *9024*.

The language of section 350(b) gives the court broad discretion in the reopening of a case. n3 *Federal Rule of Bankruptcy Procedure 5010* is also broadly worded: A case may be reopened on motion of the debtor or other party in interest pursuant to § 350(b) of the Code.

Reopening a Case to Administer Assets. Under section 350(b) and Rule 5010, the discovery of unadministered assets, which was once the sole basis for reopening a case, continues to be a sufficient reason for the court to exercise its power. However, the assets must be assets that were not known at the time the case was closed. For example, in *Miller v. Shallowford Community Hospital*, n4 a lawsuit properly abandoned by the trustee did not constitute unadministered asset for purposes of section 350(b). Section 350(b) thus corresponds to section 554(c), which provides that properly scheduled assets that are not administered at the time the case is closed are deemed abandoned. It is the trustees duty to investigate properly scheduled assets, and the fact that the debtor does not volunteer information about changes in the value of such assets, when information is not requested by the trustee, does not justify reopening the case after the trustee discovers such changes. n5 However the Court of Appeals for the Tenth Circuit, in *In re Woods*, n6 held that an inadvertent technical abandonment of assets by a trustee could be cause for reopening the case pursuant to *Federal Rule of Bankruptcy Procedure 9024*, which incorporates *Federal Rule of Civil Procedure 60*. n7 Other courts have held that Rule 9024 cannot be used to overcome the abandonment resulting from application of the statutory provisions of section

554. n8

On the other hand, it is clear that assets that are not properly disclosed on the schedules are not abandoned and remain property of the estate that can be administered if the case is reopened. n9 In addition, assets may come into the estate for the first time after the case is closed under section 541(a)(5), which includes in the estate inheritances, property settlements and life insurance proceeds acquired within 180 days after the petition. n10

On occasion, debtors have moved to reopen a case in order to schedule a cause of action after a defendant has argued that the debtor is judicially estopped from raising the cause of action because it was not disclosed in a bankruptcy case. Some courts have looked to whether the debtors nondisclosure was intentional in determining whether the case can be reopened to amend the schedules. n11 However, the better view is that creditors in the bankruptcy case should not be deprived of their ability to be paid from proceeds of the asset regardless of the debtors intent, and that the bankruptcy case should ordinarily be reopened so the asset can be administered to prevent a windfall to the defendant. n12

To justify reopening, the likelihood of recovering additional assets must be substantial. If there is only a remote possibility of obtaining assets that would provide a meaningful distribution, the bankruptcy court may decline to reopen the case. n13

Reopening a Case to Amend Schedules. Motions to reopen are often filed by debtors seeking to amend schedules to list an additional creditor. Such motions are generally liberally granted. n14 The courts have held that no prejudice will accrue to the creditor in a no-asset case when creditors have been notified under Rule 2002(e) that it is not necessary to file a claim. In such a case, the omitted creditor is not prejudiced if the case is reopened and the creditor is scheduled because the creditor would not have received a distribution in any event. If additional assets are subsequently found, the creditor has not lost its opportunity to file a claim; if that were to occur, all creditors would be notified and given reasonable time to file their claims under Rule 3002(c)(5). n15 Thus, in *Stark v. St. Marys Hospital (In re Stark)*, n16 a no-asset case, the debtor was allowed to reopen to add an omitted creditor; there was no evidence of fraud or intentional design and the debt in question was a medical bill that the debtor had mistakenly believed to have been covered by insurance.

Motions to reopen for the purpose of adding creditors to the schedules are often filed by debtors in the mistaken belief that adding the creditor to the schedules is necessary for the debt to be discharged. In fact, as explained by the Court of Appeals for the Third Circuit in *Judd v. Wolfe*, n17 the belated scheduling of a creditor after the case has been closed has no effect on whether the debt is discharged. Under section 523(a)(3), a nonscheduled debt is excepted from the discharge only if the failure to schedule resulted in the creditors lacking knowledge of the case in time to file a proof of claim or, if the creditor holds a claim that would have been found nondischargeable under subsection 523(a)(2), (4) or (6), in time to file a dischargeability complaint. n18 If the debt falls within this exception, reopening the case to schedule the debt does not render it dischargeable. If it does not fall within the exception, the debt is discharged regardless of whether it ever was scheduled.

Moreover, nowhere in section 523(a)(3) is the reason why a debt was not scheduled made relevant to the discharge of the debt. n19 As the *Judd* court explained, the plain language of section 523(a)(3) represents a choice by Congress that the discharge of a debt omitted from the schedules does not depend on the debtors good faith in making the omission. n20 Therefore, the court held, it was not an abuse of discretion to refuse the debtors motion to reopen a case that was filed as an attempt to affect the dischargeability of a debt.

Recognizing that a reopening of the case would not affect whether the debt was discharged, the court of appeals in *Judd* went on to consider whether the case should be reopened for the limited purpose of adding a creditors name to the list of creditors. The debtor asserted that this was important in her attempts to acquire new credit. The court remanded the case for a determination of whether reopening the case would serve this or any other purpose, such as assuring the creditor would be notified if assets were later discovered. n21

Some courts have conditioned reopening for the purpose of scheduling an additional creditor on the debtors payment of the reasonable attorneys fees the creditor expended in pursuing its claim prior to discovery that a debtor had filed a bankruptcy petition from which that creditor was omitted. n22 Like those courts that condition reopening on a finding that the debtors omission of a creditor on the schedules was unintentional and nonfraudulent, n23 many of these courts incorrectly assume that the debt will not be discharged if the schedules are not amended. As discussed above, reopening a case and adding a creditor to the schedules does not affect whether a debt is discharged. While a court may choose not to reopen a case to permit amendment of the schedules because the debtor has not acted in good faith, the debtors inability to amend the schedules does not affect the dischargeability of the nonscheduled debt.

Reopening a Case to File a Lien Avoidance Motion. Additional grounds for reopening include the debtors desire to file a motion to avoid a lien under section 522(f) of the Code. The majority of courts hold that a debtor may reopen a bankruptcy case to file a lien avoidance action unless the creditor has been unduly prejudiced by delay on the debtors part. n24 Unlike other provisions in the Code and rules, n25 neither section 522(f) nor *Federal Rule of Bankruptcy Procedure 4003(d)*, both governing lien avoidance motions, sets a deadline for the filing of these motions. Indeed, because the power to avoid a lien is a personal right of the debtor, having no bearing on the administration of the bankruptcy case, it is doubtful that the case has to be reopened at all to hear such a motion, which is clearly within the jurisdiction of the court. n26

However, in *Hawkins v. Landmark Finance Co. (In re Hawkins)*, n27 the Court of Appeals for the Fourth Circuit held that because of prejudice to the creditor, the bankruptcy court did not abuse its discretion in refusing to reopen a chapter 7 case to permit debtors to file a lien avoidance action. The creditor had incurred costs and attorneys fees in instituting foreclosure proceedings in state court in reliance on the debtors failure to reopen the case for eight months after discharge.

Therefore, a key factor in deciding a motion to reopen to allow late avoidance of a lien is whether the creditor would be so prejudiced that it would be inequitable to grant the motion. n28 Absent such prejudice, the case should be reopened. n29 Laches, a long delay in reopening the case, may be an equitable defense to a motion by the debtor to reopen to pursue a section 522(f) action. n30 Some courts have conditioned a debtors right to file a postdischarge lien avoidance action on the debtors reimbursing the creditor for costs and attorneys fees incurred in enforcing its judicial lien in state court, which eliminates any prejudice to the creditor due to unreasonable delay by the debtor. n31 The majority of cases have held that there is no time limit in the Code within which a motion for lien avoidance must be filed, as long as the creditor has not been prejudiced by the delay. n32 On the other hand, when the Code does set a time limit that is marked by or runs from the closing of the case, such as that set by section 546(a)(2) or section 727(e)(2)(B), it is not clear that reopening the case vitiates the time limit. n33

Reopening a Case to Grant a Discharge or Other Relief to the Debtor. The court may reopen a case to grant the debtor a discharge if the case has been closed before a discharge is granted. As indicated above, the court under the Code and Rule 5010 may reopen a case to accord relief to the debtor or to a creditor or other interested party. n34 The rule of law that had been applied before the promulgation of former Bankruptcy Rule 515 (from which Rule 5010 has been adapted), that the closing of a case without the grant of a discharge was the legal equivalent of a denial of discharge, n35 is no longer valid as a result of section 349(a) and therefore cannot be used as a ground for refusing to reopen a case. In general, reopening for this purpose is not available to a debtor whose discharge has been denied under section 727, 1141(d)(3)(C), 1228 or 1328 of the Code. n36

One situation in which a court is likely to reopen a case to grant a discharge is when the debtors case has been closed without a discharge because the debtor did not take a required personal financial management course. Under sections 727(a)(11) and 1328(g), added in 2005, n37 if a chapter 7 or chapter 13 individual debtor does not take such a course, the debtor cannot be granted a discharge. n38 The requirement may also be applicable to individual chapter 11 debtors under section 1141(d)(3). If a debtor subsequently completes the course in personal financial management, there is no reason why a court should not reopen the case and grant the discharge.

More common is the situation in which discharge-related postclosing events give rise to a motion to reopen. The debtor may seek to reopen the case to enforce the discharge injunction of section 524(a) n39 after a creditor has attempted to collect a discharged debt. Similarly, a debtor may be subjected to discrimination prohibited by section 525 n40 and seek enforcement of rights guaranteed by that section in the bankruptcy court. In these situations, which do not concern administration of the case, a motion to reopen may not be necessary for the court to render a decision; these issues clearly are within the courts jurisdiction under section 1334 of title 28. However, many courts require that a motion to reopen be filed, if only to provide a mechanism to instruct the clerk to retrieve a case file from storage. If a motion to reopen is required in such circumstances, it should be granted as a matter of course; only rarely should the bankruptcy court decline to exercise its jurisdiction to enforce rights arising under the Bankruptcy Code.

Debtors, or occasionally creditors, may also file motions to reopen to determine the dischargeability of a debt. The bankruptcy court has concurrent jurisdiction with other courts to decide if particular debts were discharged in a bankruptcy case, other than debts alleged to be nondischargeable under subsection 523(a)(2), (4), (6) or (15), which can be found nondischargeable only by the bankruptcy court. n41 Therefore a motion to reopen the case is probably not even necessary for the court to exercise its jurisdiction. n42 The bankruptcy court should normally grant a motion to reopen to determine the dischargeability of a debt. In any event, the court may choose to abstain if proceedings in another court are well advanced before the issue is brought to the bankruptcy court. n43

Reopening a Case for Other Cause. In addition to the specified causes of the need to administer assets or to accord relief to the debtor, the court may reopen a case for other cause. n44 For example, courts have granted motions to reopen a case to modify a reorganization plan n45 and to determine the validity of lien. n46 The court has discretion, after considering all the circumstances, to refuse to reopen a case. n47 While the Code does not define other cause for purposes of reopening a case under section 350(b), the decision to reopen is discretionary with the court, which may consider numerous factors, including equitable concerns, and ought to emphasize substance over technical considerations. n48

Because section 350(b) gives the bankruptcy court broad discretion in deciding whether to reopen a case, the decision to grant or deny a motion to reopen is binding on review absent a clear showing that there was an abuse of discretion. n49 The bankruptcy court, having broad discretion to reopen a case, may allow a case to be reopened so long as there is no evidence of fraud or intentional design on the part of the moving party or those in privity with the moving party. n50

Limitations on the Right to Reopen a Case. Federal Rule of Civil Procedure 9024(1) provides that a motion to reopen under Rule 5010 is not subject to the one-year time limit that generally applies to motions for relief from an order of the court under *Rule 60(b) of the Federal Rules of Civil Procedure*. Federal Rule of Civil Procedure 9024(1) codified case law under the former Bankruptcy Act that had held Rule 60(b) inapplicable to a petition to reopen the estate pursuant to Section 2a(8) of the Bankruptcy Act. n51 Moreover, the debtor need not remain eligible for relief under section 109 for a case to be reopened. In some cases, reopening may be proper even if the debtor is deceased. n52 Still, a motion to reopen must be made within a reasonable time. Laches are valid grounds for denial of the motion if the delay has been unreasonable and has prejudiced the party opposing reopening. n53 In the case of a small claim, the court may refuse to go to the time, trouble and expense of reopening the estate. n54

Procedure for Reopening a Case. The Bankruptcy Code does not expressly provide a formal procedure under section 350(b) for the reopening of a case, but the legislative history indicates that Congress intended that the Bankruptcy Rules would prescribe the procedure by which a case is reopened and how it would be conducted after reopening. n55 Bankruptcy Rule 5010 provides that a case is to be reopened on motion, n56 and this procedure replaces the earlier one.

The moving party must pay a filing fee in the same amount as the fee for filing a case under the same chapter on the date of reopening. The fee need not be paid if the reopening is to file a dischargeability complaint or to seek enforcement of the discharge order. n57 The court may waive this fee under appropriate circumstances or may defer

payment of the fee from trustees pending discovery of additional assets. If payment is deferred, the fee shall be waived if no additional assets are discovered.

Verification of a motion to reopen is not explicitly required by Rule 5010; therefore, pursuant to Rule 9011(b), a motion to reopen need not be verified. The motion should state facts that reasonably satisfy the court of the requisite cause for reopening. n58 The court may take judicial notice of the record of the original proceeding before it. n59 The limited nature of the proceeding, however, indicates that the order of reopening is not a final adjudication of the substantive issues raised by the party who sought to reopen the case. n60 The order reopening an estate itself cannot be attacked in a collateral action instituted by the trustee after the estate has been reopened. n61 Under prior law, the reopening did not reinstate the discharged trustee. n62 This is also the case under the Bankruptcy Code. Rule 5010 provides that in a chapter 7, 12 or 13 case, a trustee shall not be appointed by the United States trustee unless the court determines that a trustee is necessary to protect the interests of creditors and the debtor or to insure efficient administration of the case. n63 If a trustee is necessary, the United States trustee will appoint a new trustee under the operative provisions in the applicable chapters of the Code.

Who May Move to Reopen a Case. Rule 5010 gives the debtor or any other party in interest the right to file a motion to reopen. n64 In addition, the bankruptcy court may reopen a case *sua sponte*. n65 Courts have disagreed about whether a former trustee has standing to move to reopen. n66 Neither the debtor n67 nor an adverse claimant n68 to the property has standing to oppose the reopening of the case to administer newly discovered assets or for the allowance of valid claims. When a case is reopened, for example, to recover and administer property fraudulently transferred, the order is conclusive as to the debtor and not subject to collateral attack by the debtor or the alleged fraudulent grantee on the ground of error or irregularity in the order appointing a trustee. n69 But a debtor has been held to have the right to oppose an attempt to reopen the case for the purpose of further examining the debtor to discover assets, n70 and the application to reopen on these grounds should be granted only if the moving papers reasonably satisfy the court that there are some unadministered assets belonging to the estate. n71

Although the debtor and creditors usually have standing to reopen a case, parties who are not in any of these categories may not have standing. For example, in *Nintendo Co. v. Patten (In re Alpex Computer Corp.)*, n72 the Court of Appeals for the Tenth Circuit held that a corporation allegedly owing money to the debtor did not have standing to reopen the case, even if it might be affected by how the trustee interpreted the plan as permitting litigation against the corporation.

For a complete discussion of Code section 350, see Collier on Bankruptcy, ch. 350.

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[Return to Text](#)

n1 H.R. Rep. No. 595, 95th Cong., 1st Sess. 338 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978).

n2 *In re Income Property Builders, Inc.*, 699 F.2d 963, 7 C.B.C.2d 4 (9th Cir. 1982); *In re King*, 214 B.R. 334 (Bankr. W.D. Tenn. 1997).

n3 *In re Shondel*, 950 F.2d 1301, 26 C.B.C.2d 193 (7th Cir. 1991).

n4 767 F.2d 1556, 1559 n.4 (11th Cir. 1985).

n5 *In re Adair*, 253 B.R. 85 (B.A.P. 9th Cir. 2000).

n6 173 F.3d 770 (10th Cir.), *cert. denied*, 528 U.S. 878, 120 S. Ct. 187, 145 L. Ed. 2d 157 (1999).

n7 *See also Mendelsohn v. Ozer*, 241 B.R. 503 (E.D.N.Y. 1997) (inadvertent closing report did not preclude reopening when trustee was actively pursuing asset through special counsel).

n8 *See In re Halstead*, 228 B.R. 915 (Bankr. S.D. Ind. 1999) (language of Rule 9024 providing that one-year limit does not apply to motions to reopen indicates intent that rule does not apply to motion to reopen).

n9 *See In re Arboleda*, 224 B.R. 640 (Bankr. N.D. Ill. 1998); *In re Ozer*, 38 C.B.C.2d 10, 208 B.R. 630 (Bankr. E.D.N.Y. 1997).

n10 *See Collier on Bankruptcy*, 541.16 *supra*.

n11 *E.g., Burnes v. Pemco Aeroplex, Inc.*, 291 F.3d 1282 (11th Cir. 2002).

n12 *Lopez v. Specialty Restaurants Corp. (In re Lopez)*, 283 B.R. 22 (B.A.P. 9th Cir. 2002).

n13 *In re Herzig*, 96 B.R. 264 (B.A.P. 9th Cir. 1989).

n14 *In re Soult*, 894 F.2d 815 (6th Cir. 1990); *Samuel v. Baitcher (In re Baitcher)*, 781 F.2d 1529 (11th Cir. 1986); *Rosinski v. Boyd (In re Rosinski)*, 759 F.2d 539, 12 C.B.C.2d 923 (6th Cir. 1985); *Stark v. St. Marys Hospital (In re Stark)*, 717 F.2d 322, 324, 9 C.B.C.2d 319, 321 (7th Cir. 1983).

n15 See *Rosinski v. Boyd (In re Rosinski)*, 759 F.2d 539, 12 C.B.C.2d 923 (6th Cir. 1985).

n16 717 F.2d 322, 324, 9 C.B.C.2d 319, 321 (7th Cir. 1983). Accord *In re Hendricks*, 87 B.R. 114 (Bankr. C.D. Cal. 1988); *In re Hood*, 11 C.B.C.2d 819, 44 B.R. 775 (Bankr. N.D. Ala. 1985); see also *In re Rivers*, 89 B.R. 30 (Bankr. E.D. Ark. 1988); *In re Rhodes*, 88 B.R. 199 (Bankr. E.D. Ark. 1988).

n17 78 F.3d 110, 35 C.B.C.2d 698 (3d Cir. 1996).

n18 11 U.S.C. § 523(a)(3); see *Collier on Bankruptcy*, 523.09.

n19 11 U.S.C. § 523(a)(3); *Collier on Bankruptcy*, 523.09; *Judd v. Wolfe*, 78 F.3d 110, 116 (3d Cir. 1996). Accord *Watson v. Parker (In re Parker)*, 313 F.3d 1267 (10th Cir. 2002); *In re Madaj*, 149 F.3d 467 (6th Cir. 1998); *In re Beezley*, 994 F.2d 1433, 1439 (9th Cir. 1993).

n20 78 F.3d 110, 116, 35 C.B.C.2d 698, 706 (3d Cir. 1996).

n21 78 F.3d 110, 117, 35 C.B.C.2d 698, 707 (3d Cir. 1996); see also *In re Moyette*, 231 B.R. 494 (E.D.N.Y. 1999) (reopening warranted because Code places a premium on accurate scheduling of creditors).

n22 See *In re Brown*, 60 B.R. 983 (Bankr. S.D. Ohio 1986); *In re Scism*, 11 C.B.C.2d 137, 41 B.R. 384 (Bankr. W.D. Okla. 1984); *La Bate & Conti, Inc. v. Davidson (In re Davidson)*, 10 C.B.C.2d 46, 36 B.R. 539 (Bankr. D.N.J. 1983).

n23 *E.g.*, *In re Stone*, 10 F.3d 285, 30 C.B.C.2d 634 (5th Cir. 1994); *Rosinski v. Boyd (In re Rosinski)*, 759 F.2d 539, 12 C.B.C.2d 923 (6th Cir. 1985).

n24 *See In re Yazzie*, 9 C.B.C.2d 62, 24 B.R. 576 (B.A.P. 9th Cir. 1982); *Noble v. Yingling*, 8 C.B.C.2d 1188, 29 B.R. 998 (D. Del. 1983); *In re Quackenbos*, 71 B.R. 693 (Bankr. E.D. Pa. 1987); *In re Skakalski*, 67 B.R. 448 (Bankr. W.D. Pa. 1986); *In re Carilli*, 15 C.B.C.2d 798, 65 B.R. 280 (Bankr. E.D.N.Y. 1986); *In re Palmquist*, 54 B.R. 24 (Bankr. D. Colo. 1985); *In re Moser*, 27 B.R. 144 (Bankr. E.D.N.Y. 1983); *In re Hall*, 7 C.B.C.2d 69, 22 B.R. 701 (Bankr. E.D. Pa. 1982).

n25 *E.g.*, 11 U.S.C. § 546(a); *Fed. R. Bankr. P.* 4003(a), (b). Rule 4003(b) was amended in 2000.

n26 *In re Keller*, 24 B.R. 720 (Bankr. N.D. Ohio 1982); *see In re Menk*, 241 B.R. 896 (B.A.P. 9th Cir. 1999) (reopening case is not necessary for court to exercise jurisdiction not relating to administration); *Collier on Bankruptcy*, 350.03[4].

n27 727 F.2d 324, 10 C.B.C.2d 94 (4th Cir. 1984).

n28 *ITT Financial Servs. v. Ricks (In re Ricks)*, 19 C.B.C.2d 1437, 89 B.R. 73 (B.A.P. 9th Cir. 1988).

n29 *In re Bianucci*, 4 F.3d 526, 29 C.B.C.2d 948 (7th Cir. 1993); *In re Chabot*, 992 F.2d 891, 893 (9th Cir. 1993); *In re McDonald*, 30 C.B.C.2d 564, 161 B.R. 697 (D. Kan. 1993) (local rule setting strict deadline for lien avoidance was invalid).

n30 *See Hawkins v. Landmark Fin. Co. (In re Hawkins)*, 727 F.2d 324, 10 C.B.C.2d 94 (4th Cir. 1984); *Serafini v. Union Bank & Trust Co. (In re Serafini)*, 8 C.B.C.2d 1334, 30 B.R. 606 (Bankr. W.D. Pa. 1983), *affd*, 41 B.R. 880 (W.D. Pa. 1984); H.R. Rep. No. 595, 95th Cong., 1st Sess. 338 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978).

n31 *In re Parker*, 64 B.R. 402 (Bankr. M.D. Fla. 1986); *Noble v. Yingling*, 37 B.R. 647 (D. Del. 1984); see also *In re Ricks*, 62 B.R. 681 (Bankr. S.D. Cal. 1986), *affd*, 19 C.B.C.2d 1437, 89 B.R. 73 (B.A.P. 9th Cir. 1988); *Webb v. Robert A. Boroughs, Ltd. (In re Webb)*, 48 B.R. 454 (Bankr. E.D. Va. 1985) (court will not condition postdischarge relief under section 522(f) on payment of attorneys fees and costs unless creditor can demonstrate by clear and convincing evidence that debtor was guilty of unreasonable delay which prejudiced creditor).

n32 See, e.g., *In re Skakalski*, 67 B.R. 448 (Bankr. W.D. Pa. 1986); *In re Carilli*, 15 C.B.C.2d 798, 65 B.R. 280 (Bankr. E.D.N.Y. 1986); *In re Yazzie*, 9 C.B.C.2d 62, 24 B.R. 576 (B.A.P. 9th Cir. 1982). But see *In re Williams*, 17 B.R. 204 (Bankr. W.D. Ky. 1982); *In re Ridill*, 1 B.R. 216 (C.D. Cal. 1979).

n33 Compare *In re Cortez*, 255 B.R. 324 (Bankr. D. Or. 2000), and *In re Dolliver*, 255 B.R. 251 (Bankr. D. Me. 2000), with *In re White*, 104 B.R. 951 (S.D. Ind. 1989). See also *Collier on Bankruptcy*, 546.02[2][b].

n34 *In re Mesta Machine Co.*, 67 B.R. 147 (Bankr. W.D. Pa. 1985) (union was party in interest qualified to request case be reopened within Rule 5010); see also *Board of Trustees v. Wright (In re Wright)*, 3 C.B.C.2d 284, 7 B.R. 197 (Bankr. N.D. Ala. 1980) (bankruptcy courts authority to accord relief even after the case is closed gives it the power to entertain a creditors petition to reopen the bankruptcy case to consider dischargeability of a student loan). In *In re Danley*, 5 C.B.C.2d 296, 14 B.R. 493 (Bankr. D.N.M. 1981), the bankruptcy court refused to reopen the case when no relief could be granted.

n35 See *Perlman v. 322 West Seventy-second Street Co.*, 127 F.2d 716, 718-19 (2d Cir. 1942); *In re Butts*, 123 F.2d 250, 251 (2d Cir. 1941).

n36 See *In re Lowerree*, 157 F.2d 831 (2d Cir. 1946).

n37 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n38 See *Collier on Bankruptcy*, 727.12A and *Collier on Bankruptcy*, 1328.08.

n39 11 U.S.C. § 524(a); *In re Schneider*, 126 B.R. 626 (Bankr. M.D. Fla. 1991); see *Collier on Bankruptcy*, 524.02[2][c].

n40 11 U.S.C. § 525; see Collier on Bankruptcy, ch. 525.

n41 11 U.S.C. § 523(c)(1); see Collier on Bankruptcy, 523.03 and Collier on Bankruptcy, 523.26; see also *In re Wilborn*, 37 C.B.C.2d 917, 205 B.R. 202 (B.A.P. 9th Cir. 1996) (creditor could reopen to seek dischargeability determination under section 523(a)(3)); *In re Sobh*, 61 B.R. 576 (E.D. Mich. 1986) (debtor could reopen case to seek new determination of whether student loan was dischargeable based on changed circumstances); *In re Higgins*, 161 B.R. 993 (Bankr. W.D. Mo. 1993) (court could reopen for determination under section 523(a)(9)).

n42 *Staffer v. Predovich (In re Staffer)*, 306 F.3d 967 (9th Cir. 2002) (reopening case is not necessary for court to exercise jurisdiction not relating to administration).

n43 See *In re Iannacone*, 21 B.R. 153 (D. Mass. 1982); *In re Brice*, 79 B.R. 310 (Bankr. S.D. Ohio 1987); *In re Dabbs*, 72 B.R. 73 (Bankr. N.D. Ala. 1987); *In re Coppi*, 75 B.R. 81 (Bankr. S.D. Iowa 1987); see also *In re Strano*, 248 B.R. 493 (Bankr. D.N.J. 2000) (decision not to reopen because of pending state court litigation of same issue is a decision to abstain).

n44 See *In re Frontier Enterprises*, 70 B.R. 356 (Bankr. C.D. Ill. 1987) (blatant error in distribution of proceeds of estate was compelling cause to reopen); *In re Mesta Mach. Co.*, 67 B.R. 147 (Bankr. W.D. Pa. 1985) (unions motion to reopen to provide for accounting was cause within section 350(b)).

n45 *In re Case*, 937 F.2d 1014, 25 C.B.C.2d 368 (5th Cir. 1991). But see *In re Zurn*, 290 F.3d 861 (7th Cir. 2002) (affirming refusal to reopen case after judgment which had been paid through chapter 11 plan was reversed; debtor left to state court remedies).

n46 *In re Walters*, 22 C.B.C.2d 1747, 113 B.R. 602 (Bankr. D.S.D. 1990); see also *In re Weber*, 283 B.R. 630 (Bankr. D. Mass. 2002) (case reopened to void judgment obtained in violation of automatic stay).

n47 See, e.g., *Hawkins v. Landmark Fin. Co. (In re Hawkins)*, 727 F.2d 324, 10 C.B.C.2d 94 (4th Cir. 1984), in which the Fourth Circuit held that a bankruptcy court did not abuse its discretion by refusing to reopen

a case for a lien avoidance complaint when the debtor did not seek reopening until after the creditor had incurred court costs and counsel fees in seeking lien enforcement in state court.

n48 *In re Shondel*, 950 F.2d 1301, 26 C.B.C.2d 193 (7th Cir. 1991) (case reopened to modify discharge injunction so that creditor could proceed against insurance policy not scheduled by debtor).

n49 *Virgin Islands Bureau of Internal Revenue v. St. Croix Hotel Corp.*, 14 C.B.C.2d 1098, 60 B.R. 412 (D.V.I. 1986).

n50 *In re Young*, 16 C.B.C.2d 1090, 70 B.R. 968 (Bankr. E.D. Pa. 1987); see also *In re Peterson*, 24 C.B.C.2d 571, 118 B.R. 801 (Bankr. D.N.M. 1990).

n51 See *Perlman v. 322 West Seventy-second Street Co.*, 127 F.2d 716 (2d Cir. 1949); *Grand Union Equipment Co. v. Lippner*, 167 F.2d 958 (2d Cir. 1948); *In re Lowerree*, 157 F.2d 831 (2d Cir. 1946); *In re Consolidated Textile Corp.*, 89 F. Supp. 315 (S.D.N.Y. 1949). The power to reopen estates for cause shown was conferred without qualification by Section 2a(8) of the Bankruptcy Act. The general rule was that upon seasonable application, the court in its discretion and for good cause shown could reopen the estate and set aside the decree, unless rights of third persons had intervened so as to make reopening inequitable.

n52 *In re Walters*, 22 C.B.C.2d 1747, 113 B.R. 602 (Bankr. D.S.D. 1990).

n53 H.R. Rep. No. 595, 95th Cong., 1st Sess. 338 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978); see *In re Plumlee*, 236 B.R. 606 (E.D. Va. 1999) (no fixed time limit, but longer delay requires more compelling reason to reopen); *In re Ashe*, 228 B.R. 457 (C.D. Cal. 1998); *In re Borer*, 73 B.R. 29 (Bankr. N.D. Ohio 1987) (debtors former attorney who withdrew from case and did not file application for attorneys fees for eight months and otherwise failed to pursue payment was guilty of laches and motion to reopen was denied); *In re Pagan*, 59 B.R. 394 (D.P.R. 1986) (creditors motion to reopen was barred by laches because, although they received no formal notice, creditors were aware of the bankruptcy and discharge and waited four years before seeking to reopen); see also *In re Yazzie*, 9 C.B.C.2d 62, 24 B.R. 576 (B.A.P. 9th Cir. 1982); *Noble v. Yingling*, 8 C.B.C.2d 1188, 29 B.R. 998 (D. Del. 1983); *In re Quackenbos*, 71 B.R. 693 (Bankr. E.D. Pa. 1987); *In re Skakalski*, 67 B.R. 448 (Bankr. W.D. Pa. 1986); *In re Carilli*, 15 C.B.C.2d 798, 65 B.R. 280 (Bankr. E.D.N.Y. 1986); *In re Palmquist*, 54 B.R. 24 (Bankr. D. Colo. 1985); *In re Moser*, 27 B.R. 144 (Bankr. E.D.N.Y. 1983); *In re Hall*, 7 C.B.C.2d 69, 22 B.R. 701 (Bankr. E.D. Pa. 1982).

n54 *In re Smith & Co.*, 52 F.2d 212 (D. Neb. 1931).

n55 Pub. L. No. 95-598, § 405(d) (1978); H.R. Rep. No. 595, 95th Cong., 1st Sess. 338 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978).

n56 See Collier on Bankruptcy, ch. 5010 *infra*; see also *In re Collins*, 173 F.3d 924 (4th Cir.) (motion to reopen is not filed against any particular party and therefore is not a suit against a state barred by Eleventh Amendment).

n57 Bankruptcy Court Miscellaneous Fee Schedule, Item 11, promulgated pursuant to 28 U.S.C. § 1930(b), reprinted in Ch. App. 9 *supra*; see also Fed. R. Bankr. P. 4007(b) (A case may be reopened without payment of an additional filing fee for the purpose of filing a complaint to obtain a determination [of a debts dischargeability.]).

n58 *Schofield v. Moriyama*, 24 F.2d 473 (9th Cir. 1928); *In re Snyder*, 4 F.2d 627 (9th Cir.), cert. denied, 269 U.S. 556, 46 S. Ct. 19, 70 L. Ed. 409 (1925); *In re Graff*, 250 F. 997 (2d Cir. 1918); *In re Newton*, 107 F. 429 (8th Cir. 1901).

n59 *Pollack v. Meyer Bros. Drug Co.*, 233 F. 861 (8th Cir. 1916).

n60 *In re Dixon*, 49 F. Supp. 977 (S.D. Ga. 1943); see *In re Leigh*, 272 F. 678 (7th Cir.), cert. denied, *Davis v. Baechtel*, 256 U.S. 698, 41 S. Ct. 537, 65 L. Ed. 1177 (1921); *In re Ryburn*, 145 F. 662 (D. Conn. 1906).

n61 *Tuffy v. Nichols*, 120 F.2d 906 (2d Cir.), cert. denied, 314 U.S. 660, 62 S. Ct. 113, 86 L. Ed. 528 (1941); see *In re Joslyn* 171 F.2d 159 (7th Cir. 1948) (order of reopening not subject to collateral attack before another district judge).

n62 *In re Rochester Baths Co.*, 222 F. 22 (2d Cir. 1915); *In re Hannevig*, 25 F. Supp. 335 (S.D.N.Y. 1938) (it is for the creditors to elect a trustee to act for the reopened estate); *In re Minners*, 253 F. 300 (S.D.N.Y. 1918); *Stephan v. Merchants Collateral Corp.*, 256 N.Y. 418, 176 N.E. 824 (1931).

n63 The 1991 Advisory Committee Note to Rule 5010 states that in most reopened cases, a trustee is not needed because there are no assets to be administered and that, in the interest of judicial economy, the rule was amended so that a trustee would not be appointed unless the United States trustee or a party in interest seeks the appointment of a trustee in the reopened case.

n64 See *Nintendo Co. v. Patten (In re Alpex Computer Corp.)*, 71 F.3d 353 (10th Cir. 1995) (notwithstanding expansive definition of party in interest, for purposes of reopening a bankruptcy case, the concept of standing is implicitly confined to debtors, creditors, or trustees, each with a particular and direct stake in reopening cognizable under the Bankruptcy Code); *In re Ayoub*, 72 B.R. 808 (Bankr. M.D. Fla. 1987) (only creditors have standing to seek to reopen for the purpose of administering additional assets; debtor did not have standing to file motion to reopen to assert exemption claim to state court jury verdict obtained by debtor during bankruptcy case); see also *In re Young*, 16 C.B.C.2d 1090, 70 B.R. 968 (Bankr. E.D. Pa. 1987) (representative of the successor-in-interest to the most significant asset in the former estate had standing to reopen case).

n65 *In re Mullendore*, 741 F.2d 306 (10th Cir. 1984) (construing former Rule 515); *In re Searles*, 70 B.R. 266 (D.R.I. 1987); *In re Tall*, 79 B.R. 291 (Bankr. S.D. Ohio 1987); *In re Warren*, 7 C.B.C.2d 842, 24 B.R. 846 (Bankr. W.D. Ky. 1982); see also *In re Thomas*, 204 F.2d 788 (7th Cir. 1953).

n66 See *In re DeLash*, 260 B.R. 4 (Bankr. E.D. Cal. 2000) (it is United States trustee who should make decision whether to seek reopening because trustee's appointment was terminated); *In re Ayoub*, 72 B.R. 808 (Bankr. M.D. Fla. 1987), in which a former trustee who had been discharged when the case was closed was held to have no cognizable interest in the case. But see *Mendelsohn v. Ozer*, 241 B.R. 503 (E.D.N.Y. 1997) (trustee has standing to move to reopen inadvertently closed case); *White v. Boston*, 104 B.R. 951 (S.D. Ind. 1989); *In re Stanke*, 11 C.B.C.2d 79, 41 B.R. 379 (Bankr. W.D. Mo. 1984) (former trustee was a party in interest who could move to reopen).

n67 *Williams v. Rice*, 30 F.2d 814 (5th Cir. 1929). But see *In re Hopkins*, 11 F. Supp. 831 (W.D.N.Y. 1934) (discharged debtor had the right to move for vacation of an *ex parte* order reopening his estate).

n68 *Hunter v. Commerce Trust Co.*, 55 F.2d 1 (8th Cir. 1932); *In re Hopkins*, 11 F. Supp. 831 (W.D.N.Y. 1934).

n69 *Ivester v. McNicholas*, 157 Ga. 755, 122 S.E. 417 (1924).

n70 *In re Chapman*, 55 F.2d 965 (N.D.N.Y. 1930).

n71 *In re Chapman*, 55 F.2d 965 (N.D.N.Y. 1930).

n72 71 F.3d 353, 357 (10th Cir. 1995).

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102 of 197 DOCUMENTS

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Collier on Denial of Compensation and Reimbursement under Section 328(c)

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By Collier

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SUMMARY: Just as no man is an island, rarely can one area of the law be fully understood without also considering another area of the law. This concept can likewise be applied to the Bankruptcy Code. In the following article, section 328(c) of the Code is considered in conjunction with sections 327(a) and 1103(b) and case law interpreting the same is explored and analyzed.

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ARTICLE: *Bankruptcy Code Section 328(c)* should be read in conjunction with sections 327(a) and 1103(b) of the Code. Those sections govern the employment of professional persons by a trustee or debtor in possession and a creditors committee, respectively, and require that professionals be disinterested and not hold adverse interest to the debtors estate. Sections 327(a) and 1103(b) set forth the standards for the employment of professionals; section 328(c) sets forth the sanctions for violations. Accordingly, many cases analyzing the appropriate remedy when a professional is not disinterested or has an actual conflict of interest tainting employment discuss not only the standards under 327 or 1103, but also the permissible sanctions under section 328(c).

Exceptions Specified in Section 328(c). Three exceptions are listed in section 328(c). The exceptions permit the retention of a professional who might otherwise be unable to comply strictly with the requirements of section 327. They also make clear that certain relationships do not, *per se*, create an appearance of impropriety on the professionals part:

(1) Section 327(c) provides that the representation of, or employment by, a creditor will not, in and of itself, disqualify a professional person for employment by a trustee in a liquidation case under chapter 7 or a reorganization case under chapter 11 absent an actual conflict of interest; n1

(2) The trustee is permitted, subject to court approval under section 327(e), to employ, for a specified special purpose, other than to represent the trustee in conducting the bankruptcy case, an attorney who has previously represented the debtor. The employment must be in the best interest of the estate and the attorney may not hold or represent an interest adverse to the debtor or to the estate regarding the subject of such attorneys employment; n2 and

(3) Section 1107(b) provides that a person is not disqualified for employment by a debtor in possession under section 327 solely because of employment by or representation of the debtor before the commencement of the case. n3

Requirement of Disinterestedness; Waiver. The requirement that a professional be disinterested cannot be waived or circumvented by agreement or consent among creditors and the debtor. In *In re Amdura Corp.*,ⁿ⁴ the bankruptcy court specifically rejected the notion that the debtors law firms could obtain a waiver from the debtors and a lender concerning a possible conflict of interest. It noted that a court:

must also recognize that activities and multiple representation that may be acceptable in commercial settings, particularly with the informed consent of clients, may not be acceptable in bankruptcy.

Section 327 of the Code does not permit excusing the limitation of those provisions by waiver or by the trustees consent to the representation of dual interests. [W]hat may be acceptable in a commercial setting, where all of the entities involved are solvent and creditors are being paid, is not acceptable when those entities are insolvent and there are concerns about intercompany transfers and the preference of one entity and its creditors at, perhaps, the expense of another.ⁿ⁵

Holding or Representing an Adverse Interest. Professional persons holding or representing an interest adverse to that of the estate with respect to the subject matter of their employment may be denied compensation and reimbursement pursuant to section 328(c).ⁿ⁶ In *Rome v. Braunstein*,ⁿ⁷ the Court of Appeals for the First Circuit denied fees to an accounting firm retained by the creditors committee due to a conflict of interest arising from the accounting firms representation of the committee as well as one of the debtors largest creditors. The court also withheld compensation for the debtors attorney for failing to provide the bankruptcy court with spontaneous, timely and complete disclosureⁿ⁸ of the adverse interest to the debtors estate. In *Rome*, the attorney, after being retained as counsel for the debtor, also began counseling the debtors president and sole shareholder, as well as the presidents secretary. The court found that the attorneys failure to make full and spontaneous disclosure of financial transactions and to obtain explicit court authorization [for additional representations], provided sufficient ground for the discretionary denial of compensation under section 328(c).ⁿ⁹

Similarly, in *In re Paine*,ⁿ¹⁰ the court withheld all compensation for the debtors attorney who failed to disclose representation of the unsecured creditors in the case. The court stated:

One Court has explained that the policy behind the fee penalty is that of preventing the dishonest practitioner from [engaging in] fraudulent conduct, to preclude the honest practitioner from putting himself in a position where he may be required to choose between conflicting duties .

In other words, the penalty serves a prophylactic purpose. It strikes not only at the actual evil, but at the tendency of divided loyalty to create evil.ⁿ¹¹

The mere appearance of impropriety is sufficient to disqualify the attorney for the debtor regardless of whether an actual conflict exists.ⁿ¹²

In *In re Paine*,ⁿ¹³ the court found that an actual conflict existed, which could not be cured by mere disclosure. All compensation sought by the attorney was denied, and the attorney was directed to reimburse the estate for all fees received during the period when the conflict existed.ⁿ¹⁴ Other courts have also held that when a debtors attorney fails to disclose representation of the debtor prepetition and that it also simultaneously represented the debtor and its president in a questionable stock redemption transaction, disgorgement of fees previously paid, denial of compensation and disqualification is warranted.ⁿ¹⁵

The provisions of section 328(c) are consistent with those of section 327(a), which permit the trustee to employ only professional persons who do not have or represent an interest adverse to the estate. Because the denial of compensation and reimbursement of expenses after services have been performed may be draconian and inherently unfair, this sanction should not be rigidly applied in the absence of actual injury or prejudice to the debtors estate.ⁿ¹⁶

Penalty for Conflicts of Interest. Section 328(c) provides a penalty for conflicts of interestⁿ¹⁷ by authorizing the

court to deny compensation for services and reimbursement of expenses if the professional person is not disinterested or if such professional person represents or holds an interest adverse to the estate on the matter on which such person is employed. n18

Available sanctions include disqualification and the denial or disgorgement of all fees. n19 Disallowance may occur if a professional at any time either is not a disinterested person or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed. n20 If the court finds that the trustee failed to make diligent inquiry into facts that would require denial of compensation under section 328(c) or, with knowledge of such facts, employed a professional person who is not disinterested, or holds or represents an interest adverse to the estate with respect to the subject matter of the employment, the trustee also may be denied compensation and reimbursement payments.

The decision whether to deny fees to a professional who is not disinterested is within the discretion of the bankruptcy court. For example, in *Electro-Wire Products, Inc. v. Sirote & Permutt, P.C. (In re Prince)*, n21 the Court of Appeals for the Eleventh Circuit held that the bankruptcy courts power to deny fees under section 328(c) is permissive and should not be rigidly applied in the absence of actual injury or prejudice to a debtors estate. n22 The court stated that the language of 11 U.S.C. § 328(c) *permits* a court to deny compensation to professionals found not to be disinterested persons, but does not *require* a denial of fees in those instances. n23 The court found, however, that denial of fees was appropriate in an egregious case, such as *Prince*, in which the debtors attorney failed to advise the court of multiple representation of the individual debtor and spouse in estate planning matters and the corporation owned by the debtor. n24

Under section 328(c), the court may deny compensation for services rendered and reimbursement of expenses incurred by a professional person if the professional was not a disinterested person during the period of employment. n25 The sanction contained in section 328(c) ensures the enforcement of the Codes requirement that professional persons be disinterested. The Code enumerates certain disqualifying affiliations, connections and interests that may prevent a professional person from receiving compensation for services rendered and reimbursement of expenses incurred.

The sanctions for violating the prohibition against conflicts of interest ensures that a professional person employed by a trustee or creditors or equity security holders committee not have any personal interest concerning matters of the debtors estate that might impair the impartial and detached judgment required in the administration of a case. n26

The term disinterested person is defined in *section 101 of the Bankruptcy Code*. n27 A creditor, an equity security holder or an insider cannot be a disinterested person. Before the 2005 amendments to the Code, a person could not have been disinterested if the person had acted as an investment banker for any outstanding security of the debtor. Neither could an investment banker have been disinterested if it had had anything to do with the offer, sale or issuance of a security of the debtor within three years of the date of the filing of the petition. That prohibition was eliminated by the 2005 amendments. n28 The definition continues to provide that a former director, officer or employee of the debtor who served in such capacity within two years before the date of the filing of the petition cannot be considered disinterested. And, of course, the requirement remains that the person not have an interest materially adverse to the interest of the estate of any class of creditors or equity security holders by reason of any direct or indirect relationship to, connection with, or interest in, the debtor.

For a complete discussion of Code section 328, see Collier on Bankruptcy, ch. 328.

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n1 *See Collier on Bankruptcy*, 327.03.

n2 *See Collier on Bankruptcy*, 327.03.

n3 *See Collier on Bankruptcy*, 327.05.

n4 121 B.R. 862 (*Bankr. D. Colo.* 1990).

n5 121 B.R. 862, 866 (citations omitted); *see also In re American Printers & Lithographers, Inc.*, 148 B.R. 862, 867 (*Bankr. N.D. Ill.* 1992) (A [law] firm that is not disinterested may not represent a debtor even if that debtor has consented to such representation and waived the conflict.). *But see* Kaiser Group Intl, Inc. v. Nova Hut a.s. (*In re Kaiser Group Intl, Inc.*), 272 B.R. 846 (*Bankr. D. Del.* 2002) (waiver approved); *In re Lee*, 20 C.B.C.2d 510, 517, 94 B.R. 172, 179 (*Bankr. C.D. Cal.* 1988) (a written waiver of conflict from the debtor, all creditors and the United States trustee may be permissible).

n6 For a discussion of whether a professional person holds or represents an adverse interest, including cases discussing professionals disqualification for potential versus actual conflicts of interest, *see Collier on Bankruptcy*, ch. 327.

n7 19 F.3d 54, 30 C.B.C.2d 1346 (1st Cir. 1994).

n8 19 F.3d 54, 59, 30 C.B.C.2d 1346, 1352.

n9 19 F.3d 54, 60, 30 C.B.C.2d 1346, 1352-53.

n10 14 B.R. 272 (*W.D. Mich.* 1981).

n11 14 B.R. 272, 274-75 (citations omitted); see *In re 765 Assocs.*, 14 B.R. 449, 451 (Bankr. D. Haw. 1981) (compensation denied to attorneys for the debtor since counsel had a conflict of interest due to simultaneous representation of a corporation which was controlled by a major creditor of the estate).

n12 See, e.g., *In re Leslie Fay Cos., Inc.*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994) (failure of debtors counsel to disclose potential conflicts which might have impaired its investigation into fraud by the debtors senior management warranted disgorgement of fees but not disqualification).

n13 14 B.R. 272 (W.D. Mich. 1981).

n14 See *In re American Energy Trading, Inc.*, 291 B.R. 154 (Bankr. W.D. Mo. 2003); *In re CVC, Inc.*, 120 B.R. 874 (Bankr. N.D. Ohio 1990) (debtors accountants denied all fees and discharged from further services); see also *In re Temp-Way Corp.*, 95 B.R. 343 (E.D. Pa. 1989) (representation of debtor corporation as well as current and former shareholder constituted an impermissible conflict requiring disqualification in light of potential avoidance actions against the shareholders); *In re Condor Sys., Inc.*, 302 B.R. 55, 73-5 (Bankr. N.D. Cal. 2003) (negotiations between financial advisor and principals of debtor regarding business venture was undisclosed connection warranting denial of \$500,000 in fees and expenses); *In re Carrousel Motels, Inc.*, 97 B.R. 898 (Bankr. S.D. Ohio 1989) (corporate debtors attorneys denied fees for conflict of interest for also representing sole shareholder and owner of debtor; the debtor paid a \$3.9 million dividend to sole shareholder represented by the debtors law firm); cf. *In re Maddox*, 92 B.R. 707 (Bankr. W.D. Tex. 1988) (partial denial of fees to debtors attorneys for representation of both the debtor corporation and one of its principals who undertook a battle for corporate control of the debtor in possession; a complete denial would serve only to punish the law firm, which believed that it was diligently representing the client as instructed by the clients owner and manager); *Collier on Bankruptcy*, 327.03.

n15 *In re Granite Sheet Metal Works*, 159 B.R. 840 (Bankr. S.D. Ill. 1993); see also *In re American Energy Trading, Inc.*, 291 B.R. 154 (Bankr. W.D. Mo. 2003).

n16 See *In re National Liquidators, Inc.*, 182 B.R. 186, 192 (S.D. Ohio 1995) (although disclosure is inadequate, denial of all compensation is inequitable and draconian); cf. *In re Laurent Watch Co.*, 539 F.2d 1231 (9th Cir. 1976); *Stolkin v. Nachman*, 472 F.2d 222 (7th Cir. 1973); *In re Olson*, 10 C.B.C.2d 798, 36 B.R. 74 (D. Neb. 1983).

n17 See *Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831, 839 (7th Cir. 1998) (finding that bankruptcy court should punish a willful failure to disclose conflicts as severely as an attempt to put forth a

fraud upon the court); accord *Miller v. United States Trustee (In re Independent Engg Co.)*, 197 F.3d 13 (1st Cir. 1999); *Law Offices of Nicholas A. Franke v. Tiffany (In re Lewis)*, 113 F.3d 1040 (9th Cir. 1997); *Mapother & Mapother, P.S.C. v. Cooper (In re Downs)*, 103 F.3d 472 (6th Cir. 1996); *United States Trustee v. Price Waterhouse*, 19 F.3d 138 (3d Cir. 1994); *In re McNar*, 116 B.R. 746, 750 (Bankr. S.D. Cal. 1990) (The only truly safe harbor for those professionals subject to the stringent fiduciary standards of §§ 327 and 1103, is to represent only a single client when that client is in, or likely headed for bankruptcy court.).

n18 H.R. Rep. No. 595, 95th Cong., 1st Sess. 329 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 39 (1978); see *Collier on Bankruptcy*, 326.04.

n19 *Law Offices of Nicholas A. Franke v. Tiffany (In re Lewis)*, 113 F.3d 1040 (9th Cir. 1997) (finding that all postpetition fees are properly ordered to be disgorged upon failure to supplement initial disclosure); *Rome v. Braunstein*, 19 F.3d 54, 30 C.B.C.2d 1346 (1st Cir. 1994); *Schroeder v. Rouse (In re Redding)*, 263 B.R. 874 (B.A.P. 8th Cir. 2001); *In re El San Juan Hotel Corp.*, 239 B.R. 635 (B.A.P. 1st Cir. 1999); see also *LeBlanc v. Salem (In re Mailman Steam Carpet Cleaning Corp.)*, 212 F.3d 632, 636 (1st Cir.), cert. denied, 531 U.S. 960, 120 S. Ct. 2661, 147 L. Ed. 2d 275 (2000).

n20 11 U.S.C. § 328(c); see *Rome v. Braunstein*, 19 F.3d 54, 30 C.B.C.2d 1346 (1st Cir. 1994) (the fact that an attorney was not disinterested at the commencement of the case is immaterial since section 328(c) permits disallowance of compensation at any time a professional ceases to be disinterested or represents an interest adverse to the estate); *Pruss v. Pelofsky (In re Sauer)*, 222 B.R. 604 (B.A.P. 8th Cir. 1998).

n21 40 F.3d 356, 32 C.B.C.2d 998 (11th Cir. 1994).

n22 See, e.g., *In re XGW Excavating Co., Inc.*, 111 B.R. 469 (Bankr. D.N.J. 1990) (the denial of compensation is discretionary with the court and not mandated by section 328(c)).

n23 40 F.3d 356, 359, 32 C.B.C.2d 998, 1002 (11th Cir. 1994) (emphasis in original).

n24 See also, e.g., *Gray v. English*, 30 F.3d 1319, 31 C.B.C.2d 1278 (10th Cir. 1994); *Rome v. Braunstein*, 19 F.3d 54, 30 C.B.C.2d 1346 (1st Cir. 1994).

n25 The definition of disinterested person found in section 101 of the Code is adopted from section 158 of former Chapter X of the Bankruptcy Act and former Rule 10-202(c)(2), with some modifications. H.R. Rep. No. 595, 95th Cong., 1st Sess. 310 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 23 (1978); *see also* Collier on Bankruptcy, ch. 101.

n26 *The Law Offices of Ivan W. Halperin v. Occidental Fin. Group, Inc. (In re Occidental Financial Group, Inc.)*, 40 F.3d 1059, 32 C.B.C.2d 515 (9th Cir. 1994) (disgorgement of compensation paid to debtors attorney after attorney failed to also disclose representation of the debtors controlling shareholders, partners, officers and directors during the debtors cases); *In re Chestnut Hill Mortgage Corp.*, 158 B.R. 547 (D. Mass. 1993) (denying compensation to the debtors attorney due to undisclosed conflicts of interest including representation of the debtors president and sole shareholder, the purchaser of the debtors assets, and service as an officer of the debtor postpetition), *aff'd*, *Rome v. Braunstein*, 19 F.3d 54, 30 C.B.C.2d 1346 (1st Cir. 1994); *see also In re National Liquidators, Inc.*, 182 B.R. 186, 192 (S.D. Ohio 1995) (although disclosure may be inadequate, denial of all compensation is inequitable and draconian).

n27 11 U.S.C. § 101(14); *see Collier on Bankruptcy*, 101.14.

n28 Pub. L. No. 109-8, § 414 (2005), effective in cases commenced on or after October 17, 2005.

ABOUT THE AUTHOR(S):

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103 of 197 DOCUMENTS

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Collier on Denial of Discharge Based on Previous Discharge in a Chapter 7 Case

2008 Emerging Issues 1522

Collier on Denial of Discharge Based on Previous Discharge in a Chapter 7 Case

By Collier

December 14, 2007

SUMMARY: Debtors beware: if you have previously been granted a discharge in a Chapter 7 case, you can be denied a discharge in your current case if it is filed too soon after your previous discharge. What are the relevant time periods that prevent successive discharges? The following article explains the applicability of different time periods as they apply to Chapter 7, 11 and 12 cases.

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ARTICLE:

Bankruptcy Code section 727(a)(8) provides that a debtor should be denied a discharge in the current case if the debtor has been granted a discharge under chapter 7 or 11 in a case commenced within eight years before the date of the filing of the petition. The relevant time period was changed from six years to eight years by a 2005 amendment to section 727(a)(8). n1 Section 727(a)(9) provides for a discharge denial if the debtor has been granted a discharge under chapter 12 or 13 in a case commenced within six years before the date of the filing of the petition *unless* the payments under the plan in the chapter 12 or 13 case totaled at least 100 percent of the allowed unsecured claims, or if payments totaled 70 percent of the claims and the debtors plan was proposed by the debtor in good faith and was the debtors best effort.

Prior Case Under Chapter 7 or 11; 11 U.S.C. § 727(a)(8). Section 727(a)(8) may be invoked only when a discharge has been granted in a prior chapter 7 or 11 case under the Code. n2 It had been held under the former Act that a court could take judicial notice of a discharge in a prior proceeding and deny a discharge in the second proceeding even in the absence of an objection. n3 Although section 727(a)(8) could be read to permit a *sua sponte* denial, *Federal Rule of Bankruptcy Procedure 4004(c)* n4 seems to preclude such an action. Rule 4004(c) permits a *sua sponte* dismissal only if the debtor is not an individual n5 or if the debtor has filed a waiver of discharge. n6

The fact that a discharge has been granted does not preclude a debtor from again becoming a debtor within eight years of commencement of the prior case, although no discharge may be granted in the second proceeding. Even in a proceeding in which the debtor is not entitled to a discharge, a debtor may still obtain protection for property, since the exemptions and lien avoidance powers provided by section 522 of the Code would apply as in any other case. n7

In chapter 11 cases, confirmation of a plan operates as a discharge. n8 Section 727(a)(8) expressly provides that if a debtor has been granted a discharge by having a plan confirmed under section 1141 in a case commenced within eight years before the date of the filing of the petition, the debtor must be denied a discharge on account of the confirmation of a plan in the prior case.

Prior Case Under Chapter 12 or 13; 11 U.S.C. § 727(a)(9). Section 727(a)(9) bars the discharge of a debtor who has been granted a discharge by the confirmation of a plan under section 1228 or 1328 of the Code in a case commenced within six years before the date of the filing of the petition in the earlier case, unless (1) the payments under the plan in the chapter 12 or 13 case totaled at least 100 percent of the allowed unsecured claims, or (2) payments totaled 70 percent of the claims and the debtors plan was proposed by the debtor in good faith and was the debtors best effort. However, in the reverse situation, a debtor who has been discharged in a chapter 7 case filed less than six years before the commencement of a chapter 13 case is not prevented from obtaining confirmation of a chapter 13 plan n9 or, unless the debtor received a chapter 7, 11 or 12 discharge in a case filed within four years before a subsequent chapter 13 case, from obtaining a discharge under section 11 USCS § 1328. n10 Instead, the debtors chapter 13 plan is subject simply to the good faith requirement in section 1325(a)(3) as well as the other confirmation standards. n11 When the debtors plan represents a disguised liquidation filed under chapter 13 to avoid section 727, it is likely to be held not to be in good faith. n12 When the debtors plan proposes some payments to creditors or is otherwise distinguishable from a liquidation, however, it may be confirmed despite a previous bankruptcy discharge. n13 Section 1225(a)(3) applies similarly to a chapter 12 debtor. n14

With regard to the exception that allows a chapter 7 discharge within six years of the earlier chapter 12 or 13 case if the debtor paid 100 percent of the allowed unsecured claims or paid at least 70 percent of them in a good faith plan in which the debtors best effort was applied, the legislative history indicates that what constitutes best effort was to be decided on a case-by-case basis:

In determining whether a plan is the debtors best effort the court will evaluate several factors. Different facts and circumstances in cases under chapter 13 operate to make any rule of thumb of limited usefulness. The court should balance the debtors assets, including family income, health insurance, retirement benefits, and other wealth, a sum which is generally determinable, against the foreseeable necessary living expenses of the debtor and the debtors dependents, which unfortunately is rarely quantifiable. In determining the expenses of the debtor and the debtors dependents, the court should consider the stability of the debtors employment, if any, the age of the debtor, the number of the debtors dependents and their ages, the condition of equipment and tools necessary to the debtors employment or to the operation of his business, and other foreseeable expenses that the debtor will be required to pay during the period of the plan, other than payments to be made to creditors under the plan. n15

The debtor should be able to obtain a ruling on whether the plan is the debtors best effort in the initial chapter 13 case, n16 perhaps by inclusion of a provision constituting a finding of best effort in either the plan or the order confirming the plan.

Measurement of Time Period. The eight years begins to run as of the date the first case is commenced, i.e., the date the petition is filed, n17 and ends as of the date that the subsequent case is begun by the filing of the petition. n18

For a complete discussion of Code chapter 727, see Collier on Bankruptcy, ch. 727.

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n1 11 U.S.C. § 727(a)(8), as amended by Pub. L. No. 109-8, § 312(1) (2005), effective in cases commenced on or after October 17, 2005.

n2 See *Patterson Dental Co. v. Mendoza (In re Mendoza)*, 6 C.B.C.2d 48, 16 B.R. 990 (Bankr. S.D. Cal. 1982) (holding that a debtor who had been discharged in a case commenced within six years of a subsequent case could receive a discharge in the later case if the prior discharge had been revoked; however, under 11 U.S.C. § 523(a)(9), the debts that had been scheduled in the prior case were ruled to be nondischargeable).

n3 *In re Hammond*, 9 F. Supp. 628 (D. Kan. 1934). But see Fed. R. Bankr. P. 4004(c), discussed at *Collier on Bankruptcy*, 727.01[2].

n4 Fed. R. Bankr. P. 4004(c), as amended by the 2000 and 2002 amendments to the Federal Rules of Bankruptcy Procedure.

n5 See *Collier on Bankruptcy*, 727.01.

n6 See *Collier on Bankruptcy*, 727.12.

n7 See *Collier on Bankruptcy*, ch. 522.

n8 11 U.S.C. § 1141(d)(1); see *Collier on Bankruptcy*, 1141.05.

n9 See *Johnson v. Home State Bank*, 501 U.S. 78, 87, 111 S. Ct. 2150, 2156, 115 L. Ed. 2d 66, 24 C.B.C.2d 1171 (1991); *In re Baker*, 736 F.2d 481 (8th Cir. 1984) (reversing a bankruptcy court's summary dismissal of a chapter 13 case based solely on the fact that the debtor had obtained a bankruptcy discharge four years earlier; holding that a prior discharge does not automatically bar a chapter 13 case); *In re Hurd*, 2 C.B.C.2d 190, 4 B.R. 551 (Bankr. W.D. Mich. 1980) (analyzing the relationship between section 727 and section 1325); *Collier on Bankruptcy*, 1300.40[4]; see also *Perry v. Commerce Loan Co.*, 383 U.S. 392, 86 S. Ct. 852, 15 L. Ed. 2d 827 (1966), *reh'g denied*, 384 U.S. 934 (1966) (holding that a previous discharge in bankruptcy would not bar confirmation of a wage earner's extension" type plan under former Chapter XIII; result followed by the Code in all chapter 13 and chapter 11 cases).

n10 *11 U.S.C. § 1328(f)*, added by Pub. L. No. 109-8, § 312(2) (2005), effective in cases commenced on or after October 17, 2005.

n11 *See Collier on Bankruptcy*, ch. 1325.

n12 *Tenney v. Terry (In re Terry)*, 630 F.2d 634, 2 C.B.C.2d 1237 (8th Cir. 1980) (plan with no payments to any creditor).

n13 *In re Baker*, 736 F.2d 481 (8th Cir. 1984).

n14 *See Collier on Bankruptcy*, ch. 1225.

n15 124 Cong. Rec. H11,098 (Sept. 28, 1978); S.17415 (Oct. 6, 1978).

n16 124 Cong. Rec. H11,098 (Sept. 28, 1978); S.17415 (Oct. 6, 1978).

n17 *See 11 U.S.C. §§ 301303*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n18 *Riske v. Lyons (In re Lyons)*, 162 B.R. 242 (Bankr. E.D. Mo. 1993) (denying a discharge in a case that had been commenced as a chapter 13 case within the six year period and converted to chapter 7 after the expiration of the six-year period).

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104 of 197 DOCUMENTS

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Exceptions to the Stay Involving Certain Residential Property Evictions

2008 Emerging Issues 1531

Collier on Exceptions to the Stay Involving Certain Residential Property Evictions

By Collier

December 14, 2007

SUMMARY: This Emerging Issues Analysis covers the issues under which the automatic stay does not apply, the filing of a certification with the petition by the debtor that negates the effect of section 362(b)(22) for at least a period of 30 days, the filing of an objection by the lessor to the certification, and the inapplicability of the automatic stay if the residential property eviction involved the endangerment of or illegal drug the property.

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ARTICLE: Residential Property Evictions Involving Prepetition Judgment for Possession; 11 U.S.C. § 362(b)(22). Bankruptcy Code section 362(b)(22) provides that the automatic stay under section 362(a)(3), subject to the provisions of section 362(l), does not apply to the continuation of an eviction, unlawful detainer action, or similar proceeding involving residential property in which the debtor resides as a tenant under a lease or rental agreement if the lessor has obtained a judgment for possession of such property against the debtor before the commencement of the bankruptcy case. n1 This stay exception is limited to the continuation of proceedings stayed under section 362(a)(3), which are proceedings that seek to obtain possession of property of the estate or of property from the estate, or to exercise control over property of the estate. n2 Thus, if the lessor has obtained a judgment for possession that includes a money judgment against the debtor for back rent owed, relief from the stay under section 362(a)(6) must still be sought in order to enforce the judgment against the debtor, or at least that portion of the judgment representing the claim for back rent. Section 362(b)(22) also does not apply to actions stayed under section 362(a)(1) to recover a prepetition claim against the debtor, including further proceedings that may be necessary to enforce the judgment for possession.

The stay exception under subsection (b)(22) applies only if the prepetition judgment for possession relates to rental property in which the debtor resides under a lease or rental agreement. It does not apply, for example, to an eviction judgment obtained by a purchaser of property at foreclosure who does not have a lease or rental agreement with a debtor occupying the property. n3

Since the stay exception under subsection (b)(22) is based on the existence of a prepetition judgment for possession, it should not apply if the judgment for possession has been vacated or is no longer valid under applicable nonbankruptcy law at the time the petition is filed. This could occur, for example, if the judgment for possession has been appealed prepetition and the effect of the appeal under applicable nonbankruptcy law is that the judgment is vacated pending a *de novo* trial or other proceeding on appeal.

Section 362(l)(1) provides that the stay exception under section 362(b)(22) will not apply until 30 days after the commencement of the case if the debtor files with the petition and serves on the lessor a certification under penalty of perjury that (1) circumstances exist in which the debtor would be permitted under applicable nonbankruptcy law to cure the entire monetary default that gave rise to the judgment for possession, and (2) the debtor, or an adult dependent of the debtor, has deposited with the clerk of the bankruptcy court any rent that would become due during the 30-day period after the filing of the petition. Thus, the filing of a certification with the petition by the debtor negates the effect of section 362(b)(22), at least for a period of 30 days, and the pending eviction proceeding is automatically stayed under section 362(a)(3) upon the filing of the petition.

Section 362(l)(2) provides that the automatic stay which takes effect as a result of section 362(l)(1) may remain in force, even beyond the 30-day period following the filing of the petition, if the debtor, or an adult dependent of the debtor, files with the court and serves on the lessor within the 30-day period after the filing of the petition, an additional certification attesting that the entire monetary default that gave rise to the judgment for possession has been cured under applicable nonbankruptcy law.

The lessor may file and serve on the debtor an objection to any certification filed under section 362(l)(1) or (l)(2).ⁿ⁴ The court shall then hold a hearing within 10 days of the filing of the objection to determine whether the certification is true. If the court grants the lessors objection, the stay exception under section 362(b)(22) shall apply immediately and the lessor may proceed with court process to recover possession of the property without seeking relief from the stay provided under section 362(a)(3). The clerk shall also immediately serve upon the lessor and the debtor a certified copy of the courts order upholding the lessors objection.

Section 362(l)(5)(A) requires the debtor to indicate on the petition whether a judgment for possession against the debtor has been obtained by a residential lessor, and to provide the name and address of the lessor on the petition and on any certification filed under the subsection.ⁿ⁵ If the debtor indicates on the petition that a lessor has obtained a judgment for possession, the stay exception under section 362(b)(22) shall apply immediately upon the failure of the debtor to file a certification under section 362(l)(1).ⁿ⁶ Similarly, if the debtor does not file a certification under section 362(l)(2), the stay exception takes effect after the 30-day period following the petition has expired. In this event, the clerk shall immediately serve upon the lessor and the debtor a certified copy of the docket indicating the absence of a filed certification and the applicability of the stay exception under section 362(b)(22).ⁿ⁷

In addition to the notification requirements concerning whether the stay is applicable, section 362(b)(22) will impose new administrative burdens on bankruptcy court clerks who have not previously accepted deposits by debtors of rental payments. Section 362(l)(5)(D) also requires the clerk of the court to arrange for the prompt transmittal to the lessor of any rent deposited with the court.

Residential Property Evictions Involving Endangerment of Property or Illegal Drug Use; 11 U.S.C. § 362(b)(23). Section 362(b)(23) provides that the automatic stay under section 362(a)(3), subject to the provisions of section 362(m), does not apply to an eviction, unlawful detainer action, or similar proceeding involving residential property in which the debtor resides as a tenant under a lease or rental agreement, if the eviction is based on the endangerment of such property or the illegal use of controlled substances on such property.ⁿ⁸ This stay exception applies only if the lessor files with the bankruptcy court and serves on the debtor a certification under penalty of perjury that such an eviction action has been filed, or that during the 30-day period preceding the filing of the certification, the debtor has endangered the property or illegally used or allowed to be used a controlled substance on the property.

Section 362(m)(1) provides that this stay exception shall apply 15 days after the lessor files and serves the certification described in section 362(b)(23). Unlike other provisions of section 362(b) that create an exception to the stay upon the filing of the petition, section 362(b)(23) does not prevent the automatic stay provided under section 362(a)(3) from taking effect immediately upon the filing of the debtors petition.

If the debtor files and serves on the lessor an objection challenging the truth or legal sufficiency of the lessors

certification, the stay exception under section 362(b)(23) does not apply unless the court orders otherwise at a hearing that shall be held within 10 days after the filing of the objection. n9 At the hearing, the debtor may demonstrate that the situation which gave rise to the lessors certification of alleged property endangerment or illegal drug use either did not exist or has been remedied. Since section 362(m)(2)(C) does not specify when the cure must occur, presumably the debtor may remedy the improper activity alleged in the lessors certification at any time prior to the hearing. If the court finds that the situation did not exist or has been remedied, the stay provided under section 362(a)(3) shall remain in effect.

In the event that the court rules against the debtor on the objection to the lessors certification, or if the debtor fails to file an objection to the lessors certification within 15 days after its service, the stay exception under section 362(b)(23) shall apply and the clerk shall immediately serve upon the lessor and the debtor a certified copy of the order denying the debtors objection or of the docket indicating the absence of a filed objection. n10 The lessor may then proceed with the eviction without the need to file a motion for relief from the stay provided under section 362(a)(3). However, since the exception is limited to the stay provided under section 362(a)(3), the lessor may not proceed with an eviction or other action that seeks to recover on a claim against the debtor that arose prepetition, such as a claim for damages to the rental property, without first obtaining relief from the stay provided under subsections 362(a)(1) and (a)(6). In addition, the stay provided under section 362(a)(3) should continue to apply, even if the lessors certification is upheld, to any unrelated attempt by the lessor to obtain possession of the rental property that is not based on the endangerment of the property or the illegal use of controlled substances.

The lack of specificity in sections 362(b)(23) and (m) relating to procedural matters leaves several questions unanswered. Although the lessors certification filed under section 362(b)(23) can trigger a contested matter not unlike that which would follow the filing of a motion, it is not clear whether the procedures outlined in Bankruptcy Rule 9014 will apply, particularly given the unusually brief time frame within which the court must conduct a hearing on the debtors objection to the certification. However, unlike the certification filed by the debtor under section 362(l)(1), which attests simply to whether the debtor has a right to cure a monetary default under state law and whether the debtor made the required deposit of rent with the court, a lessors certification under section 362(b)(23) may involve contested allegations concerning drug use and property endangerment, which would require the court to hear oral testimony, make findings on disputed facts and rule on the factual or legal sufficiency of the certification or of any alleged cure of the offending behavior. It would thus seem that the lessor should be required to state in the certification sufficient facts that will provide fair notice to the debtor. Presumably Bankruptcy Rule 9014(c) will be applicable so that the parties may conduct discovery, albeit on an expedited schedule if the court does not continue the hearing beyond the 10-day period. n11 Furthermore, though the existence of affirmative defenses should be considered by the court in deciding whether the certification should be upheld and the stay terminated, the expedited nature of the proceeding would not make it appropriate for there to be a *res judicata* determination of the issues, should the issues later be litigated in a state eviction proceeding. n12 Some or all of these matters may be addressed in the future by the Federal Rules of Bankruptcy Procedure or by local court rules.

It is also worth noting that the statutory language in subsections (b)(23) and (m) provides no guidance to the court in making findings about the truth or legal sufficiency of a lessors certification that the debtor has endangered the property or used or allowed to be used a controlled substance on the property. These terms and phrases are not defined in the Bankruptcy Code, n13 and are subject to varying interpretations. For example, by stating that the illegal drug use must be on the property, it is not clear whether this consists simply of the immediate rental premises occupied by the debtor or whether it includes other apartments, parking facilities or common areas in a rental complex or manufactured-home community in which the debtor resides. Nor is it clear that courts should look to nonbankruptcy law for direction in applying these terms or in determining what constitutes a sufficient cure by the debtor of the alleged property endangerment or illegal drug use.

In many respects, subsections (b)(23) and (m) function much as a stay relief motion does under section 362(d) if the lessor files a certification. However, and perhaps as an unintended consequence of the amendment, courts may be called upon to conduct contested hearings and make findings of fact on issues that they would previously have permitted state

courts to deal with by granting relief from the stay under section 362(d) on the basis that the eviction litigation should be initiated or concluded in another forum. Thus, despite the possible advantage to the lessor of an expedited stay termination under subsections (b)(23) and (m), lessors may prefer to file a stay relief motion rather than submit a certification.

For a complete discussion of Code section 362, see Collier on Bankruptcy, ch. 362.

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Return to Text

n1 1. *11 U.S.C. § 362(b)(22)* and *362(l)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. See *Collier on Bankruptcy*, 362.03[5].

n3

3. See *In re McCray*, 342 B.R. 668 (Bankr. D.D.C. 2006).

n4 4. *11 U.S.C. § 362(l)(3)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n5

5. Section 362 (l)(5)(C) states that the bankruptcy forms (electronic and otherwise) shall be amended to reflect the requirements of section 362(l)(5). Official Form 1 was amended upon implementation of the 2005 Act to include a box containing the required information that the debtor must provide, if applicable.

n6

6. 11 U.S.C. § 362(l)(4)(A), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n7

7. 11 U.S.C. § 362(l)(4)(B), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n8

8. 11 U.S.C. § 362(b)(23) and 362(m), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n9

9. 11 U.S.C. § 362(m)(2)(A) and (B), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n10

10. 11 U.S.C. § 362(m)(2)(D) and (m)(3), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n11

11. *Fed. R. Bankr. P. 9014(c)*.

n12

12. E.g., *Grella v. Salem Five Cent Sav. Bank*, 42 F.3d 26, 31, 32 C.B.C.2d 1303, 1309-10 (1st Cir. 1994).

n13

13. Curiously, neither the term endanger nor the phrase endangerment of property are used or defined in the Uniform Residential Landlord and Tenant Act.

ABOUT THE AUTHOR(S):

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105 of 197 DOCUMENTS

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Collier on Administrative Claims Priorities Under Section 1129(a)(9) of the Code

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SUMMARY: The 13 requirements of Bankruptcy Code section 1129(a) are the focus of all confirmation hearings. Section 1129(a) (9) contains a system of priorities in chapter 11 for certain unsecured claims. This article discusses the distinctions that Section 1129(a)(9) draws among administrative and gap claims, priority nontax claims, priority unsecured tax claims, and secured tax claims that, but for their secured status, would qualify as priority tax claims.

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ARTICLE: The 13 requirements of *Bankruptcy Code* section 1129(a) are the focus of all confirmation hearings. The plan proponent, n1 bears the burden of proof of establishing that each of these requirements have been satisfied. When these requirements are satisfied, the court will confirm the plan. n2 Section 1129(a)(9) contains a system of priorities in chapter 11 for certain unsecured claims. In particular, it draws distinctions among administrative and gap claims, n3 priority nontax claims, n4 priority unsecured tax claims, n5 and secured tax claims that, but for their secured status, would qualify as priority tax claims. n6 These distinctions require numerous references to other provisions of the Code which create the priorities for all bankruptcies.

Section 1129(a)(9) represents a departure from practice under Chapters X and XI of the Bankruptcy Act. In former Chapter XI cases, Rule 11-38(a) required the court, after the plan had been accepted and prior to confirmation, to fix a time before confirmation within which the debtor was required to deposit the money necessary to pay all priority debts and costs of administration unless such claimants waived such deposit or consented to provisions in the plan otherwise dealing with their claims. The deposit is not required by chapter 11 of the Code. n7 Under Chapter XI of the Act, the debtor was not permitted to classify priority claims and bind a minority of priority claimants to treatment acceptable to the majority of such claimants. Of course, if any particular priority claimant was willing to accept satisfaction of its priority claim on terms other than cash payment at confirmation, such claimant was free to negotiate whatever payment terms were satisfactory to it. This remains true under section 1129(a)(4) of the Code.

Administrative Claims and Gap Claims. Section 1129(a)(9)(A) requires that holders of administrative claims n8 and gap claims n9 be paid cash equal to the allowed amount of such claim on the effective date of the plan, unless the holder of a particular claim agrees to different treatment. With respect to these types of priority claims, paragraph (9)

thus constitutes the only essential confirmation requirement. Section 1123(a)(1) recognizes this, and does not even allow such claims to be classified in the plan, n10 since there is no reason to create a class or classes for such claims in light of the fact that a majority of such classes cannot bind a minority to less favorable payment terms than those provided under section 1129(a)(9). Accordingly, such payment must be in cash on the effective date. The only exception will be if the holder of a particular claim has agreed to a different treatment of such claim. n11 This may be the case with professionals or other entities connected with the case. n12

Since section 1129(a)(9)(A) also covers, because they are administrative claims, postpetition trade claims of the debtor, the literal terms of this paragraph would seem to require payment in cash of all such trade claims on the effective date. n13 This unwelcome result can be avoided by either moving the effective date to a date after which most preconfirmation claims are payable, or by providing in the plan that in the absence of objection such claims will be paid in the ordinary course of business. The later option would require a finding of implied waiver, normally not desirable, but in this case would seem to conform to the spirit of the section since the creditors will be paid their cash.

Other Priority Nontax Claims. Section 1129(a)(9)(B) handles other priority, nontax claims. Because these claims may be classified under a plan, the Code provides for different possible treatments depending on whether classes so created accept or reject the plan.

Coverage. Subparagraph (B) authorizes deferred payments of prepetition domestic support obligations, n14 employee, n15 pension, n16 certain farmer and fisherman claims and n17 consumer priority claims, n18 provided that the requisite majority of the priority class consents to the treatment accorded its classes under the plan and the present value of deferred cash payments to members of the class equal the allowed amount of their claims. Thus, unlike administrative and gap claimants, a majority of these other priority claimants in each class can bind a minority to accept deferred cash payments. n19 Section 1129(a)(9) does not make any reference to ninth priority claims, n20 added by the Crime Control Act of 1990. n21 The drafters of the Crime Control Act made no amendments to section 1129(a)(9) and other sections (e.g., section 1123(a)(1)) that refer to section 507, and, as a result, it is unclear as to how section 507(a)(9) claims should be treated in a reorganization plan. n22

Treatment. Subparagraph (B) allows a plan proponent to offer a class of claimants treatment other than payment in cash. If the class accepts the plan, the proponent may offer the each holder of the class deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claims. This language, common in the Code, is interpreted to allow the proponent to offer a promise whose present value is equal to the amount of the claim, which will usually require payment of interest at the market rate. n23 Proponents may attempt this treatment for feasibility concerns. In addition, the section permits the class to make the election, under the rules for class acceptance set forth in section 1126, thus binding dissidents in the minority to accept the deferred payments. n24 If, however, the class does not accept, the plan must treat each member of the class the same as with section 1129(a)(9)(A): they must receive cash on the effective date of the plan equal to the allowed amount of such claim. n25

Unsecured Priority Tax Claims in Cases Filed on or after October 17, 2005. Section 1129(a)(9)(C) provides for special treatment of eighth priority unsecured tax claims. n26 This subparagraph (C) was extensively revised by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act), n27 which is effective for all bankruptcy cases filed on or after its effective date of October 17, 2005. n28 As revised, section 1129(a)(9)(C) offers fewer options to bankruptcy estates than did the law in effect prior to the effectiveness of the 2005 Act.

There are several features of section 1129(a)(9)(C) that are worth of initial note. First, it applies only to unsecured tax claims. n29 If the governmental entity is secured through a tax lien, the secured portion of any such claim is unaffected by section 1129(a)(9)(C), although section 1129(a)(9)(D), explored below, n30 applies directly to secured tax claims and incorporates the treatment specified in section 1129(a)(9)(C). Second, like the claims subject to subparagraph (A), the unsecured tax claims that are affected by this section may not be classified in the plan. n31 The

reason for this is that they receive full payment, and thus are not impaired. n32 As a consequence, so long as the treatment proposed in the plan conforms with that specified, the class need not be solicited for its vote, and also does not count as an impaired class for section 1129(a)(10) purposes. n33 Finally, given that the stretch out permitted by this subparagraph will often be favorable to plan proponents, the Code permits the debtor or trustee to file a proof of claim on behalf of the taxing authority, and have the unsecured tax claim administered under the plan. n34

Treatment Under Section 1129(a)(9)(C).

Total Payments Must Equal Allowed Claim; 11 U.S.C. § 1129(a)(9)(C)(i). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended section 1129(a)(9)(C) to delete the language previously used in the Code to indicate a discount to present value--deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of the claim. n35 In its place is a different locution; the present requirement is to provide regular installment payments in cash, (i) of a total value, as of the effective date of the plan, equal to the allowed amount of the claim. n36 The issue is thus whether the insertion of total as a qualifier for value adds to, or is declarative, of previous law. The legislative history of this section is of little help. n37 Also compounding the confusion is the 2005 Acts requirement that nonmarket rates of interest be used with respect to any claim of a governmental entity. n38

There is some indication, that with section 511's addition of nonmarket rates of interest--which tend to be higher than market rates--the addition of total means that the stream of payments have to have a nominal total value equal to the allowed amount of the claim, *and* that the revested debtor would have to pay interest on that payment stream at the rate selected by section 511. This reading leads to systematic overpaying or underpaying of governmental entities depending on the difference between market rates of interest and the rate selected by section 511, a result previously not contemplated under section 1129. If section 511's interest rate is greater than the market rate, for example, then the present value of the property distributed to the governmental entity will be *greater* than the allowed amount of the claim; if lower, then the present value of the claim will be *less* than the allowed amount. n39

This variability can be seen from an oversimplified example. Assume that a plan proposes to pay a \$100 priority unsecured claim in five equal annual installments of \$20, commencing one year after confirmation. Assume further that the relevant market rate of interest, used in other parts of the plan, is 10 percent. If section 511 points to an applicable nonbankruptcy interest rate of 15 percent, then under this reading the proponent would have to pay \$20 per year in principal payments, and then 15 percent interest on the unpaid balance. Such a payment stream would have a present value of approximately \$112, or 12 percent more than the allowed amount of the claim, n40 resulting in an overpayment of \$12.

The change in language, however, is probably best read to require a standard present value analysis, as in other parts of section 1129, n41 albeit not at a market rate, but at whatever rate section 511 indicates is appropriate. As an example, if a governmental entity is owed \$100 in priority taxes, and if section 511 indicates an interest rate of 10 percent when market rates are 15 percent, a plan proponent could propose treatment that, assuming it meets section 1129(a)(9)(C)(iii)'s most favored class requirement, would pay the governmental entity a present value of \$100 based upon interest on the unpaid balance at the section 511 rate of 10 percent. n42

Repayment Period Limited to Five Years from Order for Relief; 11 U.S.C. § 1129(a)(9)(C)(ii). Section 1129(a)(9)(C), effective in cases commenced on or after October 17, 2005, greatly restricts the ability of a bankruptcy estate to stretch out or otherwise modify obligations that constitute priority tax claims. Previously, a plan proponent could extend the maturity of any due priority tax for up to six years, while paying a market rate of interest on all unpaid amounts. n43 Under section 1129(a)(9)(C) as revised, however, a plan proponent may only stretch out the payments for five years from the date of the order for relief. n44

Manner of Payment Must Be as Favorable as Any Unsecured, Nonpriority Class; 11 U.S.C. § 1129(a)(9)(C)(iii). Of equal significance is that section 1129(a)(9)(C)(iii) now restricts the terms of the repayment

scheme offered to the taxing entity. This clause limits the terms of repayment to a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a class of creditors under section 1122(b)). n45 As a consequence, governmental entities will be able to scour a plan and require the plan proponent to offer them the best set of repayment terms offered any other class.

At one level, this test may be easy to apply. If general unsecured creditors are proposed to be paid in full in three years from filing, section 1129(a)(9)(C) will require that priority tax claims also be paid in three years, and not the maximum five years otherwise applicable. Also clear is the fact that governmental entities will not be able to look to convenience classes of creditors and force terms equal to those received by such claimants. n46 After these relatively easy questions, however, consensus as to the meaning of section 1129(a)(9)(C)(ii) is lost. Unanswered questions will arise in sophisticated plans in which creditors negotiate for quicker payouts in lieu of higher interest rates or greater recoveries (two attributes that cannot be negotiated with governmental entities under section 1129(a)(9)(C)). n47 If, for example, after negotiations a plan proponent offers a class of general unsecured creditors a two-year payout at a below-market rate instead of a six-year payout at a market rate, or offers a two-year payout of 50 percent of claims instead of a five-year payout at 100 percent of claim, would the governmental entity be able to insist on two-year payouts in either or both instances? Technically put, does the manner of payment include or exclude those payment terms which cannot be negotiated or altered with respect to priority tax claims? The issue is open. n48

Unsecured Priority Tax Claims in Cases Filed Before October 17, 2005. Section 1129(a)(9)(C) provides for special treatment of eighth priority unsecured tax claims. n49 Several things are peculiar to this subparagraph. First, it applies only to *unsecured* tax claims. n50 If the governmental entity is secured through a tax lien, the secured portion of any such claim is unaffected by section 1129(a)(9)(C). n51 Second, like the claims subject to subparagraph (A), the unsecured tax claims that are affected by this section may not be classified in the plan. n52 The reason for this is that they receive full payment, and thus are not impaired. n53 As a consequence, so long as the treatment proposed in the plan conforms with that specified, the class need not be solicited for its vote, and also does not count as an impaired class for section 1129(a)(10) purposes. n54

This subparagraph also provides for deferred cash payments, and expressly incorporates a maximum repayment period--six years from the date of assessment in cases commenced before October 17--and mandates that the stream of payments have a present value equal to the allowed amount of the claim. n55 The calculation of the amount and payment terms have caused the most litigation. Finally, given that the stretch out permitted by this subparagraph will often be favorable to plan proponents, the Code permits the debtor or trustee to file a proof of claim on behalf of the taxing authority, and have the unsecured tax claim administered under the plan. n56

Deferred Payment; Market Rate of Interest. Section 1129(a)(9)(C), as applicable in cases commenced before October 17, 2005, states that a plan may give a holder of an unsecured tax claim deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim. This language is the Codes signal that the present value of the payment stream offered must equal the allowed amount of the claim. This is typically accomplished by providing a payment stream that will equal in principal payments the allowed amount of the claim and which carries a market rate of interest. Many governmental entities have special interest rate provisions which are, in nonbankruptcy cases, applied to tax claims. n57 Section 1129(a)(9)(C), however, has been interpreted to require a market rate of interest, to which the tax rate may be relevant, but is certainly not determinative. n58 Moreover, in *Till v. SCS Credit Corp.*, n59 the Supreme Court indicated that its adoption of a formula-based rate of interest would likely be applicable to determinations of the appropriate interest rate under section 1129(a)(9) (C). n60 Reference is made to the general section on rates of interest for a more expanded discussion of the calculation of a market rate of interest. n61

Deferred Payment; No More Than Six Years from Date of Assessment. The subparagraph prescribes a maximum period for the payment of the claim. The entire amount of the claim must be paid over a period not exceeding six years after the date of assessment of such claim. The first item of note is that the period runs from the date of assessment, not the date of filing or the date of confirmation. Thus, claims which are stale at filing will have much shorter periods for payment.

Deferred Payment; Amortization. Before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amendments, the statute was silent as to whether the payments must be made in level or equal amounts, or whether the plan proponent may offer a balloon payment at the end of the six year period. The few courts that have looked at this have permitted balloon payments, but only in circumstances in which it is clear that payment will be made. n62 To the extent that priority continues in any subsequent reorganization, this would appear to be less of a problem, but the continued priority of such claim is as yet unresolved. n63

Secured Tax Claims. Section 1129(a)(9)(D), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, requires plan proponents to treat secured tax claims in the same manner as unsecured tax claims, if, but for the security, the tax claim would qualify for treatment as a priority unsecured tax claim within the meaning of section 1129(a)(9)(C). n64 In essence, this means that the secured tax claim must receive at least as favorable treatment in the plan as the most favored unsecured, nonpriority class of claims. The implications of this most favored class treatment are explored above. n65

For a complete discussion of Code section 1129, see Collier on Bankruptcy, ch. 1129.

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[Return to Text](#)

n1 1. See Collier on Bankruptcy-15th Edition Rev. P 1129.02[3].

n2

2. See *United States ex rel. Farmers Home Admin. v. Arnold & Baker Farms (In re Arnold & Baker Farms)*, 177 B.R. 648, 33 C.B.C.2d 31 (B.A.P. 9th Cir. 1994).

n3

3. 11 U.S.C. § 1129(a)(9)(A).

n4

4. 11 U.S.C. § 1129(a)(9)(B).

n5

5. *11 U.S.C. § 1129(a)(9)(C).*

n6

6. *11 U.S.C. § 1129(a)(9)(D).*

n7

7. *See Fed. R. Bankr. P. 3020(a)*, permitting the court to order a deposit of the consideration to be distributed on confirmation.

n8

8. Administrative claims are provided for in section 507(a)(1). They include not only claims for postpetition expenses of operation, such as salaries and supplies, but also include claims by professionals, claims by members of official committees and claims of any indenture trustees. *See generally* Collier on Bankruptcy, ch. 507 and Collier on Bankruptcy, ch. 503.

n9

9. Gap claims are those expense incurred by the estate between the time of the filing of an involuntary petition (if any) and the entry of an order for relief. *See 11 U.S.C. § 502(f).*

n10

10. *11 U.S.C. § 1123(a)(1).*

n11

11. *11 U.S.C. § 1129(a)(9).*

n12

12. In *In re Teligent, Inc.*, 282 B.R. 765 (Bankr. S.D.N.Y. 2002), the court adopted a novel approach to securing the agreement of some 2006 administrative claimants. Through a combination of offering a convenience class, and through implementing a well-staffed campaign to induce creditors to return ballots electing to take less than they were owed (since the debtor was administratively insolvent), the court found that all administrative creditors who had not returned a ballot were deemed to have agreed to the lesser treatment offered in the plan. Since no creditor had affirmatively objected, this questionable fiction allowed the court to confirm the plan.

n13

13. The concept of the effective date of the plan is undefined in the Code. See *Collier on Bankruptcy*, 1129.06[1][e].

n14

14. Section 507(a)(1), as amended in 2005, provides for a first priority for prepetition unsecured domestic support obligations, a term defined in section 101(14A). This provision is to be contrasted with section 1129(a)(14), also added in 2005, which requires all domestic support obligations which become due and payable *post* petition to be paid in full as a condition of confirmation.

n15

15. Section 507(a)(4), as amended, grants fourth priority status to certain allowed unsecured claims for unpaid wages, salaries, or commissions, including vacation, severance and sick leave pay, of up to \$10,000 for each employee. This amount is subject to adjustment every three years to account for changes in the cost of living. See *Collier on Bankruptcy*, 104.03 and *Collier on Bankruptcy*, 507.05.

n16

16. Section 507(a)(5), as amended, grants fifth priority status to certain allowed unsecured claims for unpaid contributions to employee benefit plans of up to \$10,000 per covered employee. This amount is subject to adjustment every three years to account for changes in the cost of living. See *Collier on Bankruptcy*, 104.03 and *Collier on Bankruptcy*, 507.06.

n17

17. See 11 U.S.C. § 507(a)(6), which is similar in structure to the priorities granted in subsections 507(a)(4) and (a)(5) to employee compensation claims.

n18

18. Section 507(a)(7) grants seventh priority status to certain allowed unsecured claims of consumers arising from the deposit of money in connection with the executory and unfulfilled purchase, lease or rental of property or the purchase of services.

n19

19. For a description of the method of computation of the present value of deferred cash payments, see *Collier on Bankruptcy*, 1129.06[1].

n20

20. The ninth priority set forth in section 507(a)(9) was originally added as an eighth priority in section 507(a)(8) by the Crime Control Act of 1990, Pub. L. No. 101-647; this provision, as amended in 1994, grants a priority to allowed unsecured claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution. In 1994, the insertion of a priority for certain alimony and support claims as a seventh priority caused a renumbering of subsections 507(a)(7) and (a)(8) as subsections 507(a)(8) and (a)(9), respectively. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994, and effective in cases commenced on or after that date).

n21

21. Pub. L. No. 101-647 (1990).

n22 22. Before 1986, section 1129(a)(9) did not make any mention of the fifth priority created pursuant to the 1984 Bankruptcy Amendments. Pub. L. No. 98-353, title II, § 350(3) (1984). The fifth priority, 11 U.S.C. § 507(a)(5), as added by the Bankruptcy Amendments and Federal Judgeship Act of 1984, was for priority to certain farmers and fishermen against loss due to the bankruptcy of entities which store or care for the gain they grew or the fish they caught. This was an oversight by the drafters who failed to pick up the cross-reference. The 1986 amendments, however, made the correction and the section 507(a)(5) priority claims are treated under a plan in a manner consistent with the treatment of section 507(a)(3), (a)(4) and (a)(6) claims. The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 99th Cong., 2d Sess. (1986).

n23

23. See *e Collier on Bankruptcy*, 1129.06[1].

n24

24. If, however, an objection to a claim is made which postpones the payment beyond the effective date, the plan proponent will have to pay interest on the claim. *Terex Corp. v. Metropolitan Life Ins. Co. (In re Terex Corp.)*, 984 F.2d 170 (6th Cir. 1993).

n25

25. 11 U.S.C. § 1129(a)(9)(B)(ii).

n26

26. Section 507(a)(8) grants an eighth priority to certain allowed unsecured claims of governmental units. All tax claims subject to section 1129(a)(9)(C) are nondischargeable tax claims, 11 U.S.C. § 523(a)(1)(A), although not all nondischargeable tax claims fit within section 1129(a)(9)(C).

n27

27. Pub. L. No. 109-8, § 710(2) (2005).

n28

28. Pub. L. No. 109-8, § 1501(b)(1) (2005).

n29 29. Conversely, if the unsecured claims are priority claims, the plan proponent must treat them in the plan in accordance with this subparagraph, and attempts to treat them as regular unsecured claims in order to meet feasibility concerns will be denied. *Small Bus. Admin. v. Preferred Door Co. (In re Preferred Door Co.)*, 990 F.2d 547 (10th Cir. 1993) (plan may not classify priority claims as unsecured claims to achieve confirmation; plan which cannot pay priority claims in full is not feasible).

n30

30. *See Collier on Bankruptcy*, 1129.03[9][e].

n31

31. 11 U.S.C. § 1123(a)(1).

n32

32. Under the pre-2005 Act version of the statute, the Court of Appeals for the Sixth Circuit had held that Congress has specified in section 1129(a)(9)(C) a means for fully satisfying tax creditors . Through these provisions, Congress has legislated the equivalent of payment as of the date the bankruptcy petition was filed that discharges the debt by virtue of the confirmation of a plan. *Michigan Employment Sec. Commn v. Wolverine Radio Co. (In re Wolverine Radio Co.)*, 930 F.2d 1132, 1150, 24 C.B.C.2d 1702, 1723-24 (6th Cir. 1991).

n33

33. *Travelers Ins. Co. v. Bryson Props., XVIII (In re Bryson Props., XVIII)*, 961 F.2d 496, 501 n.8, 26 C.B.C.2d 1290, 1296 n.8 (4th Cir.), cert. denied, 506 U.S. 866, 113 S. Ct. 191, 121 L. Ed. 2d 134 (1992).

n34

34. 11 U.S.C. § 501(c). After such a claim is filed, however, the taxing authority may step in and control its prosecution. *United States v. Kolstad (In re Kolstad)*, 928 F.2d 171 (5th Cir. 1991).

n35

35. As indicated below, *see Collier on Bankruptcy*, 1129.06[1], the quoted language has been the congressional indication that a present value analysis should be used.

n36

36. 11 U.S.C. § 1129(a)(9)(C)(i).

n37

37. The change from value to total value is not discussed in the legislative history regarding section 710 of the 2005 Act, which section added the new phrase to section 1129(a)(9)(C). See H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 102 (2005). The legislative history for section 511, which imposes applicable nonbankruptcy rates of interest, simply states: [T]he Act amends the Bankruptcy Code to add section 511 for the purpose of simplifying the interest rate calculation. It provides that for all tax claims (federal, state, and local), including administrative expense taxes, the interest rate shall be determined in accordance with applicable nonbankruptcy law. *Id.* at 101.

n38

38. 11 U.S.C. § 511(a).

n39

39. See *Collier on Bankruptcy*, 1111.03[6][b] for an example of where the Code explicitly adopts a similar type of analysis with respect to nonrecourse secured claims in chapter 11.

n40 40. If there is one annual payment of principal, and that payment is combined with the interest accrued over the year (that is, the interest is payable in arrears), the five annual payments would be \$35 (\$20 principal plus \$15 interest), \$32 (\$20 principal plus \$12 interest), \$29 (\$20 principal plus \$9 interest), \$26 (\$20 principal plus \$6 interest), and \$23 (\$20 principal plus \$3 interest). At a given market rate of interest of 10%, this stream of payments would have a present value of \$112.09.

On the same assumptions, were the market rate of interest 15%, the present value of the stream of payments would decrease to \$100. If the market rate of interest increased to 20% (so that the applicable rate under section 511 were less than the market rate), the present value of the payment stream would be \$89.95.

n41

41. See *Collier on Bankruptcy*, 1129.06[1], for a discussion of the use of present value in section 1129.

n42

42. One example of such treatment might be a 10% note with a face amount of \$112.35, and equal amortization over five years. The present value of such a note is approximately \$100.

n43

43. *See Collier on Bankruptcy*, 1129.03[9][d].

n44

44. 11 U.S.C. § 1129(a)(9)(C)(ii). The previous period had been six years from the date of assessment of the tax. *See Collier on Bankruptcy*, 1129.03[9][d][ii].

n45 45. 11 U.S.C. § 1129(a)(9)(C)(iii).

n46

46. Section 1129(a)(9)(C)(iii) specifically excludes classes that offer cash payments made to a class of creditors under section 1122(b) from the comparison.

n47

47. Section 1129(a)(9)(C) requires payment in full as a condition of using its provisions, and section 511 will specify the applicable nonbankruptcy rate of interest that must be applied.

n48

48. Similar but significantly different issues are raised under the unfair discrimination cases arising under section 1129(b)(1). *See Collier on Bankruptcy*, 1129.04[3].

n49

49. Section 507(a)(8) grants an eighth priority to certain allowed unsecured claims of governmental units. All tax claims subject to section 1129(a)(9)(C) are nondischargeable tax claims, 11 U.S.C. § 523(a)(1)(A), although not all nondischargeable tax claims fit within section 1129(a)(9)(C).

n50

50. Conversely, if the unsecured claims are priority claims, the plan proponent must treat them in the plan in accordance with this subparagraph, and attempts to treat them as regular unsecured claims in order to meet feasibility concerns will be denied. *Small Bus. Admin. v. Preferred Door Co. (In re Preferred Door Co.)*, 990 F.2d 547 (10th Cir. 1993) (plan may not classify priority claims as unsecured claims to achieve confirmation; plan which cannot pay priority claims in full is not feasible).

n51

51. The claim is then treated as a secured claim under section 506(a).

n52

52. 11 U.S.C. § 1123(a)(1).

n53

53. *Michigan Employment Sec. Comm'n v. Wolverine Radio Co. (In re Wolverine Radio Co.)*, 930 F.2d 1132, 1150, 24 C.B.C.2d 1702, 1723-24 (6th Cir. 1991) (Thus, Congress has specified in section 1129(a)(9)(C) a means for fully satisfying tax creditors. Through these provisions, Congress has legislated the equivalent of payment as of the date the bankruptcy petition was filed that discharges the debt by virtue of the confirmation of a plan.).

n54

54. *In re Bryson Props.*, XVIII, 961 F.2d 496, 501 n.8, 26 C.B.C.2d 1290, 1296 n.8 (4th Cir.), cert. denied, 506 U.S. 866, 113 S. Ct. 191, 121 L. Ed. 2d 134 (1992).

n55

55. See *United States v. Arrow Air, Inc. (In re Arrow Air, Inc.)*, 101 B.R. 332 (S.D. Fla. 1989) (holding that section 1129(a)(9)(C) requires interest to be paid on lump sum payment made after effective date). The plan proponent must state a date by which the proposed deferred payments will begin. *In re Made in Detroit, Inc.*, 299 B.R. 170, 181 (Bankr. E.D. Mich. 2003).

n56

56. 11 U.S.C. § 501(c). After such a claim is filed, however, the taxing authority may step in and control its

prosecution. *United States v. Kolstad (In re Kolstad)*, 928 F.2d 171 (5th Cir. 1991).

n57

57. See, e.g., 26 U.S.C. § 6621.

n58

58. Even before *Till v. SCS Credit Corp.*, 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004), most circuit courts had adopted a formula approach based upon a market-based rate of interest. *Mississippi State Tax Comm'n v. Lambert (In re Lambert)*, 194 F.3d 679, 684 (5th Cir. 1999) (rejecting Mississippi's 12% fixed rate on tax obligations, and holding that the proper rate of interest under 11 U.S.C. § 1129(a)(9)(C) is the current market rate equivalent to the rate the debtor would have to pay to borrow the same amount in the commercial loan market. In so holding, we recognize that the statutory rates may be relevant to, but not dispositive of, the bankruptcy court's determination of the current market rate under 11 U.S.C. § 1129(a)(9)(C).); *United States v. Camino Real Landscape Maintenance Contractors, Inc. (In re Camino Real Landscape Maintenance Contractors, Inc.)*, 818 F.2d 1503, 16 C.B.C.2d 1341 (9th Cir. 1987) (rate should be based on what debtor would pay to borrow in commercial loan market; neither rate on treasury obligations nor 26 U.S.C. § 6621 should be used because the former represents government's creditworthiness, not the debtors, and the latter does not take into account the risk factor or other factors relevant to debtor); *United States v. Southern States Motor Inns, Inc. (In re Southern States Motor Inns, Inc.)*, 709 F.2d 647, 8 C.B.C.2d 1283 (11th Cir. 1983), cert. denied, 465 U.S. 1022, 104 S. Ct. 1275, 79 L. Ed. 2d 680 (1984).

n59

59. 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004).

n60

60. The Court indicated that the language of the statute before it, section 1325(a)(5)(B)(ii) of the Code, was the same language used in section 1129(a)(9)(C). 124 S. Ct. 1951, 1958 n.10, 158 L. Ed. 2d 787, 797 n.10. *Till* is analyzed in more depth at *Collier on Bankruptcy*, 1129.06.

n61

61. See *Collier on Bankruptcy*, 1129.06[1].

n62

62. See *United States v. Volle Elec., Inc. (In re Volle Elec., Inc.)*, 139 B.R. 451 (C.D. Ill. 1992) (permitting balloon payment at end of six-year period).

n63

63. See *United States v. Conston, Inc. (In re Conston, Inc.)*, 33 C.B.C.2d 1466, 181 B.R. 769 (D. Del. 1995) (holding that priority status survives confirmation, and collecting cases pro and con).

n64

64. 11 U.S.C. § 1129(a)(9)(D).

n65

65. See *Collier on Bankruptcy*, 1129.03[9][c][ii].

ABOUT THE AUTHOR(S):

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106 of 197 DOCUMENTS

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Collier on Nunc Pro Tunc Retention Orders

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Collier on Nunc Pro Tunc Retention Orders

By Collier

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SUMMARY: To be compensated pursuant to Bankruptcy Code section 330, a professionals employment must be approved under section 327. Although there is no express requirement that the retention be approved before the services are rendered, courts generally read such a requirement into the statute. However, bankruptcy courts, as courts of equity, are empowered to grant nunc pro tunc retention orders. This commentary explains the circumstances under which a bankruptcy court is likely to grant a nunc pro tunc retention order.

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ARTICLE: To be compensated pursuant to *Bankruptcy Code section 330*, a professionals employment must be approved under section 327. n1 Although there is no express requirement that the retention be approved before the services are rendered, courts generally read such a requirement into the statute. n2 However, bankruptcy courts, as courts of equity, are empowered to grant *nunc pro tunc* retention orders. n3 The Latin phrase *nunc pro tunc* translated literally means now for then. When applied to orders, it means that a thing is now done which should have been done on the specified date. n4

Proscription against the granting of *nunc pro tunc* employment orders has been stated in the following terms: the purpose of a *nunc pro tunc* order is to record a prior but unrecorded act of the court, one unrecorded due to inadvertence or mistake. n5 In situations where a professional is seeking compensation for work that was never authorized, however, what is required is not a correction of the records, but a brand new substantive decision. n6 As such, some courts have stated that after-the-fact approval to retain a professional is more clearly understood as a *post facto* retention order. n7

Courts have permitted the use of *nunc pro tunc* and *post facto* orders to validate a previous failure to obtain the requisite court approval and obviate an oversight that otherwise would result in unfair and inequitable consequences. n8 While some courts purport to adhere to a *per se* approach and other courts have enunciated fact-specific tests, the ultimate decisions are based upon the equitable considerations discussed below. n9 Because the relief is equitable in nature and courts conduct a case-by-case analysis, courts place varying emphasis on different factors in conducting an analysis. n10

Notwithstanding the equitable considerations used to justify the entry of *nunc pro tunc* orders, courts are leery that this practice will lead to volunteerism and abuse. n11 Accordingly, at a minimum, the professional seeking to be

retained should demonstrate that the retention would have been approved had it been timely filed n12 and that the applicants services have benefited the estate in some manner. n13 One court has imposed a requirement that the denial of retention and the concurrent denial of related fees do not result in a windfall benefit to the estate for enjoying services rendered by the professional without paying for them. n14 Other courts, however, simply rely on a nonexclusive list of factors. n15 The better approach to determine whether a *nunc pro tunc* order should be granted is to rely on a nonexclusive list of factors to address the untimely application, but still require that all other substantive requirements of section 327 be met. Section 327s requirements of disinterestedness and that the services are reasonably necessary to the administration of the estate will minimize the danger of volunteerism and abuse. n16

The prevailing approach is that a bankruptcy court should grant retroactive retention orders in extraordinary or exceptional circumstances to deter attorneys and other professionals from general nonobservance of section 327. n17 The circumstances that will qualify as sufficiently extraordinary to warrant a retroactive order approving retention have generated split authority. The majority of courts hold that simple neglect or inadvertence on the part of the applicant in failing to file a timely retention application under section 327 is not a sufficient basis for granting retroactive approval of employment. n18 One court held that a real estate broker who entered into a prepetition agreement to sell the debtors property was not entitled to *nunc pro tunc* approval of its employment since it could not explain the delay in requesting such approval and should have been aware of the requirement for court approval before performing work. n19 Another court denied a *nunc pro tunc* retention order to a consultant assisting debtors counsel because the consultant was familiar with bankruptcy rules and requirements. n20

Other courts have indicated that neglect or inadvertence may constitute a sufficient basis for granting a *nunc pro tunc* order. n21 These courts have rejected the strict application of the rule against *nunc pro tunc* orders permitting retention of professionals, particularly when the professional has rendered valuable service to the benefit of the estate in good faith. n22

Some courts have required only that the professional satisfactorily explain the failure to obtain court approval, and to otherwise comply with the requirements of section 327. n23 For example, in *In re Coast Trading Co.*, the court entered a *nunc pro tunc* order for a professional who claimed that he did not realize that the term debtor in possession meant that the debtor was in bankruptcy. n24

Hardship to the applicant caused by another partys inaction is an additional basis upon which courts have granted retroactive employment applications provided that prior approval would have been appropriate and the delay in seeking approval was due to circumstances beyond the control of the professional. n25 For instance, a protracted negotiation with the creditors committee over the retention terms and compensation agreement was held to justify a *nunc pro tunc* order. n26 Another common consideration in such cases is the applicants justifiable reliance on another party to prepare the employment application. n27

The Courts of Appeals for the Second and Eighth Circuit previously adhered to a *per se* rule that a professional seeking compensation from the debtors estate may not receive compensation for work done before the filing of the required application for employment. n28 More recently, however, both the Second Circuit and lower courts in the Eighth Circuit have retreated from this approach and have indicated that an order approving a *nunc pro tunc* retention can be granted in extraordinary circumstances or for equitable considerations. n29 The approach of the lower courts in the Eighth Circuit is consistent with the statement in *Lavender v. Wood Law Firm* that, in limited circumstances, the bankruptcy court as a matter of fundamental fairness may exercise its discretion and enter a *nunc pro tunc* order authorizing compensation. n30 As such, some lower courts in the Second and Eighth Circuits have permitted the retroactive approval of a professionals employment where the failure to file a timely application has been explained, and the explanation has been found reasonable, n31 for excusable neglect or hardship, n32 in exceptional circumstances n33 or as a matter of fundamental fairness. n34 Notwithstanding the above exceptions, these courts are reluctant to grant *nunc pro tunc* orders when the requesting party is somehow responsible for the failure to make a timely application. n35

Some courts have recognized that circumstances may require that a professional render services before obtaining court approval. In that regard, these courts permit a 30-day period from the commencement of the bankruptcy case within which a professional must submit an application for retention, which constitutes a reasonable gap period for the professionals delay. n36 But the grace period is not absolute, for courts may still require that the debtor demonstrate the delay was caused by extraordinary circumstances. n37

Courts have also considered such factors as the professionals good faith, the urgency for services to be rendered, the party responsible for obtaining authorization and the applicants sophistication. n38 The applicants sophistication depends upon whether the applicant is an attorney, professional consultant or one who regularly appears before the bankruptcy court. n39 When courts use *nunc pro tunc* orders as an equitable device to enable a professional to obtain compensation from the estate, they have scrutinized the professionals activities to ascertain whether any misconduct, other than the failure to obtain prior court approval, has transpired. n40 For example, in *In re Arkansas Co, Inc.*, n41 the Court of Appeals for the Third Circuit delineated factors for the bankruptcy court to consider in determining whether the circumstances of a particular case adequately excuse the failure to seek prior court approval. Those factors include (1) whether the applicant or some other person bore responsibility for approval, (2) whether the applicant was under time pressure to begin service without approval, (3) the amount of delay after the applicant learned that initial approval had not been granted and (4) the extent to which compensation to the applicant will prejudice innocent third parties. n42

Another set of criteria was delineated in *In re Twinton Properties Partnership*, n43 which required that an applicant for *nunc pro tunc* employment affirmatively demonstrate certain factors by clear and convincing evidence. Subsequent cases have followed *Twinton Properties*, expanded on these factors or used the factors nonexclusively. n44 Those nine factors are as follows:

- (1) The debtor, trustee or committee expressly contracted with the professional person to perform the services which were thereafter rendered;
- (2) The party for whom the work was performed approves of the entry of the *nunc pro tunc* order;
- (3) The applicant has provided notice of the application to creditors and parties in interest and has provided an opportunity to file objections;
- (4) No creditor or party in interest offers a reasonable objection to the entry of the *nunc pro tunc* order;
- (5) The professional satisfies all the other criteria for employment pursuant to section 327 and Bankruptcy Rule 2014 at or before the time the services were actually commenced and remained qualified during the period for which services were provided;
- (6) The work was performed properly, efficiently and to a high standard of quality;
- (7) No actual or potential prejudice will inure to the estate or other parties in interest;
- (8) The applicants failure to seek employment approval is satisfactorily explained;
- (9) The applicant exhibits no pattern of inattention or negligence in soliciting judicial approval for the employment of professionals. n45

For a complete discussion of Code section 327, see Collier on Bankruptcy, ch. 327.

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Return to Text

n1 1. *Lamie v. United States Trustee*, 540 U.S. 526, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004); see Collier on Bankruptcy, ch. 330.

n2

2. See *In re Singson*, 41 F.3d 316, 320 (7th Cir. 1994); *Guerin v. Weil, Gotshal & Manges*, 205 F.2d 302 (2d Cir. 1953); *In re Shirley*, 134 B.R. 940, 944 (B.A.P. 9th Cir. 1992); *In re Anicom, Inc.*, 273 B.R. 756, 761 (Bankr. N.D. Ill. 2002); see also Collier on Bankruptcy, 330.03[2], discussing need for retention under section 327 as a condition to compensation under section 330.

n3

3. *In re Albrecht*, 233 F.3d 1258, 1261 (10th Cir. 2000) (court acknowledged the equitable power to grant *post facto* orders for the failure to conform to section 327 but would not equitably use other sections of the Code to circumvent the requirements of section 327); *In re Jarvis*, 53 F.3d 416, 418 (1st Cir. 1995); *In re Triangle Chems., Inc.*, 697 F.2d 1280, 1289 (5th Cir. 1983) (We thus find that neither bankruptcy statute nor rule preclude the bankruptcy judge in the exercise of its sound discretion, and as a court of equity administering equitable principles, from entering an order *nunc pro tunc* authorizing the employment of an attorney for the debtor in possession even after the attorney (who *should* have secured prior approval for his retainer) has performed valuable services for the debtor's estate that have increased the common funds available for distribution to the creditors. (emphasis in original)); *In re Laurent Watch Co.*, 539 F.2d 1231 (9th Cir. 1976); *Stolkin v. Nachman*, 472 F.2d 222 (7th Cir. 1973); *In re St. Vrain Station Co.*, 151 B.R. 549 (D. Colo. 1993); *In re Cormier*, 35 B.R. 424, 425 (D. Me. 1983) ([N]either § 327 nor the Bankruptcy Rules by their terms, or by any necessary implication, prohibit the court from exercising its sound discretion in deciding whether to approve employment of a professional after the fact to the end that the deserving professional may be compensated by the estate for valuable services performed for it . The bankruptcy court is governed by equitable principles and need not read statutory language woodenly.).

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4. Black's Law Dictionary (8th ed. 2004) (citing 35A C.J.S. Federal Civil Procedure § 370, at 556 (1960)).

n5

5. *In re Carolina Sales Corp.*, 45 B.R. 750, 753 (Bankr. E.D.N.C. 1985) (citing *In re Call*, 36 B.R. 374 (Bankr. S.D. Ohio 1984)); see also *In re Mork*, 6 C.B.C.2d 1334, 19 B.R. 947 (Bankr. D. Minn. 1982).

n6

6. *In re Singson*, 41 F.3d 316, 318-19 (7th Cir. 1994).

n7

7. *In re Albrecht*, 233 F.3d 1258 (10th Cir. 2000); *In re Jarvis*, 53 F.3d 416 (1st Cir. 1995) (phrase *nunc pro tunc* is a misnomer because what is being sought is not a correction of an order but a new order altogether); *In re Ponce Marine Farm Inc.*, 259 B.R. 484 (D.P.R. 2001).

n8

8. *In re Wallingford Fruit House, Inc.*, 35 B.R. 426 (D. Me. 1983); *In re Glinz*, 36 B.R. 17 (Bankr. D.N.D. 1983); *In re Wolsky*, 35 B.R. 481 (Bankr. D.N.D. 1983); *In re Tom's Variety & Hardware, Inc.*, 30 B.R. 298 (Bankr. S.D. Ohio 1983); see *In re NWFEX, Inc.*, 267 B.R. 118, 247 (Bankr. W.D. Ark. 2001) (*nunc pro tunc* retention granted because all parties were on notice of professionals retention); *In re First Sec. Mortg. Co.*, 117 B.R. 1001, 1007 (Bankr. N.D. Okla. 1990) (criticizing the strict application of the rule against *nunc pro tunc* retention, the bankruptcy court stated that such a rule tends to confer an unjust enrichment on the estate which has received valuable services without having to pay anything for them, and inflicts a substantial penalty for a wrong that may be merely technical in nature, innocent in intention, and otherwise harmless in effect"); *In re Saybrook Mfg. Co.*, 22 C.B.C.2d 454, 459-60, 108 B.R. 366, 369 (Bankr. M.D. Ga. 1989) (while ignorance of the law is no excuse for failure to obtain court approved retention, the applicant, an investment and merchant banking firm, had relied upon the debtor to handle technical matters [concerning their retention] with the bankruptcy court).

n9

9. See, e.g., *Cushman & Wakefield, Inc. v. Keren Ltd. Pshp. (In re Keren Ltd. Pshp.)*, 189 F.3d 86 (2d Cir. 1999); *Lavender v. Wood Law Firm*, 785 F.2d 247, 248-49 (8th Cir. 1986) (in limited circumstances, the bankruptcy court as a matter of fundamental fairness may exercise its discretion); *In re Piecuil*, 145 B.R. 777 (W.D.N.Y. 1992).

n10

10. *F/S Airlease II, Inc. v. Simon*, 844 F.2d 99 (3d Cir. 1988); *In re Triangle Chemicals, Inc.*, 697 F.2d 1280 (5th Cir. 1983); *In re Piecuil*, 145 B.R. 777 (Bankr. W.D.N.Y. 1992); see, e.g., *In re Lillian Laurence Ltd.*, 136 B.R. 1 (Bankr. D.D.C. 1992) (court denied *nunc pro tunc* retention and interim compensation of law firm that failed to justify its delay in submitting its initial and revised application for retention and to disclose its representation of the debtor's principal).

n11

11. *In re Laurent Watch Co.*, 539 F.2d 1231, 1233 (9th Cir. 1976) (*Nunc pro tunc* is an incantation to permit the correction of yesterday's oversight, not yesterday's failure on the part of experienced counsel to abide by plain and unambiguous rules); *see also In re Grabill Corp.*, 983 F.2d 773, 776, 28 C.B.C.2d 346, 350 (7th Cir. 1993) ([a] lawyer who was concerned that he might be disapproved if he applied under 327(a) might take a chance on not applying and instead seeking [sic] compensation later in the hope that the bankruptcy judge would be reluctant to deny all compensation for work well done); *In re Albrecht*, 245 B.R. 666, 671 (B.A.P. 10th Cir. 2000), *affd*, 233 F.3d 1258 (10th Cir. 2000) (without court approval, the person rendering services may be considered an officious intermeddler or a gratuitous volunteer).

n12 12. *See In re Keren Ltd. P'ship*, 189 F.3d 86 (2d Cir. 1999); *In re Jarvis*, 53 F.3d 416 (1st Cir. 1995); *In re Arkansas Co. Inc.*, 798 F.2d 645, 650 (3d Cir. 1986); *Stolkin v. Nachman*, 472 F.2d 222 (7th Cir. 1973); *In re Princeton Med. Mgmt., Inc.*, 249 B.R. 813 (Bankr. M.D. Fla. 2000); *In re Tidewater Mem. Hosp., Inc.*, 22 C.B.C.2d 793, 110 B.R. 221, 227 (Bankr. E.D. Va. 1989); *In re McKinney Ranch Assocs.*, 62 B.R. 249 (Bankr. C.D. Cal. 1986); *In re Lindo's Tours, U.S.A., Inc.*, 55 B.R. 475 (Bankr. M.D. Fla. 1985); *In re Mahoney, Trocki & Assocs., Inc.*, 13 C.B.C.2d 1004, 54 B.R. 823 (Bankr. S.D. Cal. 1985); *In re Roaring Creek Mining Co.*, 51 B.R. 866 (Bankr. E.D. Tenn. 1985).

n13

13. *In re Lee*, 27 C.B.C.2d 1559, 1562, 146 B.R. 13, 15-17 (E.D. Cal. 1992); *see In re F/S Airlease II, Inc.*, 844 F.2d 99 (3d Cir. 1988) (noting that, in all applications for *nunc pro tunc* approval, a benefit has accrued to the estate).

n14

14. *See In re Martin*, 102 B.R. 653 (Bankr. W.D. Tenn. 1989). *But cf. In re Welch*, 244 B.R. 802, 804 (Bankr. W.D. Ark. 2000) (benefit to estate is immaterial because presumably all work done on behalf of the debtor will benefit the estate).

n15

15. *See Farinash v. Vergos (In re Aultman Enters.)*, 264 B.R. 485 (E.D. Tenn. 2001); *In re Freehold Music Ctr., Inc.*, 49 B.R. 293, 296 (Bankr. D.N.J. 1985) (court approved retention of accountants *nunc pro tunc* when they believed in good faith that prior court approval of their employment had been obtained by the debtors attorneys); *In re Twinton Props. P'ship*, 27 B.R. 817 (M.D. Tenn. 1983); *see also In re Arkansas Co. Inc.*, 798 F.2d 645 (3d Cir. 1983); *In re Fidelity Standard Mortgage Corp.*, 43 B.R. 654, 657 (Bankr. S.D. Fla. 1984)

(although Plaintiff's services were never expressly authorized by the Court, it is obvious that these services were rendered at the request of, and with the knowledge and consent of, the Debtor in Possession. Upon equitable grounds, the Court therefore finds that Plaintiff is entitled to an award).

n16

16. See 11 U.S.C. § 327; *Collier on Bankruptcy*, 327.02[1]; see also, e.g., *In re Jarvis*, 53 F.3d 416 (1st Cir. 1995) (bankruptcy court may grant *post facto* application if employment meets statutory requirements).

n17

17. See, e.g., *In re Jarvis*, 53 F.3d 416 (1st Cir. 1995); *In re Arkansas Co.*, 798 F.2d 645 (3d Cir. 1986); *In re Triangle Chems., Inc.*, 697 F.2d 1280, 8 C.B.C.2d 116 (5th Cir. 1983); *Ibbetson v. United States Trustee*, 100 B.R. 548 (D. Kan. 1989); *In re Kroeger Prop. and Dev., Inc.*, 14 C.B.C.2d 382, 57 B.R. 821 (B.A.P. 9th Cir. 1986); *In re Ponce Marine Farm, Inc.*, 259 B.R. 484 (D.P.R. 2001); *In re W/B Assocs.*, 226 B.R. 832 (Bankr. W.D. Pa. 1998); *In re Metropolitan Hosp.*, 24 C.B.C.2d 648, 119 B.R. 910 (Bankr. E.D. Pa. 1990); *In re Wellington Dev. of Florida, Inc.*, 119 B.R. 65 (Bankr. W.D. Pa. 1990); *In re Bicoastal Corp.*, 118 B.R. 855 (Bankr. M.D. Fla. 1990); *In re Robotics Resources R2, Inc.*, 117 B.R. 61 (Bankr. D. Conn. 1990); *In re Doctors Hosp., Inc.*, 117 B.R. 38 (Bankr. D.P.R. 1990); *In re Platinum Power Co.*, 105 B.R. 381 (Bankr. N.D. Ohio 1989); *In re Samford*, 21 C.B.C.2d 656, 102 B.R. 724 (Bankr. E.D. Mo. 1989); *In re B.E.S. Concrete Prods., Inc.*, 19 C.B.C.2d 1172, 93 B.R. 228 (Bankr. E.D. Cal. 1988) (the size of fee request itself does not constitute extraordinary circumstances); *In re McDaniels*, 86 B.R. 128 (Bankr. S.D. Ohio 1988) (court awarded *nunc pro tunc* retention when extraordinary circumstances present); *In re Hospitality Ltd.*, 86 B.R. 59 (Bankr. W.D. Pa. 1988) (*nunc pro tunc* retention denied when applicant suffered no hardship beyond his control); *In re Aladdin Petroleum Co.*, 85 B.R. 738 (Bankr. W.D. Tex. 1988) (no extraordinary circumstances present); *In re Fleeman*, 73 B.R. 579 (Bankr. M.D. Ga. 1987); *In re McKinney Ranch Assocs.*, 62 B.R. 249, 252 (Bankr. C.D. Cal. 1986); *In re Roaring Creek Mining Co.*, 51 B.R. 866 (Bankr. E.D. Tenn. 1985); *In re Carolina Sales Corp.*, 45 B.R. 750 (Bankr. E.D.N.C. 1985).

n18 18. See, e.g., *In re Land*, 943 F.2d 1265, 1268 (10th Cir. 1991) (simple neglect will not justify *nunc pro tunc* approval); *In re Arkansas Co.*, 798 F.2d 645, 649 (3d Cir. 1986); *Botech Mktg., Inc. v. Primary Health Sys. (In re Primary Health Sys.)*, 2002 U.S. Dist. LEXIS 5954 (D. Del. Mar. 28, 2002) (rejects view that inadvertence or neglect constitutes an extraordinary circumstance); *Farinash v. Vergos (In re Aultman Enters.)*, 264 B.R. 485, 493 (E.D. Ten. 2001) (simple oversight does not suffice as a satisfactory explanation under the *Twinton Properties* test); *In re Platinum Mgmt. Corp.*, 226 B.R. 762 (W.D.N.Y. 1998) (attorney oversight or simple neglect does not constitute a reasonable explanation); *Ibbetson v. United States Trustee*, 100 B.R. 548 (D. Kan. 1989) (*nunc pro tunc* retention denied due to inadvertence which did not constitute excusable neglect); *In re Kroeger Prop. & Dev., Inc.*, 14 C.B.C.2d 382, 57 B.R. 821 (B.A.P. 9th Cir. 1986) (negligence is an unsatisfactory excuse for filing untimely retention application); *In re Princeton Med. Mgmt., Inc.*, 249 B.R. 813 (Bankr. M.D. Fla. 2000); *In re The Music Store Inc.*, 241 B.R. 752 (Bankr. N.D. Okla. 1999) (counsel's neglect does not justify *nunc pro tunc* retention); *In re Lillian Laurence, Ltd.*, 136 B.R. 1, 3-4 (Bankr. D. Colo. 1992) (law firms belief that its retention application was either misplaced or returned by the clerks office for some reason did not constitute extraordinary circumstances warranting a *nunc pro tunc* order); *In re Robotics*

Resources R2, Inc., 117 B.R. 61 (Bankr. D. Conn. 1990) (*nunc pro tunc* employment of debtors attorney denied as attorneys vacation and inability to complete expeditiously his admission to the court *pro hac vice* did not constitute excusable neglect or unavoidable hardship); *In re Brown*, 40 B.R. 728 (Bankr. D. Conn. 1984); *In re BSJ Tower Assocs.*, 35 B.R. 131 (Bankr. D.P.R. 1983); *In re Bear Lake West, Inc.*, 32 B.R. 272 (Bankr. D. Idaho 1983); *In re Johnson*, 21 B.R. 217 (Bankr. D.D.C. 1982); see also *In re Crook*, 79 B.R. 475 (B.A.P. 9th Cir. 1987) (court denied entry of *nunc pro tunc* order because of attorneys negligent conduct).

n19

19. *In re Timberline Property Dev., Inc.*, 115 B.R. 787 (Bankr. D.N.J. 1990); see also *In re Princeton Med. Mgmt., Inc.*, 249 B.R. 813, 816 (M.D. Fla. 2000) (debtor failed to explain why he failed to file an application for an accountants employment).

n20

20. *In re Grimes*, 115 B.R. 639, 644 (Bankr. D.S.D. 1990); see also *In re Keren Ltd. Pship*, 225 B.R. 303, 307 (S.D.N.Y. 1998), *affd*, 189 F.3d 86 (2d Cir. 1999) (sophisticated real estate broker should be familiar with bankruptcy procedure).

n21

21. See, e.g., *In re Singson*, 41 F.3d 316, 320 (7th Cir. 1994) (lower court did not abuse its discretion in applying an excusable neglect standard); *In re King Elec. Co.*, 6 C.B.C.2d 1273, 1275 n.2, 19 B.R. 660 (E.D. Va. 1982); *In re Sayegh*, 62 B.R. 601, 603 (Bankr. S.D. Tex. 1986); *In re Vlachos*, 61 B.R. 473, 479 (Bankr. S.D. Ohio 1986).

n22

22. *In re Triangle Chems., Inc.*, 697 F.2d 1280, 1289, 8 C.B.C.2d 116 (5th Cir. 1983) ([N]either bankruptcy statute nor rule preclude the bankruptcy judge in the exercise of its sound discretion, and as a court of equity administering equitable principles, from entering an order *nunc pro tunc* authorizing the employment of an attorney for the debtor in possession even after the attorney (who should have secured prior approval for his retainer) has performed valuable services for the debtor's estate that have increased the common funds available for distribution to the creditors.); *In re St. Vrain Station Co.*, 151 B.R. 549 (D. Colo. 1993) (rule requiring that a court approve an attorney before he or she can be compensated should not be curmudgeonly and dogmatically applied).

n23

23. *In re Microwave Products of Am., Inc.*, 104 B.R. 900 (Bankr. W.D. Tenn. 1989); *In re Marathon Home Loans*, 101 B.R. 221 (Bankr. E.D. Va. 1989); *In re Coast Trading Co.*, 62 B.R. 664 (Bankr. D. Or. 1986).

n24

24. 62 B.R. 664 (Bankr. D. Or. 1986).

n25

25. *In re Arkansas Co.*, 798 F.2d 645, 650 (3d Cir. 1986); *In re Saybrook Mfg. Co.* 108 B.R. 366 (Bankr. M.D. Ga. 1989); *In re Freehold Music Ctr., Inc.*, 49 B.R. 293 (Bankr. D.N.J. 1985).

n26

26. *In re ICG Communications, Inc.*, 2001 Bankr. LEXIS 1251 (Bankr. D. Del. Aug. 2, 2001); cf. *In re United Companies Fin. Corp.*, 241 B.R. 521, 526 (Bankr. D. Del. 1999) (court denied application where the delay was caused by the applicants insistence on unusual terms).

n27

27. See *In re Saybrook Mfg. Co.*, 22 C.B.C.2d 454, 457-58, 108 B.R. 366, 369 (Bankr. M.D. Ga. 1989) (holding that, while ignorance of the law is no excuse for failure to obtain court approved retention, the applicant, an investment and merchant banking firm, had relied upon the debtor to handle technical matters [concerning their retention] with the bankruptcy court); *In re Freehold Music Ctr., Inc.*, 49 B.R. 293 (Bankr. D.N.J. 1985) (court approved retention of accountants *nunc pro tunc* when they believed in good faith that prior court approval of their employment had been obtained by the debtor's attorneys); *In re Kero-Sun, Inc.*, 44 B.R. 121, 124 (Bankr. D. Conn. 1984) (compensation granted for services performed prior to entry of *nunc pro tunc* order approving employment; applicant had relied on debtors general counsel who had assumed responsibility for filing the applicants retention application); *In re Malden Mills, Inc.*, 42 B.R. 476, 485 (Bankr. D. Mass. 1984) (court entered *nunc pro tunc* order authorizing employment of accountant to perform work that went beyond the scope of the original limited appointment; court held that the accountant should not be penalized for counsels mistake); *In re Brown*, 40 B.R. 728, 731 (Bankr. D. Conn. 1984); *In re Seatrain Lines, Inc.*, 15 B.R. 583, 584 (Bankr. S.D.N.Y. 1981). But see *F/S Airlease II, Inc. v. Simon*, 844 F.2d 99, 18 C.B.C.2d 959, (3d Cir.), cert. denied, 488 U.S. 852, 109 S. Ct. 137, 102 L. Ed. 2d 110 (1988) (*nunc pro tunc* compensation denied to airplane broker who provided services to debtor because, notwithstanding his belief that the debtor was primarily responsible for filing the application, the broker had an independent obligation to see that the application was timely filed).

n28 28. See *Lavender v. Wood Law Firm*, 785 F.2d 247 (8th Cir. 1986); *Futuronics Corp. v. Arutt*,

Nachamie & Benjamin (In re Futuronics Corp.), 655 F.2d 463, 4 C.B.C.2d 1277 (2d Cir. 1981), cert. denied, 455 U.S. 941, 102 S. Ct. 1435, 71 L. Ed. 2d 653 (1982); *Albers v. Dickinson*, 127 F.2d 957 (8th Cir. 1942); *In re Progress Lektro Shave Corp.*, 117 F.2d 602, 604 (2d Cir.), reh'g denied, 118 F.2d 751 (2d Cir. 1941) (There is no question but that the appellant acted in good faith throughout and a denial to him of compensation is a harsh conclusion. However, the law is unquestionably settled that the order of the district court was correct.); *In re Rogers-Pyatt Shellac Co.*, 51 F.2d 988 (2d Cir. 1931); *In re Eureka Upholstering Co.*, 48 F.2d 95 (2d Cir. 1931); see also *Weil v. Neary*, 278 U.S. 160, 49 S. Ct. 144, 73 L. Ed. 243 (1929); *In re Am. Express Warehousing, Ltd.*, 525 F.2d 1012 (2d Cir. 1975); *In re Sapphire Steamship Lines, Inc.*, 509 F.2d 1242 (2d Cir. 1975); *In re Porto Rican Am. Tobacco Co.*, 117 F.2d 599 (2d Cir. 1941); *In re Luchka*, 152 B.R. 18, 19 (Bankr. D.R.I. 1993) (court denied *nunc pro tunc* employment of a law firm even though the firm's work was of benefit to the estate; the court did not have the authority to rescue professionals who fail to comply with the statutory and procedural red tape there appears to be little latitude or discretion within which the Court may act to correct the omission). But cf. *In re Piecuil*, 145 B.R. 777 (Bankr. W.D.N.Y. 1992) (It is fair to note that in most of these decisions some additional reason for disallowing payment of fees is shown absent the mere failure to secure a prior order, a reason that would have precluded proper issuance of the order authorizing the employment.) (quoting *In re Triangle Chems., Inc.*, 697 F.2d 1280 (5th Cir. 1983)).

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29. *In re Keren Ltd. P'ship*, 189 F.3d 86 (2d Cir. 1999); *In re NWFEX, Inc.*, 267 B.R. 118 (W.D. Ark. 2001).

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30. 785 F.2d 247, 248 (8th Cir. 1986).

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31. See, e.g., *In re Rainbow Press of Fredonia*, 197 B.R. 428, 429, 431 (Bankr. W.D.N.Y. 1996) (quoting *In re Piecuil*, 145 B.R. 777, 783 (Bankr. W.D.N.Y. 1992)) ([F]ailure to effect appointment of [counsel for the trustee] was fully explained by both the character of case administration and the special circumstances which delayed the need for legal representation.).

n32

32. See *In re 245 Assocs., LLC*, 34 C.B.C.2d 866, 188 B.R. 743 (Bankr. S.D.N.Y. 1995); *In re Rundlett*, 137 B.R. 144, 146 (Bankr. S.D.N.Y. 1992); *In re Robotics Resources R2, Inc.*, 117 B.R. 61 (Bankr. D. Conn. 1990); *In re French*, 111 B.R. 391, 394 (Bankr. N.D.N.Y. 1989); *In re Brown*, 40 B.R. 728, 731 (Bankr. D. Conn. 1984).

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33. *In re Rich Joyce Enters., Inc.*, 76 B.R. 42 (Bankr. E.D.N.Y. 1987); *In re Kero-Sun, Inc.*, 44 B.R. 121, 124 (Bankr. D. Conn. 1984); *In re C.H. Stuart, Inc.*, 16 B.R. 296 (Bankr. W.D.N.Y. 1981).

n34

34. *In re Hasset, Ltd.*, 283 B.R. 376 (Bankr. E.D.N.Y. 2002) (*nunc pro tunc* disfavored but permissible, retention approved where all parties knew of attorneys services and services benefited the estate); *In re Interco Inc.*, 135 B.R. 363, 366 (Bankr. E.D. Mo. 1991) (compensation and retroactive employment of attorney for debenture holders committee was warranted when prepetition services of counsel significantly benefited the estates).

n35

35. *In re Welch*, 244 B.R. 802, 803 (W.D. Ark. 2000) (court denied order even though attorneys may have acted in good faith); *In re Keren Ltd. Pship*, 225 B.R. 303, 307 (S.D.N.Y. 1998), *affd*, 189 F.3d 86 (2d Cir. 1999) (repeated assurances from the debtor to a broker that the fees would be paid did not relieve the broker of the obligation to obtain prior court approval).

n36

36. *See In re Metropolitan Hosp.*, 119 B.R. 910, 920 (Bankr. E.D. Pa. 1990) (30 days from commencement of case is presumed reasonable); *In re Martin*, 102 B.R. 653 (Bankr. W.D. Tenn. 1989) (30 days from the commencement of the case, rather than the commencement of the services, is appropriate as an outer limit for a reasonable gap period between the commencement of the bankruptcy case and obtaining court approval; after 30 days, the applicant has the burden of showing a reasonable explanation for the delay). *But see In re Sinor*, 18 C.B.C.2d 1263, 87 B.R. 620 (Bankr. E.D. Cal. 1988) (30 days from commencement of services to application for appointment is presumed as a reasonable time within which a professional must seek retroactive employment, as professionals may need to provide services before obtaining court approval).

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37. *In re United Companies Fin. Corp.*, 241 B.R. 521 (Bankr. D. Del. 1999) (notwithstanding the local practice of the United States trustee not objecting to *nunc pro tunc* applications filed within 30 days of the petition date, the court required the applicant to come forward with an explanation for the delay when the United States trustee did object to a late application).

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38. *In re Freehold Music Ctr., Inc.*, 49 B.R. 293, 296 (Bankr. D.N.J. 1985) (court approved retention of

accountants *nunc pro tunc* when they believed in good faith that prior court approval of their employment had been obtained by the debtors attorneys); see *In re Arkansas Co.*, 798 F.2d 645 (3d Cir. 1986); *In re Keren Ltd. Pship*, 225 B.R. 303 (S.D.N.Y. 1998), *affd*, 189 F.3d 86 (2d Cir. 1999); *In re Fidelity Standard Mortgage Corp.*, 43 B.R. 654, 657 (Bankr. S.D. Fla. 1984) ([A]lthough Plaintiff's services were never expressly authorized by the Court, it is obvious that these services were rendered at the request of, and with the knowledge and consent of, the Debtor in Possession. Upon equitable grounds, the Court therefore finds that Plaintiff is entitled to an award).

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39. See *In re Hydro Servs., Inc.*, 277 B.R. 309 (Bankr. E.D. Tex. 2001) (substantial and immediate matters for a large and sophisticated law firm experienced in bankruptcy law did not constitute exceptional circumstances); *In re United Companies Fin. Corp.*, 241 B.R. 521, 526 (Bankr. D. Del. 1999) (experienced law firm should be aware of the requirements); *In re Little Greek Restaurant*, 205 B.R. 484 (Bankr. E.D. La. 1996) (court approved *nunc pro tunc* retention of accountants who performed nonbankruptcy work and were unaware of the need for court approval); *In re Martin*, 102 B.R. 653, 655 (Bankr. W.D. Tenn. 1989) (the court is sympathetic to counsel who are not experienced in bankruptcy matters). But see *In re Carolina Sales Corp.*, 45 B.R. 750, 755 (Bankr. E.D.N.C. 1985) (ignorance of Code did not excuse consultant from making a timely application).

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40. See *Hunter Savings Ass'n v. Baggott Law Offices Co.*, 34 B.R. 368, 374 (S.D. Ohio 1983) (absent other misconduct on the part of the professional, a *nunc pro tunc* order authorizing engagement is appropriate where the sole ground urged for denial of compensation to an attorney who actually performed services of value to the debtor's estate is that the trustee or debtor in possession neglected to secure prior court approval of the employment of such attorney), *revd on other grounds*, 750 F.2d 536 (6th Cir. 1984).

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41. 798 F.2d 645 (3d Cir. 1986).

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42. 798 F.2d 645, 650; see also *F/S Airlease II, Inc.* 844 F.2d 99 (3d Cir. 1988); *In re Schachter*, 228 B.R. 359, 365 (Bankr. E.D. Pa. 1999).

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43. 27 B.R. 817 (Bankr. M.D. Tenn. 1983), *affd*, 33 B.R. 111 (M.D. Tenn. 1983).

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44. *In re Kroeger Properties & Dev., Inc.*, 57 B.R. 821 (B.A.P. 9th Cir. 1986); *Farinash v. Vargos* (*In re Aultman Enters.*), 264 B.R. 485 (E.D. Tenn. 2001); *In re Gutterman*, 42 C.B.C.2d 1768, 239 B.R. 828, 830 (Bankr. N.D. Cal. 1999) (factors are to be considered in determining extraordinary circumstances); *In re Martin*, 102 B.R. 653 (Bankr. W.D. Tenn. 1989); *In re Sinor*, 87 B.R. 620 (Bankr. E.D. Cal. 1988); *In re McDaniels*, 86 B.R. 128 (Bankr. S.D. Ohio 1988).

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45. 27 B.R. 817, 819 (Bankr. M.D. Tenn. 1983), *affd*, 33 B.R. 111 (M.D. Tenn. 1983).

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107 of 197 DOCUMENTS

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Hon. Ralph R. Mabey on In re Seven Fields Development Corp.

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Hon. Ralph R. Mabey on In re Seven Fields Development Corp.

By Hon. Ralph R. Mabey

December 14, 2007

SUMMARY: Limitations on a bankruptcy courts post-confirmation jurisdiction are a matter of judicial interpretation and have not been subject to well-defined parameters. The Third Circuit's decision is significant because it provides much needed refinement to the evolving standards. In this Emerging Issues Analysis, there is little doubt that the Third Circuit reached the correct result, yet the decision leaves unresolved numerous tricky issues.

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ARTICLE: Third Circuit Provides Needed Clarity on the Scope of Post-Confirmation Bankruptcy Jurisdiction

Few tasks carry the potential to perplex even experienced bankruptcy practitioners like the project of defining the precise scope of federal bankruptcy subject matter jurisdiction following the confirmation of a chapter 11 plan of reorganization. In a recent decision, *Geruschat v. Ernst Young LLP (In re Seven Fields Development Corp.)*, 505 F.3d 237 (3d Cir. 2007) ("*Seven Fields*"), the Court of Appeals for the Third Circuit held that the "close nexus" test for post-confirmation jurisdiction applies only in the context of "related to" jurisdiction, and not in the context of "arising in" jurisdiction, thereby providing needed clarity regarding this difficult and important issue. The Third Circuit further clarified that the "close nexus" test limits "related to" jurisdiction over all disputes raised post-confirmation, regardless of when the conduct complained of occurred.

Framing the Debate. As Justice Oliver Wendell Holmes famously wrote, "Jurisdiction is power." *Michigan Trust Co. v. Ferry*, 228 U.S. 346, 356, 33 S. Ct. 550, 57 L. Ed. 867 (1913). Indeed, as every law student learns in the first-year civil procedure course, the issue of subject matter jurisdiction is hardly a procedural nicety, but rather a fundamental threshold question in virtually every case. Without subject matter jurisdiction, a "court cannot proceed at all." *Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83, 94, 118 S. Ct. 1003, 140 L. Ed. 2d 210 (1998).

The scope and limits of bankruptcy jurisdiction and bankruptcy courts' power have long been freighted with constitutional implications, as dramatically illustrated by *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 102 S. Ct. 2858, 73 L. Ed. 2d 598 (1982). Nevertheless, the post-1984 regime--in which the limits of federal district courts' bankruptcy jurisdiction are defined by 28 U.S.C. § 1334 and the limits of federal bankruptcy

courts' adjudicative authority are defined by 28 U.S.C. § 157--is a familiar one for most bankruptcy attorneys. Under this framework, there are three distinct types of bankruptcy subject matter jurisdiction: (1) those matters "arising under" the Bankruptcy Code; (2) those matters "arising in" a bankruptcy case; and (3) those matters "related to" a bankruptcy case. See 28 U.S.C. § 1334(b). Any of these three types of proceedings may be--and almost uniformly are--"referred" to bankruptcy courts by federal district courts under 28 U.S.C. § 157(a). While a bankruptcy court may then properly exercise jurisdiction over all such matters, its ability to enter final orders is generally restricted by 28 U.S.C. § 157(c) to only those matters that are "core" to the bankruptcy process.

This delicately balanced structure is further complicated by the effects of confirmation of a plan of reorganization, which generally operates to terminate the bankruptcy "estate" itself under 11 U.S.C. § 1141. n1 In the eyes of many, the confirmation of a plan is a "bookend" of similar import to the "petition date"--confirmation signals the end of most of the formal "bankruptcy" process. Seizing on this basic idea, many courts have reasoned that the effects of confirmation ought to limit the scope of federal bankruptcy jurisdiction, although their specific approaches have not been uniform. n2 Thus was born the concept of limited post-confirmation jurisdiction.

Because the definition of limited post-confirmation jurisdiction is a product of the federal courts rather than of Congress--nothing in the relevant statutory provisions addresses the effects of confirmation vis--vis jurisdiction or suggests that confirmation has any jurisdictional ramification whatsoever--it is a definition that is still being refined. In *Seven Fields*, the Third Circuit took two sizable steps in that process of refinement by (1) holding that its limiting test for post-confirmation jurisdiction--i.e., the matter must bear a "close nexus" to the confirmed plan--applies *only* in the context of "related to" jurisdiction; and (2) declaring that this "close nexus" test limits "related to" jurisdiction over *all* disputes that are raised post-confirmation, even if the conduct complained of occurred preconfirmation (or even prepetition). n3

The Facts and Posture of *Seven Fields*. *Seven Fields* arose from the 1986 bankruptcy cases of several corporations that were in the business of developing real property in Pennsylvania (collectively, the "Debtors"). As is unfortunately too often the case, the Debtors were not legitimate businesses, but rather a sophisticated Ponzi scheme that had duped a number of innocent investors.

Weeks after the Debtors filed for bankruptcy, the bankruptcy court appointed a predecessor entity to the global accounting firm now known as Ernst & Young LLP as the Debtors' financial advisor. Ernst & Young performed a variety of services that are typically rendered by financial advisors in bankruptcy, including preparation of the Debtors' schedules and analyses of the Debtors' solvency.

On the basis of financial analysis performed by Ernst & Young, the bankruptcy court confirmed a liquidating plan of reorganization (the "Plan") on October 21, 1987. Under the Plan, the Debtors would each be merged into a successor entity, Seven Fields Development Corp., which would then liquidate the Debtors' assets and distribute the proceeds to the investors who had invested in the Ponzi scheme. Unfortunately, those proceeds ultimately were insufficient to satisfy all of the investors' claims in full.

Nearly seventeen years later--on September 29, 2004--a group of former investors (the "Appellants") sued Ernst & Young in Pennsylvania state court, asserting claims for professional negligence, fraud, and negligent misrepresentation. The gravamen of the Appellants' suit was that Ernst & Young improperly performed its financial services during the Debtors' bankruptcy case, which resulted in confirmation of a plan that caused the Appellants significant economic harm.

Soon after the suit was initiated, Ernst & Young filed a notice of removal of the suit from Pennsylvania state court to the federal bankruptcy court. The Appellants subsequently filed a motion requesting that the bankruptcy court either (1) remand the matter back to the Pennsylvania state court or (2) abstain from exercising jurisdiction over the matter. Among the arguments the Appellants made to support their requested relief was that the bankruptcy court lacked subject matter jurisdiction over the Appellants' post-confirmation claims asserting state law causes of action.

The bankruptcy court (after *sua sponte* reopening the bankruptcy case) concluded that the Appellants' action was one "arising in" a bankruptcy case, as well as a "core" proceeding, which gave the bankruptcy court subject matter jurisdiction under 28 U.S.C. § 1334(b) and adjudicative authority under 28 U.S.C. § 157(b)(1). *Geruschat v. Ernst & Young, LLP (In re Earned Capital Corp.)*, 331 B.R. 208, 21720 (Bankr. W.D. Pa. 2005). The Appellants then appealed to the district court, which affirmed the bankruptcy court's decision. *Geruschat v. Ernst & Young LLP*, 346 B.R. 123 (W.D. Pa. 2006). Having lost twice, the Appellants elected to try a third time by appealing to the Third Circuit.

The Seven Fields Opinion. As framed by the Third Circuit, the "central issue in [*Seven Fields*] implicates the question of whether the bankruptcy court had jurisdiction under 28 U.S.C. §§ 157 and 1334." 505 F.3d at 244. Or, more specifically (1) was there post-confirmation subject matter jurisdiction over the Appellants' action, and (2) was that action "core" or "non-core"? After extensively discussing the bases for its own jurisdiction and the relevant background framework, *id.* at 24459, the Third Circuit analyzed each question in turn.

The Appellants' first argument was that the Third Circuit's prior opinion in *Binder v. Price Waterhouse & Co. (In re Resorts International, Inc.)*, 372 F.3d 154 (3d Cir. 2004), established a "close nexus" test that must be met in all instances for there to be post-confirmation bankruptcy jurisdiction. Such a "close nexus" was not present in *Seven Fields*, the Appellants argued, because their action had little to do with the plan that had been confirmed nearly two decades earlier, but rather was based on state law claims against a nondebtor entity. The Third Circuit categorically rejected this argument:

The bankruptcy and district courts were not required to address the "close nexus" test because the test was not applicable in this "arising in" proceeding. As we discussed in *Resorts*, the "close nexus" standard only applies for the purposes of determining whether a federal court has jurisdiction over a non-core "related to" proceeding in the post-confirmation context. Appellants seem to believe that any time a party files a case post-confirmation, the "close nexus" test is triggered. This is plainly not the case. While courts may choose to rely on "related to" jurisdiction because it is the broadest category of federal bankruptcy jurisdiction when examining their own jurisdiction, it certainly is not incumbent upon them to do so, because, as occurred here, a party may argue and a court may decide that a proceeding falls within one of the narrower categories of jurisdiction, such as "arising in" jurisdiction, in which case "related to" jurisdiction and the corresponding "close nexus" test are not implicated.

505 F.3d at 260 (emphasis added; citation and footnote omitted). The Third Circuit then concluded that because the Appellants' allegations were based upon the theory "that in reliance upon the negligent work Ernst & Young performed during the bankruptcy, the bankruptcy court wrongly deemed the Debtors to be insolvent and caused the liquidation of the estate's assets in a manner that contravened the Amended Plan," the proceeding stemmed from conduct "arising in" a chapter 11 case, which provided independent subject matter jurisdiction under 28 U.S.C. § 1334(b). 505 F.3d at 26062.

The Third Circuit then considered, and affirmed, the lower courts' conclusion that the Appellants' case was "core" under 28 U.S.C. § 157(b)(2)(A) & (O), reasoning that

it is clear to us that a malpractice action against an accountant for misconduct during the bankruptcy on which the bankruptcy judge relied in confirming the plan of reorganization, and in reliance on which the bankruptcy court approved the fees to the accountants, and on which appellants' representatives relied to their detriment in selling the assets to pay their claims, in a manner that contravenes the terms of the reorganization plan, constitutes a core proceeding, more specifically a proceeding "arising in" the bankruptcy, which is subject to federal jurisdiction and the final adjudicative authority of the bankruptcy court.

505 F.3d at 26263.

Finally, although its resolution of the two foregoing questions did not require it to address this issue, the Third Circuit went further in an attempt to help resolve open questions about "the applicability of the close nexus' test in the related to' post-confirmation context." *Id.* at 263. More specifically, the Appellants had argued that application of the

"close nexus" test turned on when the litigation was initiated, not on when the underlying alleged misconduct occurred. Some courts have concluded that the "close nexus" test applies only when the *alleged misconduct itself* had occurred post-confirmation. On this non-necessary issue, the Third Circuit agreed with the Appellants, concluding "that the close nexus' test is applicable to related to' jurisdiction over any claim or cause of action filed post-confirmation, *regardless of when the conduct giving rise to the claim or cause of action occurred.*" *Id.* at 26465 (emphasis added). The Third Circuit again stressed, albeit in a footnote, that

this distinction and application of the respective tests applies only when the parties seek to establish jurisdiction on the grounds that the cause of action is "related to" the bankruptcy, the broadest jurisdictional hook. . . . [I]n such situations the court must impose limits in the post-confirmation context. In contrast, cases that "rise in" the bankruptcy case must satisfy a stringent standard in which the matter must have an intimate connection to the bankruptcy proceedings, and thus the stage at which the complaint is filed is not determinative.

Id. at 265 n.26 (internal alteration omitted).

Commentary on *Seven Fields*. *Seven Fields* represents an important step forward in the doctrine regarding post-confirmation jurisdiction. While numerous courts have endorsed the notion that bankruptcy jurisdiction generally ought to be narrower following the confirmation of a plan, few courts have specifically applied this inchoate idea to each of the three distinct types of bankruptcy jurisdiction--"arising in," "arising under," and "related to." *Seven Fields* provides needed clarity by holding that limitations on post-confirmation jurisdiction--such as the Third Circuit's "close nexus" test--are germane only vis--vis questions of "related to" jurisdiction.

Beyond being doctrinally significant, there is little doubt that the Third Circuit reached the correct result. Actions that "arise under" the Bankruptcy Code--such as preferences, fraudulent transfers, or claims for equitable subordination--are unique products of federal bankruptcy law and thus properly belong before bankruptcy judges (at least in the first instance) irrespective of when a suit is brought under those provisions. Likewise, actions that relate to events occurring during a bankruptcy case, and thus "arise in" bankruptcy, should be pressed before the court that is most familiar with those prior proceedings--i.e., the bankruptcy court. Despite some suggestions to the contrary, these considerations seem sufficiently weighty to justify the rejection of any uniquely post-confirmation limitation on "arising under" or "arising in" jurisdiction, which is essentially what the Third Circuit held in *Seven Fields*.

In contrast, it seems appropriate to apply some limiting considerations in the context of post-confirmation "related to" jurisdiction. The words "related to" necessarily invoke a fairly sensitive, context-dependent analysis. The notion that a relationship between a bankruptcy case and a nonbankruptcy issue is tighter during the heat of the case--much like the moon's gravitational pull is strongest when it is closest to the Earth--and weaker as the bankruptcy case draws to a close post-confirmation is an intuitive one. Moreover, the notion is consistent with the fact that Congress's enactment of a bankruptcy system with exceptional procedural aspects--such as nationwide jurisdiction and service of process--was justified by the great social good that can be accomplished by successful bankruptcy cases. Once the bulk of that process is completed, however, the considerations that motivated Congress seem substantially weaker, which in turn makes it appropriate to require a far stronger relationship between a nonbankruptcy matter and a bankruptcy case if that matter is to proceed in a federal bankruptcy court or in a federal district court sitting in bankruptcy.

Although *Seven Fields* is an important decision that reaches the right result, numerous tricky issues of bankruptcy jurisdiction remain to be resolved, two of which are worth noting here.

First, courts have yet to define precisely the scope of bankruptcy jurisdiction over a post-confirmation "litigation" or "liquidation" trust. n4 These entities--which have been the products of numerous large bankruptcies of recent vintage, including Enron, Refco, and Oakwood Homes--are creatures of bankruptcy plans and are vested with, among other things, all causes of action held by the bankruptcy estate. Following confirmation, these entities--on behalf of their creditor-beneficiaries--usually pursue a wide-range of litigation, often against the debtor's prepetition lenders and professionals, under a range of theories. Such litigation can involve a mix of traditional bankruptcy claims, such as

fraudulent transfers or preferences, and nonbankruptcy claims, such as aiding and abetting fraud, breach of fiduciary duty, or (the now largely discredited) "deepening insolvency." The question then becomes whether such nonbankruptcy, prepetition causes of action properly belong in federal bankruptcy courts. It is unclear what is the right answer regarding those claims that are, at best, "related to" the bankruptcy case. On the one hand, these claims were property of the bankruptcy estates asserted by entities created by the plan and thus have a "close nexus" to both the case and the plan itself. On the other hand, however, resolution of these claims usually requires reference to neither the specific text of the plan nor any provision of the Bankruptcy Code, which suggests there may be no "close nexus." This significant tension continues today and, one hopes, eventually will be resolved in future cases.

Second, a significant split exists among the circuits about whether bankruptcy courts can, in any instance (pre- or post-confirmation), exercise supplemental jurisdiction under 28 U.S.C. § 1367. ⁿ⁵ This issue is an important one because such powers could conceivably allow bankruptcy courts to exercise jurisdiction over matters that are "related to" matters "related to" a bankruptcy case. To the extent that there are weighty rationales for limiting the scope of "related to" jurisdiction generally following the confirmation of a chapter 11 plan, such rationales would seem to apply with even greater force to the scope of post-confirmation bankruptcy jurisdiction, if any, under section 1367.

For further discussion of bankruptcy court jurisdiction, see Collier on Bankruptcy, ch. 3 (Matthew Bender).

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Return to Text

ⁿ¹ . Among other things, unless otherwise provided in the plan or the confirmation order, plan confirmation vests all property of the estate in the debtor. 11 U.S.C. § 1141(b).

ⁿ² . See, e.g., *Boston Reg'l Med. Ctr., Inc. v. Reynolds (In re Boston Reg'l Med. Ctr., Inc.)*, 410 F.3d 100 (1st Cir. 2005); *Montana v. Goldin (In re Pegasus Gold Corp.)*, 394 F.3d 1189 (9th Cir. 2005); *Binder v. Price Waterhouse & Co. (In re Resorts Int'l, Inc.)*, 372 F.3d 154 (3d Cir. 2004); *U.S. Brass Corp. v. Travelers Ins. Group (In re U.S. Brass Corp.)*, 301 F.3d 296 (5th Cir. 2002); *Pettibone Corp. v. Easley*, 935 F.2d 120 (7th Cir. 1991).

ⁿ³ . Thus the Third Circuit in *Seven Fields* limits to only those disputes raised preconfirmation the application of its broader "related to" jurisdictional test announced in *Pacor, Inc. v. Higgins*, i.e., whether "the outcome of the proceeding could conceivably have any effect on the estate being administered in bankruptcy." 743 F.2d 984, 994 (3d Cir. 1984); see *Seven Fields*, 505 F.3d at 265 ("[W]e conclude that with respect to related to' jurisdiction, the *Pacor* test applies in all disputes raised preconfirmation and the close nexus' test applies in

all disputes raised post-confirmation, regardless of when the conduct alleged in the complaint occurred.").

n4 . See generally, e.g., *In re WRT Energy Corp.*, 2007 Bankr. LEXIS 3369, at *15-23 (Bankr. W.D. La. Sept. 28, 2007) (providing a detailed overview of the case law addressing this issue).

n5

[5]. Compare, e.g., *Montana v. Goldin (In re Pegasus Gold Corp.)*, 394 F.3d 1189 (9th Cir. 2005) (bankruptcy courts may exercise jurisdiction under section 1367), with, e.g., *Walker v. Cadle Co. (In re Walker)*, 51 F.3d 562 (5th Cir. 1995) (bankruptcy courts may not exercise jurisdiction under section 1367); see also *Enron Corp. v. Citigroup, Inc. (In re Enron Corp.)*, 353 B.R. 51 (Bankr. S.D.N.Y. 2006) (discussing the issue in some detail and concluding that bankruptcy courts may not exercise supplemental jurisdiction).

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108 of 197 DOCUMENTS

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Glosband on In re Iida

2008 Emerging Issues 1524

Glosband on In re Iida

By Daniel Glosband

December 14, 2007

SUMMARY: Is a foreign representative of a foreign bankruptcy proceeding required to obtain permission from a court in the United States before exercising ownership rights over property in the U.S.? The Bankruptcy Appellate Panel for the Ninth Circuit properly answered this question in the negative on September 26, 2007 in *Iida v. Kitahara (In re Iida)*, BAP No. HI-07-1006-DKS, 2007 Bankr. LEXIS 3574 (B.A.P. 9th Cir. Sept. 26, 2007).

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ARTICLE: Bankruptcy Appellate Panel Affirms Court Order Not Required for Foreign Representative to Exercise Control Over Property Located in the United States

The Facts and Posture of *In re Iida*. The issue before the Bankruptcy Appellate Panel for the Ninth Circuit (the "Panel") arose retrospectively in a case under Chapter 15 where the United States Bankruptcy Court for the District of Hawaii (the "Bankruptcy Court") recognized a Japanese bankruptcy case as a foreign main proceeding. The Japanese debtor, Katsumi Iida ("Iida"), was the sole stockholder of several Hawaii corporations (the "Hawaii Corporations") which held ownership interests in limited partnerships that, in turn, owned two luxury hotels in Hawaii. Iida was declared bankrupt under Japanese law in August 2004 (about a month after the first of the two hotels had been sold) and a trustee (the "Foreign Representative") was appointed in the Japanese bankruptcy to administer Iida's bankruptcy estate and liquidate assets.

In January 2005, the Foreign Representative (i) presented his credentials as bankruptcy trustee to the Hawaii Corporations, assuming the role of sole stockholder, and (ii) removed the existing officers and directors (including Iida) and replaced them with a single director and officer, all as permitted by the corporations' by-laws and Hawaii law. The following September, on request of the Foreign Representative, the Japanese bankruptcy court authorized him to (i) sell the remaining luxury hotel and (ii) exercise decision making power with respect to the stock of all companies that Iida owned. The sale of the second hotel was to close on November 30, 2005. All of this activity transpired before either Iida or the Foreign Representative set foot in a courtroom in the United States.

Nearly seven months after the Japanese bankruptcy court authorized the hotel sale and over a year after the

management changes, Iida filed a complaint in Hawaii state court. The April 2006 complaint sought a declaratory judgment against the Foreign Representative and the Hawaii Corporations' current management (the "Declaratory Judgment Action") recognizing Iida as sole shareholder and reinstating him to corporate management. The complaint also sought to enjoin the Foreign Representative from removing Iida from management and distributing the proceeds of sales of the Hawaii Corporations' assets.

To deal with the Declaratory Judgment Action, the Foreign Representative filed a chapter 15 petition on June 13, 2006 in the United States Bankruptcy Court for the District of Hawaii, seeking recognition of the Japanese bankruptcy proceeding as a foreign main proceeding pursuant to 11 USCS § 1515 and 11 USCS § 1517 and commencement of an ancillary case under 11 USCS § 1504. Iida, relying on 11 USCS § 1506, opposed the petition on the grounds that recognition would be manifestly contrary to the public policy of the United States because the Foreign Representative failed to obtain permission from the Bankruptcy Court under chapter 15 or its antecedent 11 USCS § 304 before removing Iida as officer and director of the Hawaii Corporations. n1

Iida did not prevail and, on July 14, 2006, the Bankruptcy Court entered its order recognizing the Japanese bankruptcy as a foreign main proceeding. 2007 Bankr. LEXIS 3574, at *16. The Foreign Representative then removed the Declaratory Judgment action to the Bankruptcy Court and filed a Motion to Dismiss on grounds that comity required deference to Japanese bankruptcy law and the orders of the Japanese bankruptcy court which authorized the Foreign Representative's actions. Iida opposed the motion on the grounds that the Foreign Representative lacked the authority to remove the officers and directors of the Hawaii Corporations because he did not comply with federal bankruptcy or state law, which Iida contended required prior recognition of the Foreign Representative's status as a trustee in the Japanese bankruptcy.

The Bankruptcy Court treated Iida's Motion to Dismiss as a summary judgment motion, granting summary judgment to the *Foreign Representative*. 2007 Bankr. LEXIS 3574, at *18-19. The court held that the Foreign Representative had been authorized to take action with the Hawaii Corporations because (i) the Japanese bankruptcy court orders authorized the Foreign Representative to act as sole shareholder in place of Iida and restructure management, (ii) the Foreign Representative had complied with the corporations' by-laws and Hawaii law with respect to his exercise of shareholder rights, and (iii) no provision of the United States Bankruptcy Code or Hawaii state law required an order recognizing the Foreign Representative's authority to act. *Id.* Iida appealed the ruling to the Panel.

The Appeal. The issue before the Panel was "whether a Foreign Representative must obtain permission from a court in the United States before exercising shareholder rights to vote to remove and replace the directors and officers of the Hawaii Corporations." *Id.* at * 19. Iida contended that both federal and Hawaii law required orders from a United States court before the Foreign Representative had authority to act in the United States and that Hawaii law did not recognize the exercise of shareholder voting rights by a foreign trustee. The Panel was unconvinced:

As we explain below, nothing in either the Bankruptcy Code or Hawaii state law requires the Foreign Representative to obtain a further order from a court within the United States recognizing his authority as trustee before exercising ownership rights.

Id. at *20-21. The Panel noted that the historical application of principles of comity provided "a basic mode of analysis" for a United States court to consider a case or controversy regarding a foreign bankruptcy. *Id.* at *22. In the absence of controversy, courts are not involved:

Measures taken by a foreign representative in the United States that do not require invoking the machinery of the courts and that all counterparties accept as legitimate do not present a controversy and are presumptively valid. If, however, the foreign representative's authority or capacity is challenged, then there is a controversy that would be appropriate for judicial application of principles of comity.

Id. The Panel's decision contains a thorough and thoughtful analysis of comity as it developed under common law and progressed after adoption of 11 U.S.C. § 304 in 1978. Id. at *22-29. Enactment of chapter 15 was not seen as a change in the basic approach of honoring principles of comity. However, chapter 15 added the structural requirement of recognition as a condition to the Foreign Representative's access to the courts:

[11 USCS § 1509] erects a structure in which the foreign representative passes through the bankruptcy court for a recognition decision, the specified consequences of which are that the foreign representative gains the capacity to sue and be sued in United States courts and the authority to apply directly to a court in the United States for appropriate relief, and that all courts in the United States must grant comity or cooperation to the foreign representative.

Id. at *31. Section 1509's gating requirement only applies when the Foreign Representative needs the assistance of a court in the United States. In sharp contrast, "[n]othing in the statute requires prior judicial permission for acts that do not implicate matters of comity or cooperation by courts It follows that chapter 15 does not constrain a foreign representative from acts that do not require judicial assistance." Id. at *36.

The Foreign Representative's actions regarding the exercise of his rights as shareholder of the Hawaii Corporations and his removal of their officers and directors had not been opposed by the Hawaii Corporations or Iida and did not require judicial assistance until Iida filed the Declaratory Judgment Action in Hawaii state court. Iida's argument that the recognition sought by the Foreign Representative subsequent to the Declaratory Judgment Action would be manifestly contrary to the public policy of the United States was without merit as Iida failed to identify a fundamental policy of the United States that is offended by recognition of the Japanese bankruptcy. Id. at *37.

As to state law, Iida argued that, under Hawaii law, the Foreign Representative failed to obtain recognition of his authority to exercise his rights as shareholder of the Hawaii Corporations under Hawaii's version of the Uniform Foreign Money-Judgments Recognition Act. The Panel rejected this argument on the grounds that the statute was inapplicable by its plain meaning as the orders of the Japanese bankruptcy court were not foreign money-judgments. Id. at *42. Iida also took issue with the Bankruptcy Court's determination that the Foreign Representative was authorized to vote the Hawaii Corporations' stock, despite not being the shareholder of record on the Hawaii Corporations' books. While there is statutory permission for a "trustee in bankruptcy" to vote such shares, Iida argued that the term "trustee in bankruptcy" did not include the Foreign Representative under state law. The Panel dismissed this argument by finding no material difference between an American chapter 7 trustee and a trustee in a Japanese bankruptcy. Id. at *44.

Upon undertaking an analysis of the proof regarding whether any genuine issues of material fact remained, the Panel found that Iida failed to show that any such genuine issues of material fact existed and affirmed the Bankruptcy Court's grant of summary judgment for the Foreign Representative. Id. at 52.

Practical Implications. The Iida decision suggests to foreign representatives that they explore fully their ability to act without judicial assistance. Asset recovery and administration may be possible without ever having to go court, particularly if there is no need for protection against creditor action or for discovery. On the debtor's side, prompt action would be required to initiate a proceeding seeking to block the foreign representative from acting if there were a dispute. That would likely provoke an earlier recourse to chapter 15 and permit any genuine issues to be raised before they had become moot.

The Iida decision is a positive step in the development of chapter 15 jurisprudence. It focuses clearly on the distinction between actions that do not require judicial assistance and those that do; it contains an informative recitation of the history and application of the doctrine of comity; it properly articulates chapter 15's structural requirement for recognition by the bankruptcy court as a predicate for the granting of comity or cooperation; and, it reinforces the limitation of the "manifestly contrary to public policy" exception to the most fundamental policies of the United States.

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n1 . The Japanese bankruptcy and the management change occurred while *11 U.S.C. § 304* of the Bankruptcy Code applied to ancillary proceedings; *11 U.S.C. § 304* was repealed as part of the October 17, 2005 BAPCPA amendments that added chapter 15 to the Bankruptcy Code.

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109 of 197 DOCUMENTS

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Hon. Ralph R. Mabey on In re Brown & Cole Stores

2008 Emerging Issues 1525

Hon. Ralph R. Mabey on In re Brown & Cole Stores

By Hon. Ralph R. Mabey

December 14, 2007

SUMMARY: New Code section 503(b)(9) gives a seller of goods sold in the ordinary course of business an administrative expense priority for the value of the goods received by a debtor within 20 days before the petition date. The Ninth Circuit Bankruptcy Appellate Panel, In *In re Brown & Coles*, has found the language of the statute unambiguous.

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ARTICLE: Secured Creditors Are Entitled to Administrative Expense Priority under New Section 503(b)(9), and Prepetition Claims May Be Set Off Against Such Administrative Expense Claims

In *Brown & Cole Stores, LLC v. Associated Grocers, Inc. (In re Brown & Cole Stores LLP)*, 375 B.R. 873 (9th Cir. B.A.P. 2007), the Bankruptcy Appellate Panel for the Ninth Circuit considered new *Bankruptcy Code* section 503(b)(9), which gives a seller of goods sold in the ordinary course of business administrative expense priority for the value of goods received by a debtor within 20 days before the bankruptcy petition date. The B.A.P. held (in the teeth of a thoughtful dissent) that administrative expense priority was available to a qualifying vendor under the new provision even if the vendor was fully secured, but that the administrative expense priority claim was subject to setoff against prepetition claims held by the debtor.

The Administrative Priority of Section 503(b)(9) Is Available to Secured Creditors. The debtor, Brown & Cole Stores ("B&C"), operated a grocery store chain in *Washington state*. 375 B.R. 873, 875. B&C's principal supplier, Associated Grocers, Inc. ("AGI"), held a security interest in a large block of AGI stock owned by B&C to secure various outstanding obligations from B&C to AGI. AGI was, therefore, a secured creditor of B&C.

Among the various claims asserted by AGI against B&C was an administrative expense claim for over \$6 million arising under section 503(b)(9), which was added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). 375 B.R. at 875. Separately, B&C claimed that AGI was liable for a

large damage claim resulting from AGI's alleged breach of contract. *Id.* at 876.

B&C opposed AGI's section 503(b)(9) claim, arguing that AGI should not be entitled to administrative expense priority because it was a secured creditor. B&C also argued that it should be permitted to setoff its contract claim against AGI's section 503(b)(9) claim if that claim was allowed.

The B.A.P. majority held that AGI was entitled to administrative expense priority under section 503(b)(9), notwithstanding the fact that it was a secured creditor. *Id.* at 878. The court first concluded that the plain meaning of the new section did not limit its coverage to unsecured creditors. *Id.* at 877. B&C argued that the absence of any language regarding secured claims in section 503(b)(9) was evidence that the new section should apply only to unsecured claims. B&C supported this argument by noting that section 503(b)(1)(B)(i), which provides administrative expense priority for certain tax claims, had been amended by BAPCPA specifically to include the words "whether secured or unsecured," addressing a split of authority as to whether that section could be applied to secured claims. Congress's decision not to include the same language in section 503(b)(9), B&C argued, must have been deliberate, such that section 503(b)(9) should apply only to unsecured claims.

The majority rejected B&C's reasoning. The court stood its ground that the statute was unambiguous and noted that, while Congress did indeed omit the word "secured," Congress also omitted the word "unsecured" from section 503(b)(9)-- plainly Congress omitted both limiting words because Congress intended not to limit the section's application to either secured or unsecured claims. 375 B.R. at 878. The court explained that a vendor's right to assert an administrative claim under section 503(b)(9) "is limited in only three ways: (1) the vendor must have provided goods (not services); (2) the debtor must have received the goods within 20 days of the commencement of the case; (3) the goods must have been sold in the ordinary course of the debtor's business." *Id.* at n.7. The majority determined that the "obvious conclusion" is that any claim falling within the plain language of section 503(b)(9), including a secured claim, is entitled to administrative expense priority. *Id.* at 878.

The court also dismissed B&C's argument that giving administrative expense priority to a secured creditor would be inequitable to other creditors. The court said:

We can do nothing about B&C's contention that giving priority to a secured creditor may be inequitable to other creditors. First, it is up to Congress to decide which creditors have leverage and which do not. More importantly, if AGI's twenty-day sales claim is fully secured, then payment of it by B&C will free the value of the security for that claim for the benefit of other creditors. If AGI's claim proves to be undersecured or unsecured, then to deny administrative priority would be to ignore the statute, something we cannot do.

375 B.R. at 878.

Judge Jaroslovsky, sitting by designation, dissented from the majority's decision to permit a secured creditor administrative expense priority. First, Judge Jaroslovsky agreed with B&C that Congress's inclusion of the language "whether secured or unsecured" in a neighboring provision indicated its intentional omission of that language from section 503(b)(9). As a result, there was no reason to believe that section 503(b)(9) should be available to secured creditors. *Id.* at 881.

More cogently, Judge Jaroslovsky explained that the majority's decision implicated "fundamental policy considerations" in chapter 11 cases. *Id.* Specifically, whereas administrative expense priority claims must be paid in full upon confirmation, secured claims are subject to cramdown pursuant to section 1129(b)(2)(A). Granting a secured creditor administrative expense priority under section 503(b)(9) would effectively grant the secured creditor "veto power over a plan of reorganization when § 1129(b)(2)(A) and sound bankruptcy policy dictate that a secured creditor can be forced to accept a plan which is fair and equitable to it, honors its secured status and pays its secured claim in full over time." 375 B.R. at 881. According to the dissent, the majority opinion reads too restrictively the new Code section by failing to incorporate that section into the greater "statutory scheme" designed to facilitate a debtor's

successful reorganization. *Id.* at 882. As the dissent put it: "I do not see the issue of whether a secured creditor can be entitled to an administrative expense claim being as simple as the plain meaning analysis of the majority." *Id.*

In response to the concerns expressed in the dissent, the majority conceded that "Congress gave tremendous leverage" to creditors with section 503(b)(9) claims by permitting those claimants to demand full payment as of confirmation. *Id.* at n.8. But, although this new priority has the potential of "dramatically affecting the outcome" of a chapter 11 reorganization, the majority explained that "[i]t is not our place to reallocate [the] leverage" granted by Congress to section 503(b)(9) claimants. *Id.* The majority also noted that the dissent's view would have little practical effect, because a secured creditor otherwise entitled to a section 503(b)(9) claim could simply waive its security in order to obtain administrative expense priority and obtain influence over the reorganization process. *Id.*

Prepetition Claims May Be Setoff Against Section 503(b)(9) Claims. Following its finding that administrative expense priority under section 503(b)(9) was available to secured creditors, the majority determined that B&C could set off its unsecured prepetition contract claim, to the extent it had one, against AGI's section 503(b)(9) claim. The court explained that a "crucial difference" separates section 503(b)(9) from all other subsections of section 503, in that section 503(b)(9) "applies to prepetition debt." 375 *B.R.* at 879. As a result, the court concluded that claims arising under that section, unlike other administrative expense priority claims, are nevertheless prepetition claims and may be setoff under section 553(a), which provides for the setoff of mutual prepetition debts.

Commentary. The majority's holding that secured creditors are entitled to administrative expense priority under new section 503(b)(9) is likely correct, although perhaps sadly so for many debtors and nonpriority creditors. Although the court's discussion of neighboring section 503(b)(1)(B)(i) was limited to whether the presence of the word "secured" in that provision should give restrictive meaning to its absence in section 503(b)(9), the court may have missed the more obvious, and perhaps more significant aspect of section 503(b)(1)(B)(i): By explicitly amending that section to include secured creditors within the class protected by section 503(b)(1)(B)(i), Congress has opened the administrative expense priority door to secured claims.

Despite the dissent's argument that granting administrative expense priority to some secured creditors alters the balance of power, it is hard to contest the fact that, for better or worse, Congress has deliberately made administrative expense priority available to some secured creditors. The majority's extension of that priority to section 503(b)(9) may have been breaking new ground, but Congress began the sod-busting and signaled its liberality by granting secured creditors administrative expense priority under section 503(b)(1)(B)(i).

The court's unanimous ruling that a prepetition debt may be set off against a section 503(b)(9) administrative claim may actually be the more significant piece of this opinion. As the court noted, administrative expense priority was historically available only to postpetition debt. Congress's recent decision to grant administrative expense priority to prepetition claimants under section 503(b)(9) (as well as under new section 503(b)(1)(A)(ii) relating to back pay) now redefines "administrative expenses" to include some prepetition debts. While this inclusion must ring a sour note for some veteran bankruptcy experts, the court's decision to treat a section 503(b)(9) claim as a prepetition claim for purposes of setoff muffles the sour note somewhat. After all, if section 553 permits setoff on account of a mutual, prepetition debt, and claims under section 503(b)(9) are in fact claims that arose prepetition, why should those claims not be subject to setoff?

Indeed, why shouldn't these new hybrid claims, aside from their payment priority, be treated as prepetition claims for other purposes, such as the applicability of bar date orders?

For further discussion of *Bankruptcy Code* section 503, see Collier on Bankruptcy, see ch. 503 (Matthew Bender).

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In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.

2008 Emerging Issues 1527

Glosband on *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*

By Daniel Glosband

December 14, 2007

SUMMARY: What country should conduct the bankruptcy of a hedge fund that is registered offshore but that conducts all of its business in the United States? Recent U.S. Bankruptcy cases have answered this question differently. This Emerging Issues Analysis discusses Chapter 15s eligibility requirements and the implications of these differing outcomes.

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ARTICLE: Bankruptcy Court Denies Chapter 15 Petition to Recognize Cayman Islands Proceedings of Bear Stearns Hedge Funds

The refusal by a U.S. Bankruptcy Judge to provide assistance to Cayman liquidation proceedings of failed Bear Stearns hedge funds raises the question of what country should conduct the bankruptcy of a hedge fund that is registered offshore but that conducts all of its business in the United States. If funds choose to file bankruptcy in their country of registration, will the United States Bankruptcy Court acquiesce and assist offshore proceeding by staying U.S. litigation and protecting U.S. assets? If the U.S. court demurs, must the funds seek protection in U.S. bankruptcy proceedings?

Recent cases answer the questions differently. The Bear Stearns decision denied the funds' petitions because the Cayman cases did not meet Chapter 15's eligibility requirements; nonetheless, it granted a 30-day stay to permit the filing of U.S. proceedings for the funds. A case involving similarly structured funds, *In re SPhinX*, arguably misapplied the statute by accepting the eligibility of the Cayman proceedings for U.S. assistance (and then declining to provide any). n1 Ignoring the technical distinctions, it is U.S. 2, Cayman 0.

These rulings do not suggest that Cayman registration is an unsound idea. Cayman commentators say that the "mix of regulatory, tax, speed, efficiency and cost considerations" still support Cayman as a domicile. n2 Instead, the cases reflect a U.S. legislative policy to provide the assistance of its bankruptcy courts only to those foreign bankruptcy proceedings that are premised on a tangible presence of the debtor in the foreign jurisdiction. If the debtor is really a U.S. business with only its technical domicile offshore, then the debtors' bankruptcy should be a U.S. affair.

Adopting this view, Honorable Burton R. Lifland, United States Bankruptcy Judge for the Southern District of New York denied the Chapter 15 petition of two Cayman-registered Bear Stearns hedge funds and found that the Cayman proceedings were not eligible for recognition and relief under Chapter 15 of the United States Bankruptcy Code (Code) (*In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*).ⁿ³ Chapter 15, *Ancillary and Other Cross-Border Cases*, was added to the Code in 2005 and implemented the U.S. adaptation of the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law.ⁿ⁴ Chapter 15 was designed to facilitate cooperation and coordination between U.S. bankruptcy courts and their foreign counterparts, including providing assistance to eligible foreign insolvency proceedings.

Much of Chapter 15 is structured to complement foreign proceedings and to assist foreign representatives of those foreign proceedings that meet specified definitional requirements and that take place in a country where the debtor has either its center of main interests (COMI) or a place of business operations, termed an establishment.ⁿ⁵ Chapter 15 establishes an objective test for recognition of a foreign proceeding and provides two alternative bases on which recognition can be granted: a foreign proceeding in the debtor's COMI will be recognized as a "foreign main proceeding" while a foreign proceeding where the debtor has an establishment will be recognized as a "foreign nonmain proceeding."ⁿ⁶ Relief is broader and more automatic upon recognition of a foreign main proceeding. For example, the U.S. automatic stay applies and the foreign representatives are granted many of the powers of a U.S. bankruptcy trustee. If the debtor has neither its COMI nor an establishment in the country of the foreign proceeding, then U.S. law should not recognize the foreign proceeding; implicitly, says the United States, the bankruptcy should be elsewhere. Judge Lifland endorsed this view of the law, relying in part on the author's previous ABI Journal article criticizing the *SPhinx* decision (discussed below).

The summer 2007 financial press limned the plunge of the Bear Stearns funds into liquidation. Like a slow motion video of a diving competition, the headlines captured the fall. On June 20, 2007, the funds stepped onto the platform with "Two Big Funds At Bear Stearns Face Shutdown," a bounce followed on June 21 with "Bear Stearns Staves off Collapse of 2 Hedge Funds," the arc down began on June 25 with "Wall Street Fears Bear Stearns Is Tip of an Iceberg" and finally the splash into the pool occurred on August 1 with "Bear Stearns Hedge Funds filed for Bankruptcy."ⁿ⁷ The bankruptcy filing was a two-step, two-country exercise: a winding up proceeding under the Cayman Companies Law in the Grand Court of the Cayman Islands accompanied by a Chapter 15 Petition for Recognition of a Foreign Proceeding.

It is not clear why the Bear Stearns funds chose the Cayman venue. Possible reasons include: (1) the Cayman case would be cheaper without expensive U.S.-style committees; (2) the investigation or litigation involving affiliates would be less likely; and (3) the proceedings would be less transparent and attract less media coverage. Cayman lawyers say that management is not "favoured" to the detriment of creditors and investors and that Cayman courts can handle complex cross-border cases.ⁿ⁸ Regardless of motivation, the Bear Stearns funds filed for liquidation in the Cayman Islands and the Cayman liquidators sought to have the Cayman proceedings recognized as foreign main proceedings or, if denied, as foreign nonmain proceedings. In either case they sought injunctive protection of the funds and their U.S. assets, the right to take discovery and the turnover of U.S. assets to the Cayman liquidators.

The liquidators premised their request for recognition as foreign main proceedings on the funds' Cayman registration and domicile. Chapter 15 contains no definition of center of main interests but contains a presumption that, in the absence of evidence to the contrary, the debtor's registered office is its COMI. Judge Lifland found abundant evidence to the contrary in the funds' Chapter 15 pleadings: "*The Verified Petitions have demonstrated such evidence to the contrary: there are no employees or managers in the Cayman Islands, the investment manager for the Funds is located in New York, the Administrator that runs the back-office operations of the Funds is in the United States along with the Funds' books and records and prior to the commencement of the Foreign Proceeding, all of the Funds' liquid assets were located in United States.*"ⁿ⁹

The Bear Stearns funds' Chapter 15 petitions asked, in the alternative, for recognition as foreign nonmain proceedings if the Cayman proceedings were not recognized as foreign main proceedings. The same evidence proved

that the Bear Stearns funds had no establishment in the Cayman Islands and, consequently, the proceedings were ineligible for recognition as foreign nonmain proceedings. The stimulus for the funds to seek "nonmain" recognition was the *SPhinX* decision, which has been criticized and which Judge Lifland rejected as incorrect. The SPhinX Funds bought and sold securities in a manner that tracked a hedge fund index. While the SPhinX Funds were established as Cayman Islands entities, their hedge fund business was managed by a Delaware corporation located in New York; trades were executed through Refco Capital Markets, Ltd. in New York; and corporate administration (including net asset value calculation) was conducted by an unrelated entity in New Jersey. Other than gaining tax advantages from their Cayman Islands' domicile, the SPhinX Funds had little to do with the Caymans. There were no employees, no physical offices, no directors or directors meetings, no assets, no securities or commodities trading; only minute books, statutory documents and investor documents necessary to comply with anti-money laundering requirements.

There were two attempts at Chapter 15 recognition made by two sets of Cayman liquidators of SPhinX. Both were for the clear purpose of disrupting a settlement of litigation brought against SPhinX on behalf of Refco to recover allegedly preferential payments made by Refco to Sphinx. The first Cayman liquidation case was dismissed when its provisional liquidators failed to block bankruptcy court approval of the settlement. The second Cayman case and the request for Chapter 15 recognition is the subject of a reported decision by Bankruptcy Judge Robert Drain, also in the Southern District of New York. Judge Drain indicates that, but for the improper purpose of the Chapter 15 filing, he might have recognized the case as a foreign main proceeding because the funds were registered in the Caymans, they had to be wound up somewhere and no one really objected to a Cayman liquidation. However, the Court declined to designate the SPhinX Funds proceedings as foreign main proceedings because they were filed for the improper purpose of obtaining the section 362 automatic stay to block an appeal of the settlement.

En route to this conclusion, the judge decided that he could initially enter an order of recognition without deciding that the proceedings were main or nonmain. This approach ignores the statute and avoids the mandatory eligibility test: does the debtor have its COMI or an establishment in the Cayman Islands? Having "recognized" the Cayman proceedings in the abstract and then declined to consider them foreign main proceedings, the Court defaulted to the position that they are foreign nonmain proceedings. He then declined to grant any relief. Ultimately, the parties were left in the same position as if recognition had been denied due to the ineligibility of the Cayman proceedings. However, the proper interpretation and application of the statute were compromised. The Bankruptcy Court's decision has been affirmed on appeal but on a record where no party presented the eligibility issue to the appellate court. n10

Judge Lifland acknowledged his disagreement with the *SPhinX* decisions: "I recognize that portions of this holding are at odds with the decisions in *SPhinX*, both the bankruptcy court's decision and the district court's affirmance. However, neither of those courts addressed the establishment' requirement." n11 In his conclusion, Judge Lifland included an invitation to the parties to commence "full" U.S. proceedings under Chapter 7 or Chapter 11 and left a protective injunction in place for 30 days to permit such a filing. n12

The parties appealed and sought a stay of the injunction predicated on preventing the appeal from being rendered moot and presenting allegedly new facts regarding the funds' activities in the Caymans. Judge Lifland noted that mootness "*goes both ways*" and expressed displeasure that the funds had directed over \$8 million in payments to the Caymans after the Chapter 15 filing and the grant of an injunction that protected those payments from attack by parties in the United States. He referred to the "*injunction imbalance*" created by removal of monies from the U.S. during the initial injunctive period and also rejected the merits of the "new facts." The stay was granted, however, on the grounds that matters of first impression were involved in the case and on condition that the removed payments be returned and no further monies be removed from the U.S. in order to ensure that there was "*evenhanded concern with respect to the injunction.*"

The next chapter of this serial thriller may emerge from the recently filed and now pending chapter 15 petition of the Basis Yield Alpha Fund. n13 The Basis Yield Chapter 15 petition states that the funds' administration is conducted in the Caymans but that it has over \$50 million in the United States. It may be that Basis Yield actually has its COMI or an establishment in the Caymans but the record is currently incomplete. Stay tuned.

For further discussion on Orders Granting Recognition, see Collier on Bankruptcy, ch. 1517 (Matthew Bender).

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Return to Text

n1 . *In re SPhinX, LTD.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), affirmed *Krys v. Official Comm. of Unsecured Creditors of Refco Inc. (In re SPhinX, Ltd.)*, 371 B.R. 10 (S.D.N.Y. 2007).

n2

[2]. Tim Ridley, Chairman of Cayman Islands Monetary Authority, as quoted in "US Ruling Could Impact Hedge Funds" by James Dimond, <http://www.cayCompass.com>, 9/5/07.

n3

[3]. *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007).

n4

[4]. The draftsmen of the Model Law and Chapter 15 included Dan Glosband, the author of this article, Professor Jay Westbrook of the University of Texas Law School, Judge Lifland and a consulting group of insolvency professionals, representatives of governmental entities and academics.

n5

[5]. The definition of "foreign proceeding" is in 11 U.S.C. § 101(23), the general definition section of the Bankruptcy Code: " foreign proceeding' means a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation" The foreign representative must also be a person or body that meets the definitional requirements of 11 U.S.C. § 101(24): "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding" See Collier Bankruptcy Practice

Guide, ch. 19 (Matthew Bender).

n6

[6]. *11 U.S.C. § 1502*. Definitions:

(4) foreign main proceeding' means a foreign proceeding pending in the country where the debtor has the center of its main interests;

(5) foreign nonmain proceeding' means a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment

See Collier on Bankruptcy, P 1502.LH (Matthew Bender).

n7

[7]. Headlines, respectively: 6/20/07 Wall Street Journal; 6/21/07 New York Times; 6/25/07 Wall Street Journal; 8/1/07 Associated Press.

n8

[8]. Ben Mays, Maples & Calder, and Tom Ridley quoted in Dimond article, *supra*.

n9

[9]. *374 B.R. at 130*.

n10 . *Krys v. Official Comm. of Unsecured Creditors of Refco Inc. (In re SPhinX, Ltd.)*, 371 B.R. 10 (S.D.N.Y. 2007).

n11

[11]. *374 B.R. at 131*.

n12

[12]. 374 B.R. 133.

n13

[13]. *In re Basis Yield Alpha Fund*, Case # 07-12762 (Bankruptcy S.D.N.Y. 2007).

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111 of 197 DOCUMENTS

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Collier on the Duties of a Chapter 7 Trustee Added by BAPCPA

2008 Emerging Issues 1479

Collier on the Duties of a Chapter 7 Trustee Added by BAPCPA

By Collier

December 13, 2007

SUMMARY: This Emerging Issues Analysis discusses when the notice is required and the apparent distinction under subsection 704(a)(10) in the situation when the debtor is the obligor on such an obligation, and the converse situation when the debtor is the obligee.

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ARTICLE: Added by BAPCPA

Trustee's Duty to Give Notices Regarding Domestic Support Obligations;

§ 704(a)(10)

Bankruptcy Code section 704(a)(10), added by the 2005 amendments to the Bankruptcy Code, n1 requires the trustee to provide certain notices in cases in which there is a claim with respect to the debtor for a domestic support obligation. n2 Although the language of this provision is not entirely clear, it appears from section 704(c) and the legislative history that the requirement only applies when the debtor is the obligor on such an obligation, and not when the debtor is the obligee. Section 524(c) speaks of the holder of a claim and the legislative history speaks of a domestic support claimant, n3 both of which suggest application to a person who has a claim against the debtor. Virtually identical provisions were also added in 2005 to chapters 11, 12 and 13. n4

The obvious purpose of these provisions is to enhance the ability of child support

claimants and state child support enforcement agencies to assert their claims in the bankruptcy process and after bankruptcy, in order to compete with the enhanced rights of other creditors under the 2005 amendments.

Notice of Child Support Enforcement Agency Services and Bankruptcy Rights; § 704(c)(1)(A). The trustee is required by section 704(c)(1)(A) to provide to the holder of a domestic support obligation claim written notice that the claimant is entitled to use the services of the state child support enforcement agency established under sections 464 and 466 of the Social Security Act to obtain assistance in collecting support in bankruptcy and afterwards. n5 Such agencies

exist in every state, as part of the federal government's effort to facilitate the collection of child support. However, because the definition of domestic support obligation goes beyond child support, n6 such agencies could not assist in the collection of every domestic support obligation. The notice is to include the address and telephone number of the child support enforcement agency.

The notice provided to the domestic support claimant must also include an explanation of the rights of the holder of the claim to payment in chapter 7. n7 Presumably, this would include instructions concerning how to file a timely proof of claim if proofs of claim are to be filed in the case. In the vast majority of chapter 7 cases, no proofs of claim are filed because there are no nonexempt assets to distribute. Although not within the statutory language, which is limited to information about payment of the claim under chapter 7, the notice may also include information about the automatic stay and dischargeability.

Presumably, a form of notice will be drafted by the United States trustee program, which supervises trustees.

Notice to State Child Support Agency; § 704(c)(1)(B). The trustee must also provide written notice to the state child support enforcement agency of the existence of the claim against the debtor, and include in the notice the name, address and telephone number of the holder of the claim. n8 The statute does not say how the trustee is to obtain the telephone number of the claim holder, which is not listed in any papers filed in the case. Although the schedules could perhaps be changed to include this information, many holders of domestic support obligations would probably not appreciate their phone numbers being made available in public records. The trustee could also inquire about the telephone number at the meeting of creditors, although the debtor may not know the number. Presumably, this information is to be sent in case the child support agency wants to become involved in the case, perhaps because the claim has been assigned to it or because it has assisted the claimant in the past.

Notice at Time of Discharge; § 704(c)(1)(C). The trustee is required to send another notice at the time the debtor is granted a discharge. This notice is to be sent to the domestic support obligee and to the state child support enforcement agency. n9 This notice is to inform its recipients of the granting of the discharge, the last known address of the debtor, the last known address of the debtor's employer, and the name of each creditor that holds a claim that is not discharged under section 523(a)(2), (4) or (14A) or that was reaffirmed. n10 Again, the purpose of this notice is presumably to facilitate child support collection, especially in cases in which there exist nondischarged or reaffirmed debts held by creditors that will be competing with the support claimant for the debtor's limited assets and income.

Request for Address of Debtor; § 704(c)(2). Section 704(c)(2)(A), also added in 2005, n11 permits the holder of a domestic support obligation claim or a state child support obligation agency to request the debtor's last known address from a creditor holding a claim that is not discharged under section 523(a)(2), (4) or (14A) or that was reaffirmed. This provision was likely added in recognition that large national creditors often have more sophisticated collection facilities that may give them an advantage in competing with child support creditors. However, to give the provision some meaning, courts may read into it an implication that the creditor must respond to the request.

In the unlikely event that the creditor does respond to the request, the creditor is protected from liability for disclosing the debtor's address, notwithstanding any other provision of law, by section 704(c)(2)(B). Such liability could otherwise be substantial, at least in occasional cases. It is possible for example that a child support creditor may have been the abuser in a domestic violence case, and that the debtor may have been a victim who had fled from the abuser. Although the debtor might have been able to protect her identifying information under section 107(c), n12 the debtor may not have known to seek such protection. The possibility of becoming involved in such situations is likely to discourage creditors from responding to requests for address information.

Duties to Perform Obligations of Employee Benefit Plan; § 704(a)(11)

Section 704(a)(11), added by the 2005 amendments to the Bankruptcy Code, n13 requires the chapter 7 trustee to

perform the obligations required of the administrator of an employee benefit plan if the debtor, or an entity designated by the debtor, served as administrator at the time the case was commenced. The provision incorporates the definition of administrator in section 3 of the Employment Retirement Income Security Act of 1974 (ERISA). n14

The enactment of section 704(a)(11) was accompanied by a companion amendment to section 1106 providing that if the debtor was serving as a plan administrator at the time the case was commenced, the chapter 11 trustee must continue to perform those obligations. n15 There was no similar amendment with respect to chapter 12 or chapter 13.

These amendments largely resolve confusion in the case law regarding responsibility for plan administration after a bankruptcy case is filed. The court in *In re New Center Hospital* n16 had held, consistent with the new provisions, that a chapter 11 trustee assumes the duties of a plan administrator. However, an earlier decision, *Chambers v. Kaleidoscope, Inc. Profit Sharing Plan & Trust*, n17 had held that in a chapter 11 case, even though a trustee had been appointed, the prebankruptcy administrator continued to have fiduciary duties as an administrator because he had not resigned pursuant to ERISA.

Transfer of Patients of a Closing Health Care Business; § 704(a)(12)

Under section 704(a)(12), enacted by the 2005 Code amendments, n18 a chapter 7 trustee has the obligation to use all reasonable efforts to transfer patients n19 from a closing health care business n20 to another appropriate health care business. The new health care business should be in the vicinity of the health care business that is closing, provide substantially similar services, and maintain a reasonable quality of care.

Section 704(a)(12) was part of a package of amendments clarifying that patients of failing health care providers must be protected. n21 These include provisions specifying requirements for the disposal of patient records so that a patient's privacy and the confidentiality of such records are protected. n22 In addition, the amendments added a provision granting administrative expense priority to the actual, necessary costs and expenses of closing a health care business, including the disposal of patient records or transfer of patients, incurred by a trustee, federal agency, or a department or state agency. n23 If warranted, the court is required to order the appointment of an ombudsman to monitor the quality of patient care and to represent the interests of the patients. n24

Duties of United States Trustee in Relation to Section 707(b)(2)

Although section 704, prior to 2005, had been concerned with duties of chapter 7 trustees, the 2005 amendments added a new subsection (b) that sets forth duties of the United States trustee, or Bankruptcy Administrator, if any, n25 in cases of all individual debtors. n26 These duties pertain to the determination of whether a chapter 7 case is an abuse as defined by section 707(b) and, in particular, the presumption of abuse under section 707(b)(2). n27

Statement of Whether Presumption of Abuse Exists; § 704(b)(1). The first duty is to review the materials filed by each individual debtor and, not later than 10 days after the date of the meeting of creditors, file with the court a statement as to whether the case is presumed to be an abuse under section 707(b). n28 The materials to be reviewed would include the schedules and statements filed by the debtor, which would include calculations of current monthly income and, if the debtor's income is over the applicable state median income, calculations regarding the means test presumption of abuse. n29 The materials would also include evidence of payment from employers filed by the debtor and a tax return or tax transcript provided by the debtor to the trustee. n30 Because this duty is given to the United States trustee, it is unclear whether the chapter 7 trustee has any duty to review these documents or whether the United States trustee may or will delegate some of these duties to the chapter 7 trustee.

The statement must be filed by the United States trustee in every case, although the presumption of abuse can only arise in a case in which the debtor's current monthly income is above the state median income threshold in section 707(b)(7). n31 In cases in which the debtor is protected from the presumption of abuse by section 707(b)(7), the United States trustee should file a statement that no presumption of abuse arises.

The statement must be filed within 10 days after the date of the first meeting of creditors. The first meeting of creditors is a term sometimes used in the past to refer to the section 341(a) meeting of creditors. The language is somewhat unclear, but logically it makes sense to read this deadline as running from the conclusion of the meeting of creditors, rather than the first date set for the meeting of creditors, which is specifically referenced in some other Code provisions enacted at the same time. n32 Otherwise, if the debtor is unable to attend the meeting on the first date set, or provide all necessary documents, the United States trustee might not have all of the materials necessary to make an accurate determination.

The court is to provide a copy of the statement filed by the United States trustee to all creditors within five days after it is filed. n33 Presumably, this is to give creditors an opportunity to file their own motions to dismiss under section 707(b)(2), if they are eligible to do so. n34 However, it is likely that most creditors will wait to see if the United States trustee files a motion, thereby saving them the expense.

Duty to File Motion to Dismiss or Statement Why Motion Not Appropriate;

§ 707(b)(2). Within 30 days of filing the statement required by section 704(b)(1), n35 the United States trustee must take one of two actions if the presumption of abuse under section 707(b)(2) exists in the case. n36 The United States trustee must either file a motion to dismiss or convert the case under section 707(b) or file a statement of the reasons why the United States trustee does not consider such a motion appropriate. Such reasons may include, for example, that the United States trustee believes the debtor has demonstrated special circumstances that would rebut the presumption. Alternatively, the amount by which the debtor's income exceeds the presumption amount may be de minimus or the debtor's circumstances may demonstrate a compelling need for relief despite the presumption.

The requirement to file a motion or notice only arises if the debtor's current monthly income n37 exceeds the highest state median family income n38 for a family of the same number or fewer individuals or, in the case of a debtor in a one person household, the state median family income for one earner. However, since the presumption of abuse can only arise with respect to a debtor whose current monthly income exceeds the median income thresholds in section 707(b)(7), this language is unnecessary. To the extent the median income language differs from section 707(b)(7) in not including a \$525 per month increment for each member of a family in excess of four members, therefore, the difference is of no consequence.

For a complete discussion of Code section 704, see Collier on Bankruptcy, ch. 704 (Matthew Bender).

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[Return to Text](#)

n1 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 219(a) (2005), effective in cases commenced on or after October 17, 2005.

n2 2. Domestic support obligation is defined in 11 U.S.C. § 101, as amended by Pub. L. No. 109-8, § 211(a) (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 101 (Matthew Bender).

n3 3. H.R. Rep. No. 109-31, 109th Cong., 1st Sess., 62 (2005).

n4 4. 11 U.S.C. §§ 1106(a)(8), (c), 1202(b)(6), (c), 1302(b)(6), (d), all added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 1106, ch. 1202 and ch. 1302 (Matthew Bender).

n5 11 U.S.C. § 704(c)(1)(A)(i), added by Pub. L. No. 109-8, § 219(a)(2) (2005), effective in cases commenced on or after October 17, 2005.

n6 See *Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n7 11 U.S.C. § 704(c)(1)(A)(iii), added by Pub. L. No. 109-8, § 219(a)(2) (2005), effective in cases commenced on or after October 17, 2005.

n8 11 U.S.C. § 704(c)(1)(B), added by Pub. L. No. 109-8, § 219(a)(2) (2005), effective in cases commenced on or after October 17, 2005.

n9 11 U.S.C. § 704(c)(1)(C), enacted by Pub. L. No. 109-8, § 219(a)(2) (2005), effective in cases commenced on or after October 17, 2005.

n10 11 U.S.C. § 704(c)(1)(C)(i)-(iv), enacted by Pub. L. No. 109-8, § 219(a)(2) (2005), effective in cases commenced on or after October 17, 2005.

n11 Pub. L. No. 109-8, § 219(a)(2) (2005), effective in cases commenced on or after October 17, 2005.

n12 11 U.S.C. § 107(c), added by Pub. L. No. 109-8, § 234(a) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 107.04 (Matthew Bender).

n13 Pub. L. No. 109-8, § 446(b) (2005), effective in cases commenced on or after October 17, 2005.

n14 29 *U.S.C. § 1002(16)* defines administrator.

n15 11 *U.S.C. §§ 704(a)(11), 1106(a)(1)*, as added or amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n16 200 *B.R. 592 (E.D. Mich. 1996)*.

n17 650 *F. Supp. 359 (N.D. Ga. 1986)*.

n18 Pub. L. No. 109-8, § 1105(a) (2005), effective in cases commenced on or after October 17, 2005.

n19 Patient is defined in 11 *U.S.C. § 101*, as amended by Pub. L. No. 109-8, § 1101(b) (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 101 (Matthew Bender).

n20 Health care business is defined in 11 *U.S.C. § 101*, as amended by Pub. L. No. 109-8, § 1101(a) (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 101 (Matthew Bender).

n21 See H.R. Rep. No. 109-31, 109th Cong. 1st Sess., 21 (2005).

n22 11 *U.S.C. § 351*, enacted by Pub. L. No. 109-8, § 1102(a) (2005), effective in cases commenced on or after October 17, 2005.

n23 *11 U.S.C. § 503(b)(8)*, added by Pub. L. No. 109-8, § 1103 (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 503 (Matthew Bender).

n24 *11 U.S.C. § 333*, added by Pub. L. No. 109-8, § 1104(a)(1) (2005), effective in cases commenced on or after October 17, 2005.

n25 The Bankruptcy Administrator performs most of the duties of a United States trustee in cases filed in Alabama and North Carolina, where the United States trustee program is not operational. References to the United States trustee in this chapter shall be deemed to include the Bankruptcy Administrators in those states.

n26 *11 U.S.C. § 704(b)*, added by Pub. L. No. 109-8, § 102(c) (2005), effective in cases commenced on or after October 17, 2005.

n27 See Collier on Bankruptcy, ch. 707 (Matthew Bender).

n28 *11 U.S.C. § 704(b)(1)(A)*, enacted by Pub. L. No. 109-8, § 102(c) (2005), effective in cases commenced on or after October 17, 2005.

n29 *11 U.S.C. §§ 521(a)(1), 707(b)(2)(C)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n30 *11 U.S.C. § 521(a)(1)(iv), (e)(2)(A)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n31 *11 U.S.C. § 707(b)(7)*, enacted by Pub. L. No. 109-8, § 102(a) (2005), effective in cases commenced on or after October 17, 2005, prohibits the use of the presumption of abuse if the debtor's current monthly income is below a certain income threshold; see Collier on Bankruptcy, ch. 707 (Matthew Bender).

n32 E.g., *11 U.S.C. § 521(e)(2)(A)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n33 *11 U.S.C. § 704(b)(1)(B)*, enacted by Pub. L. No. 109-8, § 102(c) (2005), effective in cases commenced on or after October 17, 2005.

n34 Under *11 U.S.C. § 707(b)(7)*, added by Pub. L. No. 109-8, § 102(a) (2005), effective in cases commenced on or after October 17, 2005, creditors may only file a motion to dismiss if the debtor's current monthly income is above a certain income threshold; see Collier on Bankruptcy, ch. 707 (Matthew Bender).

n35 See Statement of Whether Presumption of Abuse Exists; § 704(b)(1) *supra*.

n36 *11 U.S.C. § 707(b)(2)*, creating a presumption of abuse for certain chapter 7 cases, was added by Pub. L. No. 109-8, § 102(a) (2005), effective in cases commenced on or after October 17, 2005.

n37 Current monthly income is defined in *11 U.S.C. § 101*, as amended by Pub. L. No. 109-8, § 102(b) (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 101 (Matthew Bender).

n38 Median family income is defined in *11 U.S.C. § 101*, as amended by Pub. L. No. 109-8, § 102(k) (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 101 (Matthew Bender).

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112 of 197 DOCUMENTS

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Collier on Disclosure Statements in Small Business Cases

2008 Emerging Issues 1480

Collier on Disclosure Statements in Small Business Cases

By Collier

December 13, 2007

SUMMARY: This Emerging Issues Analysis covers the definition of a small business case in section 101 of the Bankruptcy Code and the application of section 1125(f), including the conditional approval of a disclosure statement.

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ARTICLE: *Section 1125(f)(1) of the Bankruptcy Code*, as amended in 2005, n1 provides that if the case is a small business case, as that term is defined in *section 101 of the Bankruptcy Code*, n2 the court may determine that the plan itself provides adequate information and that a separate disclosure statement is not necessary. In addition, section 1125(f)(2), also added in 2005, provides that the court may approve a disclosure statement submitted on standard forms approved by the court or adopted under section 2075 of title 28, which is the Rules Enabling Act. n3

Finally, under section 1125(f)(3), the court, subject to final approval after notice and a hearing, may conditionally approve a disclosure statement as the basis for solicitation of votes on a plan. Provided that the conditionally approved disclosure statement is mailed not later than 25 days before the date of the hearing on confirmation of the plan, the court may conduct a combined hearing for final approval of the disclosure statement and confirmation of the plan.

The Bankruptcy Reform Act of 1994 n4 added subsection (f) to section 1125 to provide special treatment for a small business debtor seeking reorganization under chapter 11. To qualify for the special treatment, which was intended to make the process less expensive and more expeditious, the debtor must have been within the definition of small business debtor and must have elected to be considered a small business debtor. As amended in 2005, however, section 1121(e), n5 dealing with who may file a plan, no longer requires such election by a small business debtor, and subsection (f) of section 1125, also amended in 2005, n6 no longer refers to such election.

Small Business Case Defined

Section 101 of the Code contains a definition of small business case as a case filed under chapter 11 of this title in which the debtor is a small business debtor. n7 And small business debtor is defined in section 101 as:

(A) subject to subparagraph (B), a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning

or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the date of the order for relief in an amount not more than \$2,190,000ⁿ⁸ (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

(B) [not including] any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2,190,000ⁿ⁹ (excluding debt owed to 1 or more affiliates or insiders).ⁿ¹⁰

Conditional Approval of Disclosure Statement Permitted

If eligibility exists, section 1125(f) permits the court to conditionally approve a disclosure statement, but the conditional approval is subject to a final approval after notice and hearing. Presumably, section 1125(f) means that the conditional approval does not require notice and a hearing.

Section 1125(f)(1), as revised by the 2005 Act, ⁿ¹¹ allows the court to determine that the plan itself provides adequate information and that a separate disclosure statement is not necessary. Subsection 1125(f)(2) states that the court may approve a disclosure statement on standard forms which it approves or on forms adopted by the Supreme Court. Both these subsections--suggesting that in small business cases the court may approve a plan as a disclosure statement and that standard forms may be used for disclosure statements--indicate a congressional attempt to streamline the small business chapter 11 procedures. ⁿ¹²

Vote Solicitation upon Conditional Approval

On conditional approval, acceptances and rejections may be solicited. But the debtor is required to provide adequate information to those solicited, and the conditionally approved statement is to be mailed no later than 25 days before the date of the hearing on confirmation which may be combined with the hearing on the disclosure statement.

For a complete discussion of Code section 1125, see Collier on Bankruptcy, ch. 1125 (Matthew Bender).

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ⁿ¹ 1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 431(2) (2005), effective in cases commenced on or after October 17, 2005. Section 1125(f) was added to the Bankruptcy Code by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994).

ⁿ²

2. 101 U.S.C. § 101(51C), as amended by Pub. L. No. 109-8, § 432(a) (2005), effective in cases commenced

on or after October 17, 2005.

n3

3. The language of section 1125(f)(2), by referring to section 2075 of title 28, appears to require that the Supreme Court promulgate the disclosure statement form. However, *Rule 9009 of the Federal Rules of Bankruptcy Procedure*, a rule promulgated by the Supreme Court under the Rules Enabling Act, delegates the promulgation of Official Forms to the Judicial Conference of the United States. This raises the question whether section 1125(f)(2) would be satisfied if the disclosure statement form is adopted by the Judicial Conference, but not the Supreme Court. This question appears to have been answered, however, by section 433 of the 2005 Act, which directs that within a reasonable time after the Act's effective date the Judicial Conference of the United States shall prescribe official standard form disclosure statements and plans of reorganization for small business debtors, balancing the needs of the court with economy and simplicity for debtors. Therefore, the better view is that that a disclosure statement form approved by the Judicial Conference will satisfy the requirement under section 1125(f)(2) that the form be adopted under section 2075 of title 28.

n4

4. Pub. L. No. 103-394 (1994).

n5

5. Pub L. No. 109-8, § 437 (2005), effective in cases commenced on or after October 17, 2005.

n6

6. Pub L. No. 109-8, § 431(2) (2005), effective in cases commenced on or after October 17, 2005.

n7

7. *11 U.S.C. § 101(51C)*, as amended by Pub. L. No. 109-8, § 432(a) (2005); see *Collier on Bankruptcy*, 101.51C (Matthew Bender).

n8

8. This dollar amount is subject to adjustment every three years. See *11 U.S.C. § 104(b)*; see *Collier on Bankruptcy*, 104.03 (Matthew Bender). For cases commenced before April 1, 2007, the dollar amount was

\$2,000,000.

n9

9. See note 8 *supra*.

n10

10. 11 U.S.C. § 101(51D), as added by Pub. L. No. 109-8, § 432(a) (2005); see *Collier on Bankruptcy*, 101.51D (Matthew Bender).

n11

11. Pub L. No. 109-8, § 431(2) (2005), effective in cases commenced on or after October 17, 2005.

n12

12. *Fed. R. Bankr. P. 3017.1* is intended to implement 11 U.S.C. § 1125(f).

ABOUT THE AUTHOR(S):

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113 of 197 DOCUMENTS

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Collier on Determining Reasonable Compensation under § 330

2008 Emerging Issues 1481

Collier on Determining Reasonable Compensation under § 330

By Collier

December 13, 2007

SUMMARY: This Emerging Issues Analysis covers the relevant factors to be considered by the bankruptcy court in making a determination as to the reasonableness of such fees, the application of the lodestar analysis to the determination of professional fee awards by bankruptcy courts, and the calculation of compensation for financial advisors and investment bankers.

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ARTICLE: A determination by the bankruptcy court that an applicants fees are compensable under *Bankruptcy Code section 330* does not constitute a finding as to the necessity or reasonableness of the fees. The Court of Appeals for the Ninth Circuit has explained that a finding of compensability merely means the services performed were properly charged as legal services, as opposed to administrative or otherwise nonlegal services. n1

Once services are determined to be compensable, the applicant must demonstrate that his work was necessary and reasonable. In *Unsecured Creditors Committee v. Puget Sound Plywood, Inc.*, the Court of Appeals for the Ninth Circuit held that an attorney has a duty to consider whether the burden of the probable cost of legal services is disproportionately large in relation to the size of the estate and the maximum probable recovery. n2 In *In re Cascade Oil Co.*, n3 the court held that the *section 330 of the Bankruptcy Code* determination of reasonable compensation involves three stages of inquiry: (1) whether the billed services are compensable; (2) whether the services were actual and necessary; and (3) whether the billed amounts are reasonable considering the nature, extent and value of the services provided.

Compensation authorized pursuant to section 330 is to be reasonable given the nature, the extent and the value of the services rendered. Among the relevant factors to be considered by the court in making a reasonableness determination are:

- . time spent on the services;
- . rates charged for the services;

- . necessity of the services to the administration of the case;
- . benefit of services toward the completion of the case at the time rendered;
- . amount of time spent compared with the complexity of the case;
- . importance and nature of the issues addressed; and
- . reasonableness of compensation based on the customary compensation charged by comparably skilled practitioners in nonbankruptcy cases.

Section 330(a)(3) and (4), compensation may not be awarded for unnecessarily duplicative services, services that were not reasonably likely to benefit the estate or services that were not necessary to the administration of the case.

The only significant departure from prior law under the Bankruptcy Act with respect to the factors involved in determining a reasonable compensation under section 330 is the abandonment of the strict principle of economy of the estate that dictated that professionals were not entitled to compensation at nonbankruptcy rates. n4 In other respects, the criteria are the same and prior case law remains relevant.

It has been recognized that the bankruptcy court need not review the reasonableness of compensation in every case before it, as such a requirement would be an inefficient use of both attorneys and courts time. At least courts in the Seventh Circuit have held that for routine chapter 7 and chapter 13 bankruptcy cases in which the fees do not exceed a certain amount, the court may deem such fees to be reasonable without further review. n5

The *Johnson* Factors

The leading cases with regard to the factors to be considered in determining a reasonable allowance of compensation are *Johnson v. Georgia Highway Express, Inc.*, a nonbankruptcy case, n6 and *In re First Colonial Corp. of America*, a bankruptcy case that adopted the analysis of the *Johnson* court. n7 The *Johnson* court listed twelve factors to be considered in determining and awarding reasonable attorneys fees in a Title VII class action. n8 The *Johnson* interpretation of this reasonableness standard has been relied upon, with certain modifications, by courts determining the reasonableness of compensation under both the Bankruptcy Act and under the Bankruptcy Code. Many courts continue to follow *Johnson*. n9 A majority of the *Johnson* criteria are now codified in section 330(a)(3). The *Johnson* court considered the following twelve factors to be relevant to a determination of the reasonableness of attorneys fees:

1. the time and labor required;
2. the novelty and difficulty of the questions presented by the case;
3. the skill requisite to perform the legal services properly;
4. the preclusion of other employment by the attorney due to acceptance of the case;
5. the customary fee for similar work in the community;
6. whether the fees are fixed or contingent;
7. time pressures imposed by the client or the circumstances;
8. the amount involved and the results obtained as a result of the attorneys services;
9. the experience , reputation and ability of the attorneys;

10. the desirability of the case;
11. the nature and length of the professional relationship with the client; and
12. awards in similar cases.

The *Johnson* court noted that it was the applicants burden to demonstrate his entitlement to an award for attorneys fees under the above criteria.

Spirit of Economy Factors. The Court of Appeals for the Fifth Circuit applied these factors to a bankruptcy case in *In re First Colonial Corp. of America*.ⁿ¹⁰ The court explained that, although *Johnson* involved an award of attorneys fees under Title VII, the twelve *Johnson* factors were applicable in bankruptcy cases because the guidelines we established there are equally useful whenever the award of reasonable attorneys fees is authorized by statute.ⁿ¹¹ The *First Colonial* court added the spirit of economy as a key factor to be considered in determining the reasonableness of fees under the Bankruptcy Act. The court explained that the spirit of economy requires that fee awards in bankruptcy cases be at the lower end of reasonableness in view of the fact that attorneys assisting in the administration of a debtors estate are acting as officers of the court and should not be compensated as generously as they might be if privately employed.

Economy Factor Abandoned under the Code. The economy factor was abandoned under the Bankruptcy Code in favor of the new policy that attorneys engaged in bankruptcy cases should receive compensation in parity with that received by attorneys performing services in comparable situations. The legislative history of section 330 reflects this significant shift in policy, observing that notions of economy of the estate in fixing fees are outdated and no longer have a place under bankruptcy law.ⁿ¹² The original *Johnson* factors, as embraced by *First Colonial*, remain applicable to the determination of the reasonableness of fees awarded under the Code.

The Lodestar Analysis. In determining the award of reasonable compensation under section 330, courts also have applied a lodestar analysis. Calculating the lodestar rate involves a two-step process, in which courts determine the *reasonable number of hours expended and then multiply that number by the appropriate hourly billing rate*. The resulting figure is the allowable amount of compensation. In calculating the appropriate number of hours, courts generally do not permit minimum incremental billing time.ⁿ¹³ Once the appropriate lodestar amount is established, the next step is a determination as to whether an enhancement or reduction of the fee is warranted. The lodestar analysis merely is the starting point from which a fee determination is made.ⁿ¹⁴

In making professional fee awards, bankruptcy courts should either expressly apply the lodestar method or expressly determine that the lodestar method is inappropriate under the circumstances.ⁿ¹⁵ Examples of such inappropriate circumstances may include routine chapter 13 cases, which are more susceptible to a flat, fixed rate approach, based on all relevant factors.ⁿ¹⁶

Appropriate Hourly Billing Rate. The lodestar analysis is essentially a formula. One significant variable in that formula is the appropriate hourly billing rate to be applied by the court. This issue is highlighted by large and complex bankruptcy cases involving professionals from various parts of the country with differing billing rates. In these national cases, courts must decide which rate should be used in determining the prevailing market rate.

National or Local Standards. Some courts have held that the community in which the applicant normally practices, rather than the community local to the court, should be used as the model to determine the prevailing market rate.ⁿ¹⁷ At least one court has recognized that limiting rates to those customarily charged locally would be contradictory to the bankruptcy policy of attracting experienced professionals to bankruptcy cases, regardless of where the case is pending.

n18 Other courts have reached a different conclusion, determining that the local rate in the forum should govern. This is particularly true when there is no evidence that qualified professionals based in the local forum were not available to render services in the particular case. n19

Market Driven Approach. Another interpretation has been advanced by the Court of Appeals for the Third Circuit, which has held that section 330 presents a market-driven approach for determining reasonable compensation, when the cost of comparable services is the most important of the various factors applied by a court. In *In re Busy Beaver Building Centers, Inc.*, n20 the court disapproved of an approach that allows a court confronted with undisputed, credible, contrary evidence of market prices in the record to rely solely on its own judgment. The *Busy Beaver* court explained that reliance on an applicable market rate is tempered by the bankruptcy courts review of the fee application, which it analogized to a sophisticated nonbankruptcy client reviewing the bill of a professional. n21

At least one court has concluded that there is a strong presumption that the lodestar product is reasonable compensation. n22 In addition, in *In re Boddy*, n23 the Court of Appeals for the Sixth Circuit required the use of the lodestar calculation to determine attorneys fees in bankruptcy cases. The bankruptcy court in *Boddy* had relied on an earlier opinion that established a maximum attorneys fee of \$650 for legal services considered to be normal and customary for a chapter 13 case in the Western District of Kentucky. n24 According to the bankruptcy court, the normal and customary legal services in a chapter 13 case included:

- . drafting and filing the debtors petition, schedules and plan;
- . attending the section 341 meeting of creditors and confirmation hearing;
- . drafting and filing notice and orders for the allowance and barring of claims; and
- . performing other services in furtherance of concluding the administration of the case.

The Sixth Circuit rejected the bankruptcy courts reliance on the established maximum fees as arbitrary and contrary to section 330. The Sixth Circuit held that by awarding a predetermined amount, the bankruptcy court erred in not applying the lodestar.

Some courts have concluded that the lodestar method accurately calculates the correct reasonable compensation without regard to the *Johnson* factors. n25 In *In re East Peoria Hotel Corp.*, n26 however, the court held that it need not choose between the lodestar approach or the *Johnson* factors, as the end results would be the same. n27 To the extent that the *Johnson* factors have been incorporated into section 330 by the 1994 Bankruptcy Reform Act, bankruptcy courts are required to consider such factors in making a determination of reasonable compensation.

Compensation of Financial Advisors. A number of courts have noted the difficulty in assessing the reasonable compensation for financial advisors and investment bankers due to the manner in which they ordinarily bill their time in nonbankruptcy matters. For example, the court in *In re Drexel Burnham Lambert Group, Inc.*, n28 stated that this difficulty is because:

- . the retention applications of investment bankers and financial advisors are shortened versions of presentations made to debtors and committees;
- . fee applications generally do not contain the detail usually found in the applications of attorneys and accountants; and
- . the scope of their services are not familiar to bankruptcy judges.

In addition, the court found that requests for compensation by investment bankers and financial advisors often are difficult to determine because they generally do not bill by the hour and there is a reluctance to maintain time records even in half-hour increments. The bankruptcy court in *Drexel Burnham* disapproved of the rate structure of the investment bankers and financial advisors retained in chapter 11 cases, stating that a trend has developed with respect to fees charged by such professionals, which the court deemed oligopolistic behavior at best and incestuous fee-setting practices at worst. n29 Based on information furnished regarding the compensation arrangements made by these professionals in other chapter 11 cases, the court found that the vast majority not only seek sizeable monthly retainers regardless of the size of the case, the party represented, or the complexity of the case, but also occasionally ask for indemnification. As a result, the court implemented the following requirements for applications to retain investment bankers and financial advisors:

- . a presentation of the scope and complexity of the assignment, its anticipated duration, expected results, required resources, the extent to which highly specialized skills may be needed and the extent to which such professional has them or may be able to obtain them;

- . the actual retention agreement between the investment banker/financial advisor and the client must be attached to the retention application;

- . the party retaining the professional must describe the process by which the investment banker/financial advisor has been selected; and

- . the application must explain how the investment banker/financial advisor will eliminate, or at least reduce, the duplication or effort among armies of professionals. The *Drexel* court reasoned that it would be able to measure the results achieved (or lack thereof) only with an advance picture of the job to be accomplished. n30

A number of courts have dealt with issues that arise with respect to the manner in which financial advisors charge for fees and expenses under section 330. For example, in *In re Commercial Financial Services, Inc.*, n31 an official creditors committee consisting of holders of asset-backed securities retained a financial advisor. The financial advisor was retained on terms that provided for a fixed monthly fee. The order authorizing its employment also required the firm to maintain time records. At the conclusion of the case, the firm filed its request for an award of fees and expenses, requesting the monthly fee multiplied by the number of months it had been retained. There was an objection, and the court held that the hourly rates derived from dividing the monthly fee by the numbers of hours spent on specific tasks was unreasonably high, and reduced the award by approximately 50 percent. The court compared the implied hourly rates for the financial advisor to the hourly rates charged by other financial advisors in the case who billed by the hour, and reduced the fees to a level where the hourly rate would be comparable. The financial advisor appealed, arguing that its fees were reasonable because charging a fixed fee per month is common marketplace practice. The court held that the monthly rate did not avoid the requirement that the fee be reasonable. Accordingly, the court held that the bankruptcy court was correct in assessing the reasonableness of the fee by reference to the actual number of hours worked.

In contrast, in *Miller Buckfire & Co. LLC v. Citation Corp.*, n32 the debtor retained a financial advisor on terms that provided for a monthly fee and a restructuring fee. A restructuring took place, and the firm filed its application for fees based on the restructuring fee. The bankruptcy court denied the request and instead applied an hours-based analysis to the allowance of the fee. On appeal, the district court reversed the disallowance, holding that, in assessing the reasonableness of the fees by reference to the hours worked, the bankruptcy court impermissibly rewrote the contract.

Compensation for Litigation of Retention and Compensation Orders. The responsibility for assuring the reasonableness of compensation to those rendering services in connection with bankruptcy cases belongs to the court and to the United States trustee. Section 330(a)(2) expressly provides that the court may, on its own motion or that of a party in interest, award compensation that is less than the amount of compensation that is requested by the professional.

The findings of the court as to the amount of compensation will normally not be disturbed unless they are clearly erroneous, reflect a mistake of law, or result in some injustice or gross inequity. n33

Denial of Compensation for Defending Fee Awards. Professionals may be denied compensation for time spent appealing decisions related to their retention or compensation. For example, in *Grant v. George Schumann Tire & Battery Co.*, n34 the Court of Appeals for the Eleventh Circuit denied the request of the trustees attorney for compensation incurred in defending against the debtors appeal of the attorneys fee award. The *George Schumann* court declined to read section 330 as implying a prevailing party test that would require an award of compensation when the applicant has been successful in his or her appeal. Rather, the court applied the reasonable and necessary language of section 330 to the facts before it. As the sole issue in the appeal for which compensation was sought was attorneys fees, the court found that there was absolutely no benefit to the estate, the creditors, or the debtor and denied the request for compensation. Similarly, in *In re Watervliet Paper Co.*, n35 the court held that the debtors attorneys were not entitled to compensation for their time spent pursuing an appeal of an order of the bankruptcy court that had conditioned the attorneys retention upon a waiver of their prepetition claim against the debtor. In denying compensation for 93 hours incurred in furtherance of the appeal, the court stated that such time did not benefit the estate, but rather, only benefited the law firm. n36

Compensation for Appeal of Fee Award. Other courts, however, have allowed compensation when the appeal of an order denying compensation or retention has been successful. For example, in *Nunley v. Jessee*, n37 the district court explicitly found that the language of section 330 does not preclude awards of compensation for litigation over fee awards on appeal. The court recognized the rule in other types of civil cases in which attorneys fees are statutorily allowed that litigants who prevail on fee awards initially are entitled to additional fees required to defend such awards. n38 Concluding that there is no reason to treat bankruptcy cases differently from cases arising in other contexts, the district court allowed compensation for fees incurred by debtors attorney in defending a fee award. n39

Similarly, the Court of Appeals for the Ninth Circuit has held that failure to grant fees for successfully defending challenges to an authorized fee application would dilute fee awards, in violation of section 330(a), and this would reduce the effective compensation of bankruptcy attorneys to levels below the compensation available to attorneys generally. n40

For a complete discussion of Code Section 330, see Collier on Bankruptcy, ch. 330 (Matthew Bender).

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Return to Text

n1 1. *Unsecured Creditors Comm. v. Puget Sound Plywood, Inc.*, 924 F.2d 955, 24 C.B.C.2d 1147 (9th Cir. 1991).

n2

2. 924 F.2d 955, 961, 24 C.B.C.2d 1147, 1154 (Absent unusual circumstances, an attorney must scale his or

her fee at least to the reasonably expected recovery.). *Accord In re Riverside-Linden Inv. Co.*, 925 F.2d 320, 322, 24 C.B.C.2d 1210, 1212 (9th Cir. 1991) ([W]hen a cost benefit analysis indicates that the only parties who will likely benefit from an investigation of a claim are the trustee and his professionals, investigation is unwarranted.).

n3

3. 126 B.R. 99 (D. Kan. 1991).

n4

4. *See In re UNR Indus., Inc.*, 986 F.2d 207, 208 (7th Cir. 1993); *In re Drexel Burnham Lambert Group, Inc.*, 133 B.R. 13, 17 (Bankr. S.D.N.Y. 1991) (principles of economy of the estate and conservation prevents retained professionals under the Bankruptcy Act, as officers of the court and public servants, from being awarded compensation at rates equal to those engaged in private employment).

n5

5. *See, e.g., In re Kindhart*, 167 F.3d 1158 (7th Cir. 1999) (setting the threshold for review in chapter 13 cases at \$1000 per case); *In re Geraci*, 138 F.3d 314 (7th Cir. 1998) (affirming the bankruptcy courts determination that \$800 per case is presumptively reasonable in simple no-asset chapter 7 cases).

n6

6. 488 F.2d 714 (5th Cir. 1974).

n7

7. 544 F.2d 1291, 11 C.B.C. 131 (5th Cir.), *cert. denied*, 431 U.S. 904, 97 S. Ct. 1696, 52 L. Ed. 2d 388 (1977).

n8

8. Title VII requires that attorneys fees be reasonable. 42 U.S.C.A. § 2000, *et seq.*

n9

9. See, e.g., *Grant v. George Schumann Tire & Battery Co.*, 908 F.2d 874, 23 C.B.C.2d 708, 711 (11th Cir. 1990); *In re Permian Anchor Servs., Inc.*, 649 F.2d 763 (10th Cir. 1981); see also *In re Malewicki*, 142 B.R. 353 (Bankr. D. Neb. 1992); *In re Gillett Holdings, Inc.*, 137 B.R. 475 (Bankr. D. Colo. 1992); *In re Gold Seal Products Co.*, 128 B.R. 822 (Bankr. N.D. Ala. 1991); *In re Bicoastal Corp.*, 121 B.R. 653 (Bankr. M.D. Fla. 1990).

n10

10. 544 F.2d 1291 (5th Cir.), cert. denied, 431 U.S. 904, 97 S. Ct. 1696, 52 L. Ed. 2d 388 (1977).

n11

11. 544 F.2d 1291, 1299.

n12

12. 124 Cong. Rec. H11,091-2 (daily ed. Sept. 28, 1978); S17,408 (daily ed. Oct. 6, 1978).

n13

13. See *In re Stoecker*, 114 B.R. 965 (Bankr. N.D. Ill. 1990) (law firm improperly charged time in minimum .25 hour increments which artificially inflated the number of hours of services rendered and violated bankruptcy rule requiring that actual time expended be detailed); see also *In re Wildman*, 72 B.R. 700, 708 (Bankr. N.D. Ill. 1987) (holding that fee application should indicate actual time spent on services and small items should not be uniformly reported as a minimum block of time); *In re Sapolin Paints, Inc.*, 10 C.B.C.2d 833, 38 B.R. 807 (Bankr. E.D.N.Y. 1984) (.2 hour increment too large). Other courts may require shorter minimum increments, such as one tenth of an hour. E.g., *In re Seneca Oil Co.*, 65 B.R. 902, 909 (Bankr. W.D. Okla. 1986).

n14

14. See *In re Public Serv. of N.H.*, 86 B.R. 7 (Bankr. D.N.H. 1988) (ultimate standard always is whether final fee award is in fact an award of a reasonable fee in the circumstances of the particular case and that regular hourly rates simply do not become *ipso facto* final fee awards in this court).

n15

15. *Chamberlain v. Kula (In re Kula)*, 38 C.B.C.2d 1709, 213 B.R. 729 (B.A.P. 8th Cir. 1997) (applying *In re Apex Oil Co.*, 960 F.2d 728, 26 C.B.C.2d 1187 (8th Cir. 1992)).

n16

16. *In re Howell*, 226 B.R. 279 (Bankr. M.D. Fla. 1998) (citing *In re Kula*).

n17

17. See, e.g., *Zolfo, Cooper & Co. v. Sunbeam-Oster Co.*, 50 F.3d 253, 33 C.B.C.2d 134 (3d Cir. 1995) (baseline rule is for firms to receive their customary rates); *In re Busy Beaver Bldg. Ctrs., Inc.*, 19 F.3d 833, 30 C.B.C.2d 1264 (3d Cir. 1994) (advocating market approach to determining applicable rate of compensation); *In re Robertson Cos.*, 123 B.R. 616 (Bankr. D.N.D. 1990) (restriction of fees to typical local rates is unduly parochial in light of national and regional law firms working on larger and more complex bankruptcy cases with more than local import); *In re Frontier Airlines, Inc.*, 74 B.R. 973 (Bankr. D. Colo. 1987) (foreign counsel may charge normal hourly billing rates, even if in excess of local billing rates).

n18

18. *In re Baldwin United Corp.*, 10 C.B.C.2d 273, 36 B.R. 401 (Bankr. S.D. Ohio 1984).

n19

19. See, e.g., *In re Grimes*, 115 B.R. 639 (Bankr. D.S.D. 1990) (hourly billing rate charged by the debtors out of town attorney reduced to the local hourly rate in which the case was pending based on the lack of size and complexity of the case); *In re Property Co. of Am. Joint Venture*, 22 C.B.C.2d 688, 110 B.R. 244 (Bankr. N.D. Tex. 1990) (hourly billing rates charged by the law firm for the chapter 11 trustee reduced to reflect the prevailing community standard); *In re Wendys of Mont. Inc.*, 111 B.R. 314 (Bankr. D. Mont. 1988) (allowing compensation to debtors attorney based on the fees charged by local professionals); *In re Global Intl Airways Corp.*, 38 B.R. 440 (Bankr. W.D. Mo. 1984) (reducing customary hourly rate charged by out-of-town attorneys in light of lower local rates).

n20

20. 19 F.3d 833, 30 C.B.C.2d 1264 (3d Cir. 1994).

n21

21. 19 F.3d 833, 848, 30 C.B.C.2d 1264, 1279 (3d Cir. 1994).

n22

22. *In re The Drexel Burnham Lambert Group Inc.*, 133 B.R. 13 (Bankr. S.D.N.Y. 1991).

n23

23. 950 F.2d 334 (6th Cir. 1991).

n24

24. The bankruptcy court relied upon an unreported opinion, *In re Robinson*, No. 3-88-01023(1)(13) (Bankr. W.D. Ky. Sept. 2, 1988).

n25

25. See *In re Cenas Fine Furniture, Inc.*, 109 B.R. 575 (E.D.N.Y. 1990); *In re Great Sweats of Va., Inc.*, 109 B.R. 696 (E.D. Va. 1989).

n26

26. 145 B.R. 956 (Bankr. C.D. Ill. 1991).

n27

27. 145 B.R. 956, 962-63 (Bankr. C.D. Ill. 1991); see also *Unsecured Creditors Comm. v. Puget Sound Plywood, Inc.*, 924 F.2d 955, 960, 24 C.B.C.2d 1147, 1152 (9th Cir. 1991) (although primary method for calculating fees is lodestar it is not exclusive).

n28

28. 133 B.R. 13 (Bankr. S.D.N.Y. 1991).

n29

29. 133 B.R. 13, 25.

n30

30. 133 B.R. 13, 27 (*Bankr. S.D.N.Y. 1991*); see also *In re Hillsborough Holdings Corp.*, 125 B.R. 837, 840 (*Bankr. M.D. Fla. 1991*) (in the absence of a time record, it is almost impossible to determine the reasonable value of the services rendered by an investment banker); *In re Mortgage & Realty Trust*, 123 B.R. 626 (*Bankr. C.D. Cal. 1991*) (although keeping time records is not the customary practice of financial advisors, they must keep time records indicating the date and description of the services rendered as well as the amount of time spent before they will be compensated).

n31

31. 427 F.3d 804 (10th Cir. 2005).

n32

32. 56 C.B.C.2d 1458, 2006 U.S. Dist. LEXIS 73860 (N.D. Ala. Sept. 11, 2006).

n33

33. See *Cle-Ware Indus., Inc. v. Sokolsky*, 493 F.2d 863 (6th Cir. 1974), cert. denied, 419 U.S. 829, 95 S. Ct. 50, 42 L. Ed. 2d 53 (1974). *In re James Anthony & Co., Inc.*, 531 F.2d 658 (2d Cir. 1976); *In re El San Juan Hotel Corp.*, 12 B.R. 154 (D.P.R. 1981); *In re Botelho*, 3 C.B.C.2d 739, 8 B.R. 305 (B.A.P. 1st Cir. 1981).

n34

34. 908 F.2d 874, 23 C.B.C.2d 708 (11th Cir. 1990).

n35

35. 109 B.R. 733 (*Bankr. W.D. Mich. 1989*).

N36

36. See *In re DN Assocs.*, 165 B.R. 344 (Bankr. D. Maine 1994) (denying compensation for successfully defending fee award on appeal but awarding interest on fee award from date awarded).

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37. 92 B.R. 152 (W.D. Va. 1988).

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38. See *In re Nucorp Energy, Inc.*, 764 F.2d 655, 12 C.B.C.2d 1463 (9th Cir. 1985).

n39

39. See also *In re Manoa Fin. Co.*, 853 F.2d 687, 19 C.B.C.2d 574 (9th Cir. 1988) (*dicta* in appeal from bankruptcy court denial of fee enhancement); *In re U.S. Golf Corp.*, 639 F.2d 1197 (5th Cir. 1981) (awarding fees on appeal without discussion).

n40

40. *Smith v. Edwards & Hale, Ltd.*, 317 F.3d 918, 928 (9th Cir. 2002); see also *In re Worldwide Direct*, 334 B.R. 108 (D. Del. 2005) (allowing a percentage of fees incurred in defending a fee application equal to the percentage of challenged fees that were allowed).

ABOUT THE AUTHOR(S):

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114 of 197 DOCUMENTS

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Collier on Time for Assumption or Rejection of Executory Contract

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Collier on Time for Assumption or Rejection of Executory Contract

By Collier

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SUMMARY: This Emerging Issues Analysis covers the assumption or rejection of executory contracts or leases by bankruptcy courts in Chapter 7 liquidations and in Chapter 9, 11, 12 or 13 cases, the treatment of nonresidential real property leases in bankruptcy cases that are filed after the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, and the assumption or rejection of leases for personal property.

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ARTICLE: *Section 365(d) of the Bankruptcy Code*, which is similar in approach to Section 70b of the Bankruptcy Act and former Bankruptcy Rule 607, fixes the time within which the trustee must assume or reject an unexpired lease or executory contract. n1 Because the time is statutory, it may not be extended based on excusable neglect. n2 Except for a plan provision, assumption may be accomplished only by a motion. n3

Chapter 7 Liquidation Case; § 365(d)(1)

In a case under chapter 7, the trustee must decide whether to assume or reject an executory contract or lease within 60 days after the order for relief unless the court, for cause, within the 60-day period grants additional time. When the 60-day period has run, the conduct of the other party may give the trustee grounds to assert a waiver. n4 The request for an extension need not necessarily be on notice to the other party to the contract. Depending upon the circumstances, the request might be general or specific. n5

If the trustee fails to act within the 60-day period, the contract or lease is deemed rejected. If, however, the contract is not scheduled and the trustee does not discover it, the presumption of rejection should not apply. n6 If the 60-day period expires, the court has no power to extend it thereafter. Laches and waiver have been held to create an exception to this rule n7 When a case is converted from another chapter to chapter 7, the 60 days will run from the date of conversion. n8

Chapter 9, 11, 12 or 13 Case; Ordinary Contracts and Leases; § 365(d)(2)

In a case under chapter 9, 11, 12 or 13, unless the contract or lease at issue is subject to a special rule such as the one provided under section 365(d)(4) with respect to a nonresidential real estate lease, n9 the trustee may assume or reject an executory contract or lease at any time before confirmation of the plan. n10 Thus, a trustee may, before assumption and cure of defaults, exercise a lease renewal option that is otherwise exercisable under the lease only if the lease is not in default, because to require assumption first would effectively shorten the trustee's time to assume or reject the lease. n11

Assumption or Rejection in Plan. The plan itself may provide for the assumption or rejection of any executory contract or unexpired lease not previously rejected. n12 This is often a useful means for the debtor to avoid binding itself to contracts or leases before it has formulated a feasible business plan under which it knows whether it will want the benefits and burdens of each agreement. Because of magnitude of claims that may arise from a chapter 7 rejection of a lease that was assumed in the preceding chapter 11 case, assuming liability for future rent under a long-term lease will rarely be in the best interests of the estate. So, the decision to assume a long-term lease usually should be delayed until confirmation. n13

Court May Order Earlier Determination. Sometimes, the other party to the contract will need to know whether the trustee is planning to assume or reject a contract or lease, in order for the other party to take actions either to perform its end of the contract or to mitigate its damages. Section 365(d)(2) provides that the court, on request of a party to a contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject. This is a codification of a case law remedy that had developed under the prior Act. n14

If the other party to the contract seeks an earlier determination of whether the trustee or debtor in possession will assume or reject the contract, the settled rule, which was borrowed from equity receivership practice, is that the trustee or debtor in possession has a reasonable time within which to decide. n15 Reasonableness depends upon the facts and circumstances of the particular case. n16

Effect of Denial of Request for Early Determination. If a request for an order requiring the debtor to assume or reject a contract or lease in a shortened time frame is denied, the request may be renewed at a later point in the case. n17 As the case continues, the equities that may have favored the trustee or debtor in possession early in the case may change, as the other party to the contract is increasingly burdened by the failure to assume or reject the contract.

Effect of Failure to Assume or Reject Before Plan Confirmation. The court must approve the assumption or rejection of an executory contract or lease. n18 This approval may be contained in a court order or as part of the confirmation of a plan. n19 If the trustee or debtor in possession fails either to assume or reject a contract by separate order or in the plan, it appears that the contract would continue in existence. n20 If the contract has not been rejected, however, the other party to the contract will not have a claim in the bankruptcy and will have no hope of recovery if the trustee or debtor in possession liquidates or assigns all of the estate's assets. But, if the trustee or debtor in possession continues operating, arguably the contract passes through the bankruptcy and remains a liability of the reorganized entity. n21 The discharge of section 1141(c) will not assist the debtor since, absent rejection, the other party to the contract will not be a creditor, at least with respect to postpetition damages. However, the debtor may be able to modify or amend the plan to correct an oversight and provide for rejection (or assumption) if the plan has not been substantially consummated. n22 Since a collective bargaining agreement may be rejected in a chapter 11 case only after compliance with the requirements of section 1113, failure to assume or reject such an agreement results in its assumption. n23

Debtor as Lessee of Nonresidential Real Property in Cases Commenced after the Effective Date of the 2005 Act; § 365(d)(4)

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act) n24 made substantial changes in the treatment of nonresidential real property leases in bankruptcy cases. The 2005 Act amended section

365(d)(4) to increase the initial period in which the trustee must make an assume or reject decision but limited the ability of the court to extend the period. Although the paragraph was extensively rewritten, much of the language tracks the prior provision, so much of the case law interpreting former section 365(d)(4) will remain applicable.

In cases filed on or after October 17, 2005, the trustee has 120 days after the date of the order for relief, or until the date of the entry of a plan confirmation order, whichever is earlier, to assume a lease of nonresidential real property. If the trustee does not assume within the deadline, the lease shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor. The court may extend the 120-day deadline once for cause, but only before the expiration of the deadline and only for up to 90 days. If the court grants a first extension, then the court may grant a subsequent extension only upon the prior written consent of the landlord in each instance. n25 The wording of these provisions leaves much open to interpretation.

First, the effect of the trustee's failure to act is changed slightly from the pre-amendment language. Under the 2005 Act, the lease shall be deemed rejected; under prior law, the lease is deemed rejected. Although the change seems minor and only stylistic, at least one decision suggests otherwise. In *Stumpf v. McGee (In re O'Connor)*, the plan provided that certain executory contracts are hereby rejected and that certain other executory contracts will be assumed. The court ruled that rejection occurred upon confirmation but that something more than confirmation was required to effect the assumption. n26 Similarly, Congress may have intended by the change in language here that rejection not be automatic, that something more is required. The statute does not specify what that further action might be. The following phrase, and the trustee shall immediately surrender, as well as the use of deemed, suggests that no further action is required to effect rejection.

Second, the extension language has been changed. Previously, the paragraph set the deadline as 60 days after the date of the order for relief, or within such additional time as the court fixes. The new language in subparagraph (B) specifically authorizes the court to extend the period determined under subparagraph (A) for 90 days on the motion of the trustee or lessor for cause. The new language does not by its terms appear to permit an extension shorter or longer than 90 days. n27 It specifies only a 90-day extension, not such additional time, up to 90 days, for example. Also, it refers to the period determined under subparagraph (A). That period is the earlier of 120 days after the date of the order for relief or of entry of a confirmation order. By referring to subparagraph (A), rather than to the 120-day period, as the statute does later in the same clause, a court might conclude that either deadline in subparagraph (A)--120 days after the order for relief or the entry of the confirmation order--may be extended. Such a reading would permit the court to extend the deadline for 90 days after the entry of the confirmation order.

Alternatively, a court might conclude that the period determined under subparagraph (A) is the earlier of the two dates. This reading would be bolstered by the deletion from the beginning of paragraph (4) of the phrase, Notwithstanding paragraphs (1) and (2) of this subsection. Paragraph (1) and (2) fix the time for assumption or rejection deadline at 60 days after the order for relief in a chapter 7 case or plan confirmation in a chapter 11, 12 or 13 case. Deletion of the notwithstanding phrase suggests that new paragraph (4) does not override the plan confirmation deadline for chapter 11, 12 and 13 cases. It creates another problem, however, in that it is now ambiguous whether paragraph (2) or paragraph (4) controls the assumption of nonresidential real property leases. Under the statutory construction maxim that the specific controls the general, it is likely that paragraph (4) will control.

Third, the 2005 Act does not clarify what part of the assumption process must be completed before the deadline, whether it is (at one extreme) entry of a court order approving assumption or (at the other end), a mere decision by the trustee, communicated to the lessor, to assume. If rejection is automatic at the expiration of the period, then the order would be required by then; otherwise the lease would already have been rejected by the time of the entry of the order. On the other hand, if, as noted above, something more than the passage of time is required for rejection, then an assumption or an order approving assumption after the deadline might still be effective. That would be consistent with pre-amendment law, which generally permitted a post-deadline order if the trustee filed a motion to assume before the deadline. n28

The 2005 Act clarifies at least one ambiguity in the prior language. It is now clear that any order extending the initial 120-day period must be entered before the expiration of the deadline. n29 The 2005 Act also clarifies whether more than one extension is permitted. The literal language of the former provision did not appear to permit more than one extension, but the courts generally agreed that multiple extensions were authorized. n30 The amended paragraph expressly permits multiple extensions. The 2005 Act does not specify whether any subsequent extensions (after the first) must be granted before the expiration of the previously extended period. Better practice would be to obtain the subsequent extension order before the expiration of the prior extension, to prevent automatic rejection at the end of the extended period, in case automatic rejection occurs.

The court may grant a subsequent extension only upon prior written consent of the lessor in each instance. n31 Presumably, each instance refers to each extension, rather than to each lessor or lease, and the extension period specified in the prior written consent should limit the extension that the court may grant, even though the statute is not explicit on this point. The statute leaves open the question of when the lessor must consent, that is, prior to what event? The House Committee report suggests that the consent must be received before the trustee may file a motion for an extension. n32

However, such a requirement does not appear in the statute and would not appear practical. The courts should require the landlord's consent before issuing the extension order. Finally, subparagraph (B) permits a subsequent extension. Although the language is in the singular, the singular includes the plural, n33 so more than one subsequent extension is permitted; subject, however, to the landlord's prior written consent in each instance.

Prior law interpreting section 365(d)(4) should continue to apply as to the remainder of the issues that arise in the context of assumption or rejection of a nonresidential real property lease. n34

Debtor as Lessor of Nonresidential Real Estate

Section 365(d)(2), by its terms, applies only to executory contracts and to leases of residential real property or of personal property of the debtor. This coverage excludes leases of nonresidential real property. The exclusion recognizes that leases of nonresidential real property in which the debtor is lessee are dealt with by section 365(d)(4).

Apparently Congress was not thinking about those situations in which the debtor is lessor, since neither paragraph (2) nor (4) of section 365(d) provides a time period for the assumption or rejection of a nonresidential lease by a debtor lessor. n35 Because the special limits of section 365(d)(4) are inapplicable when the debtor is a lessor, the better approach would be to apply the rule of section 365(d)(2) to leases of nonresidential real property under which the debtor is lessor, in recognition of the apparent oversight. n36 Alternatively, a court might look to pre-Code law and afford the trustee or debtor in possession a reasonable time to assume or reject such leases.

Leases of Personal Property; § 365(d)(5)

The Bankruptcy Reform Act of 1994 added section 365(d)(5) to the Code. n37 This section requires the trustee in a chapter 11 case to perform timely all the obligations of the debtor, first arising from or after 60 days after the order for relief in a chapter 11 case under an unexpired lease of personal property (other than property leased to an individual for personal, family or household purposes) until the lease is assumed or rejected, unless the court, based upon the equities of the case, orders otherwise. The amendment expressly provides that it overrides section 503(b)(1). n38 This is apparently intended to eliminate an argument over whether accrued rent was actual or necessary and, hence, entitled to an administrative priority.

Comparison with Section 365(d)(3). While in concept similar to section 365(d)(3) and the cases construing

section 365(d)(3) are equally applicable here to the extent of the similarities, n39 there are significant differences between section 365(d)(5) and section 365(d)(3). Section 365(d)(5) applies only in chapter 11 cases and applies to obligations arising from or after 60 days after the order for relief rather than from the order for relief, as provided in section 365(d)(3). In addition, under section 365(d)(3), the time to cure defaults, other than those under section 365(b), is limited to 60 days after the order for relief, while section 365(d)(5) permits the court, after notice and a hearing, to order otherwise with respect to the obligations or their timely performance based upon the equities of the case. Thus, section 365(d)(5) is considerably more flexible than section 365(d)(3). As is the case with section 365(d)(3), section 365(d)(5) is silent as to the consequence of noncompliance, leaving the issue to case law development.

Burden of Going Forward. Section 365(d)(5) shifts the burden of proceeding to the trustee. If the trustee fails to satisfy the burden, the obligation to perform will exist, and the rent after the first 60 days will accrue at the rate specified in the lease. Indeed, the principal effect of section 365(d)(5) will be to shift the burden of taking action to the trustee. The Bankruptcy Reform Act of 1994 also amended section 363(e) to permit lessors to seek adequate protection. n40

Conversion of Chapter 11 Case to Chapter 7. If the case is converted to chapter 7, section 365(d)(5) will cease to apply. This may lead to a more complex calculation, for in calculating the rent due under a commercial lease of personal property, the first 60 days in chapter 11 would be determined under the actual and necessary standard, the rent for the remainder of the chapter 11 case would be that reserved in the lease unless the court, based upon the equities, had ordered otherwise, and the rent during the first 60 days of the chapter 7 case would be under the actual and necessary standard.

Liability for Use and Occupancy under Unexpired Lease Pending Assumption or Rejection

When the contract is an unexpired lease of residential real property or noncommercial personal property, and the debtor is the lessee, an issue arises as to the obligation for rent under the lease after the inception of the case and until the lease is rejected or assumed. n41 Similarly, when the lease is of commercial personal property, the same issue arises during the first 60 days of a chapter 11 case and cases under other chapters.

Estate Does Not Take Title Until Lease Is Assumed. The general rule is that the estate does not take title to an executory contract or unexpired lease until it is affirmatively assumed, whereupon title relates back to the date of the filing of the bankruptcy petition.

Consequently, except for leases of nonresidential real estate under which the debtor is the lessee or for leases of personal property more than 60 days after the order for relief, it is the settled rule that until assumption or rejection of the debtor's lease, the estate is not liable under the terms of the contract or lease. Nevertheless, the estate is liable for the reasonable value of the use and occupancy of the premises, since this represents a benefit to the estate. n42 Such value may be, but is not necessarily, fixed at the rent reserved in the lease. n43

When Payments Are Required to Be Made Before Assumption or Rejection. If the trustee or debtor in possession is required to make payments before assumption or rejection of the lease, the final application of the payments will await the trustee's or debtor in possession's decision of whether to assume or reject the lease. If the lease is rejected, the payments will represent the charge for the use and occupancy. If the lease is assumed, the trustee or debtor in possession will be required to cure any defaults and perform thereafter. n44 In such a case, the payments will be viewed as having been made on account of rent. The trustee or debtor in possession will then be under obligation to pay the amount of rent reserved for the period extending from the filing date to the time of assumption, and thereafter, and if payments for use and occupation during the period previous to assumption were in a lesser amount than specified in the lease, the balance would have to be made up. n45

When Before Assumption or Rejection Trustee Mistakenly Continues Making Payment. If prior to

assumption or rejection the trustee or debtor in possession mistakenly continues to pay rent as such without condition and it is so accepted, and the lease is thereafter rejected, the general rule is that the difference, if any, between the rent reserved and the value of use and occupancy may be recovered, since the lessor dealing with a court officer in a reorganization must be charged with notice of the provisional character of all such transactions. n46 The rule is not inflexible, however, and there may be cases in which individual lessors have so far adjusted their affairs in actual ignorance of the contingent nature of the payments that it would be inequitable to compel them to disgorge. n47

For further discussion of Code section 365, see Collier on Bankruptcy, ch. 365 (Matthew Bender).

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n1 See *Collier on Bankruptcy*, 365.03 (Matthew Bender), text accompanying notes 1 and 2 (debtor in possession in a chapter 11 case and debtor in a chapter 12 or 13 case may assume or reject).

n2 *Magnolia Bluff Factory Shops Ltd. v. Federated Food Courts, Inc. (In re Federated Food Courts, Inc.)*, 222 B.R. 396 (Bankr. N.D. Ga. 1998). *Federal Rule of Bankruptcy Procedure 9006(b)(1)* permits an extension, based on excusable neglect, of a time period set by the Bankruptcy Rules.

n3 *South Street Seaport Ltd. P'ship v. Burger Boys, Inc. (In re Burger Boys, Inc.)*, 94 F.3d 755, 763 (2d Cir. 1996); see Fed. R. Bankr. P. 6006(a) (a proceeding to assume or reject a contract or lease is a contested matter).

n4 See, e.g., *Larkins v. Sills*, 377 F.2d 1 (5th Cir. 1967); *Ten-Six Olive, Inc., v. Curby*, 208 F.2d 117 (8th Cir. 1953); *In re THW Enters., Inc.*, 19 C.B.C.2d 451, 89 B.R. 351 (Bankr. S.D.N.Y. 1988) (laches and waiver have been held to create an exception to this rule).

n5 See *Chapman Inv. Assocs. v. American Healthcare Mgmt., Inc. (In re American Healthcare Mgmt., Inc.)*, 900 F.2d 827, 832, 22 C.B.C.2d 1740, 1746 (5th Cir. 1990) (when a statute gives a court discretion to extend the time in which a party is required to act, the court has authority to grant such an extension without affording other parties notice or a hearing); *Willamette Waterfront, Ltd. v. Victoria Station, Inc. (In re Victoria Station, Inc.)*, 875 F.2d 1380, 1386, 21 C.B.C.2d 483, 491 (9th Cir. 1989) (order extending time to assume or reject a lease merely preserves status quo, and like orders pursuant to Rule 6(b), [may be] entered in the routine administration of the court); *Bethesda-Union Society of Savannah, Inc. v. Austin (In re Austin)*, 21 C.B.C.2d 244, 102 B.R. 897 (Bankr. S.D. Ga. 1989)

n6 *Texas Western Fin. Corp. v. McCraw Candles, Inc.*, 347 F. Supp. 445 (N.D. Tex. 1972) (citing *Treatise*). But see *Cheadle v. Appleatchee Riders Ass'n (In re Lovitt)*, 757 F.2d 1035 (9th Cir.), cert. denied, 474 U.S. 849, 106 S. Ct. 145, 88 L. Ed. 2d 120 (1985) (statutory presumption of rejection by the trustee's inaction within the 60-day period is a conclusive presumption; that the leases were not scheduled is without consequence).

n7 *In re THW Enters., Inc.*, 19 C.B.C.2d 451, 89 B.R. 351 (Bankr. S.D.N.Y. 1988).

n8 *Carrico v. Tompkins (In re Tompkins)*, 95 B.R. 722 (B.A.P. 9th Cir. 1989).

n9 See Debtor as Lessor of Nonresidential Real Estate *infra*.

n10 This is consistent with pre-Code law. See *In re Grayson-Robinson Stores, Inc.*, 227 F. Supp. 609 (S.D.N.Y. 1964) (court refused to permit rejection of an executory contract after confirmation).

n11 *Coleman Oil Co., Inc. v. Circle K Corp (In re Circle K Corp.)*, 127 F.3d 904, 38 C.B.C.2d 1445 (9th Cir. 1997).

n12 11 U.S.C. § 1123(b)(2).

n13 *Nostas Assocs. v. Costich (In re Klein Sleep Prods., Inc.)*, 78 F.3d 18, 29 (2d Cir. 1996).

n14 *Texas Importing Co. v. Banco Popular de Puerto Rico*, 360 F.2d 582 (5th Cir. 1966); *In re Greenpoint Metallic Bed Corp.*, 113 F.2d 881 (2d Cir. 1940).

n15 *Data Link Sys., Inc. v. Whitcomb & Keller Mortgage Co. (In re Whitcomb & Keller Mortgage Co.)*, 715 F.2d 375, 9 C.B.C.2d 312 (7th Cir. 1983); *Theatre Holding Corp. v. Mauro*, 681 F.2d 102 (2d Cir. 1982); *In re Dunes Casino Hotel*, 63 B.R. 939 (D.N.J. 1986); *In re Mayer Pollock Steel Corp.*, 157 B.R. 952 (Bankr. E.D. Pa. 1993).

n16 See, e.g., *Theatre Holding Corp. v. Mauro*, 681 F.2d 102 (2d Cir. 1982) (when debtor failed to formulate plan a year after commencement of case and lessor was unlikely to obtain compensation for losses suffered, court could shorten time to assume or reject); *In re Dunes Casino Hotel*, 63 B.R. 939 (D.N.J. 1986) (debtor should be afforded reasonable time to develop reorganization plan); *In re Mayer Pollock Steel Corp.*, 157 B.R. 952 (Bankr. E.D. Pa. 1993) (no relief when the balance of equities favors the debtor); see also *In re Flying W. Airways, Inc.*, 328 F. Supp. 1256 (E.D. Pa. 1971) (court concluded that under the circumstances of the case three months was a reasonable time and compared this to other cases in which considerably longer time was taken).

n17 *In re Dunes Casino Hotel*, 63 B.R. 939 (D.N.J. 1986).

n18 11 U.S.C. § 365(a); see, e.g., *Thinking Machs. Corp. v. Mellon Fin. Servs. Corp.* (*In re Thinking Machs. Corp.*), 67 F.3d 1021 (1st Cir. 1995).

n19 See 11 U.S.C. § 1123(b)(2); *In re Kroh Bros. Dev. Co.*, 100 B.R. 480 (W.D. Mo. 1989); see *Collier on Bankruptcy*, 1123.02[2] (Matthew Bender).

n20 This continuance, however, does not necessarily mean an assumption and does not constitute an estoppel to bar the court from exercising its statutory power. *Texas Importing Co. v. Banco Popular de Puerto Rico*, 360 F.2d 582 (5th Cir. 1966) (citing *Treatise*); *In re Lake Winnebago Dev. Co.*, 55 B.R. 1005 (W.D. Mo. 1985).

n21 *Stumpf v. McGee* (*In re O'Connor*), 258 F.3d 392 (5th Cir. 2001); *In re Hernandez*, 287 B.R. 795 (Bankr. D. Ariz. 2002).

n22 11 U.S.C. § 1127.

n23 *Adventure Resources, Inc. v. Holland*, 137 F.3d 786 (4th Cir. 1998).

n24 Pub. L. No. 109-8, § 404 (2005), effective in cases commenced on or after October 17, 2005.

n25 11 U.S.C. § 365(d)(4), as amended by Pub. L. No. 109-8, § 404(a) (2005).

n26 258 F.3d 392 (5th Cir. 2001).

n27 Under a more aggressive reading, it could be argued that Congress did not prohibit an extension of longer than 90 days, as would be the case had the language read, may extend the period only for 90 days. However, such a reading seems unjustified in light of the apparent congressional purpose to limit the number and length of extensions.

n28 See Must Court Approve Assumption by the Deadline? *supra*.

n29 11 U.S.C. § 365(d)(4)(B); see Timing of Extension *supra* (courts divided on whether the extension order must be entered before the deadline).

n30 See Multiple Extensions *supra*.

n31 11 U.S.C. § 365(d)(4)(B)(ii).

n32 H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 86 (2005) (Any subsequent extension can only be granted by the judge upon the prior written consent of the lessor either by the lessor's motion for an extension or on motion of the trustee, provided that the trustee has the prior written approval of the lessor.).

n33 11 U.S.C. § 102(7).

n34 See Relationship to Other Provisions, Grounds for Extension of Time to Assume or Reject and Performance Before Assumption or Rejection; § 365(d)(3) *supra*.

n35 See *Oklahoma Plaza Invs., Ltd. v. Wal-Mart Stores, Inc. (In re Oklahoma Plaza Invs., Ltd.)*, 24 C.B.C.2d 1572, 124 B.R. 108 (Bankr. N.D. Okla. 1991).

n36 See *Oklahoma Plaza Invs., Ltd. v. Wal-Mart Stores, Inc. (In re Oklahoma Plaza Invs., Ltd.)*, 24 C.B.C.2d 1572, 124 B.R. 108 (Bankr. N.D. Okla. 1991) (explaining that the reason a debtor/lessor does not have to assume a lease in a chapter 11 case is that under section 1108 a trustee or debtor in possession is authorized to operate the business of the debtor without court order).

n37 Pub. L. No. 103-394, § 219(b) (1994), redesignated as section 365(d)(5) by Pub. L. No. 109-8, § 328(a)(3)(B) (2005).

n38 See *Collier on Bankruptcy*, 503.05 (Matthew Bender).

n39 See *Collier on Bankruptcy*, 365.03[3][c] (Matthew Bender).

n40 See *Collier on Bankruptcy*, 363.06 (Matthew Bender).

n41 As to the effects of assignment or rejection, see *Collier on Bankruptcy*, 365.09 (Matthew Bender).

n42 *Philadelphia Co. v. Dipple*, 312 U.S. 168, 61 S. Ct. 538, 85 L. Ed. 651 (1941); *Palmer v. Palmer*, 104 F.2d 161, 163 (2d Cir.), cert. denied, 308 U.S. 590, 60 S. Ct. 120, 84 L. Ed. 494 (1939) (the trustee need not pay the rent during the probationary period, and the court will hold off the lessor and force him to be content with the value of the use and occupancy meanwhile, though ordinarily it will fix that at the same amount as the rent); *Crook v. Zorn*, 100 F.2d 792 (5th Cir.), cert. denied, 307 U.S. 630, 59 S. Ct. 833, 83 L. Ed. 1573 (1939); *In re Johns*, 1 C.B.C.2d 174 (Bankr. D. Nev. 1979) (citing *Treatise*). But when a trustee does not occupy leased premises, no compensation is due the lessor for waiting a reasonable time for the trustee to determine whether to adopt or reject the lease. *In re McCrory Stores Corp.*, 69 F.2d 517 (2d Cir. 1934). And the collection of rents from a subtenant does not amount to actual or constructive possession of the leased premises or make the trustee

liable for use and occupation of premises the trustee never occupied. *Id.*; *In re United Cigar Stores Co. of Am.*, 69 F.2d 513 (2d Cir.), *cert. denied*, 293 U.S. 566, 55 S. Ct. 76, 79 L. Ed. 665 (1934).

n43 *Philadelphia Co. v. Dipple*, 312 U.S. 168, 61 S. Ct. 538, 85 L. Ed. 651 (1941); *Palmer v. Palmer*, 104 F.2d 161, 163 (2d Cir. 1939), *cert. denied*, 308 U.S. 590, 60 S. Ct. 120, 84 L. Ed. 494 (1939); *Crook v. Zorn*, 100 F.2d 792 (5th Cir.), *cert. denied*, 307 U.S. 630, 59 S. Ct. 833, 83 L. Ed. 1573 (1939).

n44 11 U.S.C. § 365(b).

n45 *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 9 C.B.C.2d 1219 (1984).

n46 *Palmer v. Palmer*, 104 F.2d 161 (2d Cir. 1939), *cert. denied*, 308 U.S. 590, 60 S. Ct. 120, 84 L. Ed. 494 (1939).

n47 *Id.*

ABOUT THE AUTHOR(S):

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115 of 197 DOCUMENTS

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Ehrenberg on the Successful Chapter 11 Sale of the Queen Mary Facility Lease

2008 Emerging Issues 1476

Howard M. Ehrenberg on the Successful Chapter 11 Sale of the Queen Mary Facility Lease

By Howard M. Ehrenberg

December 13, 2007

SUMMARY: A Rapidly Failing Business May Not Survive Legal Resolutions That Do Not Utilize Creative Time-Saving Tactics. Howard M. Ehrenberg, Esq., of SulmeyerKupetz details the steps taken as a chapter 11 trustee to clear the way for the sale of the Queen Mary facility lease in the In re Queen's Seaport Development case.

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ARTICLE: A Rapidly Failing Business May Not Survive Legal Resolutions That Do Not Utilize Creative Time-Saving Tactics

In *In re Queen's Seaport Development, Inc., Case No. 05-15175-VZ (Bankr. C.D. Cal.)*, as the chapter 11 trustee, I was faced with an intricate web of time-consuming and interrelated issues and needed to resolve various complex litigation matters before attempting to market the assets of the estate. I was also tasked with securing financial stability for a venture that was failing at a rapidly increasing rate, and I employed inventive solutions to work around time constraints inherent to an asset sale.

Background. Queen's Seaport Development, Inc. ("QSDI") and one of its subtenants, RMS Foundation ("RMS"), operated a \$35 million business and generated approximately \$8 million per year through its operation of peripheral services such as parking, rent from subtenants and coordination of special events provided to the main attraction, the HMS Queen Mary. Original plans to develop a 45-acre tourist attraction failed, and, when faced with other pressing financial issues, QSDI subsequently filed for chapter 11 protection on March 15, 2005.

QSDI was stalled in the bankruptcy case for over a year and, after accepting an appointment to administer the case, I was immediately charged with resolving four separate and complex litigation matters in addition to foreclosure threats from a secured creditor. Also at issue was a landlord that was determined to terminate the lease and I was faced with resolving complicated business issues with a company that did not have cash reserves and retained no executives to manage its affairs.

Operations. RMS was a subtenant who operated the main attraction provided by QSDI, the Queen Mary facility,

hotel and restaurants. RMS employees were at the time responsible for the day-to-day operations of the facility, including maintenance of the property, bookkeeping and coordination of special events.

Consolidation of RMS into the debtor in order to control operations was considered, but abandoned after a forensic analysis determined that transfer of assets from a nonprofit foundation to the debtor would have drastic tax implications and a negative impact on creditors. I requested and was granted an appointment by RMS to serve as its oversight officer, a move that allowed me to review the books and records and investigate allegations of misconduct. See 28 U.S.C § 586; *Federal Rule of Bankruptcy Procedure 6004*.

I instituted a forensic examination of both RMS and QSDI and determined that there were no unjustified transactions that would preclude a continuation of the symbiotic relationship between RMS and QSDI, at least until litigation was resolved and the master lease sold.

I was immediately thrust into the daily operations of QSDI and acted as sub-landlord for RMS, Carnival Cruise Line, and Catalina Express. Duties expanded to operating the parking lot and maintenance of landscaping. Insurance issues and obtaining certified financial statements complicated my efforts to stabilize the facility, but after attracting new tenants such as Laserium, providing a safe, clean environment for special events and continuing a popular Halloween festival, I was able to make the site attractive to potential buyers of the lease.

Litigation. The resolution of pending litigation was critical to clearing the way to a sale of the lease (see 11 U.S.C. § 363(k) and (l)). After analyzing the existing lease between the City of Long Beach (the "City") and QSDI, I determined that a settlement was advisable and I set out to partner with the City to gain an important ally in the process leading to a sale.

The settlement terms provided the City with most of what it was claiming, but limited the priority portion of the claim and subordinated the remaining portion to general unsecured creditors. The approach served three purposes:

- . to resolve the City litigation;
- . to protect the general unsecured creditors; and
- . to "partner" with the City to attract overbids which caused the pricing to be sufficient to pay the City's claim in full.

Another separate litigant was a minority shareholder who claimed "development rights" that would have to be cleared in order to transfer a clean title. I was able to favorably resolve the litigation to the benefit of the estate.

More pressing was a lawsuit by a secured creditor who was blocking efforts to resolve the issues and hindering the marketing of the lease. I was, under powers granted by *section 365 of the Bankruptcy Code*, successful in litigating an automatic stay motion, but the delay was costly to the estate. A large claim was filed by an investor who bought a sub-interest in a debt and was fighting to reclaim funds from the estate. I objected to the claim and it was denied by the court.

An expensive lease payment for a chiller facility located on the property was negotiated to allow an accrual of lease payments in exchange for certain pre-petition payments. The last important settlement was with the lessor of equipment provided to the Queen Mary, which I was able to resolve at a discount over demand to the estate.

Conclusion of Bankruptcy Case. I was then tasked with working closely with the City, the secured creditor and the Unsecured Creditors Committee to prepare for the successful sale of the lease and the eventual conclusion of the bankruptcy case. I was able to involve the parties in the process by offering certain incentives and was able to clear the complex obstacles that prevented a clean sale of assets. For a complete review of the powers of a trustee regarding executory contracts, see *Collier Bankruptcy Practice Guide*, Ch. 68 (Matthew Bender).

It became clear after an appraisal of the property that the sale of the lease was desirable and would effectively provide a substantial dividend to creditors of the estate. I undertook several steps to expedite the process. I contacted several real estate brokers who specialized in the sale of waterfront property and had contacts with potential buyers.

In order to expedite the extensive due diligence for potential buyers, I created a password-protected website into which was made available the thousands of pages of leases, agreements, contracts and other financial information necessary for the review of potential buyers. This innovative approach saved time and estate funds by streamlining the review process.

I then spent months meeting with buyers and presenting them to the City, in an effort to obtain approval of as many bidders as possible to maximize the final sale price. Bid protection was offered to the "stalking horse" bidder to begin the bidding process, but the main goal was to foment active overbidding.

I also instituted a set of incentives to brokers with no commission available upon entry of an offer, but rewarded a 10% commission on overbids. The incentives attracted a sizable number of bidders, among them four overbids and a successful bidder was submitted to the court for approval. The winning bid was \$2 million above the opening bid.

The sale of the lease was finalized under 28 U.S.C. § 158(a)(1) and an order was approved by the court in September 2007.

In my role as the chapter 11 trustee, I successfully employed several proactive approaches to resolving expensive and time-consuming issues in the QSDI bankruptcy case. The creative application of existing legal remedies resulted in a reduction of time and expense and provided a substantial benefit to the estate.

For a complete review of the right of a trustee to the use, sale and lease of property, see Collier Bankruptcy Practice Guide, Ch. 43 (Matthew Bender).

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116 of 197 DOCUMENTS

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Collier on the Definition of Community Claim Under the Bankruptcy Code

2008 Emerging Issues 1395

Collier on the Definition of Community Claim Under the Bankruptcy Code

By Collier

December 7, 2007

SUMMARY: This Emerging Issues Analysis explains that the issue of whether a creditor holds a community claim is determined by state law, and it analyzes the community property laws of several states. It also discusses the criteria that must be met before an obligation has the status of a community claim and explains how certain of the intricacies of state community property laws are preempted by the Code in favor of creditors.

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ARTICLE: The definition of community claim in section 101 and the provisions of section 541(a)(2) regulate the treatment of community property n1 under the Code and the rights and remedies of creditors in those jurisdictions that have enacted community property laws. n2 While section 541(a) governs the types of community property which pass to the estate, n3 the definition of community claim affects the definition of creditor under section 101(10), n4 the parties entitled to receive notice of the entry of an order for relief under section 342, n5 the scope of the discharge granted under section 524(a)(3) n6 and the distribution of community property assets of the estate under section 726(c). n7

As a result of the definition of community claim, creditors holding claims against the debtor or against a nondebtor (typically the debtors spouse or former spouse) are entitled to participate in the bankruptcy case, so long as under applicable state law the creditor could have satisfied the claim from community property assets of the type passing to the bankruptcy estate under section 541(a)(2). By granting the nondebtors creditors the status of community claim holders, section 101 insures that community property passing to the estate will be divided ratably among all creditors who could have satisfied their claims therefrom under state law. n8 This is accomplished through the distribution scheme of section 726(c). n9 As a result, a creditor of the debtor or nondebtor spouse or former spouse who would have been able to satisfy a claim prior to bankruptcy from community assets which would be section 541(a)(2) property of the estate holds a community claim against the debtors estate, and is entitled to participate in the distribution of community property assets which have passed to the debtors estate. This is true whether or not any such section 541(a)(2) property has passed to the estate as of the petition date. n10 Thus, an estate containing community property presents a unique situation under the Code in that its assets will be disbursed to both the creditors of the debtor and to entities who are not creditors of the debtor under state law, but who hold community claims under the Code. n11

General Analysis; Applicability of State Law. There are three criteria which must be met before an obligation has

the status of a community claim: (1) it must be a debt owed by one of the spouses; (2) it must be satisfiable from community property under applicable state law; and (3) the community property from which the debt could be satisfied under state law must be included within the assets which would pass to the debtors bankruptcy estate, whether or not such assets exist at the commencement of the case. n12 Thus, under the foregoing tests, whether a creditor holds a community claim will be determined by state law. n13

Under state law, there are two prevailing theories of liability in community property states. In those states that follow the community debt doctrine, the community is considered to have the capacity to incur debts, and is liable for an obligation of a spouse if that spouse was acting as an agent of the marital community. Otherwise, the obligation is classified as a separate debt, which typically results in restrictions on the type or amount of community property from which it can be satisfied, or wholly bars the claim from satisfaction from community property. The alternative theory of liability under state law rejects the community debt doctrine and attributes a liability to the spouse who incurs it. In these states, it is irrelevant (except for marshaling considerations) whether or not the debt was incurred for separate or community purposes. Debts are attributable to a particular spouse and may be satisfied from that spouses separate and community property. n14

Under the Code, certain of the intricacies of state community property laws are preempted in favor of an all or nothing approach. n15 If under any circumstances a creditor may satisfy any portion of its claim from community property of the type described in section 541(a)(2), then that creditor will be accorded the status of a holder of a community claim. n16 Any state law distinction limiting a creditor to only a portion of the community property assets, n17 marshaling provisions requiring separate creditors to first satisfy their claims from noncommunity assets n18 or provisions granting a spouse reimbursement rights, n19 are not recognized. n20 Any attempt to implement the refinements of liability which exist under the laws of the various community property states would have hopelessly complicated an already difficult distribution scheme. n21 In a solvent estate, however, the bankruptcy court should examine the state law scheme to enable it to distribute the surplus assets to the proper spouse. Where a creditor holds a joint and several obligation against both spouses, he or she is accorded only one community claim, for to do otherwise would give the creditor an advantage not enjoyed under state law. In such circumstances, the creditor should participate as a holder of a claim against the debtor to insure access to all assets of the estate. n22

Analysis of Community Claims by Jurisdiction

Alaska. Spouses in Alaska may elect to have some or all of their property treated as community property. n23 Alaska follows the community debt doctrine with regard to any property that is the subject of such an election. Obligations incurred for the benefit of both spouses during marriage may be satisfied from community property and from the separate property of either spouse. n24 Obligations incurred for the benefit of only one spouse, either before or during marriage, may be satisfied from the incurring spouses separate property and from the incurring spouses share of the community property. n25 Support obligations may be satisfied only from community property and the separate property of the obligated spouse. n26 If any community property exists, because all obligations may be satisfied from at least some portion of the community property, all creditors in Alaska will hold community claims against the debtors estate.

Arizona. Arizona adheres to the community debt doctrine. In Arizona, prenuptial debts incurred after September 1, 1973, may be satisfied only from a spouses separate property and from the community property to the extent of that spouses contribution to the community. n27 Prenuptial debts incurred prior to September 1, 1973, are satisfied only from a spouses separate property. n28 Postnuptial separate creditors are also limited to the spouses separate property. n29 On the other hand, community debts are satisfied first from community property, then from the separate property of the contracting spouse. n30 Thus, only two types of creditors in Arizona do not hold community claims: prenuptial creditors whose claims were incurred prior to 1973, and postnuptial separate creditors. All other creditors can reach at least some portion of the community property for the satisfaction of their claims and thus hold community claims under section 101(7).

California. Californias community property system has generally never recognized the doctrine of community and separate debts. n31 Because the community has never been regarded as an entity capable of incurring obligations, debts are attributed to either the husband or the wife. n32 All community property, as well as the separate property of the contracting spouse, is obligated for the contracts of either spouse made before or during marriage. n33 This is consistent with the concept that management and control resides in both spouses. The separate property and earnings during marriage of one spouse are exempt from liability for debts of the other spouse which were contracted before marriage. n34 With respect to tort claims, a distinction is made between torts committed while performing an activity beneficial to the marital community and those committed under other circumstances. In the former instance, the liability must be satisfied first from community property and then from the separate property of the spouse who committed the tort. In the latter, the separate property of the tortfeasor must be exhausted before the community property is liable. n35 However, because the Bankruptcy Code does not recognize such marshaling restrictions, n36 *all* creditors of either spouse, both contract and tort (except for holders of claims incurred while the spouses are living separate and apart before a legal separation), n37 will hold community claims against the debtors estate and share in the distribution of community assets in the estate. n38 Finally, in circumstances where domestic partner community property has passed to the estate under section 541(a)(2), n39 the term community claim should include the claims of creditors against the nondebtor domestic partner because the domestic partner community property in the estate is property that is liable for the payment of such claims against the nondebtor domestic partner. However, the ability of a creditor of a nondebtor domestic partner to obtain a distribution on account of such claim is less clear. n40

Idaho. Idaho is similar to California in that neither spouses separate property is liable for the obligations of the other unless that spouse consents to such liability in writing; n41 however, no statutory provisions define the rights of creditors against the community assets. Under the former community property law, which granted the husband sole management and control of the community property, the community property was liable for all debts of the husband, whether or not incurred during community activities. n42 Because the wife now possesses equal rights to management and control with the husband, her creditors should also be able to reach both the community property and her separate assets. n43 If this is so, the laws of California and Idaho are very similar, and the treatment of community claims under Idaho community property law should closely parallel the treatment under California community property law.

Louisiana. Louisiana acknowledges separate and community debts, but only for the purpose of reimbursement between the spouses. n44 A creditor holding either a separate or a community debt against a spouse may satisfy that debt from the separate property of the debtor or from the community property. n45 Accordingly, all Louisiana creditors hold community claims under section 101(7) and may share in the distribution of any community property in the estate.

Nevada. In Nevada, prenuptial creditors may reach the debtor spouses separate property and that spouses interest in the community property. n46 It is unsettled whether Nevada follows the community debt doctrine; n47 accordingly, the property from which a postnuptial separate creditor may satisfy his claim remains unresolved. n48 However, it would seem illogical for Nevada law to grant prenuptial creditors (separate by definition) a right to recovery from the community property, but deny that same right to postnuptial separate creditors. In any event, all other creditors of either spouse hold community claims.

New Mexico. In the area of creditors rights, New Mexico distinguishes between community and separate debts n49 by providing an elaborate marshaling scheme which, in the extreme, limits separate creditors to all of a spouses separate property and one-half of the community property. n50 Community creditors may reach the debtors separate property and all of the community property, but may not reach the other spouses separate property unless the other spouse is jointly and severally liable on the claim. n51 Because separate creditors do have some access to the community property, they will hold community claims in New Mexico. Accordingly, all creditors in New Mexico will have the status of community claim holders under the Code. n52

Puerto Rico. Under Puerto Rico law, all debts and obligations incurred during the marriage by either spouse are

chargeable to community property. n53 Prenuptial debts may be charged against the community property after all postnuptial obligations have been satisfied. n54 Therefore, all creditors will have the status of community claim holders.

Texas. Texas, like California, does not adhere to the community debt doctrine. Creditors of a spouse may reach that spouses separate property, the community property under that spouses sole management and control, and the community property under joint management and control, whether or not the debt was incurred in community or separate activities, or before or after marriage. n55 Postnuptial tort creditors may, in addition, reach the community property under the sole management and control of the nondebtor spouse. n56 Thus, all Texas creditors will hold community claims. n57 Postnuptial tort creditors of the debtor will also hold a claim of a nature sufficient to pull additional community property assets into the estate under section 541(a)(2)(B). n58

Washington. Washington distinguishes between community debts and separate debts. n59 Prenuptial contract creditors may reach only the separate property of the debtor and, provided the claim is reduced to judgment within three years of the marriage, the community earnings and accumulations of the debtor. n60 Other separate contract creditors are limited to the separate property of the debtor. n61 Tort creditors of one spouse may reach that spouses separate property and that spouses share of the community property, regardless of whether the tort occurred before or during the marriage. n62 Community creditors may reach all community property as well as the separate property of the contracting spouse. n63 Thus, community creditors will hold community claims under the Code, as will prenuptial contract creditors who reduce their claims to judgment within three years of the marriage and tort creditors of either spouse. All other creditors will not hold community claims in cases filed under the Code where Washington community property law applies.

Wisconsin. In Wisconsin, all creditors have the status of community claim holders, because all creditors have some access under state law to marital property of the type which would pass to the estate under section 541(a)(2). n64 For example, claims which were incurred in the interest of the marriage or the family may be satisfied from the entirety of the marital property, n65 as may a support obligation. n66 Furthermore, even premarital obligations may be satisfied from marital property that would have been available had the marriage not taken place. n67 This includes the wages of the debtor spouse, which constitute marital property n68 and thus pass to the estate under section 541(a)(2); accordingly, claims satisfiable therefrom are community claims. Finally, all other claims are, at a minimum, satisfiable from a spouses interest in marital property. n69 Accordingly, all creditors of either spouse in Wisconsin hold community claims.

For further discussion of the Code chapter 101, see Collier on Bankruptcy, chs. 101 (Matthew Bender).

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[Return to Text](#)

n1 1. The term community property is not defined in the Code, but clearly is used as a term of art referring to that certain means of holding marital property in those states which have adopted a community property system. *Johnson v. Fisher (In re Fisher)*, 67 B.R. 666, 668 (Bankr. D. Colo. 1986) (citing *Treatise*). But see *In re Brollier*, 30 C.B.C.2d 1337, 165 B.R. 286 (Bankr. W.D. Okla. 1994). The *Brollier* decision, arising in a noncommunity property jurisdiction, inappropriately stretches the limits of the plain meaning doctrine.

n2

2. *See generally* Sommer & McGarity, *Collier Family Law and the Bankruptcy Code*, 4.05[2] (Matthew Bender); Ak. Stat. §§ 34.77.01034.77.195; Ariz. Rev. Stat. Ann. §§ 25-21125-215; Cal. Fam. Code §§ 900-1103; Idaho Code §§ 32-90132-912; La. Civ. Code. arts. 23252369; Nev. Rev. Stat. §§ 123.010123.250; N.M. Stat. Ann §§ 40-3-6 to 40-3-17; 31 L.P.R.A. § 3661; Tex. Fam. Code Ann. §§ 3.0013.006, 3.1013.104, Tex. Fam. Code 3.2013.203; Wash. Rev. Code Ann. § 26.16.030; Wis. Stat. Ann. § 766.001766.97.

n3 3. *See Collier on Bankruptcy*, 541.13[1][5].

n4

4. *See Collier on Bankruptcy*, 101.10.

n5

5. *See Collier on Bankruptcy*, ch. 342.

n6

6. *See 11 U.S.C. § 524(a)(3)*.

n7

7. *See 11 U.S.C. § 726(c)*.

n8

8. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 309 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 21 (1978); *In re Whitus*, 240 B.R. 705, 707 (*Bankr. W.D. Tex.* 1999). For a discussion of the nature of a community claim when domestic partner community property has passed to the estate, *see Collier on Bankruptcy*, 101.07[3][c] and 541.13[5].

n9 9. *See Collier on Bankruptcy*, 726.04726.05.

n10

10. The language whether or not there is any such property at the time of the commencement of the case in section 101(7) will be meaningless in almost all cases. If no community property has passed to the estate, section 726(c) does not direct that sub-estates be established for distribution purposes. Therefore, the distribution would take place under sections 726(a) and (b), thus excluding the other spouses creditors. See *Collier on Bankruptcy* 726.04726.05. The language is meaningful, however, if voidable transfers retain their separate or community property nature. See *Collier on Bankruptcy*, 726.05[4]. The language is also meaningful when chapter 13 earnings are included as assets of the estate. *In re Whitus*, 240 B.R. 705, 707 (Bankr. W.D. Tex. 1999); see *Collier on Bankruptcy*, 1306.02[3].

n11

11. *Grimm v. Grimm (In re Grimm)*, 18 C.B.C.2d 590, 82 B.R. 989 (Bankr. W.D. Wis. 1988) (quoting *Treatise*). The definition of creditor includes an entity that has a community claim. See *Collier on Bankruptcy*, 101(10).

n12 12. *FDIC v. Soderling (In re Soderling)*, 998 F.2d 730, 733 (9th Cir. 1993), quoting A. Pedlar, *Community Property and the Bankruptcy Reform Act of 1978*, 11 St. Marys L.J. 349, 351-52 (1979). In addition to the foregoing, there may be instances where the former spouses are no longer married but their community property had not been divided as of the date of the petition. In such instances, creditors of the debtors former spouse would also hold community claims. See *McCoy v. Bank of America, (In re McCoy)*, 22 C.B.C.2d 1343, 111 B.R. 276 (B.A.P. 9th Cir. 1990).

n13 13. See *FDIC v. Soderling (In re Soderling)*, 998 F.2d 730, 733 (9th Cir. 1993); *Case v. Maready (In re Maready)*, 122 B.R. 378, 381 n.2 (B.A.P. 9th Cir. 1991); *Grimm v. Grimm (In re Grimm)*, 18 C.B.C.2d 590, 82 B.R. 989 (Bankr. W.D. Wis. 1988).

n14

14. See generally Sommer & McGarity, *Collier Family Law and the Bankruptcy Code*, 4.03[4][a][k], 4.05[2] (Matthew Bender).

n15 15. *Teel v. Teel (In re Teel)*, 34 B.R. 762 (B.A.P. 9th Cir. 1983); *In re Ann Arbor Brewing Co.*, 110 F. Supp. 111, 113-14 (E.D. Mich. 1951); *Merlino v. Weinstein (In re Merlino)*, 62 B.R. 836 (Bankr. W.D. Wash. 1986); *In re Hendrick*, 45 B.R. 976 (Bankr. M.D. La. 1985). See generally U.S. Const. Art. I, § 8, cl 4

(empowering Congress to establish bankruptcy laws); U.S. Const. Art. VI, cl 2 (supremacy clause); Sommer & McGarity, *Collier Family Law and the Bankruptcy Code*, 4.05[2] (Matthew Bender).

n16 16. *In re Whitus*, 240 B.R. 705, 707 (Bankr. W.D. Tex. 1999).

n17

17. *See, e.g.*, California, where prenuptial creditors of one spouse may not reach the community property wages of the other spouse, Cal. Fam. Code § 911(a), and New Mexico, where creditors of one spouse may reach one-half of the community property, N.M. Stat. Ann. § 40-3-10 (1994).

n18 18. *See, e.g.*, California, where a tort creditor whose claim is not based upon an act or omission which occurred while the spouse was performing an activity for the benefit of the community must first seek satisfaction from separate property. Cal. Fam. Code § 1000 (West).

n19

19. *See* La. Civ. Code. arts. 2358 -- 2367. Such reimbursement rights would, of course, be discharged in bankruptcy.

n20

20. *In re Whitus*, 240 B.R. 705, 707 (Bankr. W.D. Tex. 1999).

n21

21. *See In re Sweitzer*, 111 B.R. 792, 800 (Bankr. W.D. Wis. 1990); *Grimm v. Grimm (In re Grimm)*, 18 C.B.C.2d 590, 82 B.R. 989 (Bankr. W.D. Wis. 1988). *But see Swink v. Sunwest Banks (In re Fingado)*, 113 B.R. 37, 41-42 (Bankr. D.N.M. 1990), *aff'd*, 995 F.2d 175 (10th Cir. 1993), wherein the court, in *dictum*, stated that only one half of the community property would be available for distribution to the holder of a separate debt against the debtor. This statement misinterprets the language of section 101(7), which bestows community claim status upon any claim for which any community property would be liable, and section 726(c)(2)(A) and (D), which distributes all community property in the estate to holders of community claims. *See Collier on Bankruptcy*, 726.05.

n22

22. *See Collier on Bankruptcy*, 726.05.

n23

23. *See* Ak. Code Ann. §§ 34.77.030, 34.77.090.

n24

24. *See* Ak. Code Ann. § 34.77.070(k).

n25

25. *See* Ak. Code Ann. § 34.77.070(j).

n26

26. *See* Ak. Code Ann. § 34.77.070(b).

n27

27. *See* Sommer & McGarity, *Collier Family Law and the Bankruptcy Code*, 4.03[4][b] (Matthew Bender); Ariz. Rev. Stat. Ann. § 25-215(B).

n28

28. *See* Ariz. Rev. Stat. Ann. § 25-215(B); *GAF Corp. v. Diamond Carpet Corp.*, 117 Ariz. 297, 572 P.2d 125 (Ct. App. 1977).

n29

29. Ariz. Rev. Stat. Ann. § 25-215(A); *Kosac v. Clark (In re Clark)*, 179 B.R. 898 (Bankr. D. Ariz. 1995). Intentional torts that are committed for the benefit of the community constitute community claims under *Arizona law*. *Taylor Freezer Sales v. Oliphant (In re Oliphant)*, 221 B.R. 506 (Bankr. D. Ariz. 1998).

n30

30. Ariz. Rev. Stat. Ann. § 25-215(D).

n31

31. California Community Property, 4.014.11 (Matthew Bender); Sommer & McGarity, Collier Family Law and the Bankruptcy Code, 4.03[4][c] (Matthew Bender).

n32

32. *Grolemund v. Cafferata*, 17 Cal.2d 679, 111 P.2d 641, cert. denied, 314 U.S. 612, 62 S. Ct. 87, 86 L. Ed. 2d 492 (1941); *Wilson v. Wilson*, 33 Cal.2d 107, 110, 199 P.2d 671, 673 (1948).

n33

33. Cal. Fam. Code § 910(a); *Robertson v. Willis*, 77 Cal. App. 3d 358, 143 Cal. Rptr. 523 (1978). The one exception to this rule arises under Cal. Fam. Code § 910(b) which provides that debts incurred while the spouses are living separate and apart prior to a judgment for dissolution of marriage or a judgment for legal separation may not be satisfied from community property. See *McCoy v. Bank of America (In re McCoy)*, 22 C.B.C.2d 1343, 111 B.R. 276 (B.A.P. 9th Cir. 1990). As a result, such obligations should be treated in a manner similar to separate debts under Washington law.

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34. Cal. Fam. Code § 911(a).

n35

35. Cal. Fam. Code § 1000.

n36

36. See *Collier on Bankruptcy*, 101.07[2].

n37

37. See Sommer & McGarity, Collier Family Law and the Bankruptcy Code, 4.03[4][b] (Matthew Bender). Debts incurred after legal separation may be enforced only against the debtor spouses property, including any community property awarded to the debtor spouse as part of a dissolution of a marriage.

n38

38. *FDIC v. Soderling (In re Soderling)*, 998 F.2d 730 (9th Cir. 1993).

n39

39. See *Collier on Bankruptcy*, 541.13[5]. However, if a court holds that domestic partner community property is not section 541(a)(2) property, but rather passes to the estate under section 541(a), then the creditors of the nondebtor domestic partner will not hold community claims. In such circumstance, their entitlement, if any, to share in a distribution of domestic partner community property will be based on the courts willingness and ability to fashion an equitable remedy. See *Collier on Bankruptcy*, 726.04.

n40

40. See *Collier on Bankruptcy* 541.13[5] and 726.04.

n41

41. See Sommer & McGarity, Collier Family Law and the Bankruptcy Code, 4.03[4][d] (Matthew Bender); Idaho Code § 32-912; *In re Hicks*, 300 B.R. 372, 376 (Bankr. D. Idaho 2003); see also *Twin Falls Bank & Trust Co. v. Holley*, 111 Idaho 349, 723 P.2d 893 (1986).

n42

42. *Williams v. Paxton*, 98 Idaho 155, 559 P.2d 1123, *affd on reh'g* (1977); *Gustin v. Byam*, 41 Idaho 538, 240 P. 600 (1925); *Holt v. Empey*, 32 Idaho 106, 110, 178 P. 703, 704 (1919).

n43

43. *In re Acequia, Inc.*, 34 F.3d 800, 31 C.B.C.2d 1197 (9th Cir. 1994); *Amato v. United States*, 94 F. Supp. 2d 1081 (D. Idaho 1999); *In re Martell*, 349 B.R. 233 (Bankr. D. Idaho 2005); *In re Hicks*, 300 B.R. 372, 376 (Bankr. D. Idaho 2003); *In re Hegg*, 239 B.R. 833 (Bankr. D. Idaho 1999); *In re Kido*, 142 B.R. 924 (Bankr. D. Idaho 1992); *Twin Falls Bank & Trust Co. v. Holley*, 111 Idaho 349, 723 P.2d 893 (1986); *Crapo, Equal Management of Community Property: Creditors Rights*, 13 Idaho L. Rev. 177 (1977).

n44

44. See Sommer & McGarity, *Collier Family Law and the Bankruptcy Code*, 4.03[4][e] (Matthew Bender); La. Civ. Code. arts. 2358 -- 2369 (1985).

n45

45. La. Civ. Code art. 2345 (1985); *Federal Deposit Ins. Corp. v. Kemp*, 766 F. Supp. 511, 517 (E.D. La. 1991).

n46

46. See Sommer & McGarity, *Collier Family Law and the Bankruptcy Code* 4.03[4][f] (Matthew Bender); Nev. Rev. Stat. § 123.050.

n47

47. In *Randono v. Turk*, 86 Nev. 123, 466 P.2d 218 (1970), it was held that community property was liable for the separate debts of the husband because he could unilaterally give the property away and because the property was liable for such debts upon his death under former Nev. Rev. Stat. § 123.260 (1973). 86 Nev. 123, 132, 466 P.2d 218, 224. Neither of these bases for finding such liability now exist. Section 123.260 was repealed by the amendments to the community property laws, ch. 393, § 18 [May 10, 1975], Nev. Stat. 562, and neither spouse may make a gift of the community property without the consent of the other, Nev. Rev. Stat. § 123.230(2) (2000). Furthermore, more recent Nevada decisions refer to community debts and separate debts, which suggests that Nevada may follow the community debt doctrine. See *Schmanski v. Schmanski*, 115 Nev. 247, 984 P.2d 752 (1999); *Norwest Fin. v. Lawver*, 109 Nev. 242, 849 P.2d 324 (1993). But see *Jones v. Swanson*, 341 F.3d 723, 738 n.6 (8th Cir. 2003) (citing *Randono v. Turk* for the proposition that under Nevada law, community property is subject to a spouses debt irrespective of whether both spouses were a party to the action).

n48

48. In Nevada, a prenuptial creditor (one type of separate creditor) may reach a portion of the community

property. Nev. Rev. Stat. § 123.050 (2000).

n49

49. See Sommer & McGarity, Collier Family Law and the Bankruptcy Code, 4.03[4][g] (Matthew Bender); N.M. Stat. Ann. 40-3-9; *In re Strickland*, 28 C.B.C.2d 1352, 153 B.R. 909 (Bankr. D.N.M. 1993).

n50

50. N.M. Stat. Ann. § 40-3-10.

n51

51. N.M. Stat. Ann. § 40-3-11; *In re Victor*, 341 B.R. 775, 781 (Bankr. D.N.M. 2006).

n52

52. See Collier on Bankruptcy, 101.07[2].

n53

53. See Sommer & McGarity, Collier Family Law and the Bankruptcy Code 4.03[4][k] (Matthew Bender); 31 L.P.R.A. § 3661(1) (2001); *In re Lopez Melendez*, 145 B.R. 740, 742 (D.P.R. 1992); *Santiago v. Sepulveda Figueras* (*In re Sepulveda Figueras*), 193 B.R. 118 (Bankr. D.P.R. 1996); *In re Lang*, 191 B.R. 268 (Bankr. D.P.R. 1995) (citing *Treatise*).

n54

54. See 31 L.P.R.A. § 3663 (2001).

n55

55. See Sommer & McGarity, Collier Family Law and the Bankruptcy Code, 4.03[4][h] (Matthew Bender); Tex. Fam. Code Ann. § 3.202; *In re Rodriguez*, 353 B.R. 144 (Bankr. N.D. Tex. 2006); *In re Nahat*, 278 B.R.

108 (Bankr. N.D. Tex. 2002); *In re Melenzyer*, 140 B.R. 143, 148 n.16 (Bankr. W.D. Tex. 1992). Separate property of the other spouse is not liable. *Texas Com. Bank Natl Assn v. Tripp*, 516 S.W.2d 256, 259 (Tex. Civ. App. 1974).

n56

56. Tex. Fam. Code Ann. §§3.202(b), (d).

n57

57. *In re Texas Extrusion Corp.*, 68 B.R. 712 (N.D. Tex. 1986), *affd*, 836 F.2d 217 (5th Cir.), *cert. denied*, 488 U.S. 926, 109 S. Ct. 311, 102 L. Ed. 2d 330 (1988). Accordingly, the claim of the Internal Revenue Service against a nondebtor spouse is a community claim in the debtor spouses case. *In re Whitus*, 240 B.R. 705, 708 (Bankr. W.D. Tex. 1999).

n58

58. *See Collier on Bankruptcy*, 541.13 and 726.05.

n59

59. *See Sommer & McGarity*, *Collier Family Law and the Bankruptcy Code*, 4.03[4][i] (Matthew Bender); *Seattle First Natl Bank v. Marusic (In re Marusic)*, 27 C.B.C.2d 306, 139 B.R. 727 (Bankr. W.D. Wash. 1992).

n60

60. Wash. Rev. Code § 26.16.200. When bankruptcy is within three years of marriage, prenuptial creditors should be accorded the status of a holder of a community claim. *See Watters v. Doud*, 92 Wash.2d 317, 596 P.2d 280 (1979).

n61

61. Such separate property creditors of the debtor are creditors under section 101(10), but do not hold community claims. *In re Merlino*, 62 B.R. 836, 838 (Bankr. W.D. Wash. 1986).

n62

62. See *Haley v. Highland*, 142 Wash.2d 135, 12 P.3d 119 (2000); *Keene v. Edie*, 131 Wash.2d 822, 935 P.2d 588 (1997); *deElche v. Jacobsen*, 95 Wash.2d 237, 622 P.2d 835 (1980).

n63

63. It is assumed that the former rights of the husbands creditors will now be extended to include creditors of the wife as well. For an informative overview of creditors remedies against community property under the former Washington community property law, see *National Bank of Commerce v. Green*, 1 Wash. App. 713, 463 P.2d 187 (1969). See also *Smyser v. Smyser*, 17 Wash.2d 301, 135 P.2d 455, 457 (1943).

n64

64. See Sommer & McGarity, *Collier Family Law and the Bankruptcy Code*, 4.03[4][j] (Matthew Bender); *In re Passmore*, 29 C.B.C.2d 523, 156 B.R. 595 (Bankr. W.D. Wis. 1993); *In re Sweitzer*, 111 B.R. 792 (Bankr. W.D. Wis. 1990).

n65 65. Wis. Stat. § 766.55(2)(b). It is the intent of the legislature that marital is a form of community property. Wis. Stat. Ann. § 766.001(2) (1993).

n66

66. Wis. Stat. § 766.55(2)(a).

n67

67. Wis. Stat. § 766.55(2)(c).

n68

68. Wis. Stat. § 766.31(4); *In re Pfalzgraf*, 236 B.R. 390 (Bankr. E.D. Wis. 1999); *In re Passmore*, 29 C.B.C.2d 523, 156 B.R. 595 (Bankr. E.D. Wis. 1993).

n69 69. Wis. Stat. § 766.55(2)(d); *Grimm v. Grimm (In re Grimm)*, 18 C.B.C.2d 590, 592-94, 82 B.R. 989, 990-92 (Bankr. W.D. Wis. 1988). Marital property has the same essential characteristics under Wisconsin law as community property under the Code and will be treated in a similar fashion. 18 C.B.C.2d 590, 594 n.3, 82 B.R. 989, 991 n.3; Wis. Stat. Ann. § 766.001(2).

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117 of 197 DOCUMENTS

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Collier on the Definition of Transfer Under the Bankruptcy Code

2008 Emerging Issues 1396

Collier on the Definition of Transfer Under the Bankruptcy Code

By Collier

December 7, 2007

SUMMARY: "Transfer" is broadly defined in the Bankruptcy Code. It includes indirect as well as direct methods of property changing hands. This Emerging Issues Analysis from Collier on Bankruptcy explains how the term "transfer" applies to the transfer of any interest in property, such as the retention of title as a security interest, and discusses the types of property interests that may be transferred, such as leveraged buyout transactions.

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ARTICLE: Pursuant to section 101(54), the term transfer means

- (A) the creation of a lien;
- (B) the retention of title as a security interest;
- (C) the foreclosure of a debtor's equity of redemption; or
- (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with
 - (i) property; or
 - (ii) an interest in property. n1

Transfer is broadly defined in the Code. n2 It includes indirect as well as direct methods of property changing hands. It includes conditional as well as absolute methods. And it includes involuntary as well as voluntary methods. However, the legislative history indicates that the term does not include setoffs. n3 The term appears in many Code provisions, including several of the trustee's avoiding powers. n4

Interest in Property. The term transfer applies not simply to the transfer of property in the traditional sense, but to the transfer of any interest in property. A transfer may be of specific limited rights in property, leaving the transferor with some other interest in the same property. The definition gives several examples that make this clear.

The retention of title as a security interest is a transfer, just as the granting of a lien would be a transfer. n5 The definition of transfer was amended in 2005 n6 to clarify this issue by specifically including creation of a lien as an example of a transfer. The legislative history states that this amendment, along with an amendment to section 549(c) responds to a Ninth Circuit decision n7 in which two purchase money lenders (without knowledge that the debtor had recently filed an undisclosed chapter 11 case that was subsequently converted to chapter 7), funded the debtors acquisition of an apartment complex and recorded their purchase-money deed of trust immediately following recordation of the deed to the debtors. n8 The amendment makes clear that the circuit court erred in holding that the creation of a lien was not a transfer.

Similarly, the foreclosure of a debtor's equity of redemption is a separate transfer from the initial transfer of a mortgage lien. At the time of the original mortgage a lien on the property is transferred, but the debtor retains other rights, including the right to possession and the right to remove the lien by paying the underlying debt. When there is foreclosure on the lien, the debtor loses some or all of these rights, which are thus transferred separately from the interests transferred by the original lien, often in several stages.

Thus, in applying the section 101(54) definition of transfer to a tax sale under state law, several distinct transfers may occur: first, when the tax lien attaches to the debtor's property upon the debtor's failure to pay property taxes; second, when the property is sold at a tax sale and the tax sale purchaser acquires a lien as represented by a certificate of purchase; and third, when the tax deed itself is issued to the tax sale purchaser upon perfection of the deed and the expiration of the applicable redemption period. n9 Although state laws regarding foreclosure and tax sales vary, virtually all of them have a number of steps, with a transfer of certain property interests at each step.

Nonbankruptcy law concerning the existence of property interests similarly determines when or if a transfer of such interests takes place. Thus, in *In re Frierdich*, n10 the Court of Appeals for the Seventh Circuit held that a purported transfer of stock to the debtor's spouse in a prenuptial agreement had not been effectuated until well after the agreement, when the steps necessary to transfer stock under Illinois law had been taken.

Types of Property Interests That May Be Transferred. The definition of transfer is not restricted as to the time or the identity of the party making the transfer. n11 The language of section 101(54) is sufficiently broad to encompass a leveraged buyout transaction. n12 A creditors prepetition termination of an executory agreement may constitute a transfer. n13 The Bankruptcy Codes definition of transfer as used when determining whether the elements of a fraudulent transfer are present, is sufficiently broad to include within its scope a transfer that results in modification of form or value of property transferred. n14 A deposit into a bank account may be a transfer under the Code. n15 A forfeiture of an equity interest under a real estate contract constitutes a transfer. n16 Although the Bankruptcy Code does not specifically mention forfeiture of an interest under a land sales contract in the definition of transfer, the definition is broad enough and, particularly in light of its later clarifying amendment, should be interpreted to include such a forfeiture. n17 However, for the debtor to transfer property, the debtor must first have an interest in that property. The Court of Appeals for the Seventh Circuit held, in *In re Atchison* n18 that under Illinois law, a debtor who disclaimed an inheritance under a will never had a property interest in that inheritance because the disclaimer operated to prevent her from ever acquiring an interest in the property of her fathers estate. The Court of Appeals for the Eighth Circuit came to the same conclusion, relying on a Missouri statute providing that a disclaimer of inheritance relates back for all purposes to the effective date of the transfer and is not subject to the claims of any creditor of the disclaimant. n19

Time of Transfer by Check. The United States Supreme Court in *Barnhill v. Johnson* n20 held that for the purposes of payment by ordinary check, a transfer, as defined in section 101, occurred on the date of honor, in the determination as to whether such transfer fell within the 90-day preference period under section 547(b). The debtor had

made payment for a *bona fide* debt; the check was delivered on November 18 and honored by the drawee bank on November 20. The payee contended that the transfer had occurred on November 18, the date of delivery, and that it therefore fell on the ninety-second day before the petition was filed, outside the 90 day preference period. The Court disagreed, finding that when the debtor had directed the drawee bank to honor the check and the bank had done so (on the ninetieth day before filing), the debtor implemented a mode, direct or indirect of disposing of property or an interest in property, and a transfer occurred on that later date as defined by section 101. Until the bank paid the check, the debtors interest in the checking account could have been otherwise disposed of, e.g., by a writ of garnishment. n21 The Court observed that although federal law controlled the definition of a transfer, state law provided, in the absence of controlling federal law, the construction of parting with property or with an interest in property appearing in the section 101 definition of transfer. Under the Uniform Commercial Code, receipt of the check gave the recipient no right in the funds held by the bank on the drawer's account. The Court stressed that, until the moment of honor, the debtor had retained full control over the disposition of the account, the account had remained subject to a variety of actions (such as a lien attachment) by third parties and the debtor had retained the ability to stop payment on the check until the very last moment.

Comparison to Former Bankruptcy Act. The Codes definition of transfer is phrased in broad but simpler language than in Section 1(30) of the former Bankruptcy Act, which enumerated various types of transfers. However, even though the definition in this paragraph is greatly simplified in wording, the impact is just as broad in scope. For example, Section 1(30) of the former Act began with the phrase Transfer shall include the sale and every other and different mode whereas this paragraph begins simply, Transfer means every mode Although the definition in Section 1(30) of the Act used the introductory phrase includes rather than means as it appears now in the Code, the effect is the same. Even though the use of the term includes is generally construed more liberally than means, the word every extinguishes any would-be limiting influence.

The word transfer also had a most comprehensive meaning under the former Act, and even under the former more restricted clause, had been construed to include every method of disposing of or parting with property or its possession. In *Pirie v. Chicago, Title & Trust Co.*, n22 the Court, holding that payment of money was a transfer of property, stated:

Transfer is defined to be not only the sale of property, but every other mode of disposing or parting with property. All technicality and narrowness of meaning is precluded. The word is used in its most comprehensive sense, and is intended to include every means and manner by which property can pass from the ownership and possession of another, and by which the result forbidden by the statute may be accomplished n23

For further discussion of the definition of transfer under the Bankruptcy Code, see Collier on Bankruptcy, ch. 101 (Matthew Bender).

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n1 1. 11 U.S.C. § 101(54).

n2

2. See, e.g., *In re Connor*, 733 F.2d 1560 (11th Cir. 1984); *Official Comm. of Unsecured Creditors v. Lozinski (In re High Strength Steel, Inc.)*, 269 B.R. 560 (Bankr. D. Del. 2001) (reconciliation of accounts that eliminated debtors claims against insiders was a transfer); *In re Lemley Estate Bus. Trust*, 65 B.R. 185 (Bankr. N.D. Tex. 1986) (granting of security interests that attach to after-acquired crops is transfer of interests in property even though there was no actual transfer of title; transfers of possession, custody or control constitute transfers of interests in property); *Geekie v. Watson (In re Watson)*, 15 C.B.C.2d 688, 65 B.R. 9 (Bankr. C.D. Ill. 1986) (debtors filing of a disclaimer to the proceeds of a life insurance policy constitutes a postpetition transfer of property of the estate).

n3

3. *In re Mass. Gas & Electric Light Supply Co., Inc.*, 200 B.R. 471 (Bankr. D. Mass. 1996) (citing 124 Cong. Rec. H11,090 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards); 124 Cong. Rec. S17,407 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini)).

n4

4. 11 U.S.C. §§ 544, 547, 549.

n5

5. But see *In re McConville*, 110 F.3d 47, 37 C.B.C.2d 1224 (9th Cir. 1997) (erroneously holding that creation of a lien is not a transfer).

n6

6. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1201(6) (2005), effective in cases commenced on or after October 17, 2005.

n7

7. *In re McConville*, 110 F.3d 47, 37 C.B.C.2d 1224 (9th Cir. 1997).

n8

8. H.R. Rep. No.31, 109th Cong., 1st Sess. 141 (2005).

n9

9. *In re McKeever*, 25 C.B.C.2d 1260, 132 B.R. 996 (Bankr. N.D. Ill. 1991).

n10

10. 294 F.3d 864 (7th Cir. 2002).

n11

11. *Hill v. Hill Dev. Co., Ltd. (In re Hill)*, 265 B.R. 296 (Bankr. M.D. Fla. 2001) (withdrawal of partnership wholly owned by debtor from valuable position as general partner in another partnership was a transfer); *In re Hill*, 29 C.B.C.2d 637, 156 B.R. 998 (Bankr. E.D. Ill. 1993).

n12

12. *Mellon Bank, N.A. v. Metro Communications, Inc.*, 945 F.2d 635, 25 C.B.C.2d 1064 (3d Cir. 1991).

n13

13. *In re Metro Water and Coffee Servs., Inc.*, 29 C.B.C.2d 842, 157 B.R. 742 (W.D.N.Y. 1993).

n14

14. See *In re Oliver*, 11 C.B.C.2d 972, 44 B.R. 989 (D. Mass. 1984) (a transfer occurred when the debtor and his wife changed their old common law tenancy by the entirety into one governed by a new statute under which the debtor gave up considerable interest in property in favor of his wife); *In re Richmond Produce Co., Inc.*, 151 B.R. 1012 (Bankr. N.D. Cal. 1993).

n15 15. *In re Prescott*, 805 F.2d 719 (7th Cir. 1986); see also *In re Davidson*, 30 C.B.C.2d 1676, 164 B.R. 782 (Bankr. M.D. Fla. 1994) (Congress intended that the deposit of funds into a bank account or the purchase of an annuity constitute transfers for purposes of section 101(54)); *In re Clearwater Discount Marine, Inc.*, 150

B.R. 74 (*Bankr. M.D. Fla.* 1993) (bank's application of moneys on deposit in the debtor in possessions account to debt owed prepetition by debtor constituted transfer, for the purpose of determining whether avoidable transfer occurred since the debtor no longer had right to withdraw balance on account after the bank froze and applied balance). *But see In re Consolidated Pioneer Mortgage Entities*, 211 B.R. 704 (S.D. Cal. 1997) (customers bank deposits into its own unrestricted checking account are not transfers).

n16 16. *In re Veritto*, 26 C.B.C.2d 75, 131 B.R. 732 (*Bankr. D.N.M.* 1991).

n17

17. *In re Vermillion*, 176 B.R. 563 (*Bankr. D. Or.* 1994); *see also First Fed. Sav. & Loan Ass'n of Bismarck v. Hulm (In re Hulm)*, 738 F.2d 323, 11 C.B.C.2d 152 (8th Cir. 1984), *cert. denied*, 469 U.S. 990, 105 S. Ct. 398, 83 L. Ed. 2d 331 (1985) (foreclosure sale subject to redemption under a state statute was a transfer of the debtor's interest); *In re Messia*, 184 B.R. 176 (*Bankr. D. Mass.* 1995) (chapter 7 debtors prepetition act of declaring homestead exemption according to Massachusetts law was not a transfer that the trustee could avoid, because there was no third party involved in declaration of homestead); *Main v. Brim (In re Main)*, 75 B.R. 322 (*Bankr. D. Ariz.* 1987) (warranty deed given by the chapter 11 debtor in lieu of foreclosure to the holder of a deed of trust was a transfer under the Code); *In re Venice Western Motel Ltd.*, 67 B.R. 777 (*Bankr. M.D. Fla.* 1986) (execution of an agreement restructuring a mortgage to increase the interest rate and amount of principal debt was transfer because it reduced the debtor's interest in real property); *Bundles v. Baker (In re Bundles)*, 15 C.B.C.2d 576, 61 B.R. 929 (*Bankr. S.D. Ind.* 1986); *Verna v. Dorman (In re Verna)*, 14 C.B.C.2d 170, 58 B.R. 246 (*Bankr. C.D. Cal.* 1986) (when a third party purchases property at a foreclosure sale by the foreclosure of a security interest, such action constitutes the transfer of the debtor's equity of redemption).

n18

18. 925 F.2d 209 (7th Cir. 1991).

n19

19. *Blackwell v. Lurie (In re Popkin & Stern)*, 223 F.3d 764 (8th Cir. 2000).

n20

20. 503 U.S. 393, 112 S. Ct. 1386, 118 L. Ed. 2d 39, 26 C.B.C.2d 323 (1992).

n21

21. 503 U.S. 393, 399-400, 112 S. Ct. 1386, 1390, 118 L. Ed. 2d 39, 46-47, 26 C.B.C.2d 323, 328 (1992).

n22

22. 182 U.S. 438, 21 S. Ct. 906, 45 L. Ed. 1171 (1901).

n23

23. *Accord Coder v. Arts*, 152 F. 943 (8th Cir. 1907), *affd*, 213 U.S. 223, 29 S. Ct. 436, 53 L. Ed. 772 (1909); *Irving Trust Co. v. Kaminsky*, 22 F. Supp. 362 (S.D.N.Y. 1937); *In re Muir*, 212 F. 495 (D. Pa. 1914); *see also Britt v. Damson*, 334 F.2d 896 (9th Cir. 1964) (citing *Treatise* as to whether an award by a Washington court in a divorce proceeding of more than one-half of the community property to the debtor's wife was a transfer); *Feldman v. Capitol Piece Dye Works, Inc.*, 185 F. Supp. 426 (S.D.N.Y. 1960), *rev'd*, 293 F.2d 889 (2d Cir. 1961); Note, 17 *Stan. L. Rev.* 1158 (1965); Note, 40 *Wash. L. Rev.* 210 (1965).

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Collier on the Effect of Fraud on Exemption Rights

2008 Emerging Issues 1377

Collier on the Effect of Fraud on Exemption Rights

By Collier

December 6, 2007

SUMMARY: This Emerging Issues Analysis covers the effect of fraud on exemption rights under the Bankruptcy Code, including topics such as fraudulent conduct precluding the claiming of rights under state exemption laws, the transfer or concealment of property avoided or recovered, the acquisition of property to secure exemptions, and the limitations on exempt homestead interest based on fraudulent conversion.

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ARTICLE: Varieties of Fraud

Fraud and its effect upon exemptions assume many shapes and forms. Frequently, the alleged fraudulent conduct occurred before the initiation of the case, such as false statements made to obtain credit, acquisition of property by questionable methods, business misleadingly done under an assumed name or the spiriting away of assets beyond hope of later recovery by the trustee. Sometimes the objectionable act arises in the bankruptcy proceeding itself, such as falsely swearing under oath on examination as to assets, placing erroneous value on articles claimed exempt in the schedules or failing to make a full and fair disclosure of all assets. n1 In other instances, the problem is whether an exemption will be allowed out of property that has been transferred or concealed and which has been recovered by the trustee. Often a combination of these various acts occurs, as when a merchant makes false statements to obtain credit, then fraudulently transfers the goods received to a third person, or when property is fraudulently acquired and concealment is attempted but discovered.

Moreover, the statutes governing exemptions frequently limit exemptions according to the type of property or its value. n2 The statutory recognition of exemptions is of little consolation to debtors whose property does not fall neatly into those categories. Even debtors who have property that falls within the exemption categories may also own significant property that does not fall into those categories. In either event, the debtor may be interested in converting property that does not meet the statutory standards for exemption into property that does meet those standards. At some point, the thin line between legitimate exemption planning and fraudulent conveyance may be crossed.

As to most of the actions mentioned, the Code is silent and the court must depend upon state law, if state exemptions have been claimed, to determine whether the conduct warrants denial of the exemptions. n3 However, this general position taken by the Code has been altered to some extent by the enactment of *section 522(o) of the Bankruptcy*

Code, added by the 2005 Act, n4 which considers as a question of federal law the effect of a fraud on a state homestead exemption. Also, in situations in which there has been avoidance or recovery under the Code of property previously transferred or concealed by the debtor, state law, if applicable, is superseded by the Code. For example, if an exemption is claimed as to recovered property, section 522(g) prevails even if the debtor has opted for the state exemptions. n5 Section 522(g) also limits a debtor's exemptions selected under the federal exemption scheme of section 522(d). In either circumstance, the debtor may not exempt property recovered by the trustee if the debtor had voluntarily transferred the property or if the debtor had concealed the recovered property. n6

The Code is otherwise silent as to the effect of fraud on exemptions, but section 523(a) provides that some types of fraud will be grounds for exceptions to discharge. n7 Additionally, a fraudulent transfer made within one year of the commencement of the case can be grounds for the denial of the debtor's discharge in a chapter 7 proceeding. n8

Fraudulent Conduct as Working a Forfeiture of Exemption Rights

Because a bankruptcy court proceeds on equitable principles and because the laws and decisions of the state creating an exemption are generally controlling when the federal laws are silent, the bankruptcy court must generally apply state law that would preclude a debtor guilty of fraudulent conduct from claiming rights under the state's exemption laws. n9

In many cases, the misconduct may consist of a fraudulent transfer or concealment of property avoided or recovered under section 522 of the Code. When this is so, subsection (g) should govern the allowance of exemptions claimed in the property. But when the property has been or cannot be recovered, the law of the state governing the exemption should control as to whether the conduct is such that exemptions will be denied as to the remaining property. An exception to this general proposition applies to conduct involving the fraudulent conversion within 10 years of the petition date of nonexempt assets into homestead property claimed as exempt under state law, in which federal law should control based on section 522(o), as added by the 2005 Act. n10

In some cases, the debtor may seek to amend the exemption claim to include property not originally listed in the schedule of assets filed at the commencement of the case. Generally, the courts will liberally allow the amendment of the schedules. n11 However, if the court finds that the debtor intentionally omitted the property from the original schedules, the court will deny the debtor the opportunity to amend the exemption claim to include the newly disclosed asset. n12

Transfer or Concealment of Property Avoided or Recovered

When the trustee recovers property fraudulently conveyed or concealed, the debtor may not claim an exemption in the recovered property. Indeed, the transfer need not be fraudulent to defeat the debtor's right to claim an exemption in such property. Section 522(g) provides that the transfer need only be voluntary.

Section 522(g) lists the various sections of the Code under which the trustee may recover transferred property. Thus, the trustee may recover property if a transfer is avoided, n13 or if the property is held by a custodian. n14 And under section 542, the trustee may also recover estate property held by an entity other than a custodian. n15 Additionally, the trustee may order any subordinated lien returned to the estate. n16 Ordinarily, under section 522(g), in such recoveries of property, a claim of exemption would attach. This is not the case, however, when the transfer by the debtor was voluntary. n17 The debtor's voluntary transfer arguably demonstrates that the debtor did not consider it essential to retain the property.

The payment by the debtor to a creditor to obtain the release or dismissal of a garnishment action or similar judicial

collection effort clearly is not a voluntary transfer by the debtor. n18 This is not to say, however, that all payments made by debtors to avoid legal action are involuntary transfers. The settlement of a lawsuit through the execution of a note and mortgage to secure the note is a voluntary transfer. n19 On the other hand, granting a security interest in property is usually a voluntary act. Therefore, if the trustee recovers personal property from a creditor (because, perhaps, the creditor failed to perfect its interest in the property), the debtor ordinarily would not be allowed to claim the property as exempt under section 522(g). n20

Acquisition of Property to Secure Exemptions

The legislative history indicates that under section 522, the debtor may convert nonexempt property into exempt property immediately before the commencement of the case. n21 An eleventh hour acquisition of exempt property will not require disallowance of an exemption in the property. n22 Thus, in allowing an exemption in the debtor's interest in property as a tenant by the entirety or joint tenant, section 522(b)(3)(B) provides that such interest that the debtor had immediately before the commencement of the case may be exempted to the extent that such interest is exempt from process under applicable nonbankruptcy law. n23

Despite the Code drafters' generally favorable view of the exercise of a debtor's ability to exempt property from the claims of creditors, the existence of some exemption statutes that protect an unlimited amount of property has caused some problems. For example, a homestead exemption may be unlimited, n24 and insurance policies and other annuities may likewise have no cap on the amount that may be exempt. n25 The lack of any limit on the amount of exemptions in these categories makes the problem particularly acute. It also heightens the interest of creditors, trustees, and courts in evaluating the propriety of those exemption claims. In the end, such exemption provisions appear to have prompted Congress to impose certain limitations on their application as part of the 2005 Act. n26

The combination of a favorable climate and a liberal homestead exemption law has led some debtors to Florida. n27 Simply by relocating, the debtor may avoid both a cold climate and the heat generated by creditors asserting claims against the debtor. The bankruptcy courts faced a number of cases in which the debtor moved to Florida, bought a home with assets that were not exempt and, thereafter, sought bankruptcy relief. n28 Although Florida has opted out of the federal exemptions and the homestead exemption is entirely a creature of state law, some courts have denied the debtor's homestead exemption without reliance on Florida law. Instead, the courts have denied the debtor's exemption because the circumstances of the debtor's creation of the exemption indicated that the creation was accomplished through extrinsic fraud. That is, the debtor did more than simply convert nonexempt property into exempt property. Generally, the additional activity by the debtor includes evidence suggesting that the debtor planned the transaction as a response to particular creditor collection efforts.

In re Coplan n29 exemplifies the issues presented in these cases. The debtors owned and operated a retail appliance store in Wisconsin, but the business experienced financial setbacks. The debtors decided to leave Wisconsin and relocate in Florida to pursue other work there, even though job offers were extended to the debtor in Wisconsin. The debtors moved to Florida and faced an extended period of unemployment or underemployment. When they moved to Florida, the debtors used the proceeds from the sale of their Wisconsin residence to entirely fund the purchase of the new residence for \$228,000. The debtors also purchased annuities with other funds. Later, the primary lender to the debtors' former business obtained a judgment on a personal guaranty executed by the debtors. Just slightly more than one year after moving to Florida, the debtors filed a chapter 7 petition.

The court found that the circumstances of the move from Wisconsin to Florida enabled the debtors to increase their available homestead exemption from \$40,000 to the unlimited amount permitted in Florida. n30 The court also found that the debtors' assertion that the move was intended to improve their job prospects was not credible. n31 The court characterized the move from Wisconsin as being made for the purpose of obtaining the more generous homestead exemption. n32 The sale of the home was made very quickly and at a price that facilitated the expeditious move to Florida. The debtors moved to Florida without job prospects, having turned down job offers in Wisconsin. All of this

proved too much for the court, and the debtors' homestead exemption was denied to the extent that it exceeded \$40,000, which would have been exempt had the debtors remained in Wisconsin and claimed the exemption under that state's law. n33

The analytical problem with the cases that deny the debtor's exemption in these matters is that they often reach this conclusion without regard to the state law that governs those exemptions. If the state law creating the exemption does not provide for its denial on these grounds, it is questionable that denial is proper. Other bankruptcy court decisions in Florida had recognized this, n34 and the issue concerning the effect of conversion with fraudulent intent of nonexempt assets into an exempt homestead has now been resolved by the Florida Supreme Court. n35 However, Congress carved out an exception to the relevancy of state law on the effect of such conversion with the enactment of section 522(o), added by the 2005 Act. n36 And even if the exemption is allowed, the very actions that bring the exemption into question may support the denial of the debtor's discharge, the dismissal of the case, or the recovery of the property transferred. n37

This problem is certainly not limited to Florida, and perhaps the most noted cases addressing the issue were decided by the Eighth Circuit in 1989. *Hanson v. First National Bank* n38 and *Norwest Bank v. Tveten* n39 were decided on the same day by the same panel of judges. The debtors in *Hanson* were farmers who had converted approximately \$35,000 of nonexempt property into exempt property. The Eighth Circuit held that the lower courts' decisions rejecting a creditor's objection to the exemption were not clearly erroneous in finding that the debtors had no fraudulent intent in effecting the transfers. n40 The debtor in *Tveten*, however, was a physician who liquidated his nonexempt property and purchased approximately \$700,000 worth of exempt annuities and life insurance policies. The Eighth Circuit held that the lower courts' denial of the debtor's discharge in this case also was not clearly erroneous. n41

These two cases could be distinguished on the grounds that *Hanson* involved an objection to the exemption, while *Tveten* concerned an objection to the debtor's discharge. This is a distinction without a difference in the cases, because in each case, the court of appeals was evaluating the decision of the courts below that the particular conduct of the debtors either did or did not demonstrate the debtors' fraudulent intent. Thus, the same question was presented in each case. This leaves the impression that the nature of the debtor's employment and the total value of the property in question are the distinguishing factors. In any event, these cases demonstrate the importance of the factual findings in the bankruptcy court. Reversal requires a finding by the appellate court that the lower court's ruling was clearly erroneous, a difficult burden for the appellant to carry.

In some cases, it is much easier to conclude that the actions of the debtor were sufficient to disentitle the debtor to an exemption. *In re Smiley* n42 provides such an example. The debtor did much more than just convert nonexempt property into exempt property. In fact, the debtor and his counsel affirmatively misled the creditors, thereby delaying their collection efforts and giving the debtor the opportunity to move to another state with a much more extensive homestead exemption. n43 The creditors responded by bringing an involuntary bankruptcy petition against the debtor, objecting to the exemption, and objecting to the debtor's discharge. The creditors were successful on all counts. n44 The exemption was denied under the applicable state law, while the Bankruptcy Code was applied in denying the debtor's discharge.

Even if the applicable state law would protect the debtor's exemption in such a case, however, the debtor's discharge may still be vulnerable. In *First Texas Savings Association, Inc. v. Reed (In re Reed)*, n45 the debtor engaged in a lengthy and elaborate scheme to liquidate his nonexempt assets and pay down the debt secured by his home. Much of the property was sold for less than its full market value, but the debtor asserted that this was of no consequence because if he had got more for the property he simply would have applied those additional funds to the homestead debt. The Court of Appeals for the Fifth Circuit held that Texas law protected the debtor's homestead exemption. n46 It also held, however, that the transfers were fraudulent and supplied the grounds for the denial of the debtor's discharge. n47

These cases demonstrate the tension between the exemption laws and legal provisions addressing fraudulent transfers. n48 Furthermore, the potential for the denial of the debtor's discharge is a powerful incentive to tread carefully in this area. These matters should be decided according to applicable law. That is, the availability of an exemption claimed under state law should be evaluated under those provisions. The determination of a particular state that specific property may be claimed as exempt is entitled to be followed. So too is its law governing the effect of a fraudulent transfer on that exemption claim, except to the extent that the transfer involves a conversion of nonexempt property into homestead property. n49 *As Reed demonstrates, a favorable decision on the availability of the exemption does not necessarily end the matter.* n50 *Attention must be paid to the possibility of an objection to the debtor's discharge as well.* n51

Under the former Act, the mere conversion of nonexempt property into exempt property on the eve of bankruptcy was not in itself such fraud as would deprive the bankrupt of the right to exemptions. n52 In some jurisdictions, however, if it could be shown that there was fraudulent intent in the transaction, the exemption might have been refused. n53

The distinction as to whether there was fraudulent intent often depended on the facts of the particular case. For example, an exemption was disallowed when the debtor transferred property in violation of a court order. When, for example, the debtor had been ordered by the judge in a foreclosure proceeding not to dispose of any of his assets pending further hearing in that proceeding, and in violation of the order, the debtor sold his car and put \$1,000 of the proceeds in a savings and loan association, exemption was denied. n54

Before the final enactment of the Code, it had been urged that such last minute conversions be disallowed. n55 The abuses that were perceived were what is often referred to as bankruptcy or exemption planning. Such planning involves the last minute acquisition of exempt property, and those who opposed the allowance of exemptions in such property felt that these exemptions were used to defeat the legitimate claims of creditors. Opposition was based on the expectations of creditors that a debtor's assets would be used to pay the debts arising from the credit that had been extended. The sudden conversion of such property that could be used to pay creditors' claims into exempt property was viewed, by many, to be fraudulent as to these creditors.

The Code adopts a position that existed in some jurisdictions under the Act, i.e., the conversion of property into exempt property without more, will not be treated as fraudulent. n56 This position will protect those who have only a small amount of assets. Such debtors would be possibly be left without even a minimal amount of assets after liquidation if their small amount of property was not converted into exempt property. Though some states are liberal in the exemptions that they allow, thus creating the possibility of abuse in bankruptcy planning, it must be remembered that many state laws as well as section 522(d) of the Code exempt only relatively modest amounts of property. The result that would obtain if debtors were not allowed to convert nonexempt property into exempt property would be extremely harsh in those jurisdictions. This is most relevant to the situation in which a state has affirmatively prohibited the availability of the federal exemption alternative n57 (section 522(d)) and the debtor has no choice but to apply the exemptions of an even less generous state statute.

Limitation on Exempt Homestead Interest Based on Fraudulent Conversion; § 522(o)

Before the 2005 Act, the Code had been largely silent on the effect of fraud on state exemptions. Section 522 continues to adopt the position favorably viewed by the Code drafters that the mere conversion of nonexempt property into exempt property, without fraudulent intent, does not deprive the debtor of exemption rights in the converted property. n58 However, section 522(o), added by the 2005 Act, provides that if the conversion of nonexempt assets into homestead property is done with fraudulent intent, the debtor's claim of exemption may be challenged even though such conversion would not defeat the exemption under state law. n59

Section 522(o) provides that the value of the debtor's interest in certain homestead property that may be exempted shall be reduced to the extent that it is attributable to any property that the debtor could not exempt, and that had been disposed of within 10 years before the filing of the petition with the intent to hinder, delay or defraud a creditor. The action that may bring the debtor's exemption claim into question is the conversion through the sale, transfer or other disposition of nonexempt property into exempt homestead property with fraudulent intent. n60 If the property converted within the 10-year lookback period could be exempted under any applicable provision of section 522(b), there shall be no reduction in the debtor's exemptible homestead interest under this provision. n61

To be subject to limitation under section 522(o), the exemption must be claimed on property, similar to that described in section 522(d)(1), within the following categories:

- . real or personal property that the debtor or a dependent of the debtor uses as a residence;
- . a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;
- . a burial plot for the debtor or a dependent of the debtor; or
- . real or personal property that the debtor or dependent of the debtor claims as a homestead. n62

Section 522(o) applies only when the debtor seeks to exempt an interest in homestead property under section 522(b)(3)(A) (formerly section 522(b)(2)(A)) by claiming exemptions under state law or local law. n63 The provision therefore does not restrict the ability of the debtor to exempt property under section 522(b)(2) by asserting the federal homestead exemption under section 522(d)(1), or to exempt an interest in property under section 522(b)(3)(B) (formerly section 522(b)(2)(B)) held as a tenant by the entirety or by joint tenancy to the extent that interest would have been exempt from process under nonbankruptcy law.

There are two different time periods that apply to the limitation in section 522(o). The first time frame deals with the debtor's intent to hinder, delay or defraud a creditor, and it is measured at the time of disposition of the nonexempt property. Section 522(o) requires that the disposition must occur within the 10-year period ending on the filing date of the petition.

The second time frame concerns the question of whether the debtor could exempt the converted assets. Although the time of disposition would seem to be the logical choice for determining the converted assets' nonexempt status, given the potential relevancy of this status to the debtor's fraudulent intent, the statute uses a different time frame. The language of section 522(o) requires the court to look at whether the converted property could be exempted if on such date the debtor had held the property so disposed of. n64 Since the phrase on such date must refer to the only other date specified in section 522(o), which is the date of the filing of the petition, it is the petition date that controls in determining whether the converted property could be exempted. Therefore, if the property converted within the 10-year period could be exempted under any applicable provision of section 522(b) at the time the petition is filed, the debtor's exemptible interest in the homestead should not be reduced under this provision.

Actual Intent to Defraud Required. Section 522(o) requires that the disposition of nonexempt assets must be done with the intent to hinder, delay or defraud a creditor. In light of Congress' adoption in section 522(o) of the identical intent to hinder, delay or defraud a creditor language found in section 727(a)(2), courts may look to case law under section 727(a)(2) for guidance in construing the requisite intent under section 522(o). n65 Thus, if interpreted in a similar manner, the debtor's exemptible interest in homestead property should not be reduced absent a specific intent on the part of the debtor to defraud a creditor, and this intent must involve actual rather than constructive intent. n66

Direct evidence of actual intent, however, is rarely exhibited in cases involving fraud. Thus, a party asserting an

objection to the debtor's exemption under section 522(o) may attempt to prove actual fraud by relying upon circumstantial evidence, including the existence of any badges of fraud. n67 However, Congress did not expressly incorporate examples of the badges of fraud in section 522(o), as was done by the drafters of the Uniform Fraudulent Transfer Act. n68 Courts may nevertheless feel compelled to consider such circumstantial evidence in a manner similar to that under section 727(a)(2). n69

The particularly long 10-year lookback period under section 522(o), as compared to the 1-year period under section 727(a)(2), presents other evidentiary problems relating to the objecting parties' need to prove that the debtor's intent to defraud was contemporaneous with the disposition of nonexempt assets. In addition, it is questionable whether section 522(o) should be applicable if no creditor who may have been affected years earlier by a fraudulent conversion is a creditor of the debtor at the time the petition is filed. In view of the apparent purpose of section 522(o) to protect the ability of the defrauded creditors to recover on their claims, the trustee or other parties in interest should not prevail on an exemption objection under section 522(o) if the claims of the defrauded creditors have been satisfied prior to the bankruptcy proceeding.

Standard of Proof; Preponderance of the Evidence. In *Grogan v. Garner*, n70 the Supreme Court held that preponderance of the evidence is the appropriate standard of proof for determining exceptions to discharge based on fraud. Because there is nothing in the language of section 522(o) or its legislative history to suggest that Congress intended to require the more exacting clear-and-convincing standard, the preponderance of the evidence standard should apply in proceedings brought under section 522(o). n71 Application of this standard would permit the bankruptcy court to give collateral estoppel effect to elements of claims actually litigated in a prior proceeding that are identical to the elements of an objection under section 522(o).

For a complete discussion of Code section 522, see Collier on Bankruptcy, ch. 522 (Matthew Bender).

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n1 1. In *Bauer v. Iannacone (In re Bauer)*, 298 B.R. 353 (B.A.P. 8th Cir. 2003), the debtors initially concealed the true value of their home by listing it on their bankruptcy schedules with a value of \$80,000. Following the destruction of the property by fire, the debtors sought to amend their schedules to increase the home value to \$203,000, and to claim a state homestead exemption of \$200,000 in the insurance proceeds. In view of the debtors' bad faith attempt to amend their schedules only after the trustee had determined the true value of the property following the fire, the court disallowed the exemption even though the property could have been properly claimed as exempt. This activity can have even more dire consequences for the debtor than the denial of exemptions. In *U.S. v. Allen*, 13 F.3d 105 (4th Cir. 1993), the debtor was convicted of bankruptcy fraud, among other things, when he concealed assets and later sought to recover from insurance companies for the losses he suffered through theft of goods that he had not reported in his bankruptcy schedules. The debtor's attorney also may be subject to sanctions. In *re Ridner*, 102 B.R. 247 (Bankr. W.D. Okla. 1989) (debtor's attorney sanctioned under *Fed. R. Bankr. P. 9011* for advising debtors to place unreasonably low value on personal property being claimed as exempt).

n2

2. See, e.g., 11 U.S.C. § 522(d).

n3

3. In *First Texas Sav. Ass'n, Inc. v. Reed* (*In re Reed*), 700 F.2d 986, 8 C.B.C.2d 370 (5th Cir. 1983), the court of appeals stated that, while the scope of a debtor's claim for a state exemption is to be determined by state law, the Bankruptcy Code establishes separate standards for determining whether the debtor should be denied a discharge. See also *In re Clemmer*, 184 B.R. 935 (Bankr. E.D. Tenn. 1995) (court applies state law to determine availability of exemption when trustee objects to exemption on the ground that prior to the commencement of the case the debtor had concealed the asset from a judgment creditor).

n4

4. Pub. L. No. 109-8, § 308(2) (2005), adding 11 U.S.C. § 522(o), effective in cases commenced on or after April 20, 2005, the date of enactment; see *Limitation on Homestead Interest Based on Fraudulent Conversion*; § 522(o) *infra*.

n5

5. Section 522(g) provides generally that the debtor may not claim as exempt property recovered by the trustee if the debtor either had concealed the property or voluntarily transferred that property. 11 U.S.C. § 522(g). For example, in *In re Rollins*, 15 C.B.C.2d 1075, 63 B.R. 780 (Bankr. E.D. Tenn. 1986), a debtor had voluntarily transferred insurance proceeds to a creditor. The court held that the debtor was not able to exempt any of the proceeds upon recovery by the trustee under section 547.

n6

6. See *Collier on Bankruptcy*, 522.12[1] (Matthew Bender).

n7

7. See *Collier on Bankruptcy*, ch. 523 (Matthew Bender). However, exempt property is generally protected by section 522(c) after discharge and will not be subject to execution based on a prepetition claim that was not discharged because of fraud pursuant to section 523(a). This protection does not extend to certain claims for fraud that may be asserted by a federal depository institution's regulatory agency, 11 U.S.C. § 522(c)(3), or those based on a student loan, scholarship or grant obtained by fraud, 11 U.S.C. § 522(c)(4).

n8 8. 11 U.S.C. § 727(a)(2); see also *First Texas Sav. Ass'n, Inc. v. Reed (In re Reed)*, 700 F.2d 986 (5th Cir. 1983).

n9

9. See, e.g., *Jensen v. Dietz (In re Sholdan)*, 217 F.3d 1006 (8th Cir. 2000) (debtor may not claim homestead exemption under state law in property transferred with intent to defraud creditors).

n10

10. Pub. L. No. 109-8, § 308(2) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment; see *Limitation on Homestead Interest Based on Fraudulent Conversion*; § 522(o) *infra*.

n11

11. *Fed. R. Bankr. P. 1009(a)* provides that the debtor may amend schedules as a matter of course at any time before the case is closed. See, e.g., *Kaelin v. Bassett (In re Kaelin)*, 308 F.3d 885 (B.A.P. 8th Cir. 2002); *Lucius v. McLemore*, 741 F.2d 125 (6th Cir. 1984).

n12

12. See, e.g., *In re Yonikus*, 996 F.2d 866 (7th Cir. 1993) (court properly denied debtor's amendment to include workers compensation award filed more than six years after the commencement of the case and four months after revocation of the debtor's discharge although the personal injury action was filed just one month prior to the commencement of the bankruptcy case); *Wood v. Premier Capital, Inc. (In re Wood)*, 291 B.R. 219 (B.A.P. 1st Cir. 2003) (amended exemption claim disallowed because debtor intentionally failed to disclose workers' compensation claim); *In re St. Angelo*, 189 B.R. 24 (Bankr. D.R.I. 1995) (motion to amend schedules and claim exemption denied when debtor fraudulently attempted to conceal personal injury cause of action).

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13. 11 U.S.C. § 550.

n14

14. 11 U.S.C. § 543.

n15

15. 11 U.S.C. § 542.

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16. 11 U.S.C. § 510(c)(2).

n17

17. A deposit in a bank account of funds later recovered by the trustee is a voluntary transfer within the meaning of section 522(g). *Redmond v. Tuttle (In re Tuttle)*, 5 C.B.C.2d 618, 15 B.R. 14 (Bankr. D. Kan.), *aff'd*, 5 C.B.C.2d 627 (D. Kan. 1981), *aff'd*, 698 F.2d 414, 8 C.B.C.2d 1183 (10th Cir. 1983). A debtor's satisfaction of a judgment lien does not constitute a voluntary transfer when he has no choice but to satisfy the lien. The debtor may use section 522(g)(1) to avoid this involuntary satisfaction of the lien that would have been avoidable under section 522(f)(1). *Washkowiak v. Glenwood Medical Group (In re Washkowiak)*, 15 C.B.C.2d 206, 62 B.R. 884 (Bankr. N.D. Ill. 1986). *See generally Collier on Bankruptcy*, 522.12[1] (Matthew Bender).

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18. *See, e.g., Via v. Colonial Amer. Nat'l Bank (In re Via)*, 107 B.R. 91 (Bankr. W.D. Va. 1989); *In re Taylor*, 8 B.R. 578 (Bankr. E.D. Pa. 1981).

n19

19. *Terry v. Carter (In re Terry)*, 56 B.R. 538 (Bankr. D. Vt. 1986). *Compare Berman v. Forti*, 232 B.R. 653 (D. Md. 1999), *aff'd*, 203 F.3d 820 (4th Cir. 2000) (although debtors voluntarily entered into consent judgment to settle state court litigation, lien arising automatically by operation of law upon filing of judgment by creditor was involuntary).

n20

20. *See, e.g., In re Millerburg*, 61 B.R. 125 (Bankr. E.D.N.C. 1986); *In re Dipalma*, 24 B.R. 385 (Bankr. D. Mass. 1982). Similarly, the payment of an insurance premium as required by the terms of a mortgage is a voluntary transfer for section 522(g) purposes. *In re Rollins*, 63 B.R. 780 (Bankr. E.D. Tenn. 1986).

n21

21. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 361 (1977), (the conversion of nonexempt property into exempt property is not *per se* fraudulent).

n22

22. *In re Bowyer*, 932 F.2d 1100 (5th Cir. 1991) (use of nonexempt savings to pay down home mortgage and increase equity in exempt homestead was permissible prebankruptcy planning); *Williams v. Bradley (In re Bradley)*, 294 B.R. 64 (B.A.P. 8th Cir. 2003) (conversion of nonexempt assets into exempt homestead was not fraudulent under state law). Nonexempt property cannot be changed to exempt property after the commencement of the case. *Butz v. Blue (In re Blue)*, 3 C.B.C.2d 4, 5 B.R. 723 (Bankr. S.D. Ohio 1980); *see also Alexander v. Jensen-Carter (In re Alexander)*, 236 F.3d 431 (8th Cir. 2001) (in case converted from chapter 13 to chapter 7, debtor's eligibility for homestead exemption determined as of date original chapter 13 petition filed).

n23

23. 11 U.S.C. § 522(b)(3)(B), formerly § 522(b)(2)(B), as redesignated by Pub. L. No. 109-8, § 224 (2005), effective in cases commenced on or after October 17, 2005.

n24

24. *See, e.g.*, Fla. Const. art. 10, § 4; Kan. Stat. Ann. § 60-2301; Tex. Const. art. 16, §§ 50, 51.

n25

25. *See, e.g.*, Minn. Stat. § 550.37(11) (benefits payable by a fraternal benefit association are exempt without limit as to their amount). The Minnesota Supreme Court has held that the unlimited exemption for these assets violates the Minnesota constitution. *In re Tveten*, 402 N.W.2d 551 (Minn. 1987).

n26

26. *See* 11 U.S.C. § 522(p), (q), added by Pub. L. No. 109-8, §§ 308(2), 322(a) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment; *see also Collier on Bankruptcy*, 522.13 (Matthew Bender).

n27

27. Fla. Const. art 10, § 4(a)(1) provides that the debtor's homestead is exempt without any limit as to the value of the property.

n28

28. See, e.g., *Crews v. First Colony Life Ins. Co. (In re Barker)*, 31 C.B.C.2d 483, 168 B.R. 773 (Bankr. M.D. Fla. 1994); *Ameritrust Nat'l Bank v. Davidson (In re Davidson)*, 30 C.B.C.2d 1676, 164 B.R. 782 (Bankr. S.D. Fla. 1994).

n29

29. 156 B.R. 88 (Bankr. M.D. Fla. 1993).

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30. 156 B.R. 88, 91.

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31. 156 B.R. 88, 91.

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32. 156 B.R. 88, 91.

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33. 156 B.R. 88, 92. This result would be achieved under the 2005 Act without consideration of the debtors' intent, as the debtors would not have been entitled to claim the Florida homestead exemption because their move to Florida occurred within 730 days of their bankruptcy filing. 11 U.S.C. § 522(b)(3)(A), formerly § 522(b)(2)(A), as amended and redesignated by Pub. L. No. 109-8, § 224 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 522.06 (Matthew Bender).

n34

34. See, e.g., *Crews v. First Colony Ins. Co. (In re Barker)*, 31 C.B.C.2d 483, 168 B.R. 773 (Bankr. M.D. Fla. 1994).

n35

35. Noting a split of authority among bankruptcy courts on the application of the Florida homestead exemption, the Court of Appeals for the Eleventh Circuit in *Havoco of Am., Ltd. v. Hill*, 197 F.3d 1135 (11th Cir. 1999) certified to the Supreme Court of Florida the question of whether a Florida homestead exemption can be challenged if a home is purchased with nonexempt assets with the actual intent to hinder, delay, or defraud creditors. The Florida Supreme Court concluded that conversion of nonexempt assets into an exempt homestead with the intent to hinder, delay, or defraud creditors does not defeat the Florida homestead exemption because such a transfer is not one of the three exceptions provided for in the Florida Constitution. See *Havoco of Am., Ltd. v. Hill*, 790 So.2d 1018 (Fla. 2001). In accordance with the decision of the Florida Supreme Court, the Court of Appeals for the Eleventh Circuit affirmed the allowance of the debtor's exemption. *Havoco of America, Ltd. v. Hill*, 255 F.3d 1321 (11th Cir. 2001). The decision in *Havoco* has been effectively overruled by the enactment of section 522(o), effective in cases commenced on or after April 20, 2005, the date of enactment of Pub. L. No. 109-8, § 308(2) (2005); see *Limitation on Homestead Interest Based on Fraudulent Conversion*; § 522(o) *infra*.

n36

36. Pub. L. No. 109-8, § 308(2) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment; see *Limitation on Homestead Interest Based on Fraudulent Conversion*; § 522(o) *infra*.

n37

37. See, e.g., *First Texas Sav. Ass'n, Inc. v. Reed (In re Reed)*, 700 F.2d 986, 8 C.B.C.2d 370 (5th Cir. 1983); *Crews v. First Colony Life Ins. Co. (In re Barker)*, 31 C.B.C.2d 483, 488, 168 B.R. 773, 776 (Bankr. M.D. Fla. 1994).

n38

38. 848 F.2d 866 (8th Cir. 1989).

n39

39. 848 F.2d 871 (8th Cir. 1989).

n40

40. *848 F.2d 866, 869.*

n41

41. *848 F.2d 871, 875.*

n42

42. *864 F.2d 562 (7th Cir. 1989).*

n43

43. The debtor moved from Illinois to Kansas and claimed exemptions under the Kansas exemption provisions.

n44

44. *864 F.2d 562, 569.*

n45

45. *700 F.2d 986 (5th Cir. 1983).*

n46

46. *700 F.2d 986, 990.*

n47

47. *700 F.2d 986, 992.* If a court finds extraordinary prepetition payments made by a debtor to reduce or

extinguish mortgages on an exempt homestead to be fraudulent, a trustee may also seek to recover such payments. The trustee also may seek to recover payments made by the debtor to reduce or extinguish mortgages on an exempt homestead. Since these payments would increase the equity in the residence, the trustee has a ready source of payment of any judgment that might be entered against the debtor in the case. *See Shaia v. Meyer (In re Meyer)*, 206 B.R. 410 (Bankr. E.D. Va. 1997).

n48

48. *See In re Sholdan*, 217 F.3d 1006 (8th Cir. 2000) (badges of fraud approach may be used to infer fraudulent intent under Minnesota's Uniform Fraudulent Transfer Act, which disqualifies debtor from claiming homestead as exempt if assets are transferred to homestead with intent to defraud creditors).

n49

49. *See 11 U.S.C. § 522(o)*, added by Pub. L. No. 109-8, § 308(2) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment; *see also* Limitation on Homestead Interest Based on Fraudulent Conversion; § 522(o) *infra*.

n50

50. *First Texas Sav. Ass'n, Inc. v. Reed (In re Reed)*, 700 F.2d 986 (5th Cir. 1983).

n51

51. *See Collier on Bankruptcy*, 727.02 (Matthew Bender), discussing the application of 11 U.S.C. § 727(a)(2).

n52

52. *Forsberg v. Security State Bank of Canova*, 15 F.2d 499 (8th Cir. 1926); *Crawford v. Sternberg*, 220 F. 73 (8th Cir. 1915); *see also In re Irvin*, 120 F. 733 (8th Cir. 1941), *aff'g In re Stone*, 116 F. 35 (D. Ark. 1941).

n53

53. Fraudulent intent was found in *In re Martin*, 217 F. Supp. 937 (D. Or. 1963), where the court found that the debtor's conversion of cash into exempt property (a rifle) was done with fraudulent intent and action to retain an asset from the reach of his creditors. Similarly, in *In re White*, 221 F. Supp. 64 (N.D. Cal. 1963), the court

found that the debtors who had acquired goods on credit in the operation of their store without intention to pay for the goods and had then put the proceeds from the sale of the goods into exempt property, did so with fraudulent intent. The exemptions were disallowed in both cases.

n54

54. *See Mott v. Groves*, 428 F.2d 1208 (9th Cir. 1920).

n55

55. Proposed Bankruptcy Act Revision; Hearings on H.R.31 and H.R.32 Before the Subcommittee on Civil and Constitutional Rights of the Committee on the Judiciary, 94th Cong., 2d Sess. 1355 (1976) (statement of Hon. Arnold K. Phelps).

n56

56. *See Ford v. Poston (In re Ford)*, 773 F.2d 52, 13 C.B.C.2d 632 (4th Cir. 1985), in which the court of appeals held that extrinsic evidence to indicate a fraudulent purpose is needed for an exemption to be subject to the fraudulent transfer provisions in section 727(a)(2)(A) and that the bankruptcy court's finding of intent to defraud was not clearly erroneous. *See also* First Texas Sav. Ass'n, Inc. v. Reed (*In re Reed*), 700 F.2d 986, 8 C.B.C.2d 370 (5th Cir. 1983) (rapid prebankruptcy conversion of nonexempt assets into exempt assets amply supported evidence of fraudulent intent).

n57

57. *See Collier on Bankruptcy*, 522.02[2] (Matthew Bender).

n58

58. *In re Agnew*, 355 B.R. 276 (Bankr. D. Kan. 2006) (citing *Treatise*); *see* Acquisition of Property to Secure Exemptions *supra*.

n59

59. 11 U.S.C. § 522(o), added by Pub. L. No. 109-8, § 308(2) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment.

n60

60. *In re Lyons*, 355 B.R. 387, 390 (Bankr. D. Mass. 2006) (property was not disposed of by debtor's recording of homestead declaration and therefore section 522(o) was not applicable).

n61

61. *In re Mathews*, 360 B.R. 732 (Bankr. M.D. Fla. 2007) (section 522(o) is not applicable because debtor transferred exempt property into other exempt property).

n62

62. This final category is not provided for in section 522(d)(1) and is apparently intended to cover property that may be claimed as a homestead under state law that may not necessarily be used by the debtor as a residence.

n63

63. Although the limitation in section 522(o) more broadly applies for purposes of section 522(b)(3)(A), which would suggest that exemptions claimed under federal nonbankruptcy law would also be affected, homestead property is rarely, if ever, exempted under federal nonbankruptcy law.

n64

64. 11 U.S.C. § 522(o), added by Pub. L. No. 109-8, § 308(2) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment.

n65

65. *See In re Addison*, 2007 Bankr. LEXIS 972 (B.A.P. 8th Cir. Mar. 30, 2007).

n66

66. *In re Agnew*, 355 B.R. 276 (Bankr. D. Kan. 2006) (debtor's acquisition of homestead property in

exchange for transfer of nonexempt farm assets to mother's trust was done for legitimate estate planning purposes and not with intent to hinder, delay or defraud a creditor); *see Collier on Bankruptcy*, 727.02[3][a] (Matthew Bender).

n67

67. *See, e.g., Jensen v. Dietz (In re Sholdan)*, 217 F.3d 1006 (8th Cir. 2000) (badges of fraud approach to infer fraudulent intent used in denying debtor's exemption based on conversion of assets to homestead property with intent to defraud creditors); *Murphey v. Crater (In re Crater)*, 286 B.R. 756, 766 (Bankr. D. Ariz. 2002) (finding that various badges of fraud must be intentionally indicative of fraudulent intent).

n68

68. Uniform Fraudulent Transfer Act § 4.

n69

69. *In re Sissom*, 2007 Bankr. LEXIS 1683 (Bankr. S.D. Tex. May 11, 2007) (in applying section 522(o), court found that 11 of 13 badges of fraud under the Texas Uniform Fraudulent Transfer Act and existing case law were present); *see Collier on Bankruptcy*, 727.02[3][b] (Matthew Bender). In *In re Maronde*, 332 B.R. 593, 600 (Bankr. D. Minn. 2005), the court relied upon developed Eighth Circuit case law under section 727(a)(2) and held that the debtor's sale of a nonexempt truck and trailer for the purpose of paying down an equity line of credit on the debtor's home before filing bankruptcy was done with the intent to hinder, delay or defraud a creditor, and subject to the limitation in section 522(o). The deciding factor upon which the court relied in inferring fraud was that the debtor had made an earlier failed attempt to pay down the equity line using cash advances on his credit cards.

n70

70. 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed. 2d 755, 24 C.B.C.2d 1 (1991).

n71

71. *In re Agnew*, 355 B.R. 276 (Bankr. D. Kan. 2006) (objecting party has burden under section 522(o) to establish actual fraud by a preponderance of the evidence).

ABOUT THE AUTHOR(S):

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119 of 197 DOCUMENTS

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Collier on Discharge of Debts in a Chapter 11 Case

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Collier on Discharge of Debts in a Chapter 11 Case

By Collier

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SUMMARY: This Emerging Issues Analysis covers the discharge of debts in a chapter 11 case, including topics such as discharge of the debts of a debtor that is not an individual, discharge of the debts of an individual debtor, enjoining the collection of nondischargeable debt, discharge in a liquidating chapter 11 case, waiver of discharge, and the reaffirmation of debts.

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ARTICLE: Discharge of Debts of a Debtor That Is Not an Individual

Nondischargeable Debts. Under the law before the enactment of the 2005 Act, n1 a corporation's discharge in a chapter 11 case was pervasive. n2 All debts, no matter how incurred, were discharged upon confirmation. n3 The 2005 Act added *section 1141(d)(6) to the Bankruptcy Code*, which makes certain debts owed to governmental units nondischargeable in a corporate (but not an individual or partnership) chapter 11 case. n4

Section 1141(d)(6) covers tax debts, n5 but it also covers other obligations to governmental unit and obligations owing to a private party who brings a successful *qui tam* action against the debtor.

Fraudulently Incurred Claims. The 2005 Act added an exception to corporate discharge by excepting from a corporation's n6 chapter 11 discharge any debt of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to a domestic governmental unit." n7 Subsections 523(a)(2)(A) and (B) specify any debt to the extent obtained by false pretenses, a false representation, or actual fraud" or a false financial statement." n8 Thus, a corporation's debt to a domestic governmental unit, if incurred by false pretenses, a false representation or actual fraud or by use of a false financial statement is not dischargeable in a chapter 11 case.

An obvious candidate for a governmental unit's claim of nondischargeability is any government-sponsored loan program, such as a small business loan from or guaranteed by the Small Business Administration. Some other examples also come to mind. A governmental unit may seek nondischargeability of amounts owing under a government contract, if the governmental unit can argue that the debtor misrepresented either its financial condition or other ability to perform under the contract, and the government reasonably relied on the representation in awarding the contract. n9

Defense and other federal government contractors could be particularly affected by this provision. Medicare and Medicaid providers are other possible targets. To enforce this provision, the governmental unit will have to determine whether the debtor engaged in any misrepresentations, either on a financial statement or otherwise, in securing the loan or an extension of the loan, *and* the governmental unit must file a complaint objecting to dischargeability not later than 60 days following the first date set for the meeting of creditors held pursuant to § 341(a)" or within such later time as the court permits, if the request for a time extension is made before the expiration of the 60-day period. n10

Qui Tam Liabilities. The 2005 Act added another provision in the same section excepting from discharge in a corporate chapter 11 case any debt owed to a person as the result of an action filed under subchapter III of chapter 37 of title 31 or any similar State statute." n11 Subchapter III of chapter 37 of title 31 generally covers claims against the United States government. However, section 3730 permits a civil action, known as a *qui tam* action, by a private person in the name of the government to recover on behalf of the government any false claim that had been collected from the government. n12 Under section 3730, the person initiating the action is entitled to a portion of any recovery. n13 By the terms of section 1141(d)(6)(A), the portion owed to the private person is excepted from discharge in a corporate chapter 11 case. Because the language excepts from discharge only a debt owed to a person," the portion owed to the government is fully dischargeable as with any other claim. n14 Also nondischargeable are any debts owed to a person" under any similar State statute."

Nondischargeability of Certain Taxes. Following the same policy underlying nondischargeability of fraudulently incurred obligations to governmental units, the 2005 Act made nondischargeable in a corporate chapter 11 case a tax or customs duty with respect to which the debtor (i) made a fraudulent return; or (ii) willfully attempted in any manner to evade or to defeat such tax or such customs duty." n15 Before the 2005 amendments, such taxes were nondischargeable under section 523(a)(1)(C) only in an individual's case, regardless of whether under chapter 7 or chapter 11. n16 The scope of the new corporate provision in chapter 11 should be the same as the scope of section 523(a)(1)(C). Unlike debts that are nondischargeable under section 1141(d)(6)(A), taxes that are nondischargeable under section 1141(d)(6)(B) are not limited to those owed to a *domestic* governmental unit.

It is unclear the extent to which this change will actually increase the amount of taxes that must be paid in chapter 11 reorganizations. Taxes and customs duties are entitled to priority under section 507(a)(3) (for taxes incurred during the period between the filing of an involuntary petition and the order for relief) or section 507(a)(8) (for prepetition taxes). Because of the breadth of those tax priority provisions, nearly all tax claims are entitled to priority, except those that are stale, n17 and must be paid in full under a chapter 11 plan. n18 Therefore, many of the taxes covered by the nondischargeability provision will still be entitled to priority and paid in full under a chapter 11 plan, so the ultimate economic effect of this change is probably minimal, except as to postpetition, preconfirmation interest, discussed below.

Payment of Nondischargeable Claims under a Plan. A nondischargeable debt must be paid after plan confirmation. Unless provision is made for post-reorganization payment of the claim, the reorganized debtor might not have adequate resources to pay. Even if it does, failure to treat the claim under the plan could result in the creditor's pursuing collection action immediately after reorganization and demanding immediate payment in full. n19 Such a course of action could doom many reorganization plans to failure. Therefore, the plan ought to be able to provide for payment. To do so, the claim would have to be classified separately from other claims of similar type (for example, other general unsecured claims). Section 1122 permits separate classification in chapter 11 cases under certain circumstances, although the case law is decidedly mixed on the permissible circumstances. n20 Courts have permitted separate classification of nondischargeable debts in chapter 13 cases, reasoning that separate classification that facilitates full payment carries out Congress's intent that such claims receive more favorable treatment. n21 This case law should be imported into chapter 11 to permit separate classification. In addition, a plan should be permitted to enjoin a creditor from collecting a nondischargeable debt pending completion of payments under the plan, despite the narrower scope of the discharge

injunction, under the rationale of the Supreme Court's *Energy Resources* decision, n22 so that the reorganized debtor could be protected against post-effective date collection action.

Postpetition Interest on Nondischargeable Debts. Interest continues to accrue during a chapter 11 case on a nondischargeable debt. n23 Therefore, the amount required to be paid after confirmation will include postpetition interest, which is not allowable in the chapter 11 case. n24 For the same reasons that the plan should be able to provide for the postconfirmation payment of the nondischarged claim, the plan be able to provide for the payment of interest, even though the interest claim may be disallowed in the case. Accommodation will need to be made to permit classification of the disallowed claim, probably in the same class as the principal amount of the claim. However, because priority taxes must be paid in full under a plan, they are not classified. n25 If the nondischargeable tax claim is entitled to priority, interest would need to be classified separately. The interest claim would be a general unsecured claim and therefore might be placed in the same class as general unsecured claims against the debtor. However, because it is nondischargeable, separate classification may be appropriate, as for nondischargeable fraud claims, for the same reasons as in chapter 13. n26 If the underlying nondischargeable tax claim is not entitled to priority, then the plan could provide for separate classification of the claim and the interest together, under the same rationale, so as to facilitate payment after confirmation.

Discharge of Debts of an Individual Debtor

Delay of Discharge. An individual may commence a chapter 11 case even if the individual is not engaged in a business. n27

However, unlike for a non-individual debtor, under cases governed by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, n28 an individual debtor does not generally receive a discharge on plan confirmation. Rather, the chapter 11 discharge generally follows the chapter 13 model, under which the debtor receives a discharge only upon completion of all payments under the plan. n29 However, the drafting of the chapter 11 provision differs from the chapter 13 model, leaving some open questions. Section 1141(d)(5)(A) reads only as an exception to the general rule in chapter 11 for non-individual debtors that that confirmation acts as a discharge. It does not expressly require the court to grant the discharge once plan payments are completed, as does section 1328(a). It appears that the drafters intended the same result, that is, that the court would grant a discharge upon completion of payments, but by different and apparently nonmandatory language: until the court grants a discharge on completion of all payments under the plan." It is fair to read this language as parallel with the chapter 13 discharge provision, because the 2005 Act also amended other provisions in chapter 11 for individual debtors to make them parallel to the treatment of individual debtors in chapter 13, such as the requirement that an individual debtor devote all of the debtor's disposable income to payments under a plan, unless the plan provides for payment of all claims in full. n30

In addition, section 1141(d)(5)(A) contains an exception to the exception: the court may order otherwise for cause. The statute is not explicit on whether this permits the court *not* to grant discharge for cause, but that that would be a strained reading. Such a reading might make sense if the provision required the court to grant a discharge upon completion of payment but allowed the court to order otherwise for cause. However, because the provision generally prohibits the court from granting a discharge upon confirmation until "payment completion but allows the court to order otherwise for cause, the more natural reading is that in the appropriate case, the court may grant a discharge upon confirmation, rather than only upon completion of payments. Such might be the case, for example, for an individual debtor who did not expect to make plan payments primarily from future earnings, consistent with the ordinary chapter 13 model, but rather contemplated a plan more consistent with the ordinary chapter 11 model, such as by distributions of property or, in the unusual case, by the issuance of securities by the debtor's business, perhaps from a new corporation to be formed by the debtor under the plan.

Payment Noncompletion Discharge. Also generally following the chapter 13 model, the new individual chapter 11 discharge permits the court to grant the debtor a discharge if the debtor does not complete payments under the plan, if the value (as of the plan's effective date) actually distributed to creditors under the plan through the time when the court grants the discharge, is at least what creditors would have received in a chapter 7 liquidation case as of the effective date, and modification of the plan under section 1127 is not practicable. n31 As with the discharge after completion of payments, this discharge differs from the chapter 13 model, in that it does not require as a condition to the discharge that the debtor's failure to complete [payments under the plan] is due to circumstances for which the debtor should not justly be held accountable." n32 As such, there is no express statutory standard for the noncompletion discharge other than the court's discretion. It appears, however, that the omission of chapter 13's accountability requirements from the chapter 11 provision should be interpreted to mean that accountability should not enter into the court's determination of whether to grant the noncompletion discharge; the only consideration other than payment of at least liquidation value is whether plan modification is practicable.

Additional Grounds for Denial of Discharge. The 2005 Act also added another provision to limit the discharge of an individual in a chapter 11 case. However, the provision is nongrammatical and therefore difficult to interpret. n33 Section 1141(d)(5)(C) (including the lead-in of paragraph (5)) reads:

(5) In a case in which the debtor is an individual--

.

(C) unless after notice and a hearing held not more than 10 days before the date of the entry of the order granting the discharge, the court finds that there is no reasonable cause to believe that--

(i) section 522(q)(1) may be applicable to the debtor; and

(ii) there is pending any proceeding in which the debtor may be found guilty of a felony of the kind described in section 522(q)(1)(A) or liable for a debt of the kind described in section 522(q)(1)(B). n34

Following as it does subparagraphs (A) and (B), one could reasonably read subparagraph (C) as an exception, so that a discharge under subparagraph (A) or (B) should not be granted if the conditions specified in subparagraph (C) exist. Such a reading is consistent with the parallel amendments made by the same section of the 2005 Act to the chapter 12 and chapter 13 discharges. n35 In those chapters, the 2005 Act added a provision that expressly prohibits the court from granting a discharge if the conditions specified in subparagraph (C) exist. Although that reading therefore seems the most sensible reading, another factor complicates matters. New section 1141(d)(5) becomes effective under the general effective date provision for cases commenced on or after October 17, 2005. Subparagraph (C) is effective for cases commenced on or after the date of enactment, April 20, 2005. n36 It therefore applies even before subparagraphs (A) and (B) apply and even before the lead-in language of paragraph (5) applies. More confusing drafting is difficult to imagine. Nevertheless, it appears that the provision should be read *in pari materia* with the similar provisions added to chapters 12 and 13 by the same section of the 2005 Act.

Subparagraph (C) applies if the court finds that there is reasonable cause to believe that--

(i) section 522(q)(1) may be applicable to the debtor; and

(ii) there is pending any proceeding in which the debtor may be found guilty of a felony of the kind described in section 522(q)(1)(A) or liable for a debt of the kind described in section 522(q)(1)(B). n37

Section 522(q)(1) prohibits an individual debtor from exempting a homestead in excess of \$125,000 in value if--

(A) the court determines, after notice and a hearing, that the debtor has been convicted of a felony (as defined in

section 3156 of title 18), which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of this title; or

(B) the debtor owes a debt arising from--

(i) any violation of the Federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws;

(ii) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 or under section 6 of the Securities Act of 1933;

(iii) any civil remedy under section 1964 of title 18; or

(iv) any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years. n38

Section 3156 of title 18 defines felony" as an offense punishable by a maximum term of imprisonment in excess of one year." n39 The connection between the conviction of a felony and the concept of the filing of the case as an abuse of the provisions of this title" coupled with the provision's primary function as a limitation on claiming a homestead exemption in a state that provides generous homestead exemptions suggests that section 522(q)(1)(A) should apply if a debtor moves to a high homestead state to protect assets in the face of a possible felony conviction. n40

Section 522(q)(1)(B) applies if the debtor owes one or more of certain kinds of debts, either under the Federal securities laws, as a civil RICO liability, or for physical injury or death. The Federal securities laws referred to in clause (i) are defined as the Securities Act of 1933 (*15 U.S.C. 77a et seq.*), the Securities Exchange Act of 1934 (*15 U.S.C. 78a et seq.*), the Sarbanes-Oxley Act of 2002, the Public Utility Holding Company Act of 1935 (*15 U.S.C. 79a et seq.*), the Trust Indenture Act of 1939 (*15 U.S.C. 77aaa et seq.*), the Investment Company Act of 1940 (*15 U.S.C. 80a-1 et seq.*), the Investment Advisers Act of 1940 (*15 U.S.C. 80b et seq.*), and the Securities Investor Protection Act of 1970 (*15 U.S.C. 78aaa et seq.*). n41 Although the provisions referenced in clause (ii) are part of the Federal securities laws," as defined, clause (ii) seems to go beyond the Federal securities laws to include common debts for fraud, deceit, or manipulation. It appears that the purpose of the clause is to limit the homestead (and by cross-reference here, the discharge) for improper securities-related activities. Therefore, the phrase in a fiduciary capacity or in connection with the purchase or sale of any [registered] security" should be read to modify not just manipulation," but also fraud" and deceit."

The third kind of debt covered is one owing for a civil remedy under section 1964(a) of title 18, which permits a district court to enjoin certain activities or order divestiture of certain investments that violate the Racketeer Influenced and Corrupt Organizations Act of 1970 (RICO), or under section 1964(c), which permits an injured person to recover treble damages for a RICO violation.

The fourth kind of debt is one for an act or conduct that caused serious physical injury or death. The provision does not specify what constitutes serious" injury, leaving the application and interpretation to the courts on a case-by-case basis. But the injury or death must have been the result of a criminal act, an intentional tort, or willful or reckless misconduct." Given the Supreme Court's narrow interpretation of willful and malicious injury" in the discharge exception of section 523(a)(6), n42 the better reading here should be comparably narrow.

Taking this all together and returning to section 1141(d)(5)(C), an individual chapter 11 debtor's discharge should be denied in cases of felony conviction coupled with homestead exemption abuse or in cases of liability for certain kinds of debts. The denial is then required if the court finds that there is *no* reasonable cause to believe that" section

522(q)(1) may be applicable *and* there is a pending proceeding involving the section 522(q)(1) grounds. Put another way, if the court *finds* reasonable cause to believe that either condition exists, then the court should deny discharge. Procedurally, the court may make this determination only within 10 days before the date of the entry of the order granting the discharge."

Under the new chapter 11 provision governing an individual's discharge, the discharge may not be granted until the completion of payments. If the holder of an unsecured claim objects, the plan must provide for payments of the debtor's disposable income over at least five years, unless the plan provides for payment in full of all claims. n43 In the event of payment noncompletion, the discharge may occur earlier. In either event, however, the discharge is not likely to occur before the court has determined whether the debtor may enjoy the benefits of the homestead exemption. Plan confirmation will be difficult without that determination, because the plan must provide nonaccepting creditors at least as much as they would receive upon liquidation. n44 The amount of the debtor's homestead exemption is often critical to determining the amount that would be available to creditors in a chapter 7 liquidation. Therefore, by the time the discharge question arises, the question of the applicability of section 522(q)(1) will have been determined. If it has, it makes little sense to examine, as section 1141(d)(5)(C) requires, whether there is no reasonable cause to believe" that section 522(q)(1) applies. Even if the section 522(q)(1) determination has not been made, the section creates the unusual circumstance of providing for denial of discharge--a fundamental bankruptcy right--based on a court finding of no reasonable cause to believe" the applicability of a provision when the court itself could determine directly whether the provision applies. The better practice would be for the court to do so.

Similarly, section 1141(d)(5)(C) appears to require the court to deny discharge unless there is no reasonable cause to believe" that there is a pending proceeding in which the debtor may be found guilty of a felony" or liable for a debt" of the specified kinds. Obviously, the introductory no reasonable cause to believe" must apply to the likely outcome of the pending proceeding, not to whether there is a proceeding pending at all, as that question should be a fact that is not subject to dispute. The court could, under the language of the statute, act quickly on the debtor's discharge, before the conclusion of the other proceeding, based simply on the bankruptcy court's determination as to whether there is no reasonable cause to believe that the debtor will be successful in defending the other proceeding. If the bankruptcy court found no such cause, then discharge would be denied, and presumably could not later be granted, even if the debtor were ultimately successful in his or her defense. (And one might wonder whether the bankruptcy court's finding that the debtor's defense was not reasonable would collaterally estop the debtor from pursuing the defense in the other court, a result Congress did not likely intend.) Conversely, if the bankruptcy court found reasonable cause to believe that the debtor would not be convicted or found liable, the court could grant the discharge, which could not then be revoked if the debtor were later convicted or found liable for one of the prohibited debts. Given these possibilities, it would seem the better practice, strictly as a procedural matter, for the bankruptcy court to defer ruling on the discharge until the conclusion of the other proceeding.

Nondischargeable Debts. In general, unlike a corporate debtor, an individual debtor in a chapter 11 case has the same status as an individual debtor in a chapter 7 liquidation case with respect to nondischargeable debts. If a debt is excepted from discharge under section 523, the debtor cannot obtain a discharge of such debt in a chapter 11 case. n45

An individual debtor will be discharged from debts that would be nondischargeable under subsection 523(a)(2), (4) or (6) if the creditor does not request a determination of the dischargeability of such a debt. n46 Bankruptcy Rule 2002(f) requires the clerk of the bankruptcy court or some other person directed by the court to give creditors and indenture trustees notice of the time fixed for filing a complaint to determine the dischargeability of debts under section 523.

Enjoining Collection of Nondischargeable Debt

One question that has arisen is whether a plan may provide for an injunction against collection of a nondischargeable debt when the plan provides for payment in full over time. Some courts have approved injunctions that, in effect, require the creditor to await payment under the plan even though the creditor's claim is nondischargeable. n47

However, such an injunction may harm the creditor with the nondischargeable claim by preventing it from taking action to collect its claim at a time when the debtor has assets from which the claim could be collected. Nevertheless, when the court has sufficient confidence that the debtor's plan is feasible, and performance under the plan requires that creditors participate collectively, it may be appropriate to enjoin individual collection efforts. n48 In the event that the plan fails, the creditor's claim would most likely remain nondischargeable in a subsequent case. n49

Discharge in Liquidating Chapter 11 Case

Confirmation of a plan in the case of a partnership or corporation or completion of payments in the case of an individual does not necessarily entitle the debtor to a discharge. If the chapter 11 plan provides for the liquidation of all or substantially all of the property of the estate and the debtor does not continue in business after consummation of the plan, an individual, partnership or corporation debtor is subject to the limitations of section 727(a). n50 In this respect, section 1141(d)(3) is a corollary provision to section 727(a).

Section 727(a)(1) bars a discharge in a liquidation case if the debtor is not an individual. Thus, a partnership or corporation is not entitled to a discharge if its plan provides for the liquidation of substantially all of its assets and the debtor does not thereafter continue in business. This limitation prevents such debtors from avoiding the operation of section 727(a)(1) through the use of a liquidating plan under chapter 11 instead of a chapter 7 liquidation. Of course, there may be other reasons for a debtor to choose to liquidate in chapter 11 rather than chapter 7, such as the ability to control the liquidation and the possibility of maximizing the value of the assets

In the case of an individual who does not continue in a business and whose property is liquidated in a chapter 11 case, the individual is subject to the limitations of section 727(a). The absolute bar to discharge of section 727(a)(1) is inapplicable, but the other grounds for objecting to discharge continue to apply in a liquidating chapter 11 case. n51 As with corporate and partnership chapter 11 cases, the objective is to prevent an individual from avoiding the grounds for objection to discharge by liquidating in chapter 11 rather than chapter 7.

It should be noted that section 727 is applicable only when substantially all of the debtor's property is to be liquidated pursuant to the plan. If the debtor is reorganizing, the debtor may receive a discharge upon confirmation of the plan even if discharge would be denied in a liquidation. The debtor may also receive a discharge even if the plan contemplates a liquidation upon the debtor's failure to refinance the secured creditor's debt, as long as the probability of refinancing is not so unlikely that liquidation is the only viable option. n52

Waiver of Discharge

The court may approve a waiver of discharge executed after entry of the order for relief in the chapter 11 case. However, the waiver must be in writing. n53

Reaffirmation of Debts

If the debtor seeks to reaffirm a debt, the reaffirmation agreement is subject to the requirements of subsections

524(c), (d) and (k). n54 In general, the reaffirmation agreement must be made prior to the grant of the discharge and must be accompanied by certain disclosures, including a statement advising the debtor that it can be rescinded prior to discharge or within 60 days after the agreement is filed with the court, whichever is later, and that the debtor is not required to enter into the agreement. The agreement must be filed with the court and accompanied by an attorney's affidavit if the debtor was represented by an attorney in negotiating the reaffirmation, must not be rescinded and, if the debtor was not represented by an attorney, must be approved by the court. n55

Section 524 applies if the debtor seeks to reaffirm a particular debt. The requirements of section 524 do not, however, apply to the terms of the plan proposed by the debtor, which might well provide for the full payment of some or all classes of claims. The terms of the plan are, however, subject to the plan confirmation process under section 1129.

For a complete discussion of Code section 1141, see Collier on Bankruptcy, ch. 1141 (Matthew Bender).

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Return to Text

n1 1. Pub. L. No. 109-8 (2005), *reprinted in* App. Pt. 10(a) *infra*.

n2

2. See George M. Treister et al., *Fundamentals of Bankruptcy Law*, § 9.06, at 441 (5th ed. 2004, R. Levin ed.).

n3

3. See, e.g., *Beard v. A.H. Robins Co., Inc.*, 828 F.2d 1029 (4th Cir. 1987) (intentional torts, even if malicious, are dischargeable in a chapter 11 case by confirmation of a corporate debtor's plan of reorganization).

n4

4. Pub. L. No. 109-8, § 708, (2005), effective as to cases filed on or after October 17, 2005.

n5

5. Section 708 of the 2005 Act, which added section 1141(d)(6), is entitled No Discharge of Fraudulent Taxes in Chapter 11," but as noted in the text, its effect is much broader.

n6

6. An individual does not receive a chapter 11 discharge from any debts that are non-dischargeable under section 523(a). *11 U.S.C. § 1141(d)(2)* (former and as amended). A partnership does receive a discharge of such debts in chapter 11, and new section 1141(d)(6)(A) does not apply to a partnership debtor.

n7

7. *11 U.S.C. § 1141(d)(6)(A)*, added by Pub. L. No. 109-8, § 708 (2005).

n8

8. *11 U.S.C. § 523(a)(2)*; see *Cohen v. De La Cruz*, 523 U.S. 213, 118 S. Ct. 1212, 140 L. Ed. 2d 341 (1998) (compensatory and punitive damages arising from fraud are nondischargeable).

n9

9. *Field v. Mans*, 516 U.S. 59, 116 S. Ct. 437, 133 L. Ed. 2d 351 (1995) (creditor must show objectively reasonable reliance).

n10

10. *11 U.S.C. § 523(c)*; *Fed. R. Bankr. P. 4007(c)*.

n11

11. *11 U.S.C. § 1141(d)(6)(A)*, added by Pub. L. No. 109-8, § 708, (2005).

n12

12. *31 U.S.C. § 3730(b)*.

n13

13. *31 U.S.C. § 3730(d)(1)(3).*

n14

14. *11 U.S.C. § 101(41)* (person" does not include governmental unit).

n15

15. *11 U.S.C. § 1141(d)(6)(B)*, added by Pub. L. No. 109-8, § 708 (2005).

n16

16. *11 U.S.C. §§ 523(a)(1)(C), 1141(d)(3)..*

n17

17. *See 11 U.S.C. § 507(a)(8)*, as amended by Pub. L. No. 109-8, § 705 (2005).

n18

18. *11 U.S.C. § 1129(a)(9)*, as amended by Pub. L. No. 109-8, § 710 (2005).

n19

19. *11 U.S.C. § 524(a)* (discharge injunction applies only to discharged debts).

n20

20. *See Boston Post Road Ltd. P'ship v. FDIC (In re Boston Post Road Ltd. P'ship)*, 21 F.3d 477, 481, 30 C.B.C.2d 1528 (2d Cir. 1994).

n21

21. *See, e.g., In re Freshley*, 69 B.R. 96, 98 (Bankr. N.D. Ga. 1987).

n22

22. *United States v. Energy Resources Co.*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580 (1990).

n23

23. *Bruning v. United States*, 376 U.S. 358, 361-63, 84 S. Ct. 906, 908-09, 11 L. Ed. 2d 772, 775-76 (1964).

n24

24. 11 U.S.C. § 502(b)(2).

n25

25. 11 U.S.C. § 1123(a)(1).

n26

26. *Cf., e.g., In re Freshley*, 69 B.R. 96, 98 (Bankr. N.D. Ga. 1987).

n27

27. *Toibb v. Radloff*, 501 U.S. 157, 111 S. Ct. 2197, 115 L. Ed. 2d 145, 24 C.B.C.2d 1179 (1991).

n28

28. Pub. L. No. 109-8, § 1501(b) (2005) (except as specified otherwise, applicable only to cases commenced on or after Oct. 17, 2005).

n29

29. 11 U.S.C. § 1141(d)(5).

n30

30. 11 U.S.C. § 1129(a)(15); *see id.* § 1123(a)(8) (new 2005 Act requirement that individual chapter 11 debtor's plan provide for payment to creditors of a portion of the debtor's future earnings).

n31

31. 11 U.S.C. § 1141(d)(5)(B).

n32

32. 11 U.S.C. § 1328(b)(1).

n33

33. *See Lamie v. United States Trustee*, 540 U.S. 526, 124 S. Ct. 1023, 157 L. Ed. 2d 1024, 50 C.B.C.2d 1299 (2004) (even though provision is nongrammatical, court must interpret according to plain meaning rule).

n34

34. 11 U.S.C. § 1141(d)(5)(C), added by Pub. L. No. 109-8, § 330 (2005).

N35

35. 11 U.S.C. §§ 1228(f), 1328(h), added by Pub. L. No. 109-8, § 330 (2005).

n36

36. Pub. L. No. 109-8, § 1501(b)(2) (Apr. 20, 2005).

n37

37. 11 U.S.C. § 1141(d)(5)(C).

n38

38. 11 U.S.C. § 522(q)(1).

n39

39. 18 U.S.C. § 3156(3).

n40

40. For a more complete analysis of section 522(q)(1), see ch. 522 *supra*.

n41

41. Securities Exchange Act of 1934, § 3(a)(47), 15 U.S.C. § 78c(a)(47).

n42

42. *Kawaauhau v. Geiger*, 523 U.S. 57, 118 S. Ct. 974, 140 L. Ed. 2d 90, 38 C.B.C.2d 1629 (1998) (willful and malicious injury" covers an intentional tort committed with intent to cause harm).

n43

43. 11 U.S.C. § 1129(a)(15).

n44

44. 11 U.S.C. § 1129(a)(7).

n45

45. 11 U.S.C. § 1141(d)(2); see *Fien v. United States (In re Fien)*, 22 F.3d 631, 633 (5th Cir. 1994) (in the case of individual debtors, Congress consciously opted to place a higher priority on revenue collection than on debtor rehabilitation or ensuring a fresh start'); *In re Grynberg*, 986 F.2d 367, 369, 28 C.B.C.2d 779, 782-83 (10th Cir.), cert. denied, 510 U.S. 812, 114 S. Ct. 57, 114 L. Ed. 2d 27 (1993) (Section 523, when read in conjunction with § 1141(d)(2), provides that confirmation of a reorganization plan for an individual debtor will not discharge recent excise taxes whether or not a claim for such tax was filed or allowed.').

n46

46. 11 U.S.C. § 523(c)(1). But see 11 U.S.C. § 523(a)(3)(B), (c)(2).

n47

47. E.g., *In re Martin*, 150 B.R. 43 (Bankr. S.D. Cal. 1993); *In re Mercado*, 24 C.B.C.2d 1895, 124 B.R. 799 (Bankr. C.D. Cal. 1991). But see *In re Amigoni*, 22 C.B.C.2d 468, 109 B.R. 341 (Bankr. N.D. Ill. 1989) (plan may not be confirmed because it interferes with rights of holders of nondischargeable claims).

n48

48. See *United States v. Energy Res. Co.*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580, 22 C.B.C.2d 1093 (1990) (bankruptcy court may order manner of application of payments on tax claims, although payment of the non-trust fund position was not wholly assured).

n49

49. But see 11 U.S.C. § 523(b) (debts that are nondischargeable under section 523(a)(1), (a)(3) or (a)(8) may become dischargeable in subsequent case).

n50

50. See, e.g., *Dutcher v. Reorganized Pettibone Corp.*, 193 B.R. 667 (S.D.N.Y. 1996).

n51

51. *In re Nickerson*, 11 C.B.C.2d 82, 40 B.R. 693 (Bankr. N.D. Tex. 1984) (although an individual may not

obtain a second discharge in a chapter 11 case commenced within six years of a prior chapter 7 case, a reorganization plan may nevertheless be confirmed; the usual discharge afforded by confirmation will be ineffective).

n52

52. *In re T-H New Orleans Ltd. P'ship*, 116 F.3d 790 (5th Cir. 1997).

n53

53. 11 U.S.C. § 1141(d)(4).

n54

54. See ch. 524 *supra*.

n55

55. 11 U.S.C. § 524(c).

ABOUT THE AUTHOR(S):

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120 of 197 DOCUMENTS

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Collier on Who May File a Plan in a Chapter 11 Case

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Collier on Who May File a Plan in a Chapter 11 Case

By Collier

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SUMMARY: Section 1121 of the Bankruptcy Code sets forth who may file a chapter 11 plan and under what conditions and when a plan may be filed. This Emerging Issues Analysis covers section 1121, including topics such as the debtors right to file, the debtors exclusivity period for filing, the right of a party in interest to file a plan, and time periods for small business debtors.

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ARTICLE: Section 1121 of the Bankruptcy Code sets forth who may file a chapter 11 plan and under what conditions and when a plan may be filed. Subsection (a) provides that the debtor may file a plan at any time during the case. Subsection (b) specifies an exclusive period in which only the debtor may file its plan. Subsection (c) permits any party in interest to file a plan if certain conditions are met. In this regard, subsection (c) defines the circumstances under which the debtor will no longer have the exclusive right to file a plan. Subsection (d) permits the court to increase or decrease for cause the periods within which only the debtor may file a plan. Subsection (e) modifies the specified time limits in the case of a small business debtor as defined in section 101. Section 1121 must be read in conjunction with *Federal Rule of Bankruptcy Procedure 3016* n1 and any applicable local rules.

Debtor's Right to File. Section 1121(a) gives the debtor one of its two basic rights with respect to the filing of a plan. The debtors first right, accorded to no other party, is that it may file a chapter 11 plan at any time during the case. The debtor may file a plan in a voluntary or involuntary case at any time after commencement of the case or entry of the order for relief. The debtor may file a plan with its voluntary petition, or it may file a plan after an involuntary petition has been filed against it and before an order for relief has been entered. The debtor may file a plan after a disclosure statement has been approved for some other plan. It may even file a plan after some other plan has been confirmed and the order of confirmation is on appeal or after confirmation has been denied. Because the rules of construction include the plural within the singular, the debtor may, if it wishes, file more than one plan. n2 The debtor may file its plan even though other parties in interest have filed a plan or plans.

Debtor's Exclusivity Period for Filing. Section 1121(b) provides the debtor with its second basic right with respect to filing a chapter 11 plan. Subsection (b) provides that, until 120 days after the order for relief, only the debtor may file a chapter 11 plan. This period is commonly referred to as the debtor's exclusivity period. This 120-day period may be reduced or extended for cause by order of the court on a motion filed within the period. n3 However, section 1121(d)(2)(A) provides that the court may not extend this 120-day exclusive period beyond a date that is 18 months after the date of the order for relief. n4

Debtors Exclusivity Period for Acceptance. If the debtor files a plan within the 120-day exclusivity period, section 1121(c)(3) provides that exclusivity is extended for an additional sixty days to a maximum of 180 days to allow acceptance by each class of claims or interests that is impaired by the plan. This 180-day period may not be extended by the court beyond a date that is 20 months after the date of the order for relief. n5 During this extended exclusivity period, no other party in interest may file a plan. The extended period may itself be extended by the court for cause. There is disagreement among the bankruptcy courts when the original period is extended, whether the acceptance period must also be extended. n6 The better practice, when moving to extend the exclusivity period, would be to file a simultaneous motion to extend the acceptance period.

Right of a Party in Interest to File a Plan.

Conditions That Must Occur for Party in Interest to File Plan. Subsection 1121(c) provides that any party in interest may file a plan if, and only if, one of the three following conditions has occurred: (1) a chapter 11 trustee has been appointed; (2) the debtor has not filed a plan before 120 days after the date of the order of relief or any extension of that period; or (3) the debtor has not filed a plan that has been accepted by each class of impaired claims and impaired interests before 180 days after the date of the order for relief or any extension of that period. If the debtor obtains the required acceptances within the 180-day period, then competing plans are foreclosed until it can be determined whether the debtor's plan will be confirmed.

Party in Interest Defined. Subsection 1121(c) defines party in interest in the same words as *section 1109(b) of the Bankruptcy Code*--that is, the term includes but is not limited to the debtor, the trustee, a creditors committee, an equity security holders committee, a creditor, an equity security holder, or any indenture trustee. The term party in interest is fact-specific and must be approached on a case by case basis to determine whether an entity which seeks to file a plan has a sufficient stake in the outcome of the case to require its representation in the plan filing process. n7

The term has been held to include general and limited partners who owned over 99 percent of the debtor, n8 a party who purchased a claim and became a creditor n9 even if it was acquired postpetition for the express purpose of acquiring standing to file a plan, n10 an insurer of the debtor, n11 and a corporation which had managed the debtor's nursing homes and made a substantial financial investment in the debtor. n12

A party in interest has been held *not* to include an entity interested in purchasing the debtors assets. n13 However, a potential purchaser of the debtors assets was considered a party in interest when a chapter 11 trustee joined in its proposed plan, even after the chapter 11 trustee later withdrew its support. n14 The term party in interest does not include the United States trustee who is barred by section 307 from filing a plan. n15

Filing Plan after Entry of Order Approving a Disclosure Statement. Section 1121(c)(3) may be interpreted to allow the filing of competing plans if the debtor has obtained approval of disclosure for a cramdown plan in which the debtor does not intend to obtain the acceptance of every impaired class. If the debtors disclosure statement indicates that it will not seek acceptances from some impaired classes, the debtors plan by its very nature can not meet the

requirement of acceptance by each class of impaired claims and impaired interest in 180 days. Other entities might be able to file plans during the acceptance period of such a cramdown plan. The recommended course of action then is always to seek the votes of all impaired classes, whether or not the plan is a cramdown plan. Even in such a case the court might allow a creditor to file a competing plan. n16

Reduction or Increase of Exclusivity Periods for Cause. Subsection 1121(d) provides that upon the request of a party in interest made within the 120-day period for filing a plan or within the 180-day period for acceptance if a plan is filed, the court for cause, after notice and a hearing, n17 may reduce or increase the 120-day period or the 180-day period. n18 However, under the 2005 amendments to the Code, the 120-day period may not be extended beyond a date that is 18 months after the date of the order for relief, n19 and the 180-day period may not be extended beyond a date that is 20 months after the date of the order for relief. n20 Any request for extension of the 120-day or 180-day period must be made before those periods have expired. n21 Similarly, motions to reduce an extended exclusive period may be made within the extension. Such motions may be made by the debtor, as the debtor is included as a party in interest. The party seeking the change in the statutory time bears the burden of establishing that cause exists. n22

The Determination of Whether Cause Exists Is Fact Specific. The determination of whether cause exists to warrant an extension or reduction of the statutory time periods is fact specific. Cause to extend has been found where the debtor has continually proposed plans and attempted to negotiate with the creditors. n23 Cause has been found not to exist where the debtors case is not complex, n24 where there has been no progress in arranging financing n25 or where an extension would be fruitless. n26 It has been said that the creditors loss of confidence in the capability of debtors management is a factor to consider in determining cause, n27 as is the principal parties acrimonious relations. n28 One court enumerated the following factors to be considered in determining whether cause existed to warrant an extension: (1) the size and complexity of the case; (2) the necessity of sufficient time to negotiate and prepare adequate information; (3) the existence of good faith progress toward reorganization; (4) whether the debtor is paying its debts as they come due; (5) whether the debtor has demonstrated reasonable prospects for filing a viable plan; (6) whether the debtor has made progress in negotiating with creditors; (7) the length of time the case has been pending; (8) whether the debtor is seeking the extension to pressure creditors; and (9) whether unresolved contingencies exist. n29 Another court, after reviewing this enumeration, said that the overriding factor is whether terminating the debtor's exclusivity would facilitate moving the case forward. n30

Time Periods for Small Business Debtors

Debtor 180-Day Exclusive Time Period. Subsection (e) of section 1121 sets forth special rules in small business cases. As amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, (the 2005 Act), n31 it provides that in a small business case, n32 the debtor has the exclusive right to file a plan until after 180 days after the date of the order for relief under chapter 11. Although the language of section 1121(e) would seem to require that all plans, whether filed by the debtor or other parties in interest, shall be filed within 300 days of the order for relief, one court has construed the language and legislative history of section 1121(e) to mean that the 300-day deadline for the filing of reorganization plans in small business chapter 11 cases applies only to plans filed by the debtor and that there is no statutory deadline for the filing of such a reorganization plan by any party in interest other than the debtor. n33 Thus, the debtor has a 180-day exclusive period and an additional 120-day nonexclusive period in which to file a plan. Although there appears to be no specific provision for the reduction of the period during which the debtor has the exclusive right to file a plan, only the debtor may file a plan until after the exclusive period, unless the court, for cause, orders otherwise. n34

One-Hundred-Twenty-Day Nonexclusive Time Period for Nondebtor Parties in Interest. After the small business debtor's 180-day exclusive period has expired, nondebtor parties in interest have a 120-day time period in which to file plans whether or not the debtor files a plan within the exclusive period. Therefore, whether or not the debtor files a plan within the 180-day period, a party in interest may file a competing plan after the expiration of the 180-day period so long as the party files its plan before the expiration of 300 days from the order for relief. n35

Under the law as it existed before the 2005 Act, one lower court indicated that if a small business debtor has filed a plan within its 100-day exclusive period, a creditors plan filed after the then 100-day exclusive period will not be treated on the same expedited basis, but will proceed on a time line specified by the court under its section 105(d) powers. n36 The authority for such a ruling seems lacking. No distinction is made in the Code and both plans should be considered together.

Reduced and Extended Time Periods. The exclusive and nonexclusive time periods for filing a plan by a small business debtor may be extended by the court only if the debtor, after providing notice to parties in interest (including the United States trustee), demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable time. The new deadline must be imposed at the time the extension is granted, and the court must sign the order granting such extension before the existing deadline has expired. n37

Before the 2005 Act, a party in interest could file a request that either the exclusive or nonexclusive periods for filing a plan be increased or reduced. The 2005 Act does not indicate who may seek extension of the exclusive or permissive periods for filing a plan. The Code now specifies that an extension may be granted for either period if the debtor demonstrates by a preponderance of the evidence that the court will be able to confirm a plan within a reasonable time. Thus, even if a nondebtor party requests an extension, it is the debtor who must carry the burden of proof, a condition that makes it unlikely that a nondebtor party in interest will seek an extension of time.

The provisions added by the 2005 Act, unlike former law, do not specifically provide for a reduction of the exclusive or nonexclusive periods of time for filing a plan. However, under section 1121(e)(1)(B) of the Code, parties in interest, such as creditors, may seek to have the 180-day exclusive period reduced or rendered nonexclusive for cause. There is no provision for reducing the 300-day period for cause.

Failure to File. There are no provisions in the Bankruptcy Code that define the consequences if neither the debtor nor any other party files a plan within the prescribed time. Section 1121(e)(2) provides that the plan and disclosure statement (if any) shall be filed not later than 300 days after the order for relief, and section 1121(e)(3) indicates that that time period may be extended under certain conditions. However, if no party files a plan within the specified or extended time, no relief is available to the debtor in chapter 11. Consequently, cause would exist for conversion or dismissal of the case under section 1112(b)(4) on the ground of failure to propose a plan under section 1121 of this title within any time fixed by the court. n38

Appeal of Orders Relating to Exclusivity. An order extending exclusivity is an interlocutory order and formerly was appealable only with leave of the district court or bankruptcy appellate panel. n39 The Bankruptcy Reform Act of 1994 n40 amended 28 U.S.C. § 158(a) to give an immediate right of appeal of orders extending or reducing the time periods contained in section 1121(d). Making such orders appealable to the district court or bankruptcy appellate panel as a matter of right was explained by the House Committee:

This will prevent [sic] n41 those parties who feel they were harmed by an extension, or a failure to extend, to obtain possible recourse in the district court. The Committee intends that the district court carefully consider the circumstances of each case so appealed with a view to encouraging a fair and equitable resolution of the bankruptcy. n42

Appellate review of such order may establish standards on a more uniform basis for bankruptcy courts to follow in permitting or denying extensions of exclusivity periods.

Designation of Plans Required. *Federal Rule of Bankruptcy Procedure 3016(a)* requires that every proposed plan and modification thereof be dated and in a chapter 11 case, be identified with the name of the entity or entities submitting such plan or modification. The purpose of this requirement is to facilitate the identification of plans in those cases where there are multiple plans and holders of claims and equity interests are required to analyze multiple plans and disclosure statements.

Disclosure Statement Required to Be Filed with Plan. Federal Rule of Bankruptcy Procedure 3016(b) n43 provides that with the plan or within a time fixed by the court, n44 a party filing a plan shall file a disclosure statement pursuant to section 1125 or evidence showing compliance with section 1126(b) relating to compliance with nonbankruptcy law in solicitation of prepetition acceptances or rejections.

For further discussion of Code section 1121, see Collier on Bankruptcy, ch. 1121.

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Return to Text

n1 1. See Collier on Bankruptcy, ch. 3016.

n2

2. In the case of *In re Werth*, 8 C.B.C.2d 480, 29 B.R. 220 (D. Colo. 1983), the court permitted the debtor to file multiple plans, noting that only one plan could be confirmed. The court required that the disclosure statement contain a clearly worded provision advising holders of claims to accept one or the other or reject both plans.

n3

3. See Collier on Bankruptcy, 1121.06.

n4

4. This limitation was added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,

Pub. L. No. 109-8, § 411(2) (2005), effective in cases commenced on or after October 17, 2005.

n5

5. 11 U.S.C. § 1121(d)(2)(B), added by Pub. L. No. 109-8, § 411(2) (2005), effective in cases commenced on or after October 17, 2005.

n6

6. The extension of the 120-day period for filing a chapter 11 plan automatically extends the 180-day period for securing acceptances of the plan. *In re Judd*, 173 B.R. 941 (Bankr. D. Kan. 1994); *In re Ravenna Indus., Inc.*, 6 C.B.C.2d 1015, 20 B.R. 886 (Bankr. N.D. Ohio 1982); *contra In re Trainer's, Inc.*, 5 C.B.C.2d 1623, 17 B.R. 246 (Bankr. E.D. Pa. 1982).

n7

7. *In re Chandler Airpark Joint Venture I*, 163 B.R. 566 (Bankr. D. Ariz. 1992).

n8

8. *In re River Bend-Oxford Assocs.*, 114 B.R. 111 (Bankr. D. Md. 1990).

n9

9. *In re Rook Broadcasting of Idaho, Inc.*, 154 B.R. 970 (Bankr. D. Idaho 1993).

n10

10. *In re Comandante Management Co., LLC*, 359 B.R. 410, 416-8 (Bankr. D.P.R. 2006); *In re First Humanics Corp.*, 124 B.R. 87 (Bankr. W.D. Mo. 1991).

n11

11. *In re Congoleum Corp.* 362 B.R. 198, 201 (Bankr. D.N.J. 2007).

n12

12. *In re First Humanics Corp.*, 124 B.R. 87 (Bankr. W.D. Mo. 1991).

n13

13. *In re Crescent Mfg. Co.*, 122 B.R. 979 (Bankr. N.D. Ohio 1990).

n14

14. *In re Dakota Rail, Inc.*, 946 F.2d 82 (8th Cir. 1991), *reh'g denied*, *cert. denied*, 503 U.S. 962, 112 S. Ct. 1566, 118 L. Ed. 2d 212, *reh'g denied*, 504 U.S. 952, 112 S. Ct. 2295, 119 L. Ed. 2d 219 (1992).

n15

15. *In re Speece*, 159 B.R. 314 (Bankr. E.D. Cal. 1993).

n16

16. *Cf. In re Landmark Park Plaza Ltd. P'ship*, 167 B.R. 752 (Bankr. D. Conn. 1994) (where the court allowed a creditor to file a competing plan in the post-exclusivity period even though the debtors disclosure statement has been approved).

n17

17. The bankruptcy court must conduct a hearing on the motion to extend time. *In re RCN Anlageninvestitionen Frodsgesellschaft II-Kommanditgesellschaft*, 118 B.R. 460 (W.D. Mich. 1990).

n18

18. The extension of the 120-day time period for filing a chapter 11 plan automatically extends the 180-day period for securing acceptances of the plan. *In re Judd*, 173 B.R. 941 (Bankr. D. Kan. 1994); *In re Ravenna Indus., Inc.*, 6 C.B.C.2d 1015 (Bankr. N.D. Ohio 1982). *Contra In re Trainer's, Inc.*, 5 C.B.C.2d 1623, 1982 Bankr. LEXIS 5012 (Bankr. E.D. Pa. 1982).

n19

19. 11 U.S.C. § 1121(d)(2)(A), added by Pub. L. No. 109-8, § 411(2) (2005), effective in cases commenced on or after October 17, 2005.

n20

20. 11 U.S.C. § 1121(d)(2)(B), added by Pub. L. No. 109-8, § 411(2) (2005), effective in cases commenced on or after October 17, 2005.

n21

21. There can be no extension after the period has expired. *In re Perkins*, 71 B.R. 294, 297 (W.D. Tenn. 1987); *In re Cramer, Inc.*, 105 B.R. 433 (Bankr. W.D. Tenn. 1989); *In re Century Inv. Fund VII Ltd. P'ship*, 96 B.R. 884 (Bankr. E.D. Wis. 1989).

n22

22. *In re Gibson & Cushman Dredging Corp.*, 101 B.R. 405 (E.D.N.Y. 1989); *In re Washington-St. Tammany Elec. Co-op., Inc.*, 97 B.R. 852 (E.D. La. 1989); *In re Newark Airport/Hotel Ltd Pship*, 155 B.R. 93 (Bankr. D.N.J. 1993). When the party seeks to reduce a statutory period, it bears a particularly heavy burden. *In re Interco Inc.*, 137 B.R. 999 (Bankr. E.D. Mo. 1992).

n23

23. *In re Gibson & Cushman Dredging Corp.*, 101 B.R. 405 (E.D.N.Y. 1989). In *In re AmKo Plastics, Inc.*, 197 B.R. 74 (Bankr. S.D. Ohio 1996), cause was shown where extensive turnaround efforts were undertaken even though the debtor to date had shown only losses. In *In re Homestead Partners, Ltd.*, 197 B.R. 706, 720 (Bankr. N.D. Ga. 1996), cause was shown where there was substantial progress, the recalcitrance of creditors posed a significant hurdle and there were complicated legal issues.

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24. *In re Curry Corp.*, 148 B.R. 754 (Bankr. S.D.N.Y. 1992); *In re General Bearing Corp.*, 136 B.R. 361 (Bankr. S.D.N.Y. 1990).

n25

25. *In re EUA Power Corp.*, 130 B.R. 118 (Bankr. D.N.H. 1991).

n26

26. In the case of *In re Gagel & Gagel*, 24 B.R. 674 (Bankr. S.D. Ohio 1982), there were only two creditors, one who was an insider and could not be counted as an accepting class for purposes of 11 U.S.C. § 1129(a)(10) and the other who was opposed to the extension and would be impaired by anything less than full payment.

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27. *In re All Seasons Indus., Inc.*, 121 B.R. 1002 (Bankr. N.D. Ind. 1990).

n28

28. *In re Crescent Beach Inn, Inc.*, 22 B.R. 155 (Bankr. D. Me. 1982).

n29

29. *In re Express One Int'l, Inc.*, 194 B.R. 98, 100 (Bankr. E.D. Tex. 1996) (finding cause to extend the exclusive period where the debtor had been diligent in its attempts to reorganize and extension was not sought for an indefinite period). The court in *American Network Leasing v. Apex Pharmaceuticals, Inc.* (*In re Apex Pharmaceuticals, Inc.*), 203 B.R. 432, 441 (N.D. Ind. 1996), held that during the initial 120-day exclusive period bankruptcy courts have applied a lesser standard in determining whether the burden of showing a reasonable possibility of a successful reorganization within a reasonable time has been satisfied. *See also Bunch v. Hoffinger Indus.* (*In re Hoffinger Indus.*), 292 B.R. 639 (B.A.P. 8th Cir. 2003) (affirming a bankruptcy court grant of a third extension of the exclusive periods); *In re Adelpia Communications Corp.*, 352 B.R. 578, 587-90 (Bankr. S.D.N.Y. 2006) (conducting a detailed review of each of the nine factors as applied to the facts of the case and granted an extension); *In re Central Jersey Airport Servs., LLC*, 282 B.R. 176, 184 (Bankr. D.N.J. 2002) (granting a 30-day extension for progress in negotiations); *In re Service Merchandise Co., Inc.*, 256 B.R. 744, 751 (Bankr. M.D. Tenn. 2000).

n30

30. *In re Dow Corning Corp.*, 208 B.R. 661, 670 (Bankr. E.D. Mich. 1997).

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31. Pub. L. No. 109-8, § 437 (2005), effective in cases commenced on or after October 17, 2005.

n32

32. *11 U.S.C. § 101(51C)* defines small business case as a case filed under chapter 11 of this title in which the debtor is a small business debtor. *11 U.S.C. § (51D)*, added by Pub. L. No. 109-8, § 431(a) (2005), defines small business debtor as: (A) subject to subparagraph (B), a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the date of the order for relief in an amount not more than \$2,190,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and (B)[not including] any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2,190,000 (excluding debt owed to 1 or more affiliates or insiders).

n33

33. *In re Florida Coastal Airlines, Inc.*, 361 B.R. 286, 292 (Bankr. S.D. Fla. 2007)

n34

34. *11 U.S.C. § 1121(e)(1)(B)*.

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35. *But see In re Florida Coastal Airlines, Inc.*, 361 B.R. 286, 292 (Bankr. S.D. Fla. 2007).

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36. *In re Aspen Limousine Serv. Inc.*, 187 B.R. 989 (Bankr. D. Colo. 1995), *aff'd*, 193 B.R. 325 (D. Colo. 1996).

n37

37. 11 U.S.C. § 1121(e)(3).

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38. See *In re Western Steel & Metals, Inc.*, 200 B.R. 873, 876 (Bankr. S.D. Cal. 1996) (failure to file a plan within the statutory deadline imposed by section 1121(e)(2) constitutes cause for dismissal under section 1112(b)). But see *In re Florida Coastal Airlines, Inc.*, 361 B.R. 286, 292 (Bankr. S.D. Fla. 2007) (court held that the 300-day deadline for filing small business reorganization plans applied only to the debtor).

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39. 28 U.S.C. § 158(a).

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40. Pub. L. No. 103-394 (1994).

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41. Ed. note: [P]revent should read permit.

n42

42. 140 Cong. Rec. H10,752, H10,764 (daily ed. Oct. 4, 1994).

n43

43. See *Collier on Bankruptcy*, 3016.03.

n44

44. For a case in which the court noted the date the debtor anticipated filing its plan and then granted the debtor an extension of time to file its disclosure statement later than that date, see *In re Farmland Industries*, 286 B.R. 888, 895 (Bankr. W.D. Mo. 2002).

ABOUT THE AUTHOR(S):

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121 of 197 DOCUMENTS

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Collier on Modification of Plan After Confirmation in a Chapter 11 Case

2008 Emerging Issues 1321

Collier on Modification of Plan After Confirmation in a Chapter 11 Case

By Collier

December 5, 2007

SUMMARY: In enacting Bankruptcy Code section 1127(b), Congress intended to safeguard the finality of plan confirmation. This Emerging Issues Analysis covers modification of a plan after confirmation in a chapter 11 case, including topics such as postconfirmation plan modification when the debtor is an individual, the definition of substantial consummation, and requirements for the postconfirmation plan to become the plan of reorganization.

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ARTICLE: Collier on Modification of Plan After Confirmation in a Chapter 11 Case

In enacting *Bankruptcy Code section 1127(b)*, Congress intended to safeguard the finality of plan confirmation. n1 Except for the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, adding subsections (e) and (f) to section 1127 n2 in order to make chapter 13 modification provisions available when individual debtors file under chapter 11, section 1127(b) provides the sole means for modification of the plan of reorganization after it has been confirmed. n3 The equity power of section 105(a) cannot be used to produce a result contrary to the specific provisions of section 1127(b). n4 Postconfirmation modification may be made only by the proponent or by the reorganized debtor, n5 but not by the court n6 and may take place any time after confirmation, but must take place before the plan is substantially consummated. n7 Even though only the plans proponent may file a motion to modify it, if the plan contains provisions that are beyond the courts jurisdiction, such provisions may be stricken on motion of one other than the proponent. n8

Postconfirmation Plan Modification When Debtor Is an Individual. In the case of an individual who is a debtor in a case under chapter 11, postconfirmation modification can be made anytime before the completion of payments under the plan, regardless of whether the plan has been substantially consummated. When the chapter 11 debtor is an individual, the debtor, the trustee, the United States trustee or an unsecured creditor may request the modification of a plan. Because subsections (e) and (f), added in 2005, n9 make section 1127 substantially similar to sections 1229 and 1329 of the Code, it is likely that rules governing the procedure for plan modification similar to *Federal Rule of Bankruptcy Procedure 3015(g)* will be promulgated and that, until such promulgation, similar rules are likely to be adopted as local court rules.

Postconfirmation Modification Distinguished from Revocation of Confirmation Order. Postconfirmation

modification must be distinguished from revocation of the order of confirmation under *section 1144 of the Bankruptcy Code*, which can be requested by any party in interest but which must be requested before 180 days after the entry of the order of confirmation.

Substantial Consummation Defined. The term, substantial consummation is defined in section 1101(2) n10 to mean:

- (A) transfer of all or substantially all of the property proposed by the plan to be transferred;
- (B) assumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and
- (C) commencement of distribution under the plan. n11

Confirmation of Plan Equivalent to Final Judgment in Ordinary Civil Litigation. It has been said that confirmation of a plan of reorganization is equivalent to a final judgment in ordinary civil litigation. Once that milestone has been reached, further changes should be allowed only for compelling reasons. n12 Modification of a confirmed and substantially consummated plan is forbidden except to the limited extent of *11 U.S.C. § 1127*. n13 Some courts have held that section 1127(b) precludes a debtor from filing a second case under chapter 11 because any reorganization plan in the second case is a modification of the confirmed plan in the original case. n14 The better view is that the so-called chapter 22 cases, that is a chapter 11 case followed by a second chapter 11 case by the same debtor, is acceptable n15 because, as one commentator noted, [t]he commencement of a second case may at times represent the best means of maximizing creditor recoveries and perhaps preserving the debtor. n16

Requirements for Postconfirmation Modification Plan to Become Reorganization Plan. Subsection 1127(b) requires that, in order to become the plan of reorganization, the post-confirmation modified plan must meet the requirements of sections 1122 and 1123 of the Code, and must be confirmed by the court under section 1129 of the Code after notice and a hearing n17 and only if the court finds that circumstances warrant the proposed modification. The court may not adopt a modification that materially alters the plan and adversely affects creditors treatment. n18 The requirements for the modification of a plan include notice of the proposed plan modification, notice of the information necessary for the creditors to assess the nature and the impact of the modification, the opportunity of any impaired creditor to object to the modification and a ruling by the bankruptcy court that the plan as modified meets the requirements for confirmation. n19

For further discussion of Code section 1127, see Collier on Bankruptcy, ch. 1127.

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Return to Text

n1 *Antiquities of Nevada, Inc. v. Bala Cynwyd Corp. (In re Antiquities of Nevada, Inc.)*, 173 B.R. 926, 928 (B.A.P. 9th Cir. 1994).

n2 Pub. L. No. 109-8, § 321(e) (2005), effective in cases commenced on or after October 17, 2005.

n3 *In re Logan Place Properties, Ltd.*, 327 B.R. 811, 814 (Bankr. S.D. Tex. 2005) (section 1127 is the exclusive means by which a plan can be modified); *In re Rickel & Assocs., Inc.*, 260 B.R. 673, 677 (Bankr. S.D.N.Y. 2001) (Section 1127(b) provides the sole means for modifying a confirmed plan.) The court in *Lane v. Peterson*, 899 F.2d 737 (8th Cir.), cert. denied, 498 U.S. 823, 111 S. Ct. 74, 112 L. Ed. 2d 48 (1990), held that section 1127(b) does not create a right of action by the debtor against a party who engaged in postpetition transactions that allegedly modified the plan. See also *Paul v. Monts*, 906 F.2d 1468 (10th Cir. 1990) (recourse must be had to state law and not section 1127 for the breach of an agreement to purchase the debtor's stock which was incorporated in the plan).

n4 *In re Rickel & Assocs., Inc.*, 260 B.R. 673, 678 (Bankr. S.D.N.Y. 2001) (bankruptcy court cannot modify a plan under § 105(a), and produce a result at odds with the specific provisions of § 1127(b)); *In re Stevenson*, 138 B.R. 964, 967 (Bankr. D. Idaho 1992); *In re Charterhouse, Inc.*, 84 B.R. 147 (Bankr. D. Minn. 1988); see also *Doral Ctr. Inc. v. Ionosphere Clubs, Inc.* (*In re Ionosphere Clubs, Inc.*), 38 C.B.C.2d 679, 685, 208 B.R. 812, 816 (S.D.N.Y. 1997) (the bankruptcy courts approval of an agreement which changed the terms of a lease incorporated in a confirmed plan was a postconsummation modification prohibited by section 1127). But one court allowed the debtor to reopen the case under *Federal Rule of Civil Procedure 60(b)* for the purpose of modifying its plan. See *In re Midlands Utility, Inc.*, 251 B.R. 296 (D.S.C. 2000).

n5 *In re Longardner & Assocs., Inc.* 855 F.2d 455 (7th Cir. 1988), cert. denied, 489 U.S. 1015, 109 S. Ct. 1130, 103 L. Ed. 2d 191 (1989); *In re Auto Dealers Servs., Inc.*, 89 B.R. 233, 236 (Bankr. M.D. Fla. 1988) (an entity not a party in interest attempted to propose a plan modification); see also *In re Horne*, 99 B.R. 132 (Bankr. M.D. Ga. 1989); *In re Cinderella Clothing Indus., Inc.*, 93 B.R. 373, 378 (Bankr. E.D. Pa. 1988). It has been held that a disbursing agent under a plan could seek to modify the terms of a confirmed plan. *In re Castle Indus., Inc.*, 147 B.R. 941, 945 (Bankr. E.D. Ark. 1992) (also holding that the provisions of section 1127 must be followed and not the general equity powers of the bankruptcy court under section 105 of the Code). The court in *In re Chicago, M., S. P. & P. R. Co.*, 51 B.R. 1005 (N.D. Ill. 1985), stated that debenture holders were entitled to amend a trustees plan to provide for acceleration of payments. But in *In re Charter Co.*, 97 B.R. 629, 636 (Bankr. S.D. Fla. 1992), the court would not permit debenture holders to bring an action to modify a plan in order to extend the time to surrender their certificates (but allowed relief on other grounds). The court in *Pamaco P'ship Mgmt. v. TMC Terraplan Mgmt.*, 158 B.R. 61, 65 (W.D. Va. 1993), stated that the former general partners could not seek to modify a plan because they were neither the plan proponent nor the reorganized debtor.

n6 *Goodman v. Phillip R. Curtis Enters., Inc.*, 809 F.2d 228, 16 C.B.C.2d 277 (4th Cir. 1987) (reversing a bankruptcy court which on its own motion had modified a confirmed chapter 11 plan). But in *Beal Bank, S.S.B. v. Jack's Marine, Inc.*, 201 B.R. 376 (E.D. Pa. 1996), a district court said that the bankruptcy judge who extended the payment deadline of a confirmed plan and required the debtor to assign mortgages, was not rewriting the plan but clarifying its ambiguities in the exercise of the court's continuing power to supervise the plan. And in *In re A.H. Robins Co., Inc.*, 86 F.3d 364, 374-75 (4th Cir. 1996), the court found that this provision did not remove the court's inherent power to review attorneys fees.

n7 A chapter 11 plan may not be modified after substantial consummation. *Goodman v. Phillip R. Curtis Enters., Inc.*, 809 F.2d 228, 16 C.B.C.2d 277 (4th Cir. 1987); *Enterprise Financial Group, Inc. v. Curtis Mathes Corp.*, 197 B.R. 40 (E.D. Tex. 1996); *In re Rickel & Assocs., Inc.*, 45 C.B.C.2d 1614, 260 B.R. 673 (Bankr. S.D.N.Y. 2001) (after the plan was substantially consummated, it could not be amended to provide that shareholders receive a distribution).

n8 *In re A.J. Mackay Co.*, 13 C.B.C.2d 95, 50 B.R. 756 (D. Utah 1985); see also *United States Brass Corp. v. Travelers Ins. Group*, 301 F.3d 296 (5th Cir. 2002) (stating that arbitration cannot be substituted for litigation in a substantially consummated plan); *In re Manges*, 29 F.3d 1034, 31 C.B.C.2d 1247 (5th Cir. 1994) (setting out a three-pronged test to upset a reorganization plan: was a stay obtained, was there substantial consummation, and would the relief affect the rights of those not before the court); *In re Penn Dixie Indus., Inc.*, 8 C.B.C.2d 1360, 32 B.R. 173 (Bankr. S.D.N.Y. 1983) (motion to change the plan is barred by *res judicata*, particularly when there was ample opportunity to object to confirmation).

n9 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 321(e) (2005), effective in cases commenced on or after October 17, 2005.

n10 Section 1101(2) of the Code is derived almost verbatim from Section 229(a) of the Bankruptcy Act.

n11 See Collier on Bankruptcy, ch. 1101. Determination of substantial consummation turns on the facts of each case and the burden is on the party seeking to modify. *In re Antiquities of Nevada, Inc.*, 32 C.B.C.2d 738, 173 B.R. 926, 928-29 (B.A.P. 9th Cir. 1994); *In re Stevenson*, 148 B.R. 592, 597 (D. Idaho 1992); *In re Potts*, 188 B.R. 575, 579 (Bankr. N.D. Ind. 1995) (The burden of proof is on the proponent of the modification to prove that the plan has not obtained substantial modification.). A retention of jurisdiction clause in a plan will not provide authority to modify after there has been substantial consummation. *In re Davis Broadcasting, Inc.*, 169 B.R. 229, 234 (Bankr. M.D. Ga. 1994), *rev'd on other grounds*, 176 B.R. 290, 292 (1994).

n12 *In re UNR Indus., Inc.*, 20 F.3d 766, 30 C.B.C.2d 1547 (7th Cir. 1994).

n13 *Holstein v. Brill*, 987 F.2d 1268, 1270 (7th Cir. 1993). Confirmation sets the plan in stone unless the proponent chooses to alter it before it is substantially consummated. *In re Diamond Mortgage Co. of Ill.*, 105 B.R. 876, 880 (Bankr. N.D. Ill. 1989). In *Gryphon at the Stone Mansion v. U.S. Trustee (In re Gryphon at the Stone Mansion)*, 204 B.R. 460, 464 (Bankr. W.D. Pa. 1997), the bankruptcy court sitting *en banc* held that the allowance of the U.S. trustee's claim for quarterly fees in cases confirmed and substantially consummated before the amendments to 28 U.S.C. § 1930 would constitute an impermissible modification to the confirmed plan.

Contra In re CF & I Fabricators of Utah, Inc., 214 B.R. 16 (D. Utah 1997); *In re Munford, Inc.*, 216 B.R. 913, 918 (Bankr. N.D. Ga. 1997) (in which case the plan had been confirmed and substantially consummated, but a final decree had not been entered).

n14 *In re Roxy Real Estate Co., Inc.*, 30 C.B.C.2d 570, 170 B.R. 571 (Bankr. E.D. Pa. 1993); *In re Miller*, 122 B.R. 360, 366-67 (Bankr. N.D. Iowa 1990); *In re AT of Maine, Inc.*, 56 B.R. 55 (Bankr. D. Me. 1985); *In re Northhampton Corp.*, 37 B.R. 110, 113 (Bankr. E.D. Pa. 1984). *Contra In re Barrett*, 964 F.2d 588, 27 C.B.C.2d 101 (6th Cir. 1992); *In re Elmwood Dev. Co.*, 964 F.2d 508, 511 (5th Cir. 1992) (second filing is acceptable if there has been a material change in debtor's circumstances); *In re Jartran, Inc.*, 886 F.2d 859, 867-69, 21 C.B.C.2d 1141 (7th Cir. 1988) (may file second case for a liquidating plan).

n15 *In re Elmwood Dev. Co.*, 964 F.2d 508, 511 (5th Cir. 1992) (second filing is acceptable if there has been a material change in debtors circumstances); *In re Jartran, Inc.*, 886 F.2d 859, 867-69 (7th Cir. 1988) (may file second case for a liquidating plan); *In re Barrett*, 964 F.2d 588 (6th Cir. 1992). *But see In re Delray Assocs. Ltd. P'ship*, 212 B.R. 511, 516 (Bankr. D. Md. 1997) (renegotiation of previously agreed upon plan treatment is an impermissible motive for filing a successive case).

n16 Barry L. Zaretsky, *Chapter 22 Cases*, N.Y.L.J., vol. 206, no. 100, p. 3 (Nov. 21, 1991) (analyzing cases on both sides of the issue).

n17 It was improper to order the material modification of a plan where the debtor never filed a disclosure statement and did not give notice to the affected unsecured creditor. *In re Downtown Inv. Club III*, 19 C.B.C.2d 639, 89 B.R. 59 (B.A.P. 9th Cir. 1988). Where the plan had been approved by the requisite number of creditors, it was unnecessary to make disclosure to classes of creditors who had rejected the plan. *Holywell Corp. v. Bank of N.Y.*, 59 B.R. 340 (S.D. Fla. 1986), *appeal dismissed sub nom. Miami Center Ltd. P'ship v. Bank of N.Y.*, 820 F.2d 376, *reh'g denied*, 826 F.2d 1010, *vacated on denial of reh'g*, 838 F.2d 1547, 18 C.B.C.2d 887, *cert. denied*, 488 U.S. 823, 109 S. Ct. 69, 102 L. Ed. 2d 46 (1988).

n18 *In re Best Prods. Co.*, 177 B.R. 791 (S.D.N.Y. 1995). If a modification would upset the legitimate expectations of creditors, it may be refused. *In re Envirodyne Indus., Inc.*, 29 F.3d 301 (7th Cir. 1994). The debtors inability to meet the financial performance required under the plan is not grounds for modification. *In re Dam Road Mini Storage*, 156 B.R. 270, 271 (Bankr. S.D. Cal. 1993); *In re Modern Steel Treating Co.*, 25 C.B.C.2d 292, 130 B.R. 60, 65 (Bankr. N.D. Ill. 1991). However, it has been found that modification would be warranted where, through no fault of the debtor's, its postconfirmation operations resulted in serious losses rendering the original plan unworkable. *In re Gene Dunavant and Son Dairy*, 75 B.R. 328 (M.D. Tenn. 1987).

n19 *In re FCX, Inc.*, 853 F.2d 1149 (4th Cir. 1988), cert. denied sub nom. *Universal Coops., Inc., v. FCX, Inc.*, 489 U.S. 1011, 109 S. Ct. 1118, 103 L. Ed. 2d 181 (1989). *In re Scotland Guard Servs., Inc.*, 139 B.R. 264 (Bankr. D.P.R. 1991), finding that there must be an actual hearing on the propriety of the proposed modification.

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122 of 197 DOCUMENTS

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Collier on Filing of Prepetition Tax Returns in a Chapter 13 Case

2008 Emerging Issues 1322

Collier on Filing of Prepetition Tax Returns in a Chapter 13 Case

By Collier

December 5, 2007

SUMMARY: Bankruptcy Code section 1308, enacted by the 2005 amendments to the Bankruptcy Code, requires chapter 13 debtors to file with appropriate taxing authorities, by the day before the section 341 meeting, all tax returns that the debtor was required to file for all taxable periods ending in the four years before the petition. If the debtor was not required to file a return, or has filed all required returns, no additional return need be filed.

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ARTICLE: *Bankruptcy Code section 1308*, enacted by the 2005 amendments to the Bankruptcy Code, n1 requires chapter 13 debtors to file with appropriate taxing authorities, by the day before the section 341 meeting, all tax returns that the debtor was required to file for all taxable periods ending in the four years before the petition. n2 If the debtor was not required to file a return, or has filed all required returns, no additional return need be filed.

If the required returns are not filed by the first date set for the meeting of creditors, the trustee is permitted to hold the meeting open to give the debtor an opportunity to file them. However, the additional time cannot extend beyond 120 days. n3 However, if a return was not past due at the time of the petition, the extension may be to the date on which the return is due under the last automatic extension the debtor could receive, if a request for extension is made and that date is more than 120 days from the date of the meeting. n4 The court may also extend the filing period set by the trustee by 30 days, but not beyond the last extension date to which the debtor is entitled. n5

The primary purpose of section 1308 is to give taxing authorities the information they need in order to file proofs of claim, and a companion amendment to section 502(b)(9) provides that a taxing authority's proof of claim is to be considered timely if it is filed within 60 days after the filing of a tax return under section 1308. n6 Probably, this would include any return the debtor files after the petition date, although section 1308(a) could be read to encompass only returns required for the tax years ending in the four years before the petition.

Requirement to File Prepetition Tax Returns; 11 U.S.C. § 1308(a). Section 1308(a), enacted in 2005, n7 requires the debtor to file with the applicable taxing authorities all tax returns which the debtor was required to file for all taxable periods ending during the four years before the petition is filed. Those debtors who were not required to file returns, because their income was not sufficient under applicable law or for some other reason, will not be required to file returns under this provision. Presumably, section 1308(a) includes only returns that were not already filed, although

it does not say so.

As a practical matter, section 1308(a) requires debtors who have not filed all of the required tax returns to pay to have their attorney, accountant or other tax return preparer prepare and file the missing returns, even if they do not owe any taxes. If the debtors attorney assists the debtor in the preparation of the returns, the attorneys fees may be allowed as administrative expenses in the bankruptcy cases under section 330(a)(4)(B), so that they would be paid ahead of other creditors under section 1326(a)(2).ⁿ⁸ Otherwise, the necessary costs of an accountant or other tax return preparer would be allowable as a living expense under section 1325(b).ⁿ⁹

The enforcement mechanism for section 1308(a) is the right of a party in interest or the United States trustee to move for dismissal under section 1307(e), also enacted in 2005,ⁿ¹⁰ if the required returns are not filed.ⁿ¹¹ Generally, a trustee should not move for dismissal unless the trustee believes, after questioning the debtor at the section 341(a) meeting, that returns were required and not filed. A taxing authority is unlikely to move for dismissal unless the debtor has listed an obligation to the taxing authority on the schedule of liabilities. If no such obligation is listed, and the taxing authority is not aware of both the bankruptcy and an unpaid tax in time to file a proof of claim, then no obligation to the taxing authority would be discharged.ⁿ¹² In addition, the filing of returns required by section 1308 is a condition of confirmation of a chapter 13 plan.ⁿ¹³

As discussed below, the chapter 13 trustee and the court may grant additional time, within certain limits, for the debtor to file the required returns.ⁿ¹⁴

Extension of Time Granted by Trustee; 11 U.S.C. § 1308(b)(1). If the required returns are not filed by the deadline, set in section 1308(a), the chapter 13 trustee has the discretion to hold the creditors meeting open for a reasonable time to afford the debtor a period of up to 120 days to file the returns. If a return was not past due on the petition date, and the debtor timely seeks an automatic extension of time to file the return, the trustee may extend the time for that return until the latest automatic extension date if that is more than 120 days after the meeting. The debtors request for an extension to the taxing authority must comply with applicable nonbankruptcy law. Although the language is not crystal clear, it appears that the rescheduled creditors meeting need not be the same day as the extended deadline for the returns to be filed. The reasonable period of time for rescheduling the meeting does not seem to be governed by the strict deadlines applicable to the maximum extension of time to file the returns.

Ordinarily, the trustee should grant a reasonable extension of time for a debtor to file required tax returns. It is quite common for debtors, who have been facing financial pressures and often other problems such as illness or divorce, to need time to assemble the necessary documents to file a return. The debtors bankruptcy case may have been filed in haste to prevent imminent harm, such as a foreclosure or repossession, before the debtor could assemble these papers.

Extension of Time Granted by Court; 11 U.S.C. § 1308(b)(2). Whether or not the trustee grants an extension of time, the debtor may move for an extension of time to file returns beyond any time established by trustee, but not more than 30 days after the trustees deadline.ⁿ¹⁵ If a return was not past due on the petition date, and the debtor timely requested an automatic extension, the extended deadline also may not be beyond the latest automatic extension date to which the debtor is entitled.ⁿ¹⁶

The court may only enter such a order after notice and a hearing and before the tolling of any applicable filing period determined under [section 1308(b).] It is not entirely clear what this language means. To toll normally means to take away or to remove, as in the tolling of a statute of limitations. But the filing periods under the subsection are only tolled by a trustees extension or the courts order, and the same sentence talks about extending the time period beyond the time established by the trustee, meaning that the court would be extending the time after the trustee has granted an extension. It would make no sense to seek a court order before a trustee extended the time, when the purpose of the

court order is to gain an extension beyond what the trustee has granted. Perhaps the drafters meant that an order must be entered before the expiration of the filing period, but the expiration of a period is almost the opposite of its tolling. In light of this confused language, courts should probably consider any motion that is sought without unreasonable delay.

The court may grant a motion for an extension of time if the debtor demonstrates by a preponderance of the evidence that the failure to file a required return was due to circumstances beyond the debtor's control. Such circumstances could be the inability to get all necessary records, such as W-2 forms, in time or general disarray of records resulting from divorce, poor record-keeping skills, or some other cause. The preponderance of the evidence language seems gratuitous, because that is the normal standard of proof. It should not require the court to hold a hearing if the motion is unopposed.

Definition of Return; 11 U.S.C. § 1308(c). Section 1308(c), also enacted in 2005, n17 defines the term return for purposes of section 1308. The term includes n18 a return prepared pursuant to subsection (a) or (b) of *section 6020 of the Internal Revenue Code* or a similar state or local law, or written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal.

Internal Revenue Code section 6020 provides:

(a) *Preparation of return by Secretary.* If any person shall fail to make a return required by this title or by regulations prescribed thereunder, but shall consent to disclose all information necessary for the preparation thereof, then, and in that case, the Secretary may prepare such return, which, being signed by such person, may be received by the Secretary as the return of such person.

(b) *Execution of return by Secretary*

(1) Authority of Secretary to execute return. If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

(2) Status of returns. Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.

Thus, a return is deemed to have been filed for a tax year if the taxing authority has prepared a return for that tax year. Because in some places sections 1307(e) and 1308 speak of the debtor filing a return, it is unclear whether it is necessary for the debtor to have signed a return prepared by the taxing authority to meet the requirements of section 1308. A holding that the debtors signature is required might be deemed to contradict *Internal Revenue Code section 6020(b)(2)*, which states that an unsigned return prepared by the Internal Revenue Service shall be prima facie good and sufficient for all legal purposes.

For further discussion of Code section 1308, see Collier on Bankruptcy, ch 1308.

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n1 1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 716(b) (2005), effective in cases commenced on or after October 17, 2005.

n2

2. 11 U.S.C. § 1308(a); *see Collier on Bankruptcy*, 1308.02.

n3

3. 11 U.S.C. § 1308(b)(1)(A); *see Collier on Bankruptcy*, 1308.03[1].

n4

4. 11 U.S.C. § 1308(b)(1)(B); *see Collier on Bankruptcy*, 1308.03[2].

n5

5. 11 U.S.C. § 1308(b)(2); *see Collier on Bankruptcy*, 1308.04.

n6

6. 11 U.S.C. § 502(b)(9), as amended by Pub. L. No. 109-8, § 716(d) (2005), effective in cases commenced on or after October 17, 2005. Section 716(e) of Pub. L. No. 109-8 (2005) states a sense of Congress that the Judicial Conference of the United States should propose amended Federal Rules of Bankruptcy Procedure allowing a taxing authority to object to confirmation of a chapter 13 plan up to 60 days after tax returns required under section 1308 are filed and to delay any deadline for objecting to a claim for a tax year for which section 1308 requires a return until after the return has been filed.

n7

7. Pub. L. No. 109-8, § 716(b) (2005), effective in cases commenced on or after October 17, 2005.

n8

8. 11 U.S.C. § 1326(a)(2), as amended by Pub. L. No. 109-8, § 309(c)(2) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 1326.02[2][b].

n9

9. Necessary accounting fees are specifically allowed under the Internal Revenue Service Other Necessary Expenses permitted in section 707(b)(2)(A)(ii) and incorporated in section 1325(b)(3).

n10

10. *See Collier on Bankruptcy*, 1307.04[12].

n11

11. 11 U.S.C. § 521(j), added by Pub. L. No. 109-8, § 720 (2005), effective in cases commenced on or after October 17, 2005, provides for conversion or dismissal of a case for failure to file postpetition tax returns; *see Collier on Bankruptcy*, 521.25.

n12 12. 11 U.S.C. § 1328(a), (b). Section 1328(a) was amended to except from discharge certain unscheduled debts by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. *See Collier on Bankruptcy*, 1328.02.

n13

13. 11 U.S.C. § 1325(a)(9), enacted by Pub. L. No. 109-8, § 716(a) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 1325.06C.

n14

14. *See Collier on Bankruptcy*, 1308.03, *Collier on Bankruptcy* 1308.04 *infra*.

n15

15. *11 U.S.C. § 1308(b)(2)(A)*. Section 1308 was added by Pub. L. No. 109-8, § 716(b) (2005), effective in cases commenced on or after October 17, 2005.

n16

16. *11 U.S.C. § 1308(b)(2)(b)*.

n17

17. Pub. L. No. 109-8, § 716(b) (2005), effective in cases commenced on or after October 17, 2005.

n18

18. Includes is not limiting. *11 U.S.C. § 102(3)*.

ABOUT THE AUTHOR(S):

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123 of 197 DOCUMENTS

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Collier on Chapter 13 Confirmation Hearing

2008 Emerging Issues 1323

Collier on Chapter 13 Confirmation Hearing

By Collier

December 5, 2007

SUMMARY: This Emerging Issues Analysis covers chapter 13 confirmation hearings, including topics such as notice, scheduling, and agenda of the confirmation hearing; and objection to the confirmation of a chapter 13 plan under section 1324(a).

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ARTICLE: Overview of Bankruptcy Code Section 1324. Section 1324(a) of the Bankruptcy Code states that the court shall hold a hearing on the confirmation of a chapter 13 plan. n1 The Code leaves no doubt that the chapter 13 confirmation hearing must be held and must be before the court. The language of section 1324 represents a distinct departure from the more elastic term, after notice and a hearing, n2 commonly employed throughout the Code. Moreover, the legislative history is unambiguous regarding the compulsory nature of section 1324. n3

An amendment to what is now section 1324(a), enacted in 2005, n4 added the words Except as provided in subsection (b) and to the beginning of the sentence stating that the court shall hold a confirmation hearing, but section 1324(b) does not contain any exception to this mandate. Section 1324(b) simply states when the hearing must be held.

Section 341(c) forbids the court to attend or preside at any meeting of creditors held in a chapter 13 case. n5 The only hearing that the court must conduct in every chapter 13 case in which a plan is confirmed or denied confirmation is the hearing on confirmation required by section 1324. Of course, section 524(d) permits the court to conduct a discharge hearing in every chapter 13 case in which the debtor is granted or denied a discharge, and requires the court to conduct a hearing if the debtor desires to reaffirm a debt and was not represented by an attorney in negotiating the reaffirmation agreement. n6

Any party in interest may object to confirmation of the debtors proposed plan, and objections to confirmation are normally heard and adjudicated at the confirmation hearing. n7

Notice, Scheduling and Agenda of Confirmation Hearing.

Notice of Confirmation Hearing; Fed. R. Bankr. P. 2002(b), (k). The hearing on confirmation of a chapter 13 plan must be held on notice to all parties in interest, including the debtor, all creditors, the United States trustee, and the

chapter 13 trustee. n8 Subsections (b) and (k) of *Federal Rule of Bankruptcy Procedure 2002* require that no less than 25 days notice be mailed to these parties, advising them of the time fixed for filing objections to confirmation and the date of the confirmation hearing. n9 Typically, the notice of the confirmation hearing is a part of the notice of the meeting of creditors, sent shortly after the petition is filed. n10

Scheduling of Confirmation Hearing; 11 U.S.C. § 1324(b). Prior to the 2005 amendments to the Bankruptcy Code, n11 and beyond the requirement of 25 days notice, neither the Code nor the Bankruptcy Rules specified when the confirmation hearing was to be held. Some courts held the hearing almost immediately after the creditors meeting, in an effort to begin distributions to creditors as quickly as possible. The 1993 amendment to *Federal Rule of Bankruptcy Procedure 2003(a)* lengthened the time during which a section 341(a) creditors meeting can be held, so courts had more flexibility in coordinating the timing of that meeting with the scheduling of the confirmation hearing. n12 However, early scheduling of the hearing may deprive creditors of an adequate opportunity to assess the case at the creditors' meeting and then file objections to confirmation of the plan. n13

Section 1324(b), enacted in 2005, n14 provides that the confirmation hearing must be held between 20 days and 45 days after the date of the section 341(a) meeting of creditors, unless the court determines it would be in the best interests of creditors and the estate to hold the hearing earlier and there is no objection to an earlier date.

The language of this provision is somewhat unclear, but it should be interpreted as requiring the stated time periods to run from the conclusion of the meeting of creditors, rather than the first date set for the meeting of creditors. When Congress wished a time period to run from the first date set for the meeting of creditors, it so stated. n15 Moreover, interpreting the provision otherwise could result in the confirmation hearing being scheduled before the meeting of creditors is concluded. n16

Similarly, the language of section 1324(b) should be read to require only that the confirmation hearing be commenced within the deadline stated. There will be occasions on which the court cannot finish the hearing on the same day, or a proceeding to determine the amount of a claim must first be resolved, or a person necessary to the hearing is ill, and there is no reason for a rigid rule that would prevent the court from continuing the hearing to a later date. In any event, there are no apparent consequences if the confirmation hearing is not held by the deadline stated in section 1324(b).

For cases filed before the effective date of the 2005 amendments, many courts found it preferable to schedule the confirmation hearing at a later time, after the bar date for the filing of creditors' claims. Such scheduling allowed for an orderly process of filing written objections to confirmation and, if the court desires, answers to those objections. It also allowed the court to know what claims had been filed in the case, information which may be critical to whether the plan meets the confirmation standards of the Code. For example, Code section 1322(a)(2) requires the plan to provide for full payment of priority claims, n17 and it is possible that a large priority claim will not be filed until the last possible date for filing claims. Similarly, the confirmation standards of sections 1325(a)(4), n18 1325(a)(5) n19 and 1325(b) n20 all may require the courts knowledge of the amounts of allowed secured or unsecured claims in the case.

Under the 2005 amendments, courts are not able to schedule the initial confirmation hearing after the claims deadline. However, if a plans confirmation depends on the amount of a particular claim, or of all claims, filed, a court may still continue the confirmation hearing until the necessary information is available, which may not be until the claims bar date has passed.

Section 1324(b) also provides that the court may schedule the confirmation hearing earlier than 20 days after the section 341(a) meeting of creditors if it determines that is in the best interests of creditors and the estate, unless is an objection to the earlier date. This will allow continuation of the practice of some courts of holding the confirmation hearing immediately after, or within a short time after, the meeting of creditors, provided no party objects. There is no limitation on who may object, so the objection may be filed by any party, including a creditor, the trustee or the debtor.

Agenda of Confirmation Hearing. The agenda of the confirmation hearing is not set forth in section 1324, except that the section permits any party in interest to object to confirmation of the plan. The remaining agenda may include taking evidence as to the suitability of the plan for confirmation under section 1325, n21 including the ability of the debtor to comply with the plan, n22 the determination of acceptances and rejections n23 and consideration of preconfirmation modifications filed pursuant to section 1323. n24 Valuation of collateral is often an important issue at the confirmation hearing, n25 but courts vary widely in the procedure to be followed in raising the issue, with some courts requiring a separate proceeding to be filed. n26

However, the court need not take evidence on confirmation issues when there is no objection to confirmation. n27 Indeed, as the Court of Appeals for the Third Circuit stated in *In re Szostek*, n28 while the court and the trustee have some obligation to determine whether a plan complies with the appropriate sections of the Bankruptcy Code prior to confirmation, a creditor that does not object to confirmation may not later complain that the plan should not have been confirmed, because the affirmative obligation to object to the plan rests with the creditor, not the court or the trustee. The court normally has sufficient information from the documents filed in the case to determine whether the plan satisfies the requirements of section 1322(a) n29 and the confirmation standards of subsections 1325(a)(1), (2), (4), (5) and (6) are not mandatory, so that they will not be in issue unless a party objects or the court raises them *sua sponte*. n30 The Federal Rules of Bankruptcy Procedure expressly excuse the court from taking evidence on the remaining standard of good faith if no objection to the plan is timely filed. n31 The court also has the benefit of the views and any recommendation of the chapter 13 trustee, who has an overview of the case and is required to attend the confirmation hearing, n32 although the trustee's views or recommendations are in no way binding on the court. Therefore, unless the court requires the debtor's testimony or there is an objection to confirmation to which it would be relevant, the debtor need not attend the confirmation hearing. n33

Objection to Confirmation; § 1324(a). Section 1324(a) expressly authorizes any party in interest, including any secured or unsecured creditor, to object to the confirmation of a chapter 13 plan. n34 The United States trustee also has standing to be heard regarding confirmation of the plan. n35 Although acceptance of a chapter 13 plan is not required on the part of the holders of allowed unsecured claims, n36 any holder of an allowed unsecured claim may object to the confirmation of the plan on grounds that it fails to comply with one or more of the requirements of section 1325. n37 However, a creditor who does not hold an allowed claim, because, for example, a claim was never filed, generally is not a party in interest with standing to object to confirmation of the plan. n38 Any material way in which the plan is not in compliance with section 1325, n39 any other provision of chapter 13 n40 or any other applicable provision of title 11 n41 is a sufficient basis upon which to object to its confirmation. n42

The right to object to confirmation of the plan is usually a creditors only opportunity to contest the debtors treatment and possible discharge of the creditors claim in chapter 13, because--unlike in chapter 7 and chapter 11--there is no possibility of objecting to discharge at any other time. n43 Although a creditor is entitled to rely upon compliance with the terms stated in the plan, n44 if no objection to that plan is filed after proper notice of the case, the creditor is bound by the terms of the plan and has no right to later challenge its propriety. n45

Federal Rule of Bankruptcy Procedure 3015(f) provides that an objection to confirmation must be filed and served on the debtor, the trustee and any other entity designated by the court, as well as transmitted to the United States trustee, before confirmation of the plan. n46 Local bankruptcy rules sometimes set more specific deadlines, n47 although arguably a local rule cannot shorten the time period allowed by the Federal Rules of Bankruptcy Procedure. n48 The objection gives rise to a contested matter n49 that is to be litigated by the parties directly involved, including the debtor and the objecting creditor or creditors. Generally, the burden of going forward with evidence and the ultimate burden of proof is borne by the party objecting to confirmation, n50 and if that party fails to prosecute the objection, the objection should be dismissed. n51 The objection is usually heard at the hearing on confirmation, but it may also be heard at a separate hearing scheduled prior to the confirmation hearing.

For a complete discussion of Code section 1324, see Collier on Bankruptcy, ch 1324.

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[Return to Text](#)

n1 1. *11 U.S.C. § 1324(a)*, formerly § 1324, as amended and redesignated by Pub. L. No. 109-8, § 317 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. *See 11 U.S.C. § 102(1); Collier on Bankruptcy, 1300.07[1][a].*

n3

3. *See H.R. Rep. No. 595, 95th Cong., 1st Sess. 429 (1977).*

n4

4. Pub. L. No. 109-8, § 317 (2005), effective in cases commenced on or after October 17, 2005.

n5

5. *11 U.S.C. §§ 103(a), 341(c)*. Section 341(c) was amended by Pub. L. No. 109-8, § 413 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy, 1300.06[1][a][ii]* and *Collier on Bankruptcy, 1300.60[3]*. *See generally* *Collier on Bankruptcy*, ch. 341.

n6

6. *11 U.S.C. § 524(d)*; *see Collier on Bankruptcy, 1300.80[4]* and *Collier on Bankruptcy, 1328.02*. *See generally* *Collier on Bankruptcy*, ch. 524.

n7

7. *See Collier on Bankruptcy*, 1324.03.

n8

8. 11 U.S.C. § 1324(a), formerly § 1324, as amended and redesignated by Pub. L. No. 109-8, § 317 (2005), effective in cases commenced on or after October 17, 2005; *see* H.R. Rep. No. 595, 95th Cong., 1st Sess. 429 (1977).

n9

9. *Fed. R. Bankr. P. 2002(b)*, (k); *see Collier on Bankruptcy*, ch. 2002.

n10

10. *See* Official Form 9I.

n11

11. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n12

12. *Fed. R. Bankr. P. 2003(a)*.

n13

13. *See In re Robinson*, 22 B.R. 497 (W.D. Va. 1982) (scheduling of confirmation hearing on same day as meeting of creditors did not give creditor adequate opportunity to investigate case and object to confirmation).

n14

14. Pub. L. No. 109-8, § 317 (2005), effective in cases commenced on or after October 17, 2005.

n15

15. *See, e.g., 11 U.S.C. § 521(a)(2)(B)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n16

16. *See also 11 U.S.C. § 1308(b)*, which permits the meeting of creditors to be held open well beyond 45 days after the meeting.

n17

17. *11 U.S.C. § 1322(a)(2); see Collier on Bankruptcy, 1322.03.*

n18

18. *See 11 U.S.C. § 1325(a)(4)*, providing that confirmation may be denied if unsecured creditors will not receive payments equivalent to present value of what they would have received in chapter 7 case; *Collier on Bankruptcy, 1325.05.*

n19

19. *See 11 U.S.C. § 1325(a)(5)*, providing that confirmation may be denied if each allowed secured claim provided for in plan not afforded rights specified in statute; *Collier on Bankruptcy, 1325.06[1].*

n20

20. *See 11 U.S.C. § 1325(b)*, requiring, in some cases, all allowed unsecured claims to be paid in full; *Collier on Bankruptcy, 1325.08[3].*

n21

21. *11 U.S.C. § 1325(a). See generally Collier on Bankruptcy, ch. 1325.01.*

n22

22. See 11 U.S.C. § 1325(a)(6); *Collier on Bankruptcy*, 1302.03[1][1]; *Collier on Bankruptcy*, 1325.07; cf. 11 U.S.C. § 1302(b)(2)(B).

n23

23. See 11 U.S.C. §§ 1323(c), 1329(b)(1).

n24

24. See 11 U.S.C. § 1323; *Collier on Bankruptcy*, 1323.01.

n25

25. See 11 U.S.C. §§ 506, 1302(b)(2)(A), 1325(a)(5); *Collier on Bankruptcy*, 1302.03[1][k]; *Collier on Bankruptcy*, 1325.06[4].

n26

26. Compare *In re Harvey*, 213 F.3d 318 (7th Cir. 2000) (valuation as part of confirmation process); and *In re Hudson*, 260 B.R. 421 (Bankr. W.D. Mich. 2001) (valuation does not require separate proceeding as long as creditor receives adequate notice, discussing conflicting case law), with *Sun Finance Co. v. Howard (In re Howard)*, 972 F.2d 639 (5th Cir. 1992) (separate proceeding required). See generally *Collier on Bankruptcy*, 1327.02[2].

n27

27. *In re Hines*, 723 F.2d 333, 9 C.B.C.2d 1099 (3d Cir. 1983) (trustees recommendation is sufficient basis for confirming plan); *In re Powell*, 5 C.B.C.2d 775, 15 B.R. 465 (Bankr. N.D. Ga. 1981).

n28

28. 886 F.2d 1405, 21 C.B.C.2d 889 (3d Cir. 1989).

n29

29. 11 U.S.C. § 1322(a); see *Collier on Bankruptcy*, 1322.02 *Collier on Bankruptcy*, 1322.04.

n30

30 11 U.S.C. § 1325(a), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 1325.01.

n31

31. *Fed. R. Bankr. P. 3015(f)*; see 1993 Advisory Committee Notes to *Fed. R. Bankr. P. 3015* and 3020; *Collier on Bankruptcy*, ch. 3015.

n32

32. 11 U.S.C. § 1302(b)(2)(B); see *Collier on Bankruptcy*, 1302.03[1][1]; see also *In re Kelsey*, 6 B.R. 114, 2 C.B.C.2d 1192 (*Bankr. S.D. Tex.* 1980).

n33

33. *In re Perskin*, 4 C.B.C.2d 294, 9 B.R. 626 (*Bankr. N.D. Tex.* 1981).

n34

34. 11 U.S.C. § 1324(a), formerly § 1324, as redesignated by Pub. L. No. 109-8, § 317 (2005), effective in cases commenced on or after October 17, 2005; see *In re Andrews*, 49 F.3d 1404 (9th Cir. 1995) (trustee had standing to object to plan on grounds that secured creditors were not provided adequate protection); *In re Davis*, 239 B.R. 573 (B.A.P. 10th Cir. 1999) (trustee in debtors still-pending chapter 7 case could object to treatment of property chapter 7 trustee claimed as property of chapter 7 estate).

n35

35. 28 U.S.C. § 586(a)(3)(C).

n36

36. See 11 U.S.C. § 1325(a)(4); *Collier on Bankruptcy*, 1325.05.

n37

37. See 11 U.S.C. §§ 1324(a), 1325; *Collier on Bankruptcy*, 1325.02[1]; see also *Benkelman Coop. Equity Exch. v. Koerperich (In re Koerperich)*, 3 C.B.C.2d 923 (Bankr. D. Neb. 1980).

n38

38. *In re Stewart*, 12 C.B.C.2d 86, 46 B.R. 73 (Bankr. D. Or. 1985); cf. *In re Kressler*, 2001 U.S. Dist. LEXIS 11723 (E.D. Pa. Aug. 9, 2001), *aff'd*, 40 Fed. Appx. 712, 2002 U.S. App. LEXIS 14979 (3d Cir. July 25, 2002) (secured creditor could object to plan affecting its lien even though its claim had been disallowed as untimely filed).

n39

39. 11 U.S.C. § 1325(a)(1); see *Collier on Bankruptcy*, 1325.01.

n40

40. 11 U.S.C. § 1325(a)(1); see *Collier on Bankruptcy*, 1325.02[1].

n41

41. 11 U.S.C. § 1325(a)(1); see *Collier on Bankruptcy*, 1325.02[2].

n42

42. 11 U.S.C. § 1325(a)(1).

n43

43. Compare 11 U.S.C. § 1328, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on

or after October 17, 2005, with 11 U.S.C. §§ 727(c), 1141(d)(3).

n44

44. *In re Fawcett*, 758 F.2d 588, 12 C.B.C.2d 1011 (11th Cir. 1985).

n45

45. *In re Pardee*, 193 F.3d 1083 (9th Cir. 1999); *In re Andersen*, 179 F.3d 1253 (10th Cir. 1999); *United States ex rel. I.R.S. v. Norton*, 717 F.2d 767, 9 C.B.C.2d 336 (3d Cir. 1983); *Lawrence Tractor Co. v. Gregory* (*In re Gregory*), 705 F.2d 1118, 8 C.B.C.2d 605 (9th Cir. 1983); see also 1327.02 *infra*.

n46

46. See *Fed. R. Bankr. P. 3015(f)*.

n47

47. See *In re Gaona*, 290 B.R. 381 (*Bankr. S.D. Cal. 2003*) (objections untimely under local rule that required creditor to obtain hearing date by date section 341 meeting concluded and file objection next day); *In re Carbone*, 254 B.R. 1 (*Bankr. D. Mass. 2000*) (local rule required objections filed by later of 30 days after first date set for section 341(a) meeting or 30 days from service of modified plan).

n48

48. See *Fed. R. Bankr. P. 9029(a)* (local rules must be consistent with Federal Rules of Bankruptcy Procedure); *Collier on Bankruptcy*, 9029.02; *In re Gaona*, 290 B.R. 381 (*Bankr. S.D. Cal. 2003*) (local rule detailing procedure and timetable for objections was consistent with *Fed. R. Bankr. P. 3015*).

n49

49. *Fed. R. Bankr. P. 3015(f)*.

n50

50. *In re Mendenhall*, 54 B.R. 44 (Bankr. W.D. Ark. 1985); *Pennsylvania v. Flick (In re Flick)*, 5 C.B.C.2d 494, 14 B.R. 912, (Bankr. E.D. Pa. 1981). *But see In re Fries*, 68 B.R. 676 (Bankr. E.D. Pa. 1986) (party raising objection to confirmation under 11 U.S.C. § 1325(b) has burden of going forward with evidence, but debtor has ultimate burden of persuasion on that issue); *see also Education Assistance Corp. v. Zellner*, 827 F.2d 1222, 17 C.B.C.2d 867 (8th Cir. 1987) (objecting party has at a minimum the burden of producing satisfactory evidence on issue of disposable income).

n51

51. *In re Parker*, 49 B.R. 61 (Bankr. E.D. Va. 1985); *In re Powell*, 5 C.B.C.2d 775, 15 B.R. 465, (Bankr. N.D. Ga. 1981).

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124 of 197 DOCUMENTS

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New Ch. 13 Discharge Requirements Under Section 1328(f), (g) & (h) of the Code

2008 Emerging Issues 1324

Collier on New Chapter 13 Discharge Requirements Under Section 1328(f), (g) and (h) of the Code

By Collier

December 5, 2007

SUMMARY: This Emerging Issues Analysis covers the new chapter 13 discharge requirements under section 1328(f), (g), and (h) of the Code, including topics such as discharge after prior discharge in a chapter 7, 11, or 12 case; discharge after prior discharge in a chapter 13 case; the requirement that a debtor must complete a personal financial management instructional course; and the delay of discharge because of a possible exemption objection.

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ARTICLE: *Section 1328 of the Bankruptcy Code* contains the chapter 13 discharge provisions. The section provides for a discharge after the debtor has fully complied with his or her chapter 13 plan, and also for a hardship discharge in cases in which the debtor cannot complete payments under the plan due to circumstances for which the debtor should not be held accountable.

Section 1328(f), added by the 2005 amendments to the Bankruptcy Code, prohibits the court from granting a discharge of all debts provided for in the plan or disallowed under section 502 if the debtor has received a prior bankruptcy discharge in a prior bankruptcy case if the case was filed within the time period specified in section 1328(f).

Section 1328(g), also added in 2005, prohibits the court from granting a discharge if the debtor has not completed a personal financial management instructional course as described in section 111.

And section 1328(h), yet another subsection added in 2005, prohibits the court from granting a discharge until after it provides notice and a hearing on the issue of whether section 522(q) may be applicable to the debtor.

Chapter 13 Discharge as Bar to Further Chapter 13 Relief; 11 U.S.C. § 1328(f). Prior to the 2005 amendments to *Bankruptcy Code section 1328*, n1 a chapter 13 discharge, whether granted under section 1328(a) or section 1328(b), constituted no bar to further relief under chapter 13, either by way of a further composition or an extension of debt. n2 Section 1328(f), enacted in 2005, prohibits a chapter 13 discharge in certain circumstances when a prior bankruptcy discharge has been entered.

Discharge after Prior Discharge in Chapter 7, 11 or 12 Case; 11 U.S.C. § 1328(f)(1).

Section 1328(f)(1), enacted in 2005, n3 provides that if the debtor received a discharge in a chapter 7, 11 or 12 case that was filed during the four years prior to the date of the order for relief in a subsequent chapter 13 case, which is the date of the petition, n4 the debtor may not receive a chapter 13 discharge. This provision will preclude a debtor from receiving a discharge in a chapter 13 case filed soon after a chapter 7 case, a practice sometimes referred to as chapter 20 because it adds 13 to 7.

However, it is important to note that section 1328(f) does not prevent a debtor from filing a chapter 13 case after a chapter 7 case; it only prevents such a debtor from receiving a discharge in that chapter 13 case if it is filed within four years of the earlier petition. There may be occasions in which a debtor will find it advantageous to file a chapter 13 case even if a discharge is not available, in order to cure a default through a plan, or simply to seek protection of the bankruptcy court and the automatic stay while paying debts in an orderly fashion through a plan.

Discharge after Prior Discharge in Chapter 13 Case; § 1328(f)(2). Section 1328(f)(2), also added in 2005, n5 prohibits the entry of a discharge in a chapter 13 case filed within two years of the filing of a prior chapter 13 case in which a discharge was granted. This provision should rarely be applicable, because most chapter 13 cases in which discharges are granted last for three to five years. However, it is possible that a hardship discharge under section 1328(b) n6 could be granted to a debtor within two years of the chapter 13 petition in a prior case, or that a debtor completed payments on a plan within two years through a lump sum payment, perhaps obtained through refinancing a home mortgage.

It might be suggested that Congress really intended that the four-year period run from the date of the discharge in the prior case, but such a reading of the subsection does violence to its plain language, which links the time period to the filing of the prior case in each subparagraph. Moreover, because chapter 7 discharges are usually received within four or five months of the filing of the petition, such a reading would lead to a result under which a debtor could receive a discharge sooner after a chapter 7 case than after a chapter 13 case. Under such a reading, the debtor could receive a discharge within less than two and a half years after a chapter 7 case was filed, but typically not until five to seven years after a chapter 13 case was filed. That kind of reading would fly in the face of Congress oft-expresses policy of encouraging chapter 13 rather than chapter 7, punishing only those who successfully completed chapter 13 plans and received a discharge.

Again, it is important to note that section 1328(f)(2) does not preclude filing a chapter 13 case after a prior case in which a discharge was received, but only the receipt of a discharge if the second case is filed within the stated time period after the first case. A debtor may still file a chapter 13 case and utilize the tools in chapter 13 to cure a mortgage, deal with other secured debts, or simply pay debts under a plan with the protection of the automatic stay.

Section 1328(f)(2) also has no applicability if the prior chapter 13 case was dismissed, although other Code provisions may limit the debtor's rights in a subsequent chapter 13 case after a prior case is dismissed. n7

Requirement of Personal Financial Management Course; 11 U.S.C. § 1328(g). Section 1328(g), added by the 2005 amendments to the Bankruptcy Code, n8 requires that before the debtor receives a discharge in chapter 13 the debtor must complete a personal financial management instructional course as described in section 111, n9 also added by those amendments. Probably, the rules will require some evidence to be provided to the court, perhaps through the filing of a certificate of course completion, so the court will know whether a discharge can be granted.

There are two exceptions to the requirement that the debtor take a financial management course prior to receiving a discharge. The debtor need not complete such a course if the United States trustee or Bankruptcy Administrator for the district determines that the approved courses that are available are not sufficient to service the additional individuals who would be required to take the course. n10 This language is peculiar and raises questions about whether the lack availability of courses can be found with respect to a particular group of individuals, such those residing in a particular

geographic area or those who speak only certain languages other than English. In any event, such a certification must be reviewed by the United States trustee or Bankruptcy Administrator at least annually. n11

The second exception is for those individuals described in section 109(h)(4), which excuses from the credit counseling requirement individuals who the court finds to be unable to comply with the requirement because of incapacity, disability, or active military duty in a combat zone. n12 The definitions of disabled or incapacitated in section 109(h)(4) are restrictive. Incapacity is defined as impaired by reason of mental illness or mental deficiency so that [the debtor] is incapable of realizing and making rational decisions with respect to financial responsibilities. Disability is defined as so physically impaired as to be unable, after reasonable effort, to be unable to participate in an person, telephone, or Internet briefing By excepting such individuals from the education requirement, section 1328(g)(2) avoids the absurd situation in which a debtor would be required to complete a course even if suffering from Alzheimers Disease or some other disability that would make the course meaningless or even impossible.

Delay of Discharge Because of Possible Exemption Objection under Section 522(q); 11 U.S.C. § 1328(h).

Section 1328(h), added by the 2005 amendments to the Bankruptcy Code, n13 prohibits the granting of a chapter 13 discharge unless there has been notice and an opportunity for a hearing with respect to the issue of whether section 522(q)(1) may be applicable to the debtor and whether a proceeding that may implicate section 522(q) is pending. The prohibition is intended to help effectuate section 522(q), which limits a debtors state homestead exemption in certain cases if the debtor has been convicted of a felony that renders the filing of the case an abuse of title 11 or if the debtor owes a debt arising from certain types of acts with respect to securities, a civil remedy under the federal racketeering law (RICO), or a criminal act, intentional tort or willful or reckless conduct causing serious physical injury or death to an individual in the preceding five years. n14

Specifically, under section 1328(h), the entry of a discharge requires the court to first find, after notice and a hearing, that there is no reasonable cause to believe that section 522(q)(1) may be applicable and also that there is no reasonable cause to believe that there is pending a proceeding that would render the debtor subject to section 522(q)(1)(A) or (B). The wording of section 1328(h) suggests that a discharge should be granted unless both limitations exist. In other words, the court must grant a discharge unless it finds that there is a reasonable cause to believe that a proceeding is actually pending and that proceeding could result in a judgment that would be of the type described in section 522(q)(1).

Section 1328(g) will most likely be effectuated by a requirement in the rules that the court provide notice to all parties of an opportunity to claim that grounds exist to delay the debtors discharge pending a proceeding of the type described. If no party requests a delay in the discharge, the requisite finding can be made and the discharge can be granted.

If the court does find that the discharge should be delayed under section 1328(g), that finding should not result in permanent denial of the discharge. The purpose of the delay is to permit a determination regarding whether the homestead exemption should be limited under section 522(q). Once that determination is made, and the nonbankruptcy proceeding is no longer pending, the chapter 13 discharge can be granted.

For further discussion of Code section 1328, see Collier on Bankruptcy, ch. 1328.

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n1 1. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. *In re Ciotta*, 2 C.B.C.2d 132, 4 B.R. 253 (Bankr. E.D.N.Y. 1980).

n3

3. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n4

4. 11 U.S.C. § 301(b), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; 11 U.S.C. § 348(a).

n5

5. Pub. L. No. 109-8, (2005), effective in cases commenced on or after October 17, 2005.

n6

6. 11 U.S.C. § 1328(b), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 1328.03.

n7

7. See 11 U.S.C. §§ 109(g), 362(c)(3)-(4); *Collier on Bankruptcy*, 109.08 and *Collier on Bankruptcy*, ch. 362.

n8

8. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n9

9. 11 U.S.C. § 111; see *Collier on Bankruptcy*, ch. 111.

n10

10. 11 U.S.C. § 1328(g)(2), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n11

11. 11 U.S.C. § 1328(g)(3), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n12

12. 11 U.S.C. §§ 109(h)(4), 1328(g)(2); see *Collier on Bankruptcy*, 109.09[4].

n13

13. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n14

14. 11 U.S.C. § 522(q), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 522. It is unclear from which date the five years runs, especially in a chapter 13 case in which the discharge may be five years after the petition.

ABOUT THE AUTHOR(S):

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125 of 197 DOCUMENTS

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Collier on Effect of a Full-Compliance Chapter 13 Discharge

2008 Emerging Issues 1325

Collier on Effect of a Full-Compliance Chapter 13 Discharge

By Collier

December 5, 2007

SUMMARY: This Emerging Issues Analysis covers the effect of a full-compliance chapter 13 discharge, including topics such as the extension of a chapter 13 discharge to all debts provided for by the plan; the discharge exception for long-term debts provided for under section 1322(b)(5); the discharge exception for certain taxes; and the discharge exception for debts incurred through fraud.

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ARTICLE: Discharge

The discharge for full compliance required by *Bankruptcy Code section 1328(a)* is not superfluous, even in extension plan cases in which all allowed claims are satisfied in full. In many chapter 13 extension plan cases, claims may have been reduced or disallowed in accordance with section 502. n1 A discharge for full compliance under section 1328(a) discharges not only debts n2 provided for by the plan, but also debts disallowed under section 502 n3 unless a claim was disallowed solely because it was not timely filed and the debt is nondischargeable under section 1328(a). n4

As originally enacted in 1978, section 1328(a)(2) excepted from a full-compliance discharge only those debts that were nondischargeable under section 523(a)(5). However, under amendments made in 1990, 1994 and 2005, n5 section 1328(a)(2) now excepts from a full-compliance discharge also debts that are specified in section 507(a)(8)(C) and in paragraphs (1)(B), (1)(C), (2), (3), (4), (5), (8) n6 and (9) n7 of section 523(a). Additionally, paragraph (3) was added to section 1328(a) to except from a full-compliance discharge debts for a criminal fine or restitution included in a sentence on the debtors conviction of a crime n8 and paragraph (4) was added in 2005, n9 also excepting from that discharge debts for restitution or damages awarded in a civil action as a result of willful or malicious injury by the debtor that caused personal injury to an individual or the death of an individual. n10 While these amendments have had the effect of significantly narrowing the full-compliance discharge, those debts listed in section 523(a) that section 1328(a) does not explicitly except from a full-compliance discharge remain dischargeable in a chapter 13 case, notwithstanding their nondischargeability in a chapter 7 case. n11

Discharge of Debts Provided for by the Plan. The chapter 13 discharge extends to all debts provided for by the

plan, with but a few limited exceptions. The Code does not specifically define provided for, and some creditors have argued that if a plan does not propose to make payments on a debt it does not provide for that debt. The Court of Appeals for the Ninth Circuit properly rejected this argument in *Lawrence Tractor Co. v. Gregory (In re Gregory)*,ⁿ¹² which held that to provide for a claim a plan need only make a provision for it, i.e., deal with it or refer to it. This broad definition of the term provided for was subsequently adopted by the Supreme Court in *Rake v. Wade*.ⁿ¹³ Even if the plan proposes to pay nothing to unsecured claimants, if those claimants have proper notice and an opportunity to object to confirmation their claims may be discharged under section 1328(a).ⁿ¹⁴

In view of the fact that Congress clearly contemplated chapter 13 plans paying little or nothing on unsecured debts,ⁿ¹⁵ this result is consistent with other portions of the Code. It would be anomalous to hold otherwise, and thereby render nondischargeable in chapter 13 a general unsecured claim that could be discharged with no payment in a chapter 7 case filed by the same debtor, simply because no payment is made on the claim in the chapter 13 case. Nor would it make sense to conclude that a very nominal percentage payment in a chapter 13 case should make the difference between dischargeability or nondischargeability of a debt; such a result would only bring about payments of a few cents to creditors who would otherwise receive nothing, a result that would increase administrative difficulties while providing no real benefit to creditors. Similarly, the fact that a creditor is not paid because it failed to file a claim when given the opportunity to do so has no relevance to the dischargeability of the debt.ⁿ¹⁶ As long as the plan contains some provision describing the treatment of that debt, and no exception to the chapter 13 discharge applies, the debt is discharged.ⁿ¹⁷ For example, in *Pennsylvania Department of Public Welfare v. Davenport*,ⁿ¹⁸ despite the fact that the state creditor never filed a proof of claim in the chapter 13 bankruptcy case,ⁿ¹⁹ that creditors criminal restitution claim was held to be discharged.ⁿ²⁰ However, courts have held that a creditor that is not scheduled and does not have notice of the chapter 13 case in time to file a claim or to participate in the confirmation process has not been provided for by the plan. In *In re Hairopoulos*,ⁿ²¹ the Court of Appeals for the Sixth Circuit found that the Internal Revenue Service had not been scheduled as a creditor and had never received any notice that the case had been converted to chapter 13 or notice of the confirmation hearing and claims deadline. Because the Internal Revenue Service was justified in believing it had no need to monitor the case after receiving an initial notice of a chapter 7 case with no expected assets, the court held that to discharge the tax debt after the lack of notice would have resulted in a lack of fairness and due process.ⁿ²² In some cases, the failure to schedule a creditor may be remedied, even after confirmation, if the debtor or creditor files a late claim to which no party objects, or if the debtor successfully seeks an enlargement of time to file a claim on behalf of the creditor.ⁿ²³ If a party objects to the new claim, the debtor may be able to resolve the objection by modifying the plan to assure that no party is prejudiced by allowance of the additional claim. The addition of section 523(a)(3) to the list of exceptions to discharge may clarify this issue, as discussed below.ⁿ²⁴

Discharge Exception for Long-Term Debts Provided for under Section 1322(b)(5); 11 U.S.C. §§ 1322(b)(5) and 1328(a)(1). Section 1322(b)(5) permits the debtor to make special provision for curing any default and maintaining payments under the plan on any secured or unsecured claim on which the last contract payment becomes due after the final payment required under the plan.ⁿ²⁵ It would be inequitable to provide for the payment of long-term debts in accordance with an installment payment schedule extending beyond the term of the plan, and still discharge those debts upon completion of payments under the plan. Section 1328(a)(1) excepts from a full-compliance discharge long-term debts provided for in accordance with section 1322(b)(5).ⁿ²⁶ However, a debtⁿ²⁷ is not nondischargeable under this subsection simply because it is a long-term debt that could be cured under section 1322(b)(5); it is nondischargeable only if cure is, in fact, provided for by the plan.ⁿ²⁸

Discharge Exception for Certain Taxes; 11 U.S.C. §§ 507(a)(8)(C), 523(a)(1)(B) & (C) and 1328(a)(2). The 2005 amendments to the Bankruptcy Codeⁿ²⁹ added to the list of debts nondischargeable under section 1328(a) tax debts specified in section 507(a)(8)(C) and in section 523(a)(1)(B) and (C).

Section 507(a)(8)(C) describes trust fund taxes that the debtor is required to withhold for the benefit of taxing authorities, such as income taxes, Social Security and Medicare taxes withheld from employees' wages, and sales taxes.ⁿ³⁰ This exception will apply primarily to chapter 13 debtors who have operated a business in which they had

employees or made sales. It also includes liability of a debtor as a responsible person in a business owned by another, such as a corporation, under *section 6672 of the Internal Revenue Code*. n31 It does not include the employers share of employment taxes, which is covered by section 507(a)(8)(D). n32

Section 523(a)(1)(B), as amended in 2005, n33 describes taxes with respect to which a return, or equivalent report or notice was not filed or was filed late and within two years before the bankruptcy petition. n34 This addition marks a significant constriction of the chapter 13 discharge. Under the law prior to 2005, taxes for which no returns were filed could be discharged under section 1328(a), with the practical result that taxes that were old enough to no longer be entitled to priority under section 507(a)(8), and thus full payment under section 1322(a)(2), n35 could be eliminated without full payment. Under the amended section 1328(a)(2), such taxes, to the extent they are not paid in the chapter 13 case, will not be discharged.

Section 523(a)(1)(C), describes taxes with respect to which a fraudulent return was filed or the debtor willfully attempted to evade the tax. n36 Such debts, while less common, were also dischargeable prior to 2005.

Discharge Exception for Debts Incurred Through Fraud; 11 U.S.C. §§ 523(a)(2) and 1328(a)(2). Also added in 2005 n37 to the debts nondischargeable under section 1328(a) were debts described in section 523(a)(2), for money, property or services obtained by false pretenses, fraud, or a false financial statement. The voluminous case law regarding this exception to discharge n38 will become applicable. Because section 523(c) requires creditors to bring proceedings raising this exception only in the bankruptcy court, n39 it is expected that *Rule 4007 of the Federal Rules of Bankruptcy Procedure* will be amended to set a deadline for bringing a proceeding under section 523(a)(2) in chapter 13 cases.

Also, because chapter 5 of the Code is generally applicable in chapter 13 cases, n40 section 523(d) will also apply to proceedings brought under section 523(a)(2) in chapter 13 cases. Debtors who prevail in such proceedings have a right to be awarded costs and reasonable attorneys fees against the creditor if the position of the creditor was not substantially justified, unless special circumstances would make such an award unjust. n41

Discharge Exception for Debts Not Listed or Scheduled by the Debtor; 11 U.S.C. §§ 523(a)(3) and 1328(a)(2). Another exception to discharge added by the 2005 Amendment n42 to section 1328(a)(2) is the exception under section 523(a)(3) for debts not listed or scheduled in time to permit the creditor to timely file a proof of claim or, if the debt is nondischargeable under section 523(a)(2), (4), or (6), in time to file a proceeding to determine dischargeability. n43 The exception does not apply if the creditor had actual knowledge of the case in time to act, and presumably would not apply in chapter 13 with respect to debts nondischargeable under section 523(a)(6) because there is no exception to the section 1328(a) discharge for such debts. n44

Section 523(a)(3) will likely be interpreted in chapter 13 in the same way as it has been interpreted in other chapters. If a creditor would not have received a distribution even if a claim had been filed, as might occur in a plan paying no dividend to general unsecured creditors, the lack of knowledge in time to file a proof of claim would not bar discharge of the claim unless the debt was nondischargeable under section 523(a)(2) or (4) and the creditor did not learn of the case in time to file a dischargeability proceeding. n45

Discharge Exception for Debts Incurred Through Fraud as a Fiduciary; Embezzlement or Larceny; 11 U.S.C. §§ 523(a)(4) and 1328(a)(2). Section 1328(a)(2) was also amended in 2005 n46 to include debts described in section 523(a)(4). These debts are those incurred through fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. The case law regarding this exception is discussed in *Collier on Bankruptcy*. n47 Like debts under section 523(a)(2), debts are only nondischargeable in a bankruptcy case if a proceeding is brought in the bankruptcy court. n48 It is expected that *Rule 4007 of the Federal Rules of Bankruptcy Procedure* will set a deadline, similar to the deadline in other chapters, for initiating such a proceeding.

Discharge Exception for Debts for Domestic Support Obligations; 11 U.S.C.

§§ 523(a)(5) and 1328(a)(2). Debts provided for under the chapter 13 plan that are excepted from a full-compliance discharge under section 1328(a) include debts for domestic support obligationsⁿ⁴⁹ coming within the provisions of section 523(a)(5).ⁿ⁵⁰ It is important to note that this exception does not include debts in the nature of marital property settlements which are not within the scope of section 523(a)(5) but which are nondischargeable under section 523(a)(15).ⁿ⁵¹ That latter provision is applicable in chapter 13 only if the debtor receives a hardship discharge.ⁿ⁵²

Discharge Exception for Debts for Educational Loans; 11 U.S.C. §§ 523(a)(8) and 1328(a)(2). The Omnibus Budget Reconciliation Act of 1990 amended section 1328(a)(2) by adding the reference to paragraph (8) of section 523(a).ⁿ⁵³ The effect of this amendment is to exclude from the full-compliance discharge those debts for educational loans that are nondischargeable under section 523(a)(8).ⁿ⁵⁴ Thus, an educational loan within the ambit of that subsection is not discharged in chapter 13 unless repayment of the loan would impose an undue hardship on the debtor and the debtor's dependents.ⁿ⁵⁵ This amendment applies to bankruptcy cases commenced on or after November 5, 1990.ⁿ⁵⁶

Because the undue hardship provisions in section 523(a)(8) are carried over to chapter 13 through the incorporation of that section in section 1328(a)(2), a chapter 13 debtor may seek a determination that the debt should be discharged because payment of the debt would be an undue hardship. The standard for undue hardship should be the same as in chapter 7 and the debtor could thus seek such a determination early in the case based on the facts existing at that time, just as such a determination could be sought early in a chapter 7 case, in order to know whether the debt will be discharged. However, as in chapter 7, the debtor may also seek an undue hardship determination at some later time, such as the time the discharge is granted. A few courts have held that the issue of undue hardship is not ripe until at or near the time of discharge, since before then it is not known that the debtor will receive a discharge.ⁿ⁵⁷ However, there is no such limitation in *Federal Rule of Bankruptcy Procedure 4007(b)*, which provides that a complaint to determine dischargeability of a debt, other than under section 523(c), may be filed at any time.ⁿ⁵⁸ Moreover, the undue hardship determination would be necessary even if the case were to be converted to chapter 7 or if the debtor received a hardship discharge, since the same exception to discharge would be equally applicable under those circumstances. Ordinarily, the undue hardship determination is sought by an adversary proceeding filed pursuant to *Federal Rule of Bankruptcy Procedure 7001*. However, if a debtors plan provides that the holder of the loan shall be enjoined from collecting on the loan if the plan is completed because repayment would constitute an undue hardship, and a creditor has notice of that plan provision, the confirmation of a chapter 13 plan may also be a method of obtaining a finding of undue hardship.ⁿ⁵⁹ Under a 1999 amendment to Rule 7001, an injunction or other equitable relief need not be sought by an adversary proceeding if a chapter 13 plan provides for that relief. Moreover, a plan may contain any appropriate provision not inconsistent with title 11. Although a few courts have expressed displeasure with attorneys who have included such provisions in chapter 13 plans,ⁿ⁶⁰ these courts fail to recognize that every chapter 13 plan is a proposal by the debtor to which creditors can object, and that creditors must respond to the plan or be bound by their lack of response, just as debtors and other parties must respond to other types of proceedings that affect their rights.ⁿ⁶¹ In making the undue hardship determination in a chapter 13 case, the court should not presume that all funds that were used for plan payments will be available for student loan payments when the case is concluded and plan payments end. The debtor or the debtors dependents may well have been suffering undue hardship in order to make the plan payments, perhaps to save the family's home from foreclosure. Necessary family expenses may have been deferred during the plan period or may have increased since commencement of plan payments. The debtors income may have decreased. The undue hardship determination, whether made at the beginning of the case or at the time of discharge, must be decided based on all of the relevant circumstances at the time of the determination.ⁿ⁶²

Discharge Exception for Debts for Death or Personal Injury Caused by Debtors Operation of Motor Vehicle While Intoxicated; 11 U.S.C. §§ 523(a)(9) and 1328(a)(2).

The Criminal Victims Protection Act of 1990ⁿ⁶³ added to section 1328(a)(2) the reference to section 523(a)(9).

As a result of this amendment, the full-compliance discharge under section 1328(a) does not discharge debts that are nondischargeable under section 523(a)(9); i.e., debts for death or personal injury caused by the debtors operation of a motor vehicle if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance. n64

Discharge Exception for Debts for Restitution or Fine Included in Sentence on Debtors Conviction of Crime; 11 U.S.C. § 1328(a)(3). The Criminal Victims Protection Act of 1990 added paragraph (3) to section 1328(a). n65 Paragraph (3) excludes from the full-compliance discharge in chapter 13 cases debts for restitution included in a sentence on the debtors conviction of a crime. n66 This amendment has the effect of limiting the Supreme Courts decision in *Pennsylvania Department of Public Welfare v. Davenport*. n67 When the debt is for restitution included in a sentence on the debtors conviction of a crime, the provisions of paragraph (3) apply, and the Courts decision in *Davenport* cannot operate to make the debt dischargeable in the chapter 13 case. Thus, *Davenport* was legislatively overruled but only to the extent that it conflicts with section 1328(a)(3). n68

It is important to note that the amendment does not apply when the restitution order does not result from conviction of a crime. When restitution obligations result from criminal proceedings that did not result in a conviction, such as a pretrial diversion program or an agreement that charges will be dropped on condition of restitution, those obligations remain dischargeable. n69

It is also important to note that the amendment did not alter, and in fact reaffirmed, the Supreme Court's conclusions that criminal restitution obligations are claims that may be provided for in a chapter 13 plan n70 and that the automatic stay bars their enforcement during a chapter 13 case. n71 Therefore, only that portion of a nondischargeable restitution obligation that is still unpaid at the conclusion of the chapter 13 case will remain owing by the debtor due to the amendment to the statute. The debtor may even seek to separately classify the restitution obligation for payment prior to other claims to minimize this remaining debt and, in view of the more harsh enforcement mechanisms available with respect to most restitution debts, should probably be permitted to do so. n72

Section 1328(a)(3) was amended by the Bankruptcy Reform Act of 1994, n73 which added the words or a criminal fine to the subsection. This amendment renders nondischargeable any criminal fine that was imposed in a sentence upon a debtors conviction of a crime. The exception is thus narrower than the exception to the chapter 7 discharge in section 523(a)(7), which covers all fines and penalties owed to governmental units, n74 in that it is limited only to criminal fines imposed upon conviction of a crime. n75 But it is also broader than that exception to the extent that it does not exclude from the exception fines that are in compensation for actual pecuniary loss.

To determine whether a particular fine is dischargeable under section 1328(a)(3), an examination of applicable criminal law will often be necessary. n76 For example, is a debtor convicted when he or she receives a parking ticket or a traffic ticket and does not contest it? Is the fine considered a sentence as that term is defined under applicable law? Is the offense classified as a crime under state law? Only if the fine is imposed after a conviction of a crime and as part of a sentence is it nondischargeable in chapter 13. Similarly, assessments that are neither restitution nor fines, such as costs, are still dischargeable in chapter 13. Prior case law holding that criminal fines and costs are dischargeable n77 should therefore remain good law to the extent such fines and costs are not within the very specific language of section 1328(a)(3).

Debts for Restitution or Damages Awarded for Willful or Malicious Injury or Death; 11 U.S.C. § 1328(a)(4). Section 1328(a)(4), added by the 2005 amendments to the Bankruptcy Code, n78 makes nondischargeable in the full compliance discharge certain debts for personal injury to an individual or the death of an individual. For a debt to be nondischargeable under this provision it must meet several criteria.

The debt must be for damages or restitution awarded in a civil action. Thus, criminal restitution is not included, though many criminal restitution debts are within the scope of section 1328(a)(3). n79 It is also unclear whether a debt would be nondischargeable if no award had yet been made in a civil action when the bankruptcy petition was filed. If

Congress had intended for a debt to be nondischargeable even if not yet awarded, the words awarded in would appear to be surplusage.

In addition, the debt must be a result of willful or malicious injury. This is a lower standard than section 523(a)(6), which requires the debt to be the result of a willful *and* malicious injury. n80 However, unlike section 523(a)(6), injuries to property are not included. The injury must a personal injury to an individual or the death of an individual. Unlike section 523(a)(6), section 1328(a)(4) need not be asserted during the bankruptcy case. A creditor holding a claim that is nondischargeable under section 1328(a)(4) may litigate the dischargeability of any unpaid portion of that claim after the chapter 13 discharge in a nonbankruptcy court. n81

Discharge Exception for Postpetition Debts Not Provided for by Plan. Debts incurred by the chapter 13 debtor after the commencement of the case and not provided for by the plan are not discharged under section 1328(a). Postpetition debts allowed under sections 502(a) and (b) and 1305(a), (b) and (c) provided for under the plan as permitted by section 1322(b)(6) are discharged under section 1328(a), unless the debt is based on a consumer debt claim under section 1305(a)(2) incurred by the debtor without the prior approval of the chapter 13 trustee, where the obtaining of approval was practicable. n82

Discharge Exception for Postpetition Consumer Debts Incurred without Trustees Approval; 11 U.S.C. § 1328(d). Section 1305(a)(2) permits the filing of a proof of claim based on a consumer debt, arising during the chapter 13 case, that is for property or services necessary for the debtor's performance under the plan. n83 Section 1305(c) requires disallowance of a postpetition consumer debt claim if the holder of the claim knew or should have known that obtaining the approval of the chapter 13 trustee was practicable but was not done before the incurring of the debt. n84 Section 1322(b)(6) permits a chapter 13 plan to propose payment of a claim allowed under section 1305(a)(2). n85 Thus, as a practical matter, no postpetition claim may be discharged unless the holder of the claim and the debtor agree, since the claim may be allowed only if the holder files a claim and the plan will provide for the claim only if the debtor files a plan that does so. n86

Section 1328(d) renders a discharge granted under section 1328 ineffective against a postpetition consumer debt claim incurred without the prior approval of the chapter 13 trustee, where it was practicable to obtain such approval. n87 Section 1328(d) has the effect of denying discharge of a postpetition consumer debt claim disallowed under section 1305(c). n88 Of course, if the party with whom the debtor incurred a postpetition consumer debt knew or should have known that prior approval by the chapter 13 trustee was practicable, and approval was not obtained, the postpetition debt claim is to be disallowed. n89

Debts Made Nondischargeable by Other Statutes. In addition to section 1328 of the Code, Congress has passed other statutes that might render certain debts nondischargeable in chapter 13, even when there has been full compliance with the plan. Two such statutes are sections 254 and 292f(g) of title 42 of the United States Code. These statutes prohibit the discharge in bankruptcy of certain obligations arising from health education programs within five years after the date repayment is to begin, and after that five years permit discharge only if denial of a discharge would be unconscionable. n90 In part because the five-year period in each of these statutes runs to the date of discharge rather than the date of the petition, courts have struggled to reconcile them with chapter 13 in cases when the discharge is beyond the five-year time frame. n91

Congress also has passed other non-Bankruptcy Code provisions relating to discharge. In the National Defense Authorization Act of 1991, n92 certain obligations arising from retention bonuses paid to military officers are made nondischargeable when a bankruptcy discharge is entered less than five years after the termination of the retention agreement. n93 Several other similar provisions limit or prohibit the discharge of other debts incurred through participation in military programs. n94 The five-year period running back from the date of discharge in these statutes presents the same issues as the five year period in the health education provisions, n95 and could mean that in at least some chapter 13 cases, when the discharge is less than five years from the termination of the agreement, a discharge of the obligation would be barred.

In addition, section 656(b) of the Social Security Act n96 provides that a debt owed under state law to a state or a municipality that is in the nature of support and enforceable under Part IVD of the Social Security Act is not released by a discharge in bankruptcy. If the release of a debt is the same as a discharge, this provision might encompass some debts not encompassed in section 523(a)(5). However, the same legislation that enacted the 1996 amendment to 42 U.S.C. § 656 also added a new exception to discharge in section 523(a)(18) for the same debts as are described in 42 U.S.C. § 656. Because this exception does not appear in 11 U.S.C. § 1328(a), and because section 523(a)(18) would be completely superfluous if 42 U.S.C. § 656 accomplished the same result for all chapters (Congress presumably would have amended that section if it had intended the exception to apply in chapter 13), it is not altogether clear that 42 U.S.C. § 656, amended by the same section of the same legislation, should be read to create an exception to the chapter 13 full-compliance discharge. Nonetheless, the Court of Appeals for the Ninth Circuit held, in *In re Cervantes*, n97 that a support debt owed to a governmental unit is nondischargeable in chapter 13 due to section 656, despite the moderate inconsistency in the statutory scheme.

The inconsistent statutory drafting was corrected, to some extent by the 2005 amendments to section 523(a), which broadened section 523(a)(5) to include all domestic support obligations, as that term was newly defined in section 101, and by the repeal of section 523(a)(18), presumably because it was deemed superfluous. n98

Interest on Nondischargeable Debts. Ordinarily, if a debt is not discharged in a case under any chapter, interest on the debt continues to run and is also nondischargeable. n99 This rule applies in chapter 13 as well, although it can have anomalous results. For example, in *Leeper v. Pennsylvania Higher Education Assistance Agency*, n100 the Court of Appeals for the Third Circuit held that, even though the debtors had paid 100 percent of a student loan claim in their plan, interest on the loan which accrued during the plan remained to be paid after the discharge. Notwithstanding the fact that such interest could not have been included in the claim itself, due to section 502(b)(2), the court held that the interest could continue to accrue as a personal liability of the debtors. n101

However, if a plan is confirmed that specifically provides that postpetition interest on a nondischargeable debt will be discharged upon completion of the plan, that plan is binding upon the creditor under section 1327(a). n102 Although a valid objection to such a plan would probably be granted, if no objection is made at the time of confirmation, such an objection is waived. n103

A debtor might also choose to propose a plan that paid postpetition interest to a creditor holding a nondischargeable claim. Although a trustee or creditor might object to such a plan, the separate classification of a debt for this preferred treatment would likely be permissible under section 1322(b)(1), especially in the case of priority nondischargeable debts for domestic support obligations, due to the special societal concern with payment of such debts. n104 Alternatively, if the plan were confirmed because no party objected to the provision, the separate classification would also be permitted. n105

Section 1322(b)(10), added by the 2005 amendments, n106 specifically permits a debtor to pay interest on nondischargeable claims if the debtor's plan proposes to pay all allowed claims in full.

For a complete discussion of Code section 1328, see Collier on Bankruptcy, ch. 1328.

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[Return to Text](#)

n1 11 U.S.C. § 502. Section 502(b)(9) was added by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, to clarify that latefiled claims are disallowed in chapter 13 cases. *See also In re Foster*, 4 C.B.C.2d

763, 11 B.R. 476 (*Bankr. S.D. Cal. 1981*).

n2 See 11 U.S.C. § 101 (defining debt); *Collier on Bankruptcy*, 1300.12[5]; see also 11 U.S.C. §101 (defining claim). But cf. 11 U.S.C. § 1328(c); *Collier on Bankruptcy*, 1328.03[3].

n3 See *Collier on Bankruptcy*, 1300.72; see also, e.g., *In re Christian*, 8 C.B.C.2d 14, 25 B.R. 438 (*Bankr. D. N.M. 1982*) (disallowed claim for postpetition interest on federal tax claim discharged under 11 U.S.C. § 1328(c)); *In re Foster*, 4 C.B.C.2d 763, 11 B.R. 476 (*Bankr. S.D. Cal. 1981*) (disallowance of claim due to untimely filing under Fed. R. Bankr. P. 13-302(e)(2) results in discharge of debt). But see *Doane v. Appalachian Power Co. (In re Doane)*, 6 C.B.C.2d 1215, 1217, 19 B.R. 1007, 1009 (*W.D. Va. 1982*) (discharge of debts under chapter 13 only discharges those debts that were included in plan).

n4 See *Woods v. United Student Aid Funds, Inc. (In re Woods)*, 233 F.3d 324 (5th Cir. 2000) (student loan claim disallowed as untimely was not discharged due to section 1328(a) exception to discharge).

n5 See Criminal Victims Protection Act of 1990, enacted as part of Crime Control Act of 1990, Pub. L. No. 101-647 (1990), and also as separate piece of legislation, Pub. L. No. 101-581 (1990); Bankruptcy Reform Act of 1994, Pub. L. No. 103-394; Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n6 See *Collier on Bankruptcy*, 1328.02[3][h], concerning debts for student loans coming within provisions of section 523(a)(8).

n7 See 1328.02[3][i], concerning debts for death or personal injury caused by debtor's operation of motor vehicle while intoxicated, under section 523(a)(9).

n8 See *Collier on Bankruptcy*, 1328.02[3][j].

n9 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n10 See *Collier on Bankruptcy*, 1328.02[3][k].

n11 See *Pennsylvania Dep't of Public Welfare v. Davenport*, 495 U.S. 552, 110 S. Ct. 2126, 109 L. Ed. 2d 588, 22 C.B.C.2d 1067 (1990); *In re Burrell*, 1 C.B.C.2d 474, 2 B.R. 650 (Bankr. N.D. Cal. 1980), *rev'd on other grounds*, 2 C.B.C.2d 1019, 6 B.R. 360 (N.D. Cal. 1980) (debts resulting from fraud and embezzlement dischargeable in chapter 13); *William Iselin & Co. v. Lewis (In re Lewis)*, 2 C.B.C.2d 1138, 5 B.R. 575 (Bankr. N.D. Ga. 1980) (claims based upon 11 U.S.C. § 523(a)(2), (4) & (6) dischargeable in chapter 13); *In re Marlow*, 1 C.B.C.2d 705, 3 B.R. 305 (Bankr. N.D. Ill. 1980) (debt resulting from false financial statement dischargeable in chapter 13); see also *Collier on Bankruptcy*, 1328.02[2].

n12 705 F.2d 1118, 8 C.B.C.2d 605 (9th Cir. 1983).

n13 508 U.S. 464, 473, 113 S. Ct. 2187, 2193, 124 L. Ed. 2d 424, 434, 28 C.B.C.2d 983, 990 (1993).

n14 508 U.S. 464, 473, 113 S. Ct. 2187, 2193, 124 L. Ed. 2d 424, 434, 28 C.B.C.2d 983, 990.

n15 See *Collier on Bankruptcy*, 1325.08.

n16 *In re Dixon*, 218 B.R. 150 (B.A.P. 10th Cir. 1998); *United States v. Lee*, 184 B.R. 257 (W.D. Va. 1995) (responsible person tax penalties based upon prepetition withholding were discharged even though IRS had not yet assessed them on date of petition and did not file timely proof of claim for them); *In re Tomlan*, 102 B.R. 790 (E.D. Wash. 1989).

n17 See *In re Hardy*, 56 B.R. 95 (Bankr. N.D. Ala. 1985) (plan confirmed even though no creditors had filed claims and none would be paid).

n18 495 U.S. 552, 110 S. Ct. 2126, 109 L. Ed. 2d 588, 22 C.B.C.2d 1067 (1990).

n19 495 U.S. 552, 557, 110 S. Ct. 2126, 2130, 109 L. Ed. 2d 588, 595, 22 C.B.C.2d 1067, 1069.

n20 495 U.S. 552, 564, 110 S. Ct. 2126, 2134, 109 L. Ed. 2d 588, 599-600, 22 C.B.C.2d 1067, 1074. *Davenport* was decided before enactment of section 1328(a)(3), which excludes from full-compliance discharge in chapter 13 cases debts for restitution included in sentence on debtor's conviction of crime. See *Collier on Bankruptcy*, 1328.02[3][f].

n21 118 F.3d 1240 (6th Cir. 1997).

n22 See also *In re Tipton*, 118 B.R. 12 (Bankr. D. Conn. 1990).

n23 See *In re Moore*, 247 B.R. 677 (Bankr. W.D. Mich. 2000).

n24 See *Collier on Bankruptcy*, 1328.02[3][e].

n25 11 U.S.C. § 1322(b)(5); see *Collier on Bankruptcy*, 1322.09.

n26 A technical amendment to section 1328(a)(1) deleting the words of this title was made by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n27 A technical amendment to section 1328(a)(1) deleting the words of this title was made by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n28 *In re Chappell*, 984 F.2d 775, 28 C.B.C.2d 431 (7th Cir. 1993); *In re Ali*, 63 B.R. 591 (Bankr. E.D. Wis. 1986).

n29 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n30 *See Collier on Bankruptcy*, 507.10[4].

n31 *See Collier on Bankruptcy*, 507.10[4][a].

n32 *See Collier on Bankruptcy*, 507.10[5].

n33 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n34 *See Collier on Bankruptcy*, 523.07[3].

n35 *See Collier on Bankruptcy*, 1322.03.

n36 *See Collier on Bankruptcy*, 523.07[4].

n37 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n38 *See Collier on Bankruptcy*, 523.08.

n39 *See Collier on Bankruptcy*, 523.03, *Collier on Bankruptcy*, 523.04.

n40 11 U.S.C. § 103(a).

n41 See *Collier on Bankruptcy*, 523.08[8].

n42 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n43 See *Collier on Bankruptcy*, 523.09.

n44 Some debts within the scope of section 523(a)(6) are also within the scope of section 1328(a)(4), but there is no requirement that a proceeding be brought during the bankruptcy case under the latter exception. See *Collier on Bankruptcy*, 1328.02[3][k]. However, it remains to be seen whether courts will apply section 523(c) to a debt that is nondischargeable under section 1328(a)(4) where the debt is for willful and malicious injury to a person and, therefore, the debt is of a kind specified in section 523(a)(6).

n45 See *Collier on Bankruptcy*, 523.09[3][a].

n46 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n47 See *Collier on Bankruptcy*, 523.10.

n48 11 U.S.C. § 523(c), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 523.03, *Collier on Bankruptcy*, 523.04.

n49 Domestic support obligation is defined in section 101; see *Collier on Bankruptcy*, ch. 101.

n50 11 U.S.C. §§ 523(a)(5) (as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or

after October 17, 2005); 1328(a)(2); see *Norman v. Norman (In re Norman)*, 4 C.B.C.2d 1573, 13 B.R. 894 (Bankr. W.D. Mo. 1981); *In re Syrus*, 4 C.B.C.2d 1172, 12 B.R. 605 (Bankr. D. Kan. 1981); *William Iselin & Co. v. Lewis (In re Lewis)*, 2 C.B.C.2d 1138, 5 B.R. 575 (Bankr. N.D. Ga. 1980); *In re Marlow*, 1 C.B.C.2d 705, 3 B.R. 305 (Bankr. N.D. Ill. 1980); *In re Haag*, 2 C.B.C.2d 144, 3 B.R. 649 (Bankr. D. Or. 1980); *Johnson v. Seely (In re Seely)*, 2 C.B.C.2d 1128, 6 B.R. 309 (Bankr. E.D. Va. 1980); *In re Burrell*, 1 C.B.C.2d 474, 2 B.R. 650 (Bankr. N.D. Cal. 1980), *rev'd on other grounds*, 2 C.B.C.2d 1019, 6 B.R. 360 (N.D. Cal. 1980). See generally *In re McGinnis*, 18 B.R. 525 (Bankr. N.D. Ga. 1982); *Cleveland Trust Co. v. Keckler (In re Keckler)*, 3 B.R. 155, 1 C.B.C.2d 574 (Bankr. N.D. Ohio 1980).

n51 11 U.S.C. § 523(a)(15), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 523.

n52 11 U.S.C. § 1328(c); see *Collier on Bankruptcy*, 1328.03[3].

n53 Pub. L. No. 101-508 (1990).

n54 11 U.S.C. § 523(a)(8) was amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005 to include additional educational loans not previously included under the exception; see *Collier on Bankruptcy*, 523.14.

n55 *Woods v. United Student Aid Funds, Inc. (In re Woods)*, 233 F.3d 324 (5th Cir. 2000).

n56 As originally enacted, the amendment made by Pub. L. No. 101-508 contained a sunset provision. However, that provision was repealed by section 1558 of Pub. L. No. 102-325 (enacted on July 23, 1992).

n57 E.g., *In re Raisor*, 180 B.R. 163 (Bankr. E.D. Tex. 1995).

n58 See *Collier on Bankruptcy*, 4007.03.

n59 *In re Andersen*, 179 F.3d 1253 (10th Cir. 1999). See generally *Collier on Bankruptcy*, 1327.02[1][c].

n60 *E.g.*, *In re Hensley*, 249 B.R. 318 (Bankr. W.D. Okla. 2000) (threatening sanctions if counsel did not delete provision from plan); *In re Evans*, 242 B.R. 407 (Bankr. S.D. Ohio 1999) (ordering counsel to show cause why he should not be sanctioned for including provision).

n61 See *Educational Credit Mgmt. Corp. v. Gardner (In re Gardner)*, 287 B.R. 822 (D. Kan. 2002) (including undue hardship provisions in a plan is not automatically sanctionable and is not inappropriate if there is a good faith basis for them).

n62 See *In re Strauss*, 216 B.R. 638 (Bankr. N.D. Cal. 1998) (applying undue hardship standard in chapter 13 case).

n63 The Criminal Victims Protection Act of 1990 was enacted as part of the Crime Control Act of 1990, Pub. L. No. 101-647 (1990), and also enacted as a separate piece of legislation, Pub. L. No. 101-581 (1990). The identical language exists in Pub. L. No. 101-647 as well as Pub. L. No. 101-581 because the text in Pub. L. No. 101-647 was not excised when it was duplicated in the separate legislation enacted as Pub. L. No. 101-581. Pub. L. No. 101-647 was signed into law on November 29, 1990, and became effective as of the date of enactment; Pub. L. No. 101-581 was signed into law on November 15, 1990 and became effective as of the enactment date.

n64 11 U.S.C. § 523(a)(9), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see also *Collier on Bankruptcy*, 523.15.

n65 The Criminal Victims Protection Act of 1990 was enacted as part of the Crime Control Act of 1990, Pub. L. No. 101-647 (1990), and also enacted as a separate piece of legislation, Pub. L. No. 101-581 (1990).

n66 11 U.S.C. § 1328(a)(3), as added by Pub. L. Nos. 101-647 and 101-581 and amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394.

n67 495 U.S. 552, 110 S. Ct. 2126, 109 L. Ed. 2d 588, 22 C.B.C.2d 1067 (1990). For discussion of *Davenport*, see *Collier on Bankruptcy*, 1328.02[2][a].

n68 See 136 Cong. Rec. S9663 (daily ed., July 12, 1990).

n69 Cf. 11 U.S.C. § 523(a)(13) (making nondischargeable all orders of restitution issued under title 18 of U.S. Code, enacted by Violent Crime Control and Law Enforcement Act of 1994, Pub. L. No. 103-322 (1994)).

n70 *Pennsylvania Dept of Public Welfare v. Davenport*, 495 U.S. 552, 558-60, 110 S. Ct. 2126, 2130-31, 109 L. Ed. 2d 588, 596-7, 22 C.B.C.2d 1067, 1070-71 (1990).

n71 495 U.S. 552, 560, 110 S. Ct. 2126, 2131-32, 109 L. Ed. 2d 588, 597-8, 22 C.B.C.2d 1067, 1071-72 (1990).

n72 11 U.S.C. § 1322(b)(1); see *Collier on Bankruptcy*, 1322.05.

n73 Pub. L. No. 103-394.

n74 11 U.S.C. § 523(a)(7); see *Collier on Bankruptcy*, 523.13.

n75 But see *In re Wilson*, 252 B.R. 739 (B.A.P. 8th Cir. 2000) (interpreting conviction of a crime to include plea of guilty followed by deferred adjudication of probation).

n76 See, e.g., *Bova v. St. Vincent De Paul Corp. (In re Bova)*, 276 B.R. 726 (B.A.P. 1st Cir. 2002) (examining Illinois criminal law to determine that use of enforcement mechanism allowing civil judgment for restitution did not divest the restitution obligation of its identity as part of the criminal sentence).

n77 E.g., *Hardenberg v. Virginia, DMV (In re Hardenberg)*, 42 F.3d 986 (6th Cir. 1994).

n78 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n79 *See Collier on Bankruptcy*, 1328.02[3][j].

n80 *See Collier on Bankruptcy*, 523.12.

n81 However, it remains to be seen whether courts will apply section 523(c) to a debt that is nondischargeable under section 1328(a)(4) where the debt is for willful and malicious injury to a person and, therefore, the debt is of a kind specified in section 523(a)(6). If courts hold that section 523(c) applies in those circumstances, section 1328(a)(4) would have to be asserted in the bankruptcy court.

n82 11 U.S.C. § 1328(d); *see In re Thornton*, 6 C.B.C.2d 1116, 21 B.R. 462 (Bankr. W.D. Va. 1982).

n83 11 U.S.C. § 1305(a)(2); *see Collier on Bankruptcy*, 1305.02[2].

n84 11 U.S.C. § 1305(c); *see Collier on Bankruptcy*, 1305.05.

n85 11 U.S.C. § 1322(b)(6); *see Collier on Bankruptcy*, 1322.10.

n86 *See Collier on Bankruptcy*, 1305.03[1].

n87 11 U.S.C. § 1328(d); *cf.* 11 U.S.C. § 1305(c).

n88 11 U.S.C. § 1305(c); see *Collier on Bankruptcy*, 1305.05.

n89 *In re Thornton*, 6 C.B.C.2d 1116, 21 B.R. 462 (Bankr. W.D. Va. 1982); 11 U.S.C. § 1305(c); see 1305.05 *supra*.

n90 See also 42 U.S.C. § 288-5 (National Institutes of Health loan program with similar five-year provisions).

n91 See, e.g., *In re Johnson*, 787 F.2d 1179, 14 C.B.C.2d 1223 (7th Cir. 1986); *In re Cleveland*, 89 B.R. 69 (B.A.P. 9th Cir. 1988); *United States v. Green (In re Green)*, 82 B.R. 955 (Bankr. N.D. Ill. 1988); *In re Gronski*, 15 C.B.C.2d 967, 65 B.R. 932 (Bankr. E.D. Pa. 1986).

n92 Pub. L. No. 101-510 (1990).

n93 Pub. L. No. 101-510 (1990), amending 37 U.S.C. to add §§ 301d(c)(3) and 317(f)(3).

n94 E.g., 37 U.S.C. § 302f (obligation of reserve health specialists who fail to honor military service obligation to refund special bonus pay not dischargeable); 37 U.S.C. § 302g(e) (refund obligations of reservist physicians who receive special pay and terminate service early not dischargeable for five years); 37 U.S.C. §§ 301d(c)(3), 301e(d)(3), 314(d)(4), 317(f)(3), 318(h)(3), 319(f)(3), 321(f)(3), 322(f)(4).

n95 See, e.g., *In re Johnson*, 787 F.2d 1179, 14 C.B.C.2d 1223 (7th Cir. 1986); *United States v. Green (In re Green)*, 82 B.R. 955 (Bankr. N.D. Ill. 1988); *In re Lee*, 16 C.B.C.2d 715 (Bankr. N.D. Ga. 1987); *In re Gronski*, 15 C.B.C.2d 967, 65 B.R. 932 (Bankr. E.D. Pa. 1986).

n96 42 U.S.C. § 656(b), as amended by the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193.

n97 219 F.3d 955, 962 (9th Cir. 2000).

n98 11 U.S.C. §§ 101, 523, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n99 *Bruning v. United States*, 376 U.S. 358, 84 S. Ct. 906, 11 L. Ed. 2d 772 (1964).

n100 49 F.3d 98 (3d Cir. 1995). *But see In re Wasson*, 152 B.R. 639 (Bankr. D.N.M. 1993).

n101 *See also In re Foross*, 242 B.R. 692 (B.A.P. 9th Cir. 1999) (postpetition interest on alimony, maintenance and support claims not discharged by chapter 13 discharge).

n102 *See Collier on Bankruptcy*, 1327.02.

n103 *In re Pardee*, 193 F.3d 1083 (9th Cir. 1999).

n104 *See In re Pitt*, 240 B.R. 908 (Bankr. N.D. Cal. 1999); 1322.05[2][a] *infra*; *see also In re Jacobson*, 231 B.R. 763 (Bankr. D. Ariz. 1999) (debtor to pay postpetition interest directly to nondebtor support creditor).

n105 *But see In re Blumenschein*, 283 B.R. 908 (Bankr. S.D. Ohio 2002) (when creditor did file claim for postpetition interest and plan did not clearly provide for payment of postpetition interest, such interest was not discharged).

n106 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. Former section 1322(b)(10) was redesignated as section 1322(b)(11); *see Collier on Bankruptcy*, 1322.13A.

ABOUT THE AUTHOR(S):

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126 of 197 DOCUMENTS

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Collier on Scope and Application of Chapter 15 of the Code

2008 Emerging Issues 1326

Collier on Scope and Application of Chapter 15 of the Code

By Collier

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SUMMARY: This Emerging Issues Analysis covers the scope and application of chapter 15 of the Code, including topics such as the purpose of chapter 15, other bankruptcy code provisions related to chapter 15, eligibility to be a debtor, proper venue for an ancillary proceeding, the scope of the application of chapter 15, and the exclusions from the scope of chapter 15.

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ARTICLE: Chapter 15 was added to the Bankruptcy Code by title VIII of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, (the 2005 Act) n1 to encourage cooperation between the United States and foreign countries with respect to transnational insolvency cases. This new chapter of the Bankruptcy Code incorporates the Model Law on Cross-Border Insolvency promulgated in 1997 by the United Nations Commission on International Trade Law (UNCITRAL). The Guide to Enactment of the Model Law published by UNCITRAL as an aid to enacting countries provides historical and interpretive guidance to the meaning and purpose of the provisions that are embodied in chapter 15. n2 The Model Law and chapter 15 recognize the increasing incidence of cross-border insolvencies that follow continuing globalization of trade and investment. This increase leads to the concomitant need for domestic insolvency laws to deal predictably with cross-border cases. n3

The most striking impact of the title VIII amendments is the repeal of former section 304, Cases Ancillary to Foreign Proceedings, and its replacement by chapter 15 as the law governing ancillary cases. n4 Chapter 15 and accompanying amendments to the Bankruptcy Code also modify the venue rules for ancillary cases, provide outbound authority for representatives of United States bankruptcy cases to seek relief from foreign courts, address the management of simultaneous foreign and domestic proceedings involving the same debtor and assure fair notice and treatment of foreign creditors of United States debtors. n5

Chapter 15, like the Model Law, seeks to accomplish the primary goals of an ancillary proceeding through a legal regime that reconciles three related concepts: recognition of foreign insolvency proceedings; access to judicial proceedings in the United States by duly appointed foreign representatives of foreign proceedings; and availability of specified relief upon recognition of the foreign proceeding. Relief is designed to protect the interests of the debtor and its creditors in an orderly administration of the bankruptcy estate and to promote fairness for both local and foreign creditors. Chapter 15 then envelops its mechanism for ancillary relief in a broader structure that mandates cooperation

with foreign courts and foreign representatives and coordination of multiple proceedings involving a common debtor.

Chapter 15 cases are generally intended to be supplementary to cases brought in the debtors home country. n6 Chapter 15, however, does not prevent commencement of a plenary case under another chapter of title 11 either before or after recognition has been granted to a foreign representative of a foreign proceeding. n7 In fact, upon recognition of a foreign proceeding, a foreign representative is authorized by the statute to commence a plenary case under title 11. n8 If a full case is commenced under another chapter of title 11 (or is already pending when a petition for recognition is filed), the court must follow chapter 15s provisions for cooperation and coordination of the cases. Alternatively, section 305 permits the court, after notice and a hearing, to dismiss or suspend proceedings in a case if a petition for recognition has been granted and the purposes of chapter 15 would be best served by such dismissal or suspension. n9

Chapter 15 is divided into several subchapters that address general provisions, access of foreign representatives and creditors to courts in the United States, recognition of foreign proceedings and relief, cooperation with foreign courts and foreign representatives and coordination of concurrent proceedings. Insofar as possible and as recommended by the Guide, chapter 15 follows the language, section numbering and general structure of the Model Law to promote uniformity in its adoption and application. n10

Purpose of Chapter 15; 11 U.S.C. § 1501(a). Chapter 15 is unique in that it contains a statement of its purpose, nearly replicating the language that begins the Model Law. *Section 1501(a) of the Bankruptcy Code* sets forth the purpose and five objectives of the chapter, namely, (i) to encourage cooperation between courts of the United States (including the United States trustee and appointed fiduciaries) and foreign courts in cross-border insolvency cases, (ii) to provide greater legal certainty for trade and investment, (iii) to promote the fair and efficient administration of cross-border insolvencies that protect the interests of all creditors, the debtor and other interested entities, (iv) to protect and maximize the value of the debtor's assets and (v) to facilitate the rescue of financially troubled businesses with the goal of protecting investment and preserving employment.

More universally, chapter 15 manifests the United States subscription to the purpose of the Model Law, namely, to assist States to equip their insolvency laws with a modern, harmonized and fair framework to address more effectively instances of cross-border insolvency. Those instances include cases where the insolvent debtor has assets in more than one State or where some of the creditors of the debtor are not from the State where the insolvency proceeding is taking place. The Model Law reflects practices in cross-border insolvency matters that are characteristic of modern, efficient insolvency systems. Thus, the States enacting the Model Law (enacting States) would be introducing useful additions and improvements in national insolvency regimes designed to resolve problems arising in cross-border insolvency cases. Both jurisdictions that currently have to deal with numerous cases of cross-border insolvency and jurisdictions that wish to be well prepared for the increasing likelihood of cases of cross-border insolvency will find the Model Law useful. n11

In no small measure, the adoption of the Model Law by the United States is intended to encourage adoption by other countries. n12

Other Bankruptcy Code Provisions Related to Chapter 15. Although chapter 15 is the principal chapter of the Bankruptcy Code that governs the conduct of ancillary cases, several other sections of the Bankruptcy Code and of title 28 of the United States Code directly affect cases under chapter 15. These include *section 101 of the Bankruptcy Code*, which defines the terms foreign proceeding and foreign representative; section 109, which limits the types of debtors eligible for chapter 15; section 305, which permits the court to abstain from a case under another chapter of the Bankruptcy Code in favor of a chapter 15 case; section 306, which provides for limited appearances by foreign representatives in cases under other chapters; *section 1334 of title 28, United States Code*, which establishes jurisdiction over ancillary cases; section 157(b)(2) of title 28, which makes recognition of foreign proceedings a core proceeding; and section 1410 of title 28, which governs the venue for a chapter 15 proceeding.

Foreign Proceeding Defined under Section 101(23). *Section 101(23) of the Bankruptcy Code* was amended by the 2005 Actⁿ¹³ to be consistent with the Model Law. Section 101(23) provides that, a foreign proceeding' means a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.ⁿ¹⁴ The words under a law relating to insolvency or adjustment of debt emphasize that chapter 15 is available not only to debtors that are technically insolvent or facing liquidation, but also to debtors who are in financial distress and may need to reorganize.ⁿ¹⁵

The collective proceeding requirement is intended to limit access to chapter 15 to proceedings which benefit creditors generally and to exclude proceedings which are for the benefit of a single creditor. For example, a receiver appointed under a debenture which secures a debt to a creditor, to facilitate collection of that debt, would not commence a collective proceeding.ⁿ¹⁶

Foreign Representative Defined under Section 101(24). Foreign representative is defined in *section 101(24) of the Bankruptcy Code* as a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding.ⁿ¹⁷

The interim appointment language was designed to accommodate insolvency systems which have a two stage process for commencement. England and many of the British Commonwealth countries provide for interim or provisional fiduciaries at the outset of a proceeding who almost always become permanent appointees. Other systems have a gap period between an application to commence a proceeding and actual commencement. An interim fiduciary is often appointed to serve during the gap period.ⁿ¹⁸ The United States analogs are the appointment of an interim trustee under section 303(g) prior to entry of an order for relief in an involuntary case or the appointment of an interim trustee under section 701 in a liquidation case.

Eligibility to Be a Debtor; 11 U.S.C. § 109. Section 109 limits who may be a debtor under the Bankruptcy Code. Section 109(a) provides that only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title. Sections 109(b) through (h) further limit the right to be a debtor in a Bankruptcy Code case by excluding various categories of persons and entities from eligibility.ⁿ¹⁹ Section 1501(c) provides that chapter 15 does not apply to entities identified by exclusion in section 109(b), other than foreign insurance companies.

The 2005 Act, therefore, permits recognition of foreign proceedings involving foreign insurance companies. It would also apply to proceedings involving foreign banks that do not have a branch or agency in the United States (as defined in *section 3101 of title 12 of the United States Code*).²⁰ Conversely, if the foreign banks activities in the United States would constitute it having a branch or agency, it is ineligible for relief under title 11 and cannot be the subject of either a plenary case or a chapter 15 case.

Abstention; 11 U.S.C. § 305. Section 305 of the Bankruptcy Code ⁿ²¹ provides:

(a) The court, after notice and a hearing, may dismiss a case under this title or may suspend all proceedings in a case under this title, at any time if--

(1) the interests of creditors and the debtor would be better served by such dismissal or suspension; or

(2) (A) a petition under section 1515 for recognition of a foreign proceeding has been granted; and

(B) the purposes of chapter 15 of this title would be best served by such dismissal or suspension.

(b) A foreign representative may seek dismissal or suspension under subsection (a)(2) of this section.

(c) An order under subsection (a) of this section dismissing a case or suspending all proceedings in a case, or a decision not so to dismiss or suspend, is not reviewable by appeal or otherwise by the court of appeals under section 158(d), 1291, or 1292 of title 28 or by the Supreme Court of the United States under section 1254 of title 28.

The concept of abstention in favor of a foreign proceeding was present in section 305 prior to the 2005 amendment. The language was changed to conform to chapter 15. Section 305 is mirrored by section 1529(4) which offers section 305 as an avenue to cooperation and coordination between multiple proceedings involving a common debtor.

Limited Appearance by a Foreign Representative; 11 U.S.C. § 306. Section 306 of the Bankruptcy Code provides:

An appearance in a bankruptcy court by a foreign representative in connection with a petition or request under section 303 or 305 of this title does not submit such foreign representative to the jurisdiction of any court in the United States for any other purpose, but the bankruptcy court may condition any order under section 303 or 305 of this title on compliance by such foreign representative with the orders of such bankruptcy court. n22

The only change effected by the 2005 Act to section 306 was removal of the reference to former section 304, n23 which was repealed and replaced by chapter 15. n24 Section 1510 now provides an analogous limit on jurisdiction over a foreign representative who files a chapter 15 petition.

Jurisdiction and Procedures; 28 U.S.C. §§ 1334 and 157(b)(2)(P). The jurisdiction of the bankruptcy court to preside over cases commenced under chapter 15 derives from the general grant in title 28, section 1334 of original and exclusive jurisdiction over cases under title 11 to the United States district court in which a case under title 11 is commenced. Section 1334(c) generally permits the district court to abstain from hearing a proceeding in the interests of justice or in deference to a state court or law. The 2005 Act amended this section to created an exception for chapter 15 cases, n25 requiring a request for recognition of a foreign proceeding to be heard only in the district court. This requirement combined with the venue provisions of section 1410 of title 28 and the court access provisions of section 1509 to make a petition for recognition in the proper district court the single point of entry for a foreign representative to any court in the United States, state or federal. n26

Under section 157(a) of title 28, the district court can refer cases under title 11 and proceedings arising under title 11 or arising in or related to a case under title 11 to the bankruptcy judges for the district. Each district has adopted a rule providing automatic reference. n27 The bankruptcy judges have power to hear and determine cases under title 11 and core proceedings arising in those cases. The 2005 Act adds to the list of core proceedings in section 157 of title 28 (P) recognition of foreign proceedings and other matters under chapter 15 of title 11.

Proper Venue for Ancillary Proceeding; 28 U.S.C. §1410. Section 1410 of title 28, as amended in 2005, n28 provides a hierarchy of choices for determining venue for a chapter 15 case as follows:

(a) A case under chapter 15 of title 11 may be commenced in the district court of the United States for the district

(1) in which the debtor has its principal place of business or principal assets in the United States;

(2) if the debtor does not have a place of business or assets in the United States, in which there is pending against the debtor an action or proceeding in a Federal or State court; or

(3) in a case other than those specified in paragraph (1) or (2), in which venue will be consistent with the interests of justice and convenience of the parties, having regard to the relief sought by the foreign representative. n29

The 2005 venue provision combines with the chapter 15 recognition procedure to create a single entry point for a

foreign representative seeking access to any state or federal court in the United States. Before foreign representatives can appear before any state or federal court, other than to file a petition for recognition or collect an account receivable, an order granting recognition must be entered. n30 That order can only enter on a petition filed in the district court for the district determined by 28 U.S.C. § 1410. This structure contrasts with the pre-amendment venue rule which ostensibly required multiple section 304 cases in different venues where litigation was pending or property was located. Also, the prior rules were not exclusive, so that a foreign representative could choose to seek relief under section 304 or to proceed on general principles of comity in a state or federal court. n31

Scope of Application of Chapter 15; 11 U.S.C. § 1501(b). *Section 1501(b) of the Bankruptcy Code* outlines the types of issues that may arise in cross-border insolvency cases and for which chapter 15 provides solutions. Specifically, chapter 15 applies where

(1) A foreign representative or foreign court seeks assistance in the United States in connection with a pending foreign proceeding;

(2) A United States court or party in interest in a United States proceeding seeks assistance in a foreign court in connection with the United States proceeding;

(3) A foreign proceeding and a United States proceeding are pending concurrently; or

(4) Foreign creditors or other foreign interested persons request the commencement of or participation in a United States proceeding.

Former section 304 addressed only the first situation, relief sought by a foreign representative. The authority of a trustee or debtor in possession to seek assistance in a foreign court was perhaps implicit in sections 704 and 1107 but is now specifically granted and implemented by sections 1526 and 1527. In other countries, trustees were limited to domestic activities and the Model Law would remedy this deficiency. n32 The third situation, concurrent proceedings, has been pragmatically addressed by adoption of cross-border protocols in significant cases and this practice will likely continue under the more formal tutelage of chapter 15. n33 The fourth situation, treatment of foreign parties in United States proceedings, has not been a problem under the Bankruptcy Code, which does not discriminate against foreign parties. Nonetheless, it provides an exemplary statement and conformity to the Model Law. n34

Exclusions from Scope of Chapter 15; 11 U.S.C. § 1501(c). *Section 1501(c) of the Bankruptcy Code* excludes certain types of entities from the scope of chapter 15.

Prior to the 2005 Act, section 109 did not apply to section 304. Entities not otherwise eligible to be a debtor in a title 11 case were, if they were debtors in a foreign proceeding, eligible for section 304 relief. n35 The Model Law recognized, in Article 1, that countries might wish to designate for exclusion entities which were subject to a special regulatory insolvency regime, such as banks or insurance companies. To adopt this approach in chapter 15, the 2005 Act first amended section 109 to replace the existing bank exclusionary language (a foreign bank engaged in such business in the United States) with more precise terminology suggested by bank regulators (a foreign bank that has a branch or agency in the United States). It then provided that chapter 15 would not apply to an entity which would be ineligible for relief under section 109(b). Consequently, foreign representatives of foreign banks which are subject to foreign proceedings will not be eligible for chapter 15 recognition if the foreign banks have a branch or agency in the United States.

Foreign insurance companies doing business in the United States also were excluded under the initial draft of chapter 15, since section 1501(c) incorporated section 109(b) eligibility and foreign insurance companies were excluded by section 109(b). At the request of the insurance industry, section 1501(c) was modified to except foreign insurance companies from the exclusion, rendering them eligible for chapter 15 recognition. The industry position reflects the common practice of invoking ancillary proceedings in the United States as part of the wind up of multi-national

insurers. Insurance regulators can ask the United States court to abstain under *Bankruptcy Code section 305* if an ancillary case of a foreign insurance company would interfere with a regulatory winding up under state law.

Section 1501 also excludes individuals who are within the section 109(e) debt limits for chapter 13 eligibility, so long as they are citizens of the United States or permanent residents, and further excludes entities subject to proceedings under the Securities Investor Protection Act and stockbrokers subject to, respectively, subchapters III and IV of chapter 7. n36

Exclusion for Funds Subject to State Insurance Law or Regulation; 11 U.S.C. § 1501(d). *Section 1501(d) of the Bankruptcy Code* provides that the court cannot grant relief under chapter 15 with respect to deposits, escrows, trust funds or other security required or permitted under state insurance law or regulation for the benefit of claim holders in the United States. This section has the effect of leaving to state regulation any deposit, escrow, trust fund or the like posted by a foreign insurer under state law. At the request of insurance regulators and industry associations, this exclusionary provision had been inserted in earlier versions of bankruptcy reform legislation as an addition to former section 304. With the impending repeal of section 304, the provision was added to chapter 15. n37

For further discussion of Code section 1324, see Collier on Bankruptcy, ch. 1501.

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Return to Text

n1 1. Pub. L. No. 109-8, § 801 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 106 (2005). The text of the Model Law and the Guide to Enactment can be found at www.UNCITRAL.org under UNCITRAL Texts & Status/Insolvency. The full history of the Model Law is recounted in a series of reports of the UNCITRAL colloquia and the sessions of the Working Group on Insolvency Law that led to its adoption. These, in turn, are fully cited in the Guide to Enactment and also can be found on the UNCITRAL website.

n3

3. Guide to Enactment of Model Law, 13; H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 20 (2005).

n4

4. Pub. L. No. 109-8, §§ 801, 802(d)(3) (2005); H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 118 (2005).

n5

5. *11 U.S.C. § 1501(b)*; H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 118 (2005).

n6

6. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 106 (2005).

n7

7. *See 11 U.S.C. §§ 301, 302, 303, 1511.*

n8

8. *See Collier on Bankruptcy*, ch. 1511.

n9

9. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 106 n.101 (2005).

n10

10. *Guide to Enactment of Model Law*, 21.

n11

11. *Guide to Enactment of Model Law*, 1, 2.

n12

12. Legislation based on the UNCITRAL Model Law on Cross-Border Insolvency has been adopted in Eritrea, Japan (2000), Mexico (2000), Poland, Romania (2003), South Africa (2000), Montenegro (2002), British Virgin Islands (2005) and Great Britain (2006). The United Kingdom has adopted legislation enabling the Model law to be adopted by regulation. Enactment is under consideration in Argentina and Pakistan and has been recommended in New Zealand, Australia and Canada. The Spanish Insolvency Act, effective 2004, contains provisions which reflect in part the Model Law. UNCITRAL, *Developments in Insolvency Law, Note by Secretariat*, U.N. Doc. A/CN. 9/580 (Apr. 14, 2005).

n13

13. Pub. L. No. 109-8, § 802(b) (2005).

n14

14. 11 U.S.C. § 101(23); see 101.23; *In re Tri-Continental Exch. Ltd.*, 349 B.R. 627 (Bankr. E.D. Cal. 2006).

n15

15. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 118 (2005).

n16

16. Guide to Enactment of Model Law 23.

n17

17. 11 U.S.C. § 101(24), as amended by Pub. L. No. 109-8, § 802(b) (2005); *In re Tri-Continental Exch. Ltd.*, 349 B.R. 627 (Bankr. E.D. Cal. 2006).

n18

18. Guide to Enactment of Model Law, 69.

n19

19. Section 109(b), as amended by Pub. L. No. 109-8, § 802(d)(1) (2005), provides as follows:

(3) (A) a foreign insurance company, engaged in such business in the United States; or

(B) a foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union, that has a branch or agency (as defined in section 1(b) of the International Banking Act of 1978) in the United States.

n20

20. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 118-119 (2005).

n21

21. Section 305(a)(2) was amended by section 802(d)(6) of Pub. L. No. 109-8 (2005). *See Collier on Bankruptcy*, ch. 305.

n22

22. For a discussion of section 306, *see Collier on Bankruptcy*, ch. 306.

n23

23. Pub. L. No. 109-8, § 802(d)(5) (2005).

n24

24. Pub. L. No. 109-8, §§ 801, 802(d)(3) (2005).

n25

25. Pub. L. No. 109-8, § 802(c)(1) (2005).

n26

26. 28 U.S.C. § 1334(c) now begins Except with respect to a case under chapter 15 of title 11 .

n27

27. See *Collier on Bankruptcy*, 3.02[1].

n28

28. Pub. L. No. 109-8, § 802(c)(4) (2005).

n29

29. See *Collier on Bankruptcy*, 4.03.

n30

30. 11 U.S.C. § 1509 imposes the recognition requirement and contains the exception for collection of claims which are property of the debtor. See *United States v. J.A. Jones Constr. Group, LLC*, 333 B.R. 637 (E.D.N.Y. 2005) (finding a lack of jurisdiction to honor a stay request by a Canadian receiver because of a failure to obtain an order recognizing the foreign proceeding and entering a temporary stay to enable the receiver to file a chapter 15 petition).

n31

31. *Cunard S.S. Co., Ltd. v. Salen Reefer Serv., A.B.*, 773 F.2d 452 (2d Cir. 1985).

n32

32. Guide to Enactment of Model Law, 26, 27.

n33

33. Examples of cases in which courts have agreed to institute protocols include *In re Maxwell*

Communication Corp., 93 F.3d 1036, 1053 (2d Cir. 1996); *In re Commodore Int'l Ltd.*, 242 B.R. 243, 260 (Bankr. S.D.N.Y. 1999); and *Nakash v. Tsur* (*In re Joseph Nakask*), No. 94 B 44840 (S.D.N.Y. May 24, 1996).

n34

34. Model Law art. 13.

n35

35. See, e.g., *In re Georg*, 844 F. 2d 1562 (11th Cir. 1988) (involving a decedents estate); *Agency for Deposit Insurance, Rehabilitation and Liquidation of Banks v. Superintendent of Banks of the State of New York*, 310 B.R. 793 (S.D.N.Y. 2004) (involving foreign banks with agencies in New York; not excluded from section 304 eligibility but would be excluded from chapter 15 eligibility).

n36

36. The chapter 13 limits are unsecured debt of \$307,675 and secured debts of \$922,975, subject to periodic inflation adjustments. 11 U.S.C. § 109(e).

n37

37. See H.R. 3150 § 605 (1998).

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127 of 197 DOCUMENTS

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Collier on Retainer Agreements in Bankruptcy Cases

2008 Emerging Issues 1327

Collier on Retainer Agreements in Bankruptcy Cases

By Collier

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SUMMARY: This Emerging Issues Analysis covers retainer agreements in bankruptcy cases, including topics such as prepetition retainer agreements, types of retainer agreements, special retainers, disclosure of retainer, retainers as property of the estate, prepetition and postpetition retainers as property of the estate, retainers held in trust by debtors attorneys, retainers as attorney property, and retainers under state law.

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ARTICLE: Prepetition Retainer Agreements. Before the commencement of a chapter 11 case, it is common for a debtors professionals to obtain retainer agreements and fees to insure compensation for costs anticipated during the pendency of the case. As noted by one bankruptcy court, [g]iven the proliferation of bankruptcy filings and the increased complexity of the newer Chapter 11 filings it is neither surprising nor unreasonable that such retainers would be required before counsel would undertake the arduous task of guiding a debtor through a complicated reorganization laden with risk. n1

Types of Retainer Agreements. The most common fee arrangements in bankruptcy cases are made pursuant to retainer agreements. Retainers are typically classified as either classic or special. A special retainer can take one of three forms: security, advance payment or evergreen. Some courts also approve postpetition retainers. The nature of a retainer will determine whether these funds are considered property of the debtors estate, which will, in turn, define the professionals rights and interest in such funds. n2

Classic or Earned on Receipt Retainer. A classic or earned on receipt retainer is defined as both a payment to bind the attorney from representing another and as a payment for accepting the case. n3 It is intended to insure the attorneys availability over time on behalf of the client regardless of whether the attorney actually renders services to the client. [A]n essential characteristic of the classic retainer is that it is entirely earned by the attorney upon payment, with the client retaining no interest in the funds. n4

The concept of an earned on receipt retainer in a bankruptcy case has been questioned by a majority of the courts. In *In re NBI, Inc.*, n5 the court determined that a prepetition nonrefundable or earned retainer would frustrate the Codes requirement of court supervision over professional fees. According to the court, earned retainers are *per se* unreasonable as a matter of bankruptcy law, an anomaly in a Chapter 11 case, n6 and would impermissibly circumvent the explicit

and implicit requirements of the Bankruptcy Code and rules pertaining to compensation of professionals, particularly debtors counsel. The Code provides for compensation only for actual and necessary legal services allowed only after such services have been provided. n7 The court, in concluding that earned retainers would nullify the protection afforded to a debtors estate and creditors, ordered that the retainers be held in trust until professional fees were awarded in the chapter 11 case. n8 The minority of courts permitting earned on receipt retainers have considered the following factors in determining whether an earned on receipt retainer is reasonable:

- whether the attorney has particular expertise in the debtors industry;
- whether the attorney has to forbear other employment to take on the debtors case; and
- whether the debtors case will place extraordinary demands on the attorney. n9

Although *In re NBI, Inc.*, was not appealed, the district court in another Colorado case n10 specifically found that the *In re NBI, Inc.*, opinion is limited to the context of chapter 11 proceedings and that, in chapter 7 cases, prepetition payment for services to be rendered postpetition is allowed. Indeed, the Supreme Court in *Lamie v. United States Trustee*, n11 in declining to approve payment of chapter 7 debtors attorney fees from estate assets, recognized that the debtors attorney in these cases should look to the prepetition retainer.

Special Retainers.

Security Retainer. A security retainer is defined as one held by attorneys to secure payment of fees for future services that the attorneys are expected to render. n12 The funds do not constitute a present payment for future services but, rather, remain the property of the estate until the attorney applies charges for services rendered against the retainer. n13 Any unearned portion of the retainer must be returned to the estate.

Advance Payment and Fixed Fee Retainers. Advance payment and fixed fee retainers are defined as retainers in which the debtor pays for all or a portion of the services to be rendered by the attorney in advance. These kinds of retainers are different from security retainers in that ownership of the retainer is intended to pass to the attorney at the time of payment, in exchange for the commitment to provide the legal services. n14 Advanced payment and fixed fee retainers are also different from classic or earned on receipt retainers because they presume that certain work will be performed by the attorney in exchange for the payment. In the case of an earned on receipt retainer, the attorneys availability is being assured whether or not any services are performed. An example of an advance payment or fixed fee is a flat fee of \$2,000 paid to the debtors attorney for all enumerated work to be performed in the bankruptcy case.

In light of the Supreme Courts decision in *Lamie v. United States Trustee*, n15 chapter 7 debtors attorneys should enumerate or outline in writing the work to be performed for the flat or fixed fee agreed upon prior to the filing of the bankruptcy case. As amended in 2005, n16 section 328(a) now specifically provides for payment of a retainer on a fixed fee basis. A more difficult question arises when the advance and fixed fee retainers are not paid in full prepetition. There have been instances when the debtor paid part of the agreed-upon amount prior to the filing and also agreed to make payments after the filing of the chapter 7 bankruptcy case. The bankruptcy court in *In re Griffin* addressed the issue and considered decisions of the Seventh and Ninth Circuits reflecting somewhat different conclusions regarding the dischargeability of the installments on the advance and fixed fee retainers that were to be paid postpetition. n17 The Seventh Circuit Court of Appeals concluded that when the debtor voluntarily filed for chapter 7 bankruptcy protection, the prepetition contract for payment of fees became a prepetition claim against the estate. Any fees unpaid at the time of the filing became subject to the discharge injunction of section 524 and the attorney for the debtor was prohibited from pursuing payment of the unpaid installments. n18 The Ninth Circuit Court of Appeals, in an earlier decision, had concluded that the portion of the retainer reflecting work done during the bankruptcy is immune from discharge because a claim does not accrue upon agreement but upon performance. The court concluded that each retainer agreement could be considered multiple claims depending on when performance took place. n19 In any event, the better practice would

be for debtors attorneys to obtain the entire advance or fixed fee retainers before the bankruptcy case is filed.

Evergreen Retainer. An evergreen retainer, for purposes of a chapter 11 case, provides for the payment of interim fees to professionals from operating cash of the debtor while preserving the prepetition retainer held by the professional to be applied towards the final payment of fees at the conclusion of the debtors case and after approval of a final fee application. n20 By preserving the professionals ability to charge against the retainer at the end of the case, an evergreen retainer has the economic effect of replenishing the retainer funds during the course of the case. Evergreen retainers are common outside bankruptcy cases, and there is no *per se* rule against their use in bankruptcy cases. n21

The court in *In re Benjamins-Arnolds, Inc.*, n22 examined the propriety of evergreen retainers used in connection with the retention of a debtors law firm and accountants, whereby all interim fee awards would be paid out of the debtors operating income. The court rejected the United States trustees assertion that evergreen retainers were violative of both the Bankruptcy Code and congressional policy because they removed the financial risk necessary to induce the debtors professionals to pursue a swift reorganization. According to the court, the professionals have sufficient financial risk even with evergreen retainers, as they could be compelled to disgorge the retainers if there were insufficient assets to pay all similarly situated or superior administrative expense claimants. Further, the court found that absent the use of evergreen retainers, professionals would require the payment of standard retainers, which would increase the financial burden on the debtors estate.

Postpetition Retainer. In determining whether a postpetition retainer is justified and reasonable in a chapter 11 case, courts consider various factors, including:

- the retainers economic impact on the debtors ongoing business operation and the debtors ability to reorganize;
- the amount and reasonableness of the retainer;
- the reputation of the debtors counsel; and
- the ability of the debtors counsel to disgorge any unjustified portion of a retainer paid. n23

One bankruptcy court has stated that a substantial argument can be made that, under appropriate circumstances professionals employed by a statutory creditors committee may obtain a retainer from the debtors estate. n24

Status of Professional with Secured Retainer as Secured Creditor of the Debtor. With respect to secured retainers, courts generally hold that a professional with such a prepetition retainer is a secured creditor and has a security interest in the retainer, noting that the professionals receiving prepetition retainers to insure payment of fees to be earned in the chapter 11 case (or postpetition retainers authorized by the court) become secured creditors by virtue of a possessory interest in cash. n25 The professionals status as a secured creditor by virtue of the retainer does not disqualify the professional from being retained by the estate as required by section 327 of the Code. n26

Disclosure of Retainer. The Code requires that the debtors attorney disclose the terms of any prepetition retainer agreement to the court. n27 It does not matter that no further compensation will be sought from the estate, that the retainer may be paid by a nondebtor third party n28 or that the retainer is not estate property. n29 The Court of Appeals for the Second Circuit recognized in *In re Arlan's Dep't Stores, Inc.*, n30 that [t]he [debtors] law firm is not expected to disregard its own welfare but neither is it expected to ignore its obligation to advise the court [of the retainer arrangement] so that the court might make the determination of propriety [of such an arrangement] based on the circumstances of the case. n31

Retainers as Property of the Estate. A majority of courts hold that prepetition retainers constitute property of the estate under section 541 of the Code. A court, therefore, must authorize application of the retainers to the allowed amount of the professionals awarded compensation before it can be used. n32 These courts suggest that characterizing a prepetition retainer as property of the estate enables the court to supervise the administration of the estate, thus minimizing the difficulties associated with an order requiring disgorgement of the retainer.

One court has held that its disgorgement power was not an adequate substitute for the prior approval of fees for services rendered. Such a position assumes counsel will remain financially responsive to a disgorgement order, on a timely basis. n33 The United States Supreme Court ruling in *Lamie v. United States Trustee*, n34 appeared to approve the advance payment of the entire fee in a chapter 7 case. These retainers now appear more like flat or fixed fee or earned on receipt retainers.

Prepetition and Postpetition Retainers as Property of the Estate. In *In re Bread & Chocolate, Inc.*, n35 the bankruptcy court held that both prepetition and postpetition retainers were property of the estate and ordered the retainer funds deposited as security for payment of fees and expenses. The court based its holding primarily on the need to protect the other parties in interest and to avoid possible abuses of the system:

A retainer that becomes property of the attorney is allowable only in certain rare circumstances when adequate safeguards are taken and only after a detailed application is filed, an opportunity for objection has been provided and the retainer fee procedure [is], itself, notice to creditors. Crucial to a determination that such a retainer arrangement is appropriate is that the courts control over the funds is undiminished. n36

The court was concerned that if retainers are property of the attorneys, courts would be forced to make complicated inquiries into a law firm's financial condition. In the event the law firm later filed its own bankruptcy case, the debtors estate would be a mere creditor of the law firm for any unearned portion of the retainer and would not be able to recover the retainer under section 541 of the Code. Prepetition retainers that are property of the attorneys would not only frustrate the courts disgorgement powers, particularly in cases where estate assets are insufficient to pay other administrative claims in full, but also may encourage abuse of the system. By treating the retainer as property of the estate, it gave the attorneys incentive to apply for fees promptly, which further enabled the court to maintain control over professional fees.

Retainers Held in Trust by Debtors Attorneys. Many courts find that prepetition retainers are advances against attorney fees and should be held in trust by the debtors attorneys until professional fees and expenses are allowed by the court. n37 For example, in *In re Tri-County Water Association*, n38 the court stated:

The general rule is that prepetition retainers are held in trust for the debtor, and the debtors equitable interest in this trust constitutes property of the estate. [T]hat portion of the fees incurred after the petition was filed are [sic] property of the estate. Debtors counsel may remove these funds from the retainer account only after court approval preceded by proper notice of the application. n39

Another court held that even a retainer earned in full on receipt was nevertheless property of the estate to be maintained in a special client trust fund account pending court approval of fees and that to allow an attorney for a debtor to draw against a retainer at will and without prior Court approval is a *de facto* emasculation of § 331. n40

Retainers as Attorney Property. Bankruptcy courts generally do not extend the reach of section 541(a)(1) of the Code to include that portion of a retainer earned prepetition as property of the estate. n41 In *In re McDonald Brothers Construction, Inc.*, n42 the court held that the attorneys for the debtor may treat prepetition retainers as their own property and deduct expenses therefrom without leave of the court and without submission of a detailed fee application. The court found that the possibility that retainer funds might have to be returned does not give the debtor an interest in the transferred funds at the time the case is commenced [but] gives the estate a potential claim against the transferee. Such a claim is no different from a claim to recover assets under fraudulent transfer or preference theories. n43

Retainers under State Law. One court predicated its analysis of whether a retainer is considered property of the attorney or the client using applicable nonbankruptcy law, such as state law. n44 It could then determine whether the retainer constitutes property of the debtors estate. When ownership of the retainer funds was absolutely transferred to the attorney under state law, notwithstanding the possibility for recovery of all or a portion of such funds by the debtors estate, the court concluded that the retainer funds were not property of the estate. If the nature of the retainer is such that ownership of the funds remains with the debtor under state law, then approval is required. In examining the state law property issue, the court concluded that only a security retainer constitutes property of the debtors estate that requires compliance with the provisions of the Bankruptcy Code prior to use of such funds by a professional. [B]ecause the debtor continues to hold an interest in security retainers, such a retainer is estate property, which can only be used by debtors counsel upon compliance with the entire fee application process, including court approval. n45

The court in *In re Bread & Chocolate, Inc.*, n46 disagreed with the holding in *McDonald* and concluded that regardless of whether state law permits the retainers in question, a court must consider issues beyond local law when approving the terms and conditions of employment as required under section 328(a). Instead, the *Bread & Chocolate* court addressed whether, as a term of employment, the retainer should be treated as property of the estate. It concluded that it was in the best interest of all parties involved that the retainer be deemed to be property of the estate.

In *In re Dividend Development Corporation*, n47 the court concluded that state law alone cannot determine whether the debtors estate retains an interest in a prepetition retainer. The debtors attorneys argued that the retainers were earned on receipt, which was permissible under state law and, thus, because the funds passed to the attorneys prepetition, they had absolute ownership of the retainers. But the court found that even if a type of retainer is permissible under state law, section 328(a) requires that the court review its reasonableness as a necessary condition to employment of the professional under section 327.

[Section] 328(a) specifically mandates that the bankruptcy judge review the reasonableness of any fee arrangement between a debtor and its counsel as a condition of counsels employment under § 327. Section 328 makes the reasonableness of a claimed earned-on-receipt retainer a question of federal law, rather than state law. Further, the authorization in § 328(a) to modify fees after conclusion of employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions, clearly anticipates that the court will make a determination as to the reasonableness of a fee arrangement at the beginning of a case. n48

Finding that the attorneys failed to establish adequately the reasonableness of the earned on receipt retainer, the court approved the retainers as advances against the attorneys fees and ordered the funds to be placed in a trust account.

Professionals Use of Retainer Funds. The principle expressed by courts imposing strict conditions upon a professionals use of retainer funds arguably contravenes policies underlying the Code, which sought to remedy past practices which, in effect, forced professionals to finance the debtors bankruptcy case. While there is a debate about whether retainers constitute property of the estate or should be held in trust, a reasoned approach may be to permit professionals to receive a portion of their compensation and reimbursement through the use of a prepetition retainer agreement but subject to subsequent review by the court. n49 Notably, in *In re Knudsen Corp.*, n50 the bankruptcy appellate panel reasoned that sections 330 and 331 of the Code do not absolutely prohibit the transfer of funds to a professional before the court approves any interim compensation. The *Knudsen* analysis thereby rejected the argument n51 that any preapproval removal of funds pursuant to a retainer arrangement emasculates the policy underlying section 331. n52

Necessity of Fee Application; Retainer. Notwithstanding that receipt of funds pursuant to a retainer arrangement occurred prepetition, professionals in chapter 11 cases may still have to file fee applications with the court detailing the usage of the funds. Some courts do not require a subsequent fee application when the retainer represents a flat fee for services rendered long ago and no further compensation will be sought from the estate. n53 However, other courts

require that fee applications be filed, especially when the retainer was obtained to provide security for a *portion* of the overall costs in the case. n54

For further discussion of Code section 328, see Collier on Bankruptcy, ch. 328.

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n1 1. *In re Chapel Gate Apartments, Ltd.*, 64 B.R. 569, 572 (Bankr. N.D. Tex. 1986); see *In re Robotics Resources R2, Inc.*, 117 B.R. 61 (Bankr. D. Conn. 1990).

n2

2. *In re Production Assocs., Ltd.*, 264 B.R. 180, 184 (Bankr. N.D. Ill. 2001) (discussing different types of retainer agreements).

n3

3. *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989, 998 (Bankr. N.D. Ill. 1990).

n4

4. 114 B.R. 989, 998; see *In re Dividend Dev. Corp.*, 145 B.R. 651 (Bankr. C.D. Cal. 1992).

n5

5. 25 C.B.C.2d 43, 129 B.R. 212 (Bankr. D. Colo. 1991); see also *In re Bressman*, 214 B.R. 131, 141 (Bankr. D.N.J. 1997); *In re Printing Dimensions, Inc.*, 153 B.R. 715, 720-22 (Bankr. D. Md. 1993); *In re Hathaway Ranch P'ship*, 116 B.R. 208, 216-17 (Bankr. C.D. Cal. 1990) (earned on receipt retainer actually an advance payment).

n6

6. 25 *C.B.C.2d* 43, 55, 129 *B.R.* 212.

n7

7. 25 *C.B.C.2d* 43, 55, 129 *B.R.* 212, 212, 222-23.

n8

8. *But see In re Environmental Waste Control*, 122 *B.R.* 341 (*Bankr. N.D. Ind.* 1990) (attorney was free to use retainer subject to possible disgorgement, since it was received prior to filing of bankruptcy petition and was not part of debtor's estate).

n9

9. *In re Dividend Dev. Corp.*, 145 *B.R.* 651, 657 (*Bankr. C.D. Cal.* 1992). *But see In re Bressman*, 214 *B.R.* 131, 141 (*Bankr. D.N.J.* 1997); *In re Printing Dimensions, Inc.*, 153 *B.R.* 715, 720-22 (*Bankr. D. Md.* 1993); *In re Hathaway Ranch P'ship*, 116 *B.R.* 208, 216-17 (*Bankr. C.D. Cal.* 1990) (earned on receipt retainer actually an advance payment).

n10

10. *Schofield v. United States Trustee (In re Jones)*, 236 *B.R.* 38, 40 (*D. Colo.* 1999).

n11

11. 540 *U.S.* 526, 124 *S. Ct.* 1023, 157 *L. Ed. 2d* 1024 (2004); see also *In re Channel Master Holdings, Inc.*, 309 *B.R.* 855, 859 (*Bankr. D. Del.* 2004).

n12

12. *In re McDonald Bros. Constr., Inc.*, 114 *B.R.* 989, 999 (*Bankr. N.D. Ill.* 1990).

n13

13. *Schofield v. United States Trustee (In re Jones)*, 42 C.B.C.2d 705, 236 B.R. 38 (D. Colo. 1999) (since section 328 recognizes that prepetition payments may be made to an attorney for services to be rendered postpetition, only that amount which exceeds the reasonable value of the services must be returned to the estate; moreover, there is nothing unlawful or unethical about an agreement to pay debtor's counsel reasonable compensation for services to be performed after the filing of the petition).

n14

14. 114 B.R. 989, 1000; see *In re Fulton*, 80 B.R. 1009 (Bankr. D. Neb. 1988); *In re Chapel Gate Apartments, Ltd.*, 64 B.R. 569, 573 (Bankr. N.D. Tex. 1986) (retainer fully earned and nonrefundable upon its payment and receipt, is considered advance payment retainer). But see *In re Printing Dimensions, Inc.*, 153 B.R. 715, 720 (Bankr. D. Md. 1993) (finding that debtor retains an equitable interest).

n15

15. 540 U.S. 526, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004).

n16

16. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1206 (2005), effective in cases commenced on or after October 17, 2005.

n17

17. 313 B.R. 757, 761-64 (Bankr. N.D. Ill. 2004).

n18

18. *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1129 (7th Cir. 2003), cert. denied, 541 U.S. 1043, 124 S. Ct. 2176, 158 L. Ed. 2d 733 (2004).

n19

19. *Gordon v. Hines (In re Hines)*, 147 F.3d 1185, 40 C.B.C.2d 684 (9th Cir. 1998). But see also *Hessinger & Assocs. v. United States Trustee (In re Biggar)*, 110 F.3d 685 (9th Cir. 1997).

n20

20. See *In re Benjamin's-Arnolds, Inc.*, 24 C.B.C.2d 1396, 123 B.R. 839 (Bankr. D. Minn. 1990). But see *In re Fitzsimmons Trucking, Inc.*, 124 B.R. 556, 558 (Bankr. D. Minn. 1991) (declining to approve evergreen retainer noting that, unlike the debtor in *Benjamin's-Arnolds*, there were sufficient assets to replenish the retainer without adversely affecting reorganization); *In re Insilco Technologies, Inc.*, 291 B.R. 628 (Bankr. D. Del. 2003); see also *In re Pan Am. Hosp. Corp.*, 312 B.R. 706, 711-12 (Bankr. S.D. Fla. 2004) (approving evergreen retainer).

n21

21. 24 C.B.C.2d 1396, 1398, 123 B.R. 839, 841 (Bankr. D. Minn. 1990).

n22

22. 24 C.B.C.2d 1396, 123 B.R. 839 (Bankr. D. Minn. 1990).

n23

23. See *In re Jefferson Bus. Ctr. Assocs.*, 135 B.R. 676, 680 (Bankr. D. Colo. 1992); see also *In re Truong*, 259 B.R. 264, 267 (Bankr. D.N.J. 2001) (citing factors in *In re Knudsen Corp.*, 84 B.R. 668 (B.A.P. 9th Cir. 1988) and *Jefferson* factors).

n24

24. See *In re 1606 New Hampshire Ave. Assocs.*, 96 B.R. 406 (Bankr. D.D.C. 1989) (retainer under such circumstances comes from the estate, not the debtor, and thus is not an involuntary extraction of funds from the debtor against its wishes); cf. *In re Structurlite Plastics Corp.*, 19 C.B.C.2d 1308, 1315, 91 B.R. 813, 817 (Bankr. S.D. Ohio 1988) (because § 328(a) permits a professional employed by a creditors' committee to receive a retainer, it does not necessarily follow that a retainer may be extracted from a debtor against its wishes).

n25

25. *In re K & R Mining, Inc.*, 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989) (citing *In re Burnside Steel Foundry Co.*, 19 C.B.C.2d 761, 90 B.R. 942 (Bankr. N.D. Ill. 1988)).

n26

26. *In re NBI, Inc.*, 129 B.R. 212, 224 (Bankr. D. Colo. 1991); *In re K & R Mining, Inc.*, 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989); see also *In re Martin*, 817 F.2d 175 (1st Cir. 1987).

n27

27. 11 U.S.C. § 329(a); see also *Neben & Starrett, Inc. v. Chartwell Fin. Corp. (In re Park-Helena Corp.)*, 63 F.3d 877 (9th Cir. 1995), cert. denied, 516 U.S. 1049, 116 S. Ct. 712, 133 L. Ed. 2d 667 (1996) (counsel disqualified for failure to disclose and ordered to disgorge all fees); accord *In re Smitty's Truck Stop, Inc.*, 210 B.R. 844 (B.A.P. 10th Cir. 1997); *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989 (Bankr. N.D. Ill. 1990).

n28

28. *In re Missouri Mining, Inc.*, 186 B.R. 946, 948-49 (Bankr. W.D. Mo. 1995) (payment of counsel's retainer by third party must be examined on a case-by-case basis).

n29

29. See *In re Crimson Invs., N.V.*, 22 C.B.C.2d 271, 109 B.R. 397 (Bankr. D. Ariz. 1989) (retainer provided to debtor's attorney by third party was property of the debtor's estate, which attorney was required to disclose); *In re Independent Engineering Co.*, 197 F.3d 13 (1st Cir. 1999) (counsel, under a court order requiring approval for any compensation, who fails to disclose withdrawal of funds from a security retainer paid by chapter 11 debtor's principal, and who later fails to disclose subsequent draws, is subject to denial of compensation, sanctions, disqualification and disgorgement of fees, despite contention that the retainer is not estate property).

n30

30. 615 F.2d 925 (2d Cir. 1979).

n31

31. 615 F.2d 925, 936.

n32

32. See *In re Emco Enters., Inc.*, 94 B.R. 184 (Bankr. E.D. Cal. 1988); *In re Tri-County Water Ass'n, Inc.*,

91 B.R. 547 (Bankr. D.S.D. 1988); *In re Chicago Lutheran Hosp. Ass'n*, 89 B.R. 719 (Bankr. N.D. Ill. 1988); *In re Kinderhaus Corp.*, 58 B.R. 94, 97 (Bankr. D. Minn. 1986) (a retainer, taken prior to the filing of the petition, becomes property of the estate upon the commencement of the case, subject however, to the terms of the trust.). But see *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989, 996 (Bankr. N.D. Ill. 1990) (the *Kinderhaus* court assume[s] that when services are rendered to the debtor during a bankruptcy, the services must be compensated from the estate. But nothing in the Code so provides).

n33

33. *In re Printing Dimensions, Inc.*, 153 B.R. 715, 723 (Bankr. D. Md. 1993) (questioning the soundness of earned on receipt retainers in a bankruptcy case).

n34

34. 540 U.S. 526, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004).

n35

35. 148 B.R. 81 (Bankr. D.D.C. 1992); see also *Tyler v. Prudoff* (*In re Prudoff*), 186 B.R. 64, 66-7 (Bankr. E.D. Va. 1995).

n36

36. 148 B.R. 81, 82 (quoting *In re Knudsen Corp.*, 84 B.R. 668, 671-72 (B.A.P. 9th Cir. 1988)).

n37

37. See *In re Bressman*, 214 B.R. 131 (Bankr. D.N.J. 1997); *In re Dividend Dev. Corp.*, 145 B.R. 651 (Bankr. C.D. Cal. 1992); *In re Crimson Invs., N.V.*, 109 B.R. 397 (Bankr. D. Ariz. 1989) (retainer provided to debtor's attorney by third party was property held in trust for the debtor's estate); *In re C & P Auto Transp., Inc.*, 20 C.B.C.2d 1620, 94 B.R. 682 (Bankr. E.D. Cal. 1988) (prepetition retainers are property of the estate based upon the possibility of a court ordered return of all or a portion of such retainers under section 329(b) of the *Bankruptcy Code*).

n38

38. 91 B.R. 547 (Bankr. D.S.D. 1988).

n39

39. 91 B.R. 547, 551 (*Bankr. D.S.D. 1988*) (citations omitted); accord *In re Hathaway Ranch P'ship*, 23 C.B.C.2d 777, 116 B.R. 208 (*Bankr. C.D. Cal. 1990*); *In re Indep. Sales Corp.*, 73 B.R. 772, 774-75 (*Bankr. S.D. Iowa 1987*) ([c]learly, a retainer obtained by the attorney for the debtor prior to filing the petition for relief, as in this case, is held in trust to the extent it is for services to be rendered and for costs to be incurred *during* the pendency of the case and until allowed by the court.); *In re Kinderhaus Corp.*, 58 B.R. 94, 97 (*Bankr. D. Minn. 1986*) (prepetition retainer taken by a debtor's attorney for services to be rendered and costs to be incurred during the pendency of a bankruptcy case is held in trust, except to the extent that attorney's fees are allowed by the Court and ordered paid until the case is closed or until the Court orders otherwise); see also Local Bankruptcy Rule 2016.1(b) for the Northern District of Texas, *reprinted in* Collier Bankruptcy Practice Guide Local Rules Pamphlet: Fifth Circuit (Matthew Bender) (professional must deposit retainer funds into a trust account and may not withdraw funds therefrom until a Motion for Distribution of Retainer is filed and approved by the court, after a hearing if an objection is made).

n40

40. *In re Chapel Gate Apartments, Ltd.*, 64 B.R. 569, 573 (*Bankr. N.D. Tex. 1986*). But see *In re Production Assocs., Ltd.*, 264 B.R. 180 (*Bankr. N.D. Ill. 2001*); *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989 (*Bankr. N.D. Ill. 1990*).

n41

41. *Stewart v. Law Offices of Dennis Olson*, 93 B.R. 91 (*N.D. Tex. 1988*), *aff'd*, 878 F.2d 1432 (5th Cir. 1989); *In re Mondie Forge Co.*, 154 B.R. 232, 237-8 (*Bankr. N.D. Ohio 1993*).

n42

42. 114 B.R. 989, 997 (*Bankr. N.D. Ill. 1990*); see also *In re Production Assocs., Ltd.*, 264 B.R. 180 (*Bankr. N.D. Ill. 2001*).

n43

43. *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989 (*Bankr. N.D. Ill. 1990*).

n44

44. See *In re GoCo Realty Fund I*, 151 B.R. 241, 250 (Bankr. N.D. Cal. 1993) (a prepetition retainer becomes property of the estate only if, under applicable state law, the debtor has an interest in the retainer at the time of filing the bankruptcy case); see also *In re D.L.I.C., Inc.*, 120 B.R. 348 (Bankr. S.D.N.Y. 1990) (the determination of whether a prepetition retainer is property of the estate depends upon what interest, if any, the debtor retains in the retainer funds under state law).

n45

45. *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989, 1000; see also *In re K & R Mining, Inc.*, 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989) (attorney with a prepetition retainer which was an advance payment is a secured creditor with a possessory security interest in the retainer funds). In *McDonald Bros.*, the court stated:

Given their belief that they had been given an advance payment retainer, and in the absence of any facts indicating the contrary, counsel for the debtor in this case had no obligation under the Bankruptcy Code beyond disclosure of their retainer under section 329. Neither approval of a fee application nor leave of court is required for their use of the retainer. Of course, any interested party may challenge counsel's treatment of the retainer. If the retainer should have been held as client funds, counsel would have violated both the automatic stay and their ethical obligations by using the retainer without a fee application. However, in the absence of any challenge to counsel's treatment and of any facts indicating that this treatment was improper, this court will not itself inquire further into the circumstances surrounding the retainer agreement.

114 B.R. 989, 1003; accord *In re Printing Dimensions, Inc.*, 153 B.R. 715 (Bankr. D. Md. 1993) (prepetition retainer, although characterized in agreement as an engagement fee retainer, was really an advance fee retainer and, thus, property of the estate); *In re Montgomery Drilling Co.*, 121 B.R. 32 (Bankr. E.D. Cal. 1990) (prepetition retainer received on the eve of a bankruptcy filing by the debtor's attorney is a security retainer and property of the estate and not an advance payment).

n46

46. 148 B.R. 81 (Bankr. D.D.C. 1992).

n47

47. 145 B.R. 651 (Bankr. C.D. Cal. 1992).

n48 48. 145 B.R. 651, 654-55. *In re NBI, Inc.*, 25 C.B.C.2d 43, 57-58, 129 B.R. 212, 224 (Bankr. D. Colo. 1991) (Consideration of whether the retainers are or are not property of the estate based on state contract law is largely academic in this case. It is not dispositive of reasonableness under Section 328(a).); see also *Schofield v. United States Trustee (In re Jones)*, 236 B.R. 38 (D. Colo. 1999).

n49

49. See *General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 75, 10 C.B.C.2d 1309, 1312 (2d Cir. 1984).

n50

50. 84 B.R. 668 (B.A.P. 9th Cir. 1988).

n51

51. See *In re Chapel Gate Apartments, Ltd.*, 64 B.R. 569, 573 (Bankr. N.D. Tex. 1986).

n52

52. See *In re Bicoastal Corp.*, 118 B.R. 855 (Bankr. M.D. Fla. 1990) (ownership of the portion of prepetition retainer earned prepetition passed to law firm at the time the services were rendered; reasonableness of such fees were still subject to scrutiny under section 329); see also *In re Production Assocs., Ltd.* 264 B.R. 180 (Bankr. N.D. Ill. 2001); *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989 (Bankr. N.D. Ill. 1990).

n53

53. See *In re McDonald Bros. Constr., Inc.*, 114 B.R. 989 (Bankr. N.D. Ill. 1990); *In re Fulton*, 80 B.R. 1009 (Bankr. D. Neb. 1988). But see *In re Printing Dimensions, Inc.*, 153 B.R. 715, 720 (Bankr. D. Md. 1993) (finding that debtor retains an equitable interest).

n54

54. See *In re Burnside Steel Foundry Co.*, 19 C.B.C.2d 761, 90 B.R. 942 (Bankr. N.D. Ill. 1988).

ABOUT THE AUTHOR(S):

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128 of 197 DOCUMENTS

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Collier on Interim Compensation

2008 Emerging Issues 1329

Collier on Interim Compensation

By Collier

December 5, 2007

SUMMARY: Section 331 of the Bankruptcy Code permits a trustee, an examiner, an attorney or any professional person employed under section 327 or section 1103 to apply to the court for interim compensation and reimbursement for expenses for services rendered before the date of the fee application. This Emerging Issues Analysis covers interim compensation.

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ARTICLE: Section 331 of the Bankruptcy Code permits a trustee, an examiner, an attorney or any professional person employed under section 327 or section 1103 to apply to the court for interim compensation and reimbursement for expenses for services rendered before the date of the fee application. Section 331 remove[s] any doubt that officers of the estate may apply for, and the court may approve, compensation and reimbursement during the case, instead of being required to wait until the end of the case, which in some instances, may be years. n1 Although some courts did allow interim compensation in proceedings under the Bankruptcy Act prior to the adoption of the Code, Congress intended that the practice of interim compensation become system-wide as part of the intent to make bankruptcy practice more attractive to qualified professionals. The new practice replaced the former guideline of spirit of economy of administration in bankruptcy cases, in which courts generally awarded bankruptcy attorney fees calculated at rates lower than those employed in other fields. n2

Section 331 is thus designed to assure the continued efficient rendition of professional services to the estate. The section also furthers the policy of the Code that bankruptcy professionals be compensated in parity with professionals rendering comparable services. n3 Otherwise, bankruptcy professionals would be forced to finance the administration of a case while professionals in most nonbankruptcy areas of the law do not suffer an equivalent hardship. n4 Accordingly, even if confirmation of a reorganization plan has been delayed, the professionals may still receive interim compensation, so long as it has not been demonstrated that the professionals were responsible for any delay. n5

Section 331 Not Applicable to Officers of the Debtor. Although section 331 applies to a trustee, an examiner, a debtors attorney n6 and certain other professionals, it is not applicable to officers of the debtor or debtor in possession, n7 and it is not applicable to certain professionals, such as auctioneers and appraisers, who are paid on a per-job basis.

n8

Courts Should Award Interim Compensation When Appropriate. Some bankruptcy courts have noted the permissive language in section 331 and have therefore suggested that a court could simply defer ruling on interim fee applications. n9 However, although section 331 does not contain mandatory language, courts should consider interim fee applications filed under section 331 and grant them when the professional has made an appropriate showing. n10 Otherwise, the intent and purpose of section 331 will not be fulfilled. n11

Thus, if a court determines, based on the appropriate factors, that interim compensation is unwarranted, the court should deny the requested fees under section 331. If the court finds that an award of fees or expenses is appropriate, but further finds that it is likely that there will be insufficient assets to pay all administrative claims, the court may award the appropriate amount but defer all or part of the payment of the compensation sought. n12 In any event, the court should evaluate the application based on appropriate standards. If the court declines to do so, it would be avoiding its responsibility under the statute to determine whether the compensation sought is reasonable and whether payment is appropriate. n13

Discussed below are interim fees in liquidation cases, n14 receipt of payment on allowed interim fees n15 and the ability of the court to revisit interim fees at any time through the allowance of the final fee application. n16

Interim Compensation Periods May Be Less Than 120 Days. Section 331 establishes a schedule for the consideration of applications for interim compensation. Generally, an application for interim compensation and reimbursement of expenses may be made only once every 120 days after an order for relief in a case under the Code. n17 However, section 331 states that the court may permit more frequent applications. The circumstances which would warrant more frequent applications include very large cases where the legal work is extensive and merits more frequent payments. n18 Defining the circumstances under which deviation from the 120-day period is appropriate lies solely within the discretion of the court before whom the case is pending, to be determined on a case-by-case basis. n19

The Knudsen Factors. Courts in certain very large reorganization cases have allowed payment of interim compensation covering periods of less than 120 days (e.g., monthly), reasoning that the complexity of the issues involved and the time required on the part of the attorneys for the debtor in possession in providing services necessary to achieve a successful reorganization of the debtors merit a reduction in the time period. n20 The leading case on monthly payment procedures is *United States Trustee v. Knudsen Corp (In re Knudsen Corp.)*, n21 where the court approved a monthly payment procedure for interim compensation, subject to subsequent court review. The court indicated, however, that such an alternative procedure should be implemented only in rare cases in which the following criteria were met:

- (1) The case is an unusually large one in which an exceptionally large amount of fees accrue each month;
- (2) The court is convinced that waiting an extended period for payment would place an undue hardship on counsel;
- (3) The court is satisfied that counsel can respond to any reassessment; and
- (4) The retainer procedure is, itself, the subject of a noticed hearing prior to any payment thereunder. n22

Expansion of the Knudsen Criteria. Several courts have expanded on the *Knudsen* criteria. In *In re Mariner Post-Acute Network, Inc.*, n23 the court recognized other relevant factors to be considered, such as cash-flow needs of the debtor in possession, the ability to monitor and control administrative costs, the ability of the debtor to reorganize, the reputation of debtor in possessions counsel and some assurance that any fees subsequently disallowed can be repaid. n24 Although almost all of the cases that allow compensation faster than the statutory 120 days have been large and complex business reorganizations, one court allowed an accountant to receive monthly payment in a small

reorganization case, focusing on the hardship to the professional. n25 The size of the professional firm as well as the case size should be taken into account. A single practitioner or a small professional firm will be less able than a larger firm to front the costs of what would look like a small bankruptcy case to the larger firm.

Cases Where Special Compensation Procedures Were Denied. The burden of proof is on the professional to establish to the satisfaction of the bankruptcy court that the terms and conditions proposed for interim compensation, including any special compensation procedures, are reasonable. n26 In certain circumstances, professionals have not met that burden. For example, some courts have distinguished and declined to apply the interim compensation procedure set forth in *Knudsen* on the basis of the smaller size and relative simplicity of the case, n27 and on the basis that there has been no showing of undue hardship. n28 Those cases have emphasized the statement in *Knudsen* that it is the rare case that will qualify for special compensation procedures. n29 It has also been held that monthly compensation procedures which might be appropriate for an ongoing business are inappropriate when the debtor goes into a liquidation mode. n30

Payments Can Be Made Monthly with Fee Applications to Follow. There has been disagreement among the courts as to whether *Knudsen's* special compensation procedure is permissible under the Bankruptcy Code. *Knudsen* allowed professionals to be paid monthly upon invoices submitted to the debtor in possession, if those invoices were acceptable to the debtor in possession, with interim fee applications to follow on a quarterly basis. n31 Following *Knudsen*, a number of courts have agreed that similar procedures are appropriate and acceptable. n32 Yet a number of courts have disagreed, holding that there is no provision in section 331 or anywhere else in the Bankruptcy Code to allow payment of fees prior to approval of fee applications, following notice and a hearing. n33

There are good practical reasons for allowing a procedure providing for monthly fee invoices followed by quarterly fee applications. The main reason is to prevent the burden on the professionals and the court and the excessive cost in large cases of dealing with monthly fee applications. As one court with extensive experience in large chapter 11 cases noted, in a large case it can be very difficult to review monthly invoices because there is too much ongoing activity and too narrow a picture is presented. n34 As long as adequate allowance is made to ensure the return of any moneys that might not be eventually allowed, the procedure should benefit a debtor in possessions planning and cash flow, preventing large surprises. In addition, payment on a monthly basis in large cases is necessary to compensate the professionals in those cases on par with how professionals in other, non-bankruptcy cases are being compensated, as Congress intended. n35

There is also a statutory basis that supports allowing special interim compensation procedures. Section 331 does indeed require that interim compensation follow notice and a hearing. However, notice and a hearing means such notice as is appropriate in the particular circumstances. n36 Under the *Knudsen* procedure, there is a hearing on the establishment of the special procedures on notice to all interested parties. It is very important for professionals seeking interim compensation procedures to obtain the bankruptcy courts approval before instituting that special payment procedure. Self-help will not work. n37 Any party in interest is entitled to appear at that initial hearing and object and seek modification of the procedures, including seeking the right to participate in the interim compensation process. Payment on monthly invoices is allowed only after parties in interest have had an opportunity to review and object to the specific invoices. No invoices are paid prior to court approval if there is any timely objection. n38 Thus, the better view is that the monthly invoicing procedures followed by quarterly fee applications, as established in *Knudsen*, are permissible in the appropriate circumstance.

Unreported Orders Implementing Procedures for Submission of Monthly Billing Statements. It is not uncommon for bankruptcy courts to enter unpublished orders implementing an administrative procedure for the submission of monthly billing statements to the debtor in possession, the creditors committee(s) and the United States trustee. n39 These parties are provided with an opportunity to review and object to the monthly billing request. If no objection to payment is made, a fixed percentage (e.g., 80 percent of fees and 100 percent of expenses) is paid. Thereafter, the amounts paid on a monthly basis (as well as any amounts requested in the monthly billing statements that may have been subject to an objection that, consequently, were not paid) are subject to court approval pursuant to a

subsequent interim fee application. n40

Notice and a Hearing. Section 331 requires notice and a hearing before the court may grant interim compensation. However, section 331 does not specify who is to receive such notice, leaving that particular issue to the bankruptcy rules. n41

Federal Rule of Bankruptcy Procedure 2002 Specifies Notice Requirements. *Federal Rule of Bankruptcy Procedure 2002(a)(6)* requires at least 20 days notice by mail to the debtor, the trustee, all creditors and indenture trustees of hearings on all applications for compensation or reimbursement of expenses, which includes interim compensation, totaling in excess of \$1,000. Under Rule 2002(c)(2), the notice must specify the applicant and the amounts requested. Rule 2002(i) provides that the court may direct that the notice given under subdivision (a)(6) be transmitted to the United States trustee and be mailed only to committees elected pursuant to Code section 705 or appointed pursuant to Code section 1102 or their authorized agents and to the creditors and equity security holders who serve on the trustee or debtor in possession and file a request that all notices be mailed to them. Such a request would be made to the court, either by separate motion or in the original administrative procedures motion relating to professional fees; in either event, the request must be made before the service of the notice of the hearing on the interim fee request.

In a chapter 11 case, Rule 2002(j) requires service on the Securities and Exchange Commission, the Internal Revenue Service for the district in which the case is pending and, if the schedules disclose a debt to the United States other than for taxes, to the United States attorney for the district in which the case is pending and to the appropriate department or agency. If a stock interest of the United States is disclosed, notice is to be given to the Secretary of the Treasury. Rule 2002(k) requires service on the United States trustee.

Applications for Interim or Final Compensation; Fed. R. Bankr. P. 2016. *Federal Rule of Bankruptcy Procedure 2016* relates to applications for either interim or final compensation. Rule 2016(a) requires an entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate to file an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred and (2) the amounts requested. The application shall also include, among other things, a statement as to what payments were previously made or promised to the applicant, the source of the payment, whether any compensation previously received has been shared and whether any understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in connection with the case.

Service of Notice. The applicant is required to file its fee application, together with supporting documentation, with the court and, generally, serve a copy of it on the trustee (or debtor in possession), the United States trustee and any creditors' or equity committees in a chapter 11 case. The applicant must also serve other parties, such as secured lenders, who may be entitled to such service pursuant to an order of the court governing the submission and service of fee applications in a bankruptcy case. A party seeking interim compensation need not distribute a complete interim fee application to all parties in interest. Instead, the applicant is merely required to send the notice (as opposed to the entire application) pursuant to Bankruptcy Rule 2002(a)(7).

Court Review Possible Even If No Party in Interest Objects. It is generally accepted that a bankruptcy court has a duty to review fee applications, interim and final, and to reduce or disallow fee requests even if no party in interest, or the United States trustee, objects. n42 However, if the bankruptcy court reduces or disallows a fee application, reasonable notice and an opportunity to be heard should be given to the affected professional. n43

For further discussion of Code section 331, see Collier on Bankruptcy, ch. 331.

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[Return to Text](#)

n1 1. H.R. Rep. No. 595, 95th Cong., 1st Sess. 330 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 41-42 (1978); U.S. Code Cong. & Admin. News pp. 5787, 5827, 5828, 6287; *see Leichty v. Neary (In re Strand)*, 375 F.3d 854 (9th Cir. 2004).

n2

2. *In re Child World, Inc.*, 185 B.R. 14, 16 (Bankr. S.D.N.Y. 1995).

n3

3. H.R. Rep. No. 595, 95th Cong., 1st Sess. 330 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 41-42 (1978).

n4

4. *See In re Commercial Fin. Servs., Inc.*, 41 C.B.C.2d 868, 871, 231 B.R. 351, 354 (Bankr. N.D. Okla. 1999) (It is clear that Section 331 was intended to alleviate the unwarranted financial burden on professionals that occurs when judicial scrutiny, allowance, and payment of fee applications is withheld until the conclusion of the case, as contemplated by Section 330.); *In re International Horizons, Inc.*, 10 B.R. 895, 897-98 (Bankr. N.D. Ga. 1981).

n5

5. *In re City Mattress, Inc.*, 174 B.R. 23, 26 (Bankr. W.D.N.Y. 1994) (recognizing that [c]onfirmation of a reorganization plan has never been a precondition for the allowance of legal fees).

n6

6. Although section 331 specifically allows a debtors attorney to receive interim compensation, the 1994 amendments to section 330 eliminated the debtors attorney from the list of entities entitled to final compensation. Section 330(a)(1) still allows compensation for all professionals retained under section 327, which include debtor in possession counsel in chapter 11 cases, and section 330(a)(4) allows compensation to debtor's counsel in individual chapter 12 and 13 cases. Thus, it would not make sense to allow the debtor's

attorney to receive interim compensation for services rendered in originally filed or converted chapter 7 cases, as the debtor's attorney cannot receive final compensation. *See Collier on Bankruptcy*, 331.05[2].

n7

7. *See In re Microwave Prods. of Am.*, 100 B.R. 379, 382-83 (Bankr. W.D. Tenn. 1989) (holding that because the former president of the debtor in possession had not been retained under either section 327 or section 1103, he was not entitled to interim compensation under section 331; instead he had an administrative claim under section 503 and had to wait until confirmation of the plan for payment).

n8

8. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 330 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 42 (1978); *Collier on Bankruptcy*, 6005.01.

n9

9. *In re Child World, Inc.*, 185 B.R. 14, 17 (Bankr. S.D.N.Y. 1995) (granting interim fee applications, with a holdback); *cf. In re Spanjer Bros., Inc.*, 191 B.R. 738, 747 (Bankr. N.D. Ill. 1996) (interim fee awards are discretionary).

n10

10. *See In re ACT Mfg., Inc.*, 281 B.R. 468, 474 (Bankr. D. Mass. 2002) (The Court, however, has the authority and indeed the responsibility for reviewing and determining whether the fees and expenses, whether paid or unpaid, are reasonable and necessary.); *In re Quick Release, Inc.*, 6 B.R. 713, 716 (Bankr. D.S.D. 1980) (when debtor in possession's counsel rendered necessary services, counsel is entitled to reasonable compensation on an interim basis, even if the reorganization might ultimately prove unsuccessful).

n11

11. *In re ACT Mfg., Inc.*, 281 B.R. 468, 474 n.7 (Bankr. D. Mass. 2002) (recognizing that section 331 ensures that competent and qualified professionals represent parties in the bankruptcy arena without fear that they will be driven to the brink of financial ruin while awaiting payment for their services).

n12

12. See *Collier on Bankruptcy*, 331.02[2]. For the circumstances under which a court could require disgorgement of fees already awarded and paid, see *Collier on Bankruptcy*, 331.04.

n13

13. See *Thermtron Products, Inc. v. Hermansdorfer*, 423 U.S. 336, 96 S. Ct. 584, 46 L. Ed. 2d 542 (1976) (a district court could not avoid hearing a case removed from state court simply because of its full docket where the statute allowed for remand to the state court only if the case was removed improvidently and without jurisdiction); see also *Things Remembered, Inc. v. Petrarca*, 516 U.S. 124, 127-28, 116 S. Ct. 494, 497, 133 L. Ed. 2d 461, 466 (1995) (citing *Hermansdorfer* for the proposition that a district court remanding a case based on the grounds set forth in the removal statute was acting within its authority under the statute).

n14

14. See *Collier on Bankruptcy*, 331.05.

n15

15. See *Collier on Bankruptcy*, 331.02[2].

n16

16. See *Collier on Bankruptcy*, 331.03.

n17

17. Thus, in *In re T.A.B. Construction*, 197 B.R. 821 (Bankr. W.D. Tex. 1996), the court denied without prejudice an initial interim fee application filed 74 days after the order for relief. In *In re Bicoastal Corp.*, 117 B.R. 700, 702 (Bankr. M.D. Fla. 1990), the court allowed a second interim fee application more than 120 days after the case was filed but less than 120 days after the first application was filed, where the first application was denied *in toto*.

n18

18. H.R. Rep. No. 595, 95th Cong., 1st Sess. 330 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. at 41 (1978).

n19

19. *In re Commercial Fin. Servs., Inc.*, 41 C.B.C.2d 868, 871, 231 B.R. 351, 354 (Bankr. N.D. Okla. 1999).

n20

20. See, e.g., *In re Bennett Funding Group, Inc.*, 213 B.R. 227, 232 (Bankr. N.D.N.Y. 1997); *In re Kaiser Steel Corp.*, 74 B.R. 885 (Bankr. D. Colo. 1987).

n21

21. 84 B.R. 668 (B.A.P. 9th Cir. 1988).

n22

22. 84 B.R. 668, 672.

n23

23. 257 B.R. 723, 731 (Bankr. D. Del. 2000).

n24

24. *Id.*

n25

25. *In re Niover Bagels, Inc.*, 214 B.R. 291, 294 (Bankr. E.D.N.Y. 1997) (nothing in the language of the Code suggests that the 120-day period can be shortened only in large cases).

n26

26. *In re W & W Protection Agency, Inc.*, 200 B.R. 615, 620 (Bankr. S.D. Ohio 1996) (citing *In re NBI, Inc.*, 129 B.R. 212, 219 (Bankr. D. Colo. 1991)).

n27

27. See, e.g., *In re W & W Protection Agency, Inc.*, 200 B.R. 615, 620-21 (Bankr. S.D. Ohio 1996); *In re Shelly's, Inc.*, 91 B.R. 803, 807 (Bankr. S.D. Ohio 1988) (rejecting a special compensation procedure where the case was not unusually large, the debtor had not shown undue hardship and there had been no showing that fees could be returned).

n28

28. *In re ICS Cybernetics, Inc.*, 97 B.R. 736, 738 (Bankr. N.D.N.Y. 1989) (finding that the *Knudsen* criteria were not met by conclusory statements by creditors' committee counsel about having to wait six months for payment, and implying that a higher standard would have to be met by creditors' committee's, as opposed to debtor's, counsel).

n29

29. *In re W & W Protection Agency, Inc.*, 200 B.R. 615, 620 (Bankr. S.D. Ohio 1996) (if special procedures were to be authorized in this case, the rare exception would swallow the general rule); see *In re Shelly's, Inc.*, 91 B.R. 803, 806 (Bankr. S.D. Ohio 1988); *In re Knudsen Corp.*, 84 B.R. 668, 672 (B.A.P. 9th Cir. 1988).

n30

30. *In re Braniff, Inc.*, 117 B.R. 702 (Bankr. M.D. Fla. 1990) (noting that the court can thus better maintain control over administrative expenses and be fair to professionals and other interested parties alike). *But see Collier on Bankruptcy*, 331.05[1][c] (suggesting that courts should still consider and allow interim compensation procedures in the appropriate liquidation case).

n31

31. *In re Knudsen Corp.*, 84 B.R. 668, 669-70 (B.A.P. 9th Cir. 1988) (viewing the monthly payments like a retainer, allowed under section 328).

n32

32. *In re ACT Mfg., Inc.*, 281 B.R. 468, 478 (Bankr. D. Mass. 2002) (finding compensation particularly appropriate where a secured creditor approves the payments in a debtor in possession financing agreement); *In re Mariner Post-Acute Network, Inc.*, 257 B.R. 723, 731 (Bankr. D. Del. 2000); *In re Pittsburgh Corning Corp.*, 255 B.R. 162 (Bankr. W.D. Pa. 2000); *In re The Bennett Funding Group, Inc.*, 213 B.R. 227, 232 (Bankr. N.D.N.Y. 1997); *In re Dandy Lion Inns*, 120 B.R. 1015, 1018 (D. Neb. 1990) (reversing and remanding the bankruptcy court's approval of special compensation procedures, but only because the court had not considered whether this was that rare case where special procedures were appropriate).

n33

33. *In re Commercial Fin. Servs., Inc.*, 231 B.R. 351, 356 (Bankr. N.D. Okla. 1999) (the retainer language of section 328 cannot be used to support payment of fees prior to approval of a fee application, as required by the more specific section 331); *In re Genlime Group, L.P.*, 167 B.R. 453, 455 (Bankr. N.D. Ohio 1994) (statutory interpretation begins with the language of the statute itself, which requires notice and a hearing); *In re Pacific Forest Indus., Inc.*, 95 B.R. 740, 743 (Bankr. C.D. Cal. 1989) (suggesting that unpaid fees will provide incentive to properly serve the estate).

n34

34. *In re Mariner Post-Acute Network, Inc.*, 257 B.R. 723, 731 (Bankr. D. Del. 2000).

n35

35. *See In re Commercial Consortium of Cal.*, 135 B.R. 120, 123-4 (Bankr. C.D. Cal. 1991) (pointing out that most attorneys customarily billed clients on a quarterly basis back in 1978 when the Code was adopted, but that computerization has accelerated the billing process and that since 1991 most professionals have billed monthly).

n36

36. 11 U.S.C. § 102(1).

n37

37. *In re Tri-State Plant Food Inc.*, 273 B.R. 250 (Bankr. M.D. Ala. 2002), debtor's counsel billed and was paid postpetition, as in the cases cited in this section, but without any prior court approval. After the payment procedure was discovered, counsel cited the *Knudsen* case to the court in support of what had been done, arguing that the case authorized similar payment procedures. The court noted the split of authority as to whether a payment procedure could be established even with court approval, but held that in any event, a special

compensation procedure could be instituted only after notice and a hearing and approval by the court. All unauthorized payments were ordered returned.

n38

38. See General Order M-219 of the United States Bankruptcy Court for the Southern District of New York, posted at www.nysb.uscourts.gov/orders/m219.pdf.

n39

39. See *In re ACT Mfg., Inc.*, 281 B.R. 468, 475-78 (Bankr. D. Mass. 2002) (providing a comprehensive review of reported cases dealing with compensation procedures and noting that the case of *In re Kaiser Steel Corp.*, 74 B.R. 885, 892-93 (Bankr. D. Colo. 1987), appears to be the first reported case on their use); *In re Pittsburgh Corning Corp.*, 255 B.R. 162, 165 (Bankr. W.D. Pa. 2000) (providing an extensive list of courts that have adopted such general orders).

n40

40. General Order M-219 of the United States Bankruptcy Court for the Southern District of New York, posted at www.nysb.uscourts.gov/orders/m219.pdf. Other courts have similar orders posted at their Web sites. See also Form No. 10.12-4, motion for an administrative order establishing interim compensation procedures, and Form No. 10.12-5, the order approving such a motion.

n41

41. See *Fed. R. Bankr. P.* 2002(a)(6), (c)(2), (i), (j).

n42

42. *In re Busy Beaver Building Centers, Inc.*, 19 F.3d 833, 840-41 (3d Cir. 1994) (citing *Fed. R. Bankr. P.* 2017(b)); *In re Bonneville Pac. Corp.*, 147 B.R. 803, 805 (Bankr. D. Utah 1992), *aff'd in part, rev'd in part and remanded sub nom. Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434 (D. Utah 1998); *In re Car Hauler Specialist, Inc.*, 128 B.R. 325, 326 (Bankr. N.D.N.Y. 1990); *In re S.T.N. Enterprises*, 70 B.R. 823, 831 (Bankr. D. Vt. 1987).

n43

43. *In re Busy Beaver Building Centers, Inc.*, 19 F.3d 833, 845-46 (3d Cir. 1994); *Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434, 445 (D. Utah 1998). *Contra In re Poseidon Pools of America*, 216 B.R. 98, 100-01 (E.D.N.Y. 1997) (declining to follow *Busy Beaver* and pointing out that uncertainties due to poor record keeping will be resolved against the applicant).

ABOUT THE AUTHOR(S):

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129 of 197 DOCUMENTS

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Collier on Personal Property Stay Termination

2008 Emerging Issues 1330

Collier on Personal Property Stay Termination

By Collier

December 5, 2007

SUMMARY: This Emerging Issues Analysis covers personal property stay termination, including topics such as termination of the automatic stay as to personal property under section 362(h)(1)(A) if the debtor fails to timely file a statement of intention required under section 521(a)(2).

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ARTICLE: *Bankruptcy Code Section 362(h)*, added by the 2005 Act, provides for the termination of the stay as to certain personal property if the debtor fails to comply in a timely manner with certain requirements in section 521. n1 In the event that the stay is terminated as to personal property under this subsection, that property is also rendered no longer property of the estate. This subsection is applicable only in regard to personal property of the estate or of the debtor that secures a claim or is subject to an unexpired lease. Although section 362(h) is not by its terms limited to cases brought under a specific chapter, when read together with section 521, it is clear that an early stay termination under section 362(h) can occur only in a chapter 7 case in which the debtor is an individual. n2 Similarly, section 362(h) would become inapplicable in a chapter 7 case upon the conversion of the case to chapter 13.

Section 362(h)(1)(A) terminates the automatic stay as to personal property if the debtor fails to timely file a statement of intention required under section 521(a)(2). The stay also may be terminated under this provision if the debtor fails to indicate on the statement an intention to either surrender the personal property, redeem the property pursuant to section 722, enter into a reaffirmation agreement with respect to the secured debt in accordance with section 524(c), or assume an unexpired lease on the property pursuant to section 365(p). Based on the applicable time period for compliance set out in section 521(a)(2), the stay shall not terminate based on the debtor's failure to file a statement of intention any sooner than the date of the meeting of creditors or 30 days after the filing date of the petition, whichever is earlier.

One question that arises is whether the stay is terminated under this subsection if the debtor states an intention to take an action that is not specifically listed in section 362(h)(1)(A), but the intention is consistent with the options listed in section 521(a)(2). For example, with respect to personal property which secures a consumer debt, the debtor may state an intention to claim the secured property as exempt and the lien voidable under section 522(f) or (h), an option that is perfectly permissible under section 521(a)(2), though not listed in section 362(h)(1)(A). Since the stated options in section 362(h)(1)(A) are joined with the word or, the rule of construction found in section 102(5) suggests that the

listed options are not exclusive. Moreover, in light of the apparent purpose of section 362(h) to encourage debtor compliance with section 521, there is no reason to conclude that Congress intended to limit the options under section 521(a)(2) with the enactment of section 362(h), and the two subsections should be read together in a manner that gives effect to both.

Based on the interplay between section 362(h) and section 521(a)(2), the stay should not terminate under section 362(h)(1)(A) because the debtor states an intention to perform an option on terms that the secured creditor may not find acceptable. For example, the debtor need not state an intention to reaffirm the entire amount owed on a particular debt, and the stay should continue to apply while the debtor and secured creditor attempt to negotiate the terms of a reaffirmation. Similarly, the debtor may state an intention to redeem at a reasonable redemption amount, not simply at an amount that it is anticipated the secured creditor would agree to.

Additionally, section 362(h)(1)(B) provides that the stay under section 362(a) is terminated if the debtor does not take timely the action specified in the statement of intention, unless the statement specifies an intention to reaffirm the debt on the original contract terms and the creditor refuses to agree to such reaffirmation. The debtor's action is timely, as provided in section 521(a)(2), if taken within 30 days after the first date set for the meeting of creditors, or such additional time as fixed by the court within such 30-day period. Any extension of the time for performance of the stated intention as ordered by the court would in turn extend the application of the stay.

The event that triggers stay termination under section 362(h)(1)(B) is the debtors failure to take timely action, and it may not always be clear whether the debtor has acted in a timely manner. For example, if the debtor states an intention to reaffirm, the parties may not conclude negotiations of an agreement, or the court may not schedule or conclude a hearing under section 524(m) on the filed reaffirmation agreement, within the time specified under section 521(a)(2). And if the debtor has timely stated an intention to reaffirm on the original contract terms and has made such an offer to the creditor, the creditor may not respond to the offer within the time specified in section 521(a)(2). Another possible delay in performance could arise if the debtor has stated an intention to redeem and a court hearing is required to determine the redemption amount. Similarly, full performance of the debtors intention to assume a lease within the time permitted under section 521(a)(2) may be complicated by the different set of time periods in section 365 for actions to be taken by the trustee, debtor and the lessee. Moreover, it does not appear that section 362(h) applies to a lease assumption since section 521(a)(2) does not require the debtor to state an intention to assume a lease. Because of the consequences of stay termination, particularly when done automatically without a stay relief proceeding, courts may be reluctant to construe the phrase take timely the action in section 362(h)(1)(B) in a manner that would require complete performance of the stated option within the time specified if extenuating circumstances exist.

Another question arises in relation to the provision that renders section 362(h) inapplicable if the creditor refuses to agree to a reaffirmation on the original contract terms. If a dispute arises under this provision, and the court is called upon to determine whether the reaffirmation offer has been made on the original contract terms, n3 the stay should remain in effect until these issues are determined.

Section 362(h)(2) permits the trustee to file a motion before the expiration of the time specified in section 521(a)(2) seeking to bar the application of section 362(h). n4 If the court determines, after notice and hearing on the motion, that the personal property is of consequential value or benefit to the estate, and the court orders appropriate adequate protection of the creditor's interest, and orders the debtor to deliver any collateral in the debtor's possession to the trustee, section 362(h) does not apply and the stay remains in effect.

Although the stay is terminated automatically without a stay relief proceeding if section 362(h) is applicable, creditors may act at their peril should it later be determined that the debtor had actually performed the stated intention within the applicable time period or the creditor had refused to reaffirm on the original contract terms. Since section 362(j), which requires a court to issue an order on request of a party under section 362(c) confirming that the stay has been terminated, does not apply to a stay termination under section 362(h), there is some question as to the court's authority to issue such an order under section 362(h). In any event, it may be prudent for a secured creditor or lessee of

personal property to request an order confirming the stay termination or seek stay relief under section 362(d) if there is any doubt about whether the stay is in force.

For further discussion of Code section 362, see Collier on Bankruptcy, ch. 362.

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Return to Text

n1 1. 11 U.S.C. § 362(h), added by , Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. *In re Schlitzer*, 55 C.B.C.2d 120, 332 B.R. 856, 858 (Bankr. W.D.N.Y. 2005).

n3

3. See *Collier on Bankruptcy*, 521.10.

n4

4. *In re Norton*, 347 B.R. 291 (Bankr. E.D. Tenn. 2006) (section 362(h) does not expressly state which of the two deadlines in section 521(a)(2) applies; trustee's motion to extend stay deemed timely when filed 51 days after debtor filed petition, though beyond deadline under section 521(a)(2)(A), but 16 days prior to deadline for performance in section 521(a)(2)(B)).

ABOUT THE AUTHOR(S):

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130 of 197 DOCUMENTS

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Exemption for Avoidance of Payments in the Ordinary Course of Business

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Collier on Exemption for Avoidance of Payments in the Ordinary Course of Business

By Collier

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SUMMARY: This Emerging Issues Analysis covers the exemption for avoidance of payments in the ordinary course of business, including topics such as the elements of ordinary course payments, transfers made in the ordinary course of the parties respective business or financial affairs, and transfers made according to ordinary business terms.

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ARTICLE: As amended in 2005, n1 *Bankruptcy Code section 547(c)(2)* provides that the trustee may not avoid under section 547 a transfer to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary court of business or financial affairs of the debtor and the transferee, and such transfer was--

- (A) made in the ordinary court of business or financial affairs of the debtor and the transferee; or
- (B) made according to ordinary business terms[.]

This section is intended to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business of the debtor and the debtors transferee. n2 The term financial affairs is intended to make it clear that the exception applies to both consumer and business debtors.

The 2005 amendments make it easier to invoke the ordinary course of business defense successfully in a preference action. To qualify for the defense, the defendant no longer needs to prove all three prongs of the defense. As under current law, the defendant must still plead and prove that the suspect transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee. Under the amendments, the defendant need only plead and prove in addition either that the transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee or that it was made according to ordinary business terms. Formerly, the defendant was required to prove all three prongs of the defense. Although none of the key statutory terms is defined in the Bankruptcy Code, the case law regarding ordinary course of business has been well developed for some time. These cases survive the enactment of the 2005 amendments, since the language of each prong of the defense remains unchanged.

The limited legislative history indicates that the purpose of this exception is to leave undisturbed normal financial relations because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy. n3

As originally enacted, section 547(c)(2) required the transfer to have been made within 45 days after the debt was incurred in order to qualify for the ordinary course of business exception. This requirement provoked considerable litigation regarding the fixing of the time the debt was incurred; in 1984, Congress eliminated the 45-day requirement.

Elements of Ordinary Course Payments. To fall under the ordinary course of business exception, a transferee must show that the underlying debt on which payment was made was incurred by the debtor in the ordinary course of business or financial affairs of both parties and, further, that the transfer was either (1) made in the ordinary course of business or financial affairs of both parties, *or* (2) made according to ordinary business terms[.] n4

The Code fails to define these phrases, and the courts have developed unique definitions for each of the requirements. The ordinary course of business exception is an affirmative defense, and so the defendant carries the burden of proof on each of the elements. Only if that burden is satisfied with regard to each separate element will the defense be successful. n5

Inter-Relationship of Three Prongs and Emergence of Third Prong as a Separate and Distinct Element. The relationship between subparagraphs (B) and (C) of subsection 547(c)(2) has been tumultuous, but has settled into a pattern in which subparagraph (B) requires an inquiry into whether the transfers were in the ordinary course of business between the debtor and the creditor, and in which subparagraph (C) requires an inquiry into whether the transfers were in the ordinary course for business of members of the relevant industry. The subparagraph (B) inquiry is referred to as the subjective test, and the subparagraph (C) inquiry is referred to as the objective test. During the first decade of the Bankruptcy Code, most courts concentrated solely on the relationship between the debtor and the creditor in determining whether the defendant had satisfied its burden of proof under *both* subparagraphs (B) and (C). Only in the absence of a history between the parties did these courts look to transactions involving third parties.

As early as 1989, n6 however, courts began interpreting subparagraph (C) as requiring an independent inquiry into whether the payment practice at issue comports with industry standards. At least 10 of the courts of appeals have now adopted this view. This shift in interpretation coincided with the repeal of the 45-day limit, the onslaught of cases in which the defendant sought to use the ordinary course of business defense and the decision of the United States Supreme Court in *Union Bank v. Wolas*. n7 The march of the circuits to the holding that subparagraph (C) requires an independent analysis of the standard of the industry n8 was based partially upon a principle of statutory construction that [a]n interpretation of § 547(c)(2)(C) which focuses exclusively on the relationship between the creditor and the debtor, would deprive subsection (c)(2)(C) of any independent meaning because (c)(3)(B) already requires that the payment be evaluated in the context of the ongoing relationship between the debtor and the creditor. n9 Under the holdings of these cases, subparagraph (B) requires a subjective inquiry into the ordinariness of the transaction based upon the history between the debtor and the transferee and subparagraph (C) calls for an objective inquiry into whether the payments were ordinary for the relevant industry; courts compare the credit arrangements between other similarly situated debtors and creditors in the industry to see whether the payment practices at issue are consistent with what takes place in the industry. Moreover, some circuits have determined that the relative importance of industry standards depends on the length and breadth of the relationship between the debtor and creditor. n10

The 2005 amendments resolved this issue fully by making the ordinary course of business defense and the ordinary business terms defense alternative defenses rather than conjunctive defenses. n11 Cases decided under former subsections 547(c)(2)(A) (incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee) and (c)(2)(B) (in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee) will continue to be valid precedent under the revisions to the ordinary course of business defense. Cases decided under former section 547(c)(2)(C) (made according to ordinary business terms) will be less instructive under the revisions. As the courts struggled to determine the relationship between the ordinary course of

business prong of subsection (B) and the ordinary business terms prong of subsection (C), many courts subordinated the importance of ordinary business terms in those cases where the parties had an extensive history. Under the amendments, ordinary business terms prong is a full equal to the ordinary course of business prong, and so long as the defendant satisfies the requirement of section 547(c)(2)(A), the defense will apply if it satisfies either the ordinary course of business standard or the ordinary business terms standard. Thus, those cases decided under the former statute that relegated the ordinary business standard may not be fully applicable after the revisions. They will, however, continue to be important with regard to such issues as defining the applicable industry.

Detailed Analysis of Each of the Three Prongs

Debt Incurred in the Ordinary Course of Business. The underlying debt on which the payment was made must have been incurred in the ordinary course of business or financial affairs of both parties.

This first element of section 547(c)(2)--subparagraph (A)--requires the court to examine the debt incurred for which the alleged preferential transfer was payment. This is different from subparagraphs (B) and (C), which require the court to examine the transfers

themselves. Subparagraph (A) requires the court to examine the normality of such incurrences in each party's business operations generally. n12

Although this is the most straightforward and least litigated of the three prongs, for a defendant to be successful under the ordinary course of business defense the record must include evidence that satisfies the defendant's burden of proof on the issue. If the transaction from which the debt arose was not ordinary for the debtor or the transferee, then the defense will fail. Most courts assume this requirement is met by inferring from the evidence that there was nothing unusual about the transactions underlying the preferential payment.

As compared with other areas of preference law, there is scant case law on the issue of whether a debt has been incurred in the ordinary course of business between the debtor and the transferee. What case law there is reveals that courts generally are interested in whether the debt was incurred in a typical, arms-length commercial transaction that occurred in the marketplace or, on the other hand, whether it was incurred as an insider arrangement with a closely held entity. n13 If the debt was incurred in the routine operation of the debtor and the creditor, then it can be said to have been incurred in the ordinary course of each party's business. n14 Provided that these criteria are met, either long-term or first-time debt can be debt incurred in the ordinary course of business.

The primary tension in the interpretation of subsection 547(c)(2)(A) is whether it requires that the debt at issue be normal with regard to *each* party's business operations generally or that such debt be considered ordinary based upon the specific transactional history between the debtor and the defendant. The better reasoned decisions hold that a debt will not be considered incurred in the ordinary course of business if creation of the debt is atypical, fraudulent or not consistent with an arms-length commercial transaction. n15

Yet there is a contrary line of cases holding that, to satisfy subsection 547(c)(2)(A), the transferee must show that the debt at issue was incurred in the ordinary course of business between the debtor and the transferee. These cases narrow their focus to look only at whether the transaction that generated the challenged transfer is consistent with other transactions between the debtor and the creditor, rather than looking at whether the transaction is consistent with the general business operations of both the debtor and the creditor. These courts believe that subparagraph (A) contemplates a subjective test: Was the debt and the transfer ordinary as between the debtor and the creditor? To be subjectively ordinary implies some consistency with other business transactions between the parties. n16

Transfer Made in the Ordinary Course of the Parties Respective Businesses or Financial Affairs (Subjective Test). As noted above, Congress enacted section 547(c)(2) to leave undisturbed normal financial relations, because they do not detract from the general policy of the preference section to discourage unusual action by either the debtor or creditors during the debtor's slide into bankruptcy. n17 Even if the debtor's business transactions were irregular, they may be considered ordinary for purposes of section 547(c)(2) if they were consistent with the course of dealing between the particular parties. n18

There is no precise legal test that can be applied in determining whether payments by the debtor during the 90-day period were made in the ordinary course of business; rather, the court must engage in a peculiarly factual analysis. n19 The controlling factor is whether the transactions between the debtor and the creditor both before and during the ninety-day period were consistent.

The defendant must establish a baseline of dealing so that the court may compare the transfers made during the preference period with the parties prior course of dealings. n20 This baseline of dealing must be fixed at least in part during a time in which debtor's day-to-day operations were ordinary in the layman's sense of the word. Preferably, the material period should extend back into the time before the debtor became financially distressed. n21

Courts have relied upon a number of different factors in determining whether a payment is ordinary for purposes of subparagraph (B). The four factors most commonly cited by courts in making this determination are:

- (1) length of time the parties were engaged in the transaction in issue;
- (2) whether the amount or form of tender differed from past practices;
- (3) whether the debtor or creditor engaged in any unusual collection or payment activities; and
- (4) the circumstances under which the payment was made. n22

Duration of Relationship Between the Parties. If the debtor and the transferee have had a significant number of business dealings with one another, the court will examine those dealings to determine whether the challenged transfer fit within their previous pattern. If the challenged transfer arises from the initial transaction between the debtor and the transferee, then the court may refer solely to the written terms of the transaction to define the ordinary course of business between the parties. n23 A number of courts have held that it is possible for a first-time transaction between the parties during the preference period to qualify as being in the ordinary course. n24

Timing of the Payment(s)/Method of Transfer. The vast majority of ordinary course of business cases deal with payments that are made later than the express written terms require. A payment that is made beyond invoice or contract terms may still be considered in the ordinary course for purposes of subparagraph (B) if late payments were the standard course of dealing between the parties. n25

To determine whether a late payment may still be considered ordinary between the parties, a court will normally compare the degree of lateness of each of the alleged preferences with the pattern of payments before the preference period to see if the alleged preferences fall within that pattern. Areas of contention that arise in this comparison include (1) how far back the court should look in determining the parties' course of dealing prior to the preference period, (2) whether to use an average number of days late or a median number of days late and (3) how great a variance will render a challenged transfer inconsistent with the parties' course of dealing prior to the preference period.

Just as payments that are made after the due date may be considered out of the ordinary course, payments may likewise be out of the ordinary course of business if they are early, that is before the due date, and the defendant does not produce evidence that early payment was the norm between the parties prior to the preference period. n26 Similarly, if the transfer under scrutiny was by wire transfer or cashier's check, the defendant must show that this type of payment falls within the circle of ordinary course transactions between the parties. A sufficient pattern of similar types

of payments before the preference period must be shown in order to prevail. n27 The fact that a payment was made by wire transfer or by cashiers check is not a *per se* indication that the payment was out of the ordinary course of business.

Unusual Collection Efforts or Payment Practices. Payments made in response to unusual debt collection practices by the creditor are outside the scope of ordinary course of business. n28 It seems clear from the legislative history that section 547(c)(2) should protect only those payments that do not result from unusual debt collection or payment practices. Otherwise normal payments, however, should not be deemed outside the ordinary course if they are not made in response to unusual collection efforts. Thus, whenever the bankruptcy court receives evidence of unusual collection efforts, it must consider whether the debtor's payment was in fact, a response to those efforts. n29 In many circumstances, a phone call or two demanding an overdue payment or threatening to delay further deliveries until overdue payments are made may be ordinary between the parties. n30

The court will normally compare the collection activities that preceded each challenged transfer with the pattern of collection activities occurring prior to the preference period to see if the collection activities that preceded the alleged preferences fall within that pattern. In addition the court will examine and compare the relationship between such collection activity and the making of the challenged payment with the pre-preference period relationship between collection activity and payment. The more intense the collection activity during the preference period the greater the likelihood that the activity will take the payment out of the ordinary course of business.

Transfer Made According to Ordinary Business Terms (Objective/Industry Standard Test). The determination that subparagraph (C) requires proof that the challenged payment satisfies an industry standard raises several questions.

The Industry Standard. Subparagraph (C) establishes a requirement that a creditor prove that the debtor made the challenged transfer in harmony with the range of terms prevailing in some relevant industry's norms. The provision allows the creditor considerable latitude in defining what the relevant industry is; even departures from the relevant industry norms that are not so flagrant as to be unusual remain within subparagraph (C)'s protection. n31

Ordinary business terms refers to the range of terms that encompass the practices in which firms similar in some general way to the creditor in question engage, and only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subparagraph (C). This does not imply that the creditor must prove the existence of some single uniform set of industry-wide credit terms, a formidable if not insurmountable obstacle given the great variances in billing practices likely to exist within the set of markets or submarkets which one could plausibly argue comprise the relevant industry. n32

Defining the Industry. In order to determine whether the defendant has satisfied its burden of showing that the payments were within industry standards, the court must first define the relevant industry. Most courts appear to begin by looking to the creditor's industry. This is only a portion of the solution, however, since the court must determine how broadly or how narrowly to define the creditor's industry.

The Court of Appeals for the Seventh Circuit delivered a soliloquy on this complicated question in *In re Tolona Pizza Products Corp.* n33 Not only is it difficult to identify the industry whose norm shall govern (is it, here, the sale of sausages to maker of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?), but there can be great variance in billing practices within an industry. n34 Most opinions do not identify precisely the industry within which the transaction is being compared.

In one of the few decisions to identify with specificity the relevant industry for purposes of subparagraph (C), n35 the creditor had provided legal services to Midway Airlines, and the court defined the industry as the domestic airline legal-service industry. The court determined that the fair way to try and define the relevant industry or market is between domestic air carriers and lawyers they hire. The creditor's competitors included other law firms that provided

legal services to the debtor. It is conceivable that a single firm might constitute an entire industry, but few courts seem willing to apply that definition.

The Relative Importance of the Industry Standard. In the Third Circuit, the relative importance of compliance with industry standards depends upon the length and depth and breadth of the prepetition relationship between the debtor and the creditor. The likelihood of unfair overreaching by a creditor is reduced if the parties sustained the same relationship for a substantial time period before the debtor's insolvency. n36 The enactment of the 2005 amendments in which the ordinary course of business defense and the ordinary business terms defense were made alternative defenses, rather than conjunctive defenses, overrules these decisions. n37

Proof That Transfer Was Consistent with Industry Standards. Once the court has defined the relevant industry, chosen the industry standard and decided how much weight to give that standard, the court must weigh the evidence to determine whether the defendant has met the standard. Relevant evidence might include the testimony of disinterested experts not employed by the creditor and of an employee of the defendant, and it might include evidence of practices of other members of the industry. n38 Defendants have implored the courts to recognize that the very evidence the court requires (i.e., the payment and collection practices of its competitors) constitutes proprietary information that is difficult to obtain. n39 As in other matters, the weight given to expert witnesses depends both on the credentials of the expert and the quality of the expert's testimony. Courts have given varying weight to testimony of an employee of the creditor depending on the extent of experience of the employee and the quality of the testimony.

Specific Applications

Payments on Long-Term Debts. Before its amendment in 1984, n40 section 547(c)(2) provided that to be excepted from avoidance a transfer in the ordinary course of the debtor's business or financial affairs had to be made not later than 45 days after the debt was incurred. With the elimination of the 45-day rule, Congress extended the protections of section 547(c)(2) beyond payments on short-term trade debt. Resolving a split between the circuits, the Supreme Court, in *Union Bank v. Wolas*, n41 held that payments on long-term debt, as well as payments on short-term debt, may qualify for the ordinary course of business exception to the trustee's power to avoid preferential transfers. n42

The debtor in *Wolas* filed a petition for chapter 7 relief seven months after borrowing \$7 million from a bank. During the 90-day period preceding the filing, the debtor made two interest payments totalling approximately \$100,000 and paid a loan commitment fee of approximately \$2,500 to the bank. The trustee sued to recover these payments as preferences under section 547(b). The bankruptcy court found that the loans had been made in the ordinary course of business or financial affairs of both the bank and the debtor, and that the interest payments and loan commitment fee payment had been made according to ordinary business terms and in the ordinary course of business. The district court affirmed. n43

The Ninth Circuit, relying upon its prior decision in *In re CHG International, Inc.*, n44 reversed the lower court. In *CHG International*, the Ninth Circuit had concluded that section 547(c)(2) was merely an extension of the protections contained in section 547(c)(1) for contemporaneous exchanges for new value and that, as reflected in the legislative history and underlying policies of the preference provisions of the Bankruptcy Code, Congress did not intent to include long-term debt payments under section 547(c)(2).

In reversing the Ninth Circuit, the Supreme Court held that section 547, on its face, makes no distinction between long-term and short-term debt. Accordingly, the burden of persuading us that Congress intended to create or to preserve a special rule for long-term debt is exceptionally heavy. n45 Finding the legislative history ambiguous, the Court concluded that there was no persuasive evidence of a congressional intent to distinguish between long-term and

short-term debt and that the literal reading of section 547(c)(2) must prevail.

Ponzi Schemes. Several courts have denied section 547(c)(2) protection to transfers arising out of Ponzi schemes, n46 reasoning that such schemes are not in the ordinary course of business or financial affairs of the debtor. n47 However, some courts have indicated a willingness to protect payments to ordinary trade creditors for utilities, supplies, etc., even when the payments are made by a debtor engaged in a Ponzi scheme. n48

Payment Pursuant to Settlement Agreements. Although some courts have held that a payment made pursuant to a forbearance or standstill agreement, or a payment made pursuant to a litigation settlement agreement can never secure the protection of section 547(c)(2), n49 the better rule is that of the Ninth, n50 Second, n51 Third n52 and Eighth n53 Circuits that it is error to hold that payments made pursuant to a debt restructuring agreement can never be made in the ordinary course of business. Rather, such a determination is a question of fact that depends on the nature of industry practice in each particular case.

For further discussion of Code section 547, see Collier on Bankruptcy, ch. 547.

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Return to Text

n1 1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 409 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. Although the former Bankruptcy Act had no comparable preference exception for ordinary course transfers, many transfers that are currently protected under section 547(c)(2) were similarly protected under the judicially created current expense exception.

n3

3. H.R. Rep. No. 595, 95th Cong., 1st Sess. 373-74 (1997), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6329.

n4

4. 11 U.S.C. § 547(c)(2), as amended by Pub. L. No. 109-8, § 409 (2005), effective in cases commenced on or after October 17, 2005.

n5

5. This point was made by the Utah Supreme Court in a case where unsuccessful ordinary course of business defendants had sued their bankruptcy attorney for failing to include in the record any evidence that supported the ordinary business terms prong of the ordinary course of business. *Glencore, Ltd. v. Ince*, 972 P.2d 376 (Utah 1998); see also *Sigmon v. Butner*, 2001 U.S. App. LEXIS 9376, at *9 (4th Cir. May 15, 2001) (The recipient of [a payment within the preference period] has the burden of proving by a preponderance of the evidence that [such] payment falls within § 547(c)(2).").

n6

6. *In re Loretto Winery, Ltd.*, 22 C.B.C.2d 112, 107 B.R. 707 (B.A.P. 9th Cir. 1989).

n7

7. 501 U.S. 151, 112 S. Ct. 527, 116 L. Ed. 2d 514(1991).

n8

8. *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co. (In re Gulf City Seafoods Inc.)*, 296 F.3d 363 (5th Cir. 2002); *Arrow Elecs., Inc. v. Justus (In re Kaypro)*, 218 F.3d 1070 (9th Cir. 2000); *United States Trustee v. First Jersey Sec., Inc. (In re First Jersey Sec., Inc.)*, 180 F.3d 504 (3d Cir. 1999); *Miller v. Florida Mining & Materials (In re A.W. & Assocs., Inc.)*, 136 F.3d 1439 (11th Cir. 1998); *Luper v. Columbia Gas (In re Carled, Inc.)*, 91 F.3d 811 (6th Cir. 1996); *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, 78 F.3d 30 (2d Cir. 1996); *In re Midway Airlines, Inc.*, 69 F.3d 792 (7th Cir. 1995); *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044 (4th Cir. 1994); *Unicom Computer Corp. v. IBM (In re Unicom Computer Corp.)*, 21 F.3d 1116 (9th Cir. 1994); *Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Prods., Inc.)*, 18 F.3d 217 (3d Cir. 1994); *Clark v. Balcov Real Estate Finance, Inc. (In re Meridith Hoffman Partners)*, 12 F.3d 1549 (10th Cir. 1993); *Jones v. United Sav. & Loan Ass'n (In re U.S.A. Inns)*, 9 F.3d 680 (8th Cir. 1993); *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029 (7th Cir. 1993); *In re Food Catering & Housing, Inc.*, 971 F.2d 396 (9th Cir. 1992); *In re Fred Hawes Organization, Inc.*, 957 F.2d 239 (6th Cir. 1992).

n9

9. *Miller v. Florida Mining & Materials (In re A.W. & Assocs., Inc.)*, 136 F.3d 1439, 1442 (11th Cir. 1998). Commentators do not believe it was necessary or wise to impose this objective industry standard. Lawrence Ponoroff & Julie C. Ashby, *Desperate Times and Desperate Measures: The Troubled State of the Ordinary Course of Business Defense--and What To Do About It*, 72 Wash. L. Rev. 5 (1997); 1 Epstein, Nickels & White, *Bankruptcy*, § 6-31, at 619.

n10

10. *Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Prods., Inc.)*, 18 F.3d 217 (3d Cir. 1994); see *Collier on Bankruptcy*, 547.04[2][a][ii][C].

n11

11. 11 U.S.C. § 547(c)(2), as amended by Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 409(1) (2005).

n12

12. *Speco Corp. v. Canton Drop Forge (In re Speco Corp.)*, 218 B.R. 390 (Bankr. S.D. Ohio 1998) (citing *In re Youthland*, 160 B.R. 311 (Bankr. S.D. Ohio 1993)).

n13

13. *Huffman v. New Jersey Steel Corp. (In re Valley Steel Corp.)*, 182 B.R. 728 (Bankr. W.D. Va. 1995).

n14

14. *Youthland, Inc. v. Sunshine Girls (In re Youthland Inc.)*, 160 B.R. 311 (S.D. Ohio 1993).

n15

15. *In re Pioneer Technology, Inc.*, 107 B.R. 698, 702 (B.A.P. 9th Cir. 1988); *Youthland, Inc. v. Sunshine Girls (In re Youthland)*, 160 B.R. 311 (S.D. Ohio 1993); *Huffman v. New Jersey Steel Corp. (In re Valley Steel Corp.)*, 182 B.R. 728, 735 (Bankr. W.D. Va. 1995); *In re Jackson*, 90 B.R. 793, 794 (Bankr. D.S.C. 1988).

n16

16. *Tennessee Valley Steel Corp. v. Central Communications & Elecs., Inc. (In re Tennessee Valley Steel Corp.)*, 203 B.R. 949 (Bankr. E.D. Tenn. 1996).

n17

17. *In re Advance Glove Mfg. Co.*, 761 F.2d 249, 251 (6th Cir. 1985) (quoting S. Rep. No. 989, 95th Cong., 2d Sess. 88 (1978)).

n18

18. *In re Yurika Foods Corp.*, 888 F.2d 42, 44 (6th Cir. 1989); *In re Fulghum Constr. Corp.*, 872 F.2d 739, 743 (6th Cir. 1989).

n19

19. *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494, 497 (8th Cir. 1991) (quoting *In re Fulghum Constr. Corp.*, 872 F.2d 739, 743 (6th Cir. 1989)).

n20

20. *Cassirer v. Herskowitz (In re Schick)*, 234 B.R. 337 (Bankr. S.D.N.Y. 1999); *Ellenberg v. Plaid Enters., Inc. (In re T.B. Home Sewing Enters., Inc.)*, 173 B.R. 790 (Bankr. N.D. Ga. 1993); *In re Hancock-Nelson Mercantile Co., Inc.*, 122 B.R. 1006, 1013 (Bankr. D. Minn. 1991).

n21

21. *In re Hancock-Nelson Mercantile Co. Inc.* 122 B.R. 1006 (Bankr. D. Minn. 1991).

n22

22. *Payne v. Clarendon Nat'l Ins. Co. (In re Sunset Sales, Inc.)*, 220 B.R. 1005 (B.A.P. 10th Cir. 1998); *In re Jerry-Sue Fashions, Inc.*, 91 B.R. 1006 (Bankr. S.D. Fla. 1988).

n23

23. *Official Comm. of Unsecured Creditors v. Charleston Forge, Inc. (In re Russell Cave Co., Inc.)*, 259 B.R. 879 (Bankr. E.D. Ky. 2001); *In re Keller Tool Corp.*, 151 B.R. 912 (Bankr. E.D. Mo. 1993).

n24

24. *Kleven v. Household Bank FSB*, 334 F.3d 638, 643 (7th Cir. 2003) (with regard to a first time transaction, the ordinary course of business may be established by the terms of the parties agreement until that agreement is somehow modified by actual performance; in the absence of modifying behavior, court saw no reason why we should not look to the terms of the parties agreement in order to determine the ordinary course of business); *Styler v. Landmark Petroleum, Inc. (In re Peterson Distributing, Inc.)*, 197 B.R. 919, 927-928 (D. Utah 1996); *In re Morren Meat & Poultry Co., Inc.*, 92 B.R. 737 (W.D. Mich. 1988); *Hovis v. Aerospace Solutions, Inc. (In re Air South Airlines, Inc.)*, 247 B.R. 153, 162 (Bankr. D.S.C. 2000).

n25

25. *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1032 (7th Cir. 1993).

n26

26. *R.M. Taylor, Inc. v. Employers Ins. of Wausau (In re R.M. Taylor, Inc.)*, 245 B.R. 629 (Bankr. W.D. Mo. 2000); *Cassirer v. Herskowitz (In re Schick)*, 234 B.R. 337 (Bankr. S.D.N.Y. 1999).

n27

27. *Central Hardware Co. v. Sherwin-Williams Co. (In re Spirit Holding Co., Inc.)*, 153 F.3d 902 (8th Cir. 1998); *Tomlins v. BRW Paper Co. (In re Tulsa Litho Co.)*, 229 B.R. 806 (B.A.P. 10th Cir. 1999).

n28

28. *In re Craig Oil Co.*, 785 F.2d 1563 (11th Cir. 1986); *Ellenberg v. Plaid Enters., Inc. (In re T.B. Home Sewing Enters., Inc.)*, 173 B.R. 790 (Bankr. N.D. Ga. 1993).

n29

29. *In re Craig Oil Co.*, 785 F.2d 1563 (11th Cir. 1986).

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30. *Grant v. Suntrust Bank, N.A. (In re L. Bee Furniture Co.)*, 203 B.R. 778, 782 (Bankr. M.D. Fla. 1996).

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31. *Ganis Credit Corp. v. Anderson (In re Jan Weilert RV, Inc.)*, 315 F.3d 1192, 1198 (9th Cir. 2003) (Only a transaction that is so unusual or uncommon as to render it an aberration in the relevant industry, falls outside the broad range of terms encompassed by the meaning of ordinary business terms. (citation omitted)); *Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Prods., Inc.)*, 18 F.3d 217 (3d Cir. 1994).

n32

32. *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029 (7th Cir. 1993).

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33. 3 F.3d 1029 (7th Cir. 1993).

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34. 3 F.3d 1029, 1033.

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35. *Solow v. Ogletree, Deakins, Nash, Smoak & Stewart (In re Midway Airlines, Inc.)*, 180 B.R. 1009, 1017 (Bankr. N.D. Ill. 1995); cf. *Jones v. United Sav. & Loan Assn (In re U.S.A. Inns)*, 9 F.3d 680 (8th Cir. 1993), in which the comparison groups seem to be similarly situated savings and loans with delinquent customers.

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36. *Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Prods., Inc.)*, 18 F.3d 217 (3d Cir. 1994).

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37. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 409(1) (2005), effective in cases commenced on or after October 17, 2005.

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38. See *G.H. Leidenheimer Baking Co., Ltd. v. Sharp & Patton Sausage Co., Inc. v. A.T. Patton Co. v. Sharp (In re SGSM Acquisition Co., LLC)*, 439 F.3d 233 (5th Cir. 2006) (bankruptcy court did not err in holding that the defendants' witnesses failed to qualify as expert witnesses and thus the only evidence on the objective prong was the testimony of the plaintiff's expert witness).

n39

39. *Troisio v. E.B. Eddy Forest Products (In re Global Tissue LLC)*, 2004 U.S. App. LEXIS 14003, at *10 (3d Cir. July 7, 2004) (unpublished) ([I]nformation about competitors trade practices used to establish industry standards may be difficult to obtain, particularly if antitrust concerns prevent the sharing of payment information among firms in a particular industry. Thus, courts must allow some flexibility regarding sources of evidence used to establish the range of practices that will be deemed the industry standard in the section 547(c)(2)(C) analysis.).

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40. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

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41. 502 U.S. 151, 112 S. Ct. 527, 116 L. Ed. 2d 514, 25 C.B.C.2d 1011 (1991).

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42. 502 U.S. 151, 162, 112 S. Ct. 527, 533, 116 L. Ed. 2d 514, 525, 25 C.B.C.2d 1011, 1019; see also *Arrow Elecs., Inc. v. Justus (In re Kaypro)*, 218 F.3d 1070 (9th Cir. 2000) (holding that, under appropriate circumstances, payments made pursuant to debt restructuring agreements may be insulated under the section 547(c)(2) exception).

n43

43. *In re ZZZZ Best Co., Inc.*, 1989 U.S. Dist. LEXIS 17500 (C.D. Cal. Aug. 4, 1989), revd, 921 F.2d 968

(9th Cir. 1990), *revd*, *Union Bank v. Wolas*, 502 U.S. 151, 112 S. Ct. 527, 116 L. Ed. 2d 514, 25 C.B.C.2d 1011 (1991).

n44

44. 897 F.2d 1479(9th Cir. 1990).

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45. 502 U.S. 151, 156, 112 S. Ct. 527, 530, 116 L. Ed. 2d 514, 521, 25 C.B.C.2d 1011, 1014; *see also In re Jeffrey Bigelow Design Group, Inc.*, 956 F.2d 479, 487-88 (4th Cir. 1992) (debtors payments to its shareholder on line of credit qualified for ordinary course of business exception when debtor made such payments regularly for two years and payments were made according to ordinary business terms).

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46. A Ponzi scheme is any sort of fraudulent arrangement that uses later acquired funds or products to pay off previous investors." *In re Bullion Reserve of N. Am.*, 836 F.2d 1214, 1219 (9th Cir.), *cert. denied*, 486 U.S. 1056, 108 S. Ct. 2824, 100 L. Ed. 2d 925 (1988); *see Jobin v. McKay (In re M & L Bus. Mach. Co., Inc.)*, 84 F.3d 1330, 1340 (10th Cir. 1996) (because investment companies do not ordinarily pay fraudulent profits to early investors, the § 547(c)(2) defense is inapplicable to payments to investors in a Ponzi scheme).

n47

47. *See In re Bullion Reserve of N. Am.*, 836 F.2d 1214, 1219 (9th Cir.), *cert. denied*, 486 U.S. 1056, 108 S. Ct. 2824, 100 L. Ed. 2d 925 (1988); *Grauly v. Brooks (In re Bishop, Baldwin, Rewald, Delingham & Wong, Inc.)*, 819 F.2d 214, 16 C.B.C.2d 1394 (9th Cir. 1987); *Rafoth v. Bailey (In re Baker & Getty Fin. Servs., Inc.)*, 88 B.R. 792, 799 (Bankr. N.D. Ohio 1988); *In re W. World Funding, Inc.*, 54 B.R. 470, 481 (Bankr. D. Nev. 1985); *cf. First Fed. of Mich. v. Barrow*, 878 F.2d 912, 918 (6th Cir. 1989) (secondary mortgage service agencies fraudulent business manipulations were not made in the ordinary course of business because such practices do not comport with ordinary course of business practices commonly pursued by properly conducted mortgage companies).

n48

48. *See Jobin v. McKay (In re M & L Bus. Mach. Co., Inc.)*, 84 F.3d 1330 (10th Cir. 1996); *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 874 (D. Utah 1987) (We believe that the bankruptcy court read section 547(c)(2) too narrowly. Just because a debtor does not have a legitimate or ordinary business does not mean that transfers he makes in the course of that business may not be made in the

ordinary course of business.).

n49

49. *American Honda Fin. Corp. v. A. Angelle, Inc. (In re A. Angelle, Inc.)*, 230 B.R. 287 (Bankr. W.D. La. 1998) (citing *Hickey v. Nightingale Roofing, Inc.*, 83 B.R. 180 (D. Mass 1988); *In re Industrial & Mun. Engg, Inc.*, 127 B.R. 848 (Bankr. C.D. Ill. 1990)).

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50. *Arrow Elecs., Inc. v. Justus (In re Kaypro)*, 218 F.3d 1070 (9th Cir. 2000).

n51

51. *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, 78 F.3d 30 (2d Cir. 1996).

n52

52. *J.P.Fyfe, Inc. of Florida v. Bradco Supply Corp.*, 891 F.2d 66 (3d Cir. 1989).

n53

53. *Jones v. United Sav. & Loan Ass'n (In re U.S.A. Inns)*, 9 F.3d 680 (8th Cir. 1993).

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131 of 197 DOCUMENTS

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Collier on Subordination of Tax Claims

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Collier on Subordination of Tax Claims

By Collier

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SUMMARY: Bankruptcy Code section 724(b) provides a mechanism for subordinating certain tax liens to the payment of certain priority claims. This Emerging Issues Analysis covers the subordination of tax claims under the Bankruptcy Code.

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ARTICLE: Subordination of Tax Claims; 11 U.S.C. § 724(b). Bankruptcy Code section 724(b) provides a mechanism for subordinating certain tax liens to the payment of certain priority claims. It provides that proceeds of property in which the estate has an interest and that are subject to a lien securing an allowed claim for taxes, other than a lien for *ad valorem* taxes, will be distributed in accordance with the priority schedule contained in section 724(b). The priority schedule is complicated and is discussed in detail below. n1 Section 724 applies only in chapter 7. There are no comparable provisions in chapter 11, 12 or 13. n2 The impact of sections 724(e) and 724(f) should not be overlooked. Section 724(e) limits subordination under section 724(b) to circumstances where the trustee has exhausted the unencumbered assets of the estate and obtained any recovery to which the trustee is entitled under section 506(c). Section 724(f) provides a limited exception to the exclusion of *ad valorem* taxes from the scope of section 724(b). n3

Section 724(b) Applies to All Types of Property. Section 724(b) applies to all types of property in which the estate has an interest. n4 Unlike Section 67c(3), its predecessor under the Bankruptcy Act, which applied only to personal property, section 724(b) applies to real property as well. It applies to all property in which the estate has an interest, regardless of whether possession of the property is in the hands of the trustee or in the hands of the lienholder.

Exclusion of Lien for Ad Valorem Taxes. Prior to 2005, section 724(b) extended to property securing any tax lien that was otherwise unavoidable. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 created an exception for *ad valorem* taxes on real or personal property. The exception is tempered by the provisions of section 724(f), also enacted by the 2005 Act, that provide for the subordination of *ad valorem* taxes to two categories of priority claims. The first are claims for wages, salaries and commissions that are entitled to priority under section 507(a)(4). The

second are claims for contributions to employee benefit plans entitled to priority under section 507(a)(5). n5

The Liens to Which Section 724(b) Applies. Section 724(b) refers to a lien that is not avoidable under this title and that secures an allowed claim for a tax. The most common type of lien falling within the scope of section 724(b) is a lien for real property taxes, and prepetition real property taxes have often been subordinated under section 724(b). n6 Under the amendment to section 724(b) made by the 2005 Act, however, real property taxes are excluded from the scope of section 724(b) unless the provisions of section 724(f) come into effect. One case, decided before the 2005 Act went into effect, held that section 724(b) applies to liens for real property taxes attaching after commencement of the case. n7

In *Barstow v. United States (In Re Markair, Inc.)*, 308 F.3d 1057 (9th Cir. 2002), n8 the Court of Appeals for the Ninth Circuit held that section 724(b) did not apply to a judicial lien held by the Internal Revenue Service, even though the obligation secured by the lien was a tax obligation. The court held that the language of section 724(b) was ambiguous, reviewed section 101(36) defining judicial lien and considered the legislative history and the public policy intended to be effectuated by section 724(b). The court concluded that section 724(b) should not be held applicable to a judicial lien for taxes obtained as part of a settlement in the prior chapter 11 case despite the fact that the underlying debt was an obligation for taxes.

Section 724(b) will not apply if the lien securing the claim for taxes is avoidable under any section of the Bankruptcy Code. If the lien can be avoided under another section of the Code, then the avoided lien would be preserved for the benefit of the estate and the preserved item would not be subject to section 724(b).

One case has held that section 724(b) does not limit the ability of the United States government to offset a tax refund owing to a debtor against a debtors tax obligation owing to the United States. n9 The decision reversed a bankruptcy court ruling to the effect that the right to set off a tax lien should be treated as a lien subject to the effect of section 724(b).

Challenge to Constitutionality of Section 724(b). State taxing authorities have sought to have section 724(b) declared unconstitutional as being a violation of the Tenth Amendment. These states have argued that the statute interferes with a states ability to fulfill its governmental responsibilities. All such challenges have proven unsuccessful. n10

Distribution of Proceeds under Section 724(b). Section 724(b) provides that proceeds received from property subject to a lien securing an allowed claim for taxes are to be distributed in the following order:

First, to the holder of an allowed claim secured by a lien on the property that is senior to the tax lien and that is not itself avoidable under any section of the Bankruptcy Code--section 724(b)(1); n11

Second, to the holders of unsecured priority claims that are senior in priority to the section 507(a)(8) priority for unsecured tax claims (i.e., domestic support obligations, administrative, gap, wage, employee benefit, grain and consumer deposit claims entitled to priority under section 507(a)(1) through 507(a)(7)), but only up to the amount of the tax lien claim and excluding administrative expenses, other than wage claims, incurred in a superseded chapter 11 case--section 724(b)(2); n12

Third, to the holder of the tax lien claim, to the extent that the amount of the tax lien claim exceeds any amount distributed pursuant to the previous paragraph--section 724(b)(3);

Fourth, to the holders of liens on the property that are junior to the lien securing the tax lien claim and that are not avoidable under any section of the Bankruptcy Code--section 724(b)(4);

Fifth, to the holder of the tax lien claim, to the extent the tax lien claim has not been paid under the third paragraph above--section 724(b)(5);

Sixth, to the estate--section 724(b)(6). n13

Exclusion of Chapter 11 Administrative Expenses. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended paragraph (2) of section 724(b) to exclude certain claims from the scope of a distribution under section 724(b). The exclusion was accomplished by excepting out administrative expenses incurred during the predecessor chapter 11 case other than claims for wages, salaries or commissions. The exclusion language was unfortunately included in the wrong place in section 724(b)(2). This language was intended to modify the portion of section 507 that grants priority to bankruptcy administrative expenses. That section was formerly numbered as section 507(a)(1) but was renumbered as section 507(a)(2) by the 2005 Act. When this additional exclusion was added to section 724(b), the renumbering was overlooked and the exclusionary language was inserted behind the reference to section 507(a)(1) rather than section 507(a)(2). Nevertheless, it was clearly intended to modify section 507(a)(2) and should be read as such.

The exclusion extends to all administrative expenses in the predecessor chapter 11 case with one exception. The exception is for wages, salaries and commissions arising after the filing of the initial petition and before conversion to chapter 7. The reference to wages, salaries and commissions is not qualified by any time or dollar limitations and so any wages, salaries or commissions arising during the predecessor chapter 11 case will be within the scope of the exception. This stands in contrast to the priority accorded wages, salaries and commissions under section 507(a)(4), which has both a dollar limit (\$10,000 per individual) and a time limit (180 days). n14

Example of Order of Priorities for Distribution. The formula described above is best understood by using an example. Assume that the estate owns a piece of property that has been sold for a price yielding \$50,000 in net proceeds. The property is not subject to an exemption. The property is encumbered by a first priority tax lien in the amount of \$14,000 and a second lien for a mortgage in the amount of \$35,000. The aggregate priority claims under section 507(a)(1) through section 507(a)(7) are \$13,000 and do not include any unpaid administrative expenses from a superseded chapter 11 case.

Distribution of the \$50,000 in proceeds would be made as follows: First, \$13,000 would be allocated to the trustee on account of priority claims because the trustee steps into the shoes of the holder of the first tax lien claim under section 724(b)(2). Second, \$1,000, the remaining portion of the tax lien claim, would be allocated to the holder of the tax lien under section 724(b)(3). Third, \$35,000 would be allocated to the holder of the second lien mortgage under section 724(b)(4). Fourth, \$1,000 would be allocated to the holder of the first tax lien under section 724(b)(5) representing the amount that was subordinated to the trustee.

Holder of Tax Lien Essentially Given Junior Lien on Property. As the above example illustrates, the holder of the tax lien is essentially given a junior lien on the property to secure the amount to which it was otherwise entitled but which was paid to the trustee.

The extent of this junior lien is limited by the extent of the sales proceeds. n15 If the sales proceeds are exhausted without payment of the tax lien claim, then the remaining balance of such claim remains unsatisfied and is a general claim against the estate with whatever priority it may be entitled to under other sections of the Bankruptcy Code. In most instances, the claim will be entitled to priority under section 507(a)(8) and paid ahead of general unsecured claims. n16

Section 724(b) Does Not Affect Liens Junior or Senior to Tax Lien. Another significant aspect of section 724(b) is that it has no effect whatsoever on liens that are junior or senior to a tax lien. The effect of section 724(b) is to adjust distributions as between the holder of the tax lien and the trustee without affecting other lienholders. n17

It should also be noted that section 724(b) only benefits claims entitled to priority under sections 507(a)(1) through 507(a)(7). Tax claims entitled to priority under section 507 (a)(8) are not entitled to the benefit of section 724(b) nor are any priority claims that are junior in priority to such claims.

Section 724(b) Should Be Invoked Only When It Would Benefit the Estate. Section 724(b) should be invoked only when doing so will have some benefit to the estate. If the administrative costs of sale exceed the value to the estate of the displaced tax lien, sale by the trustee should not be permitted. n18 For instance, if a tax lien attaching to overencumbered property is in the amount of \$2,500, and the aggregate of the trustee's fee and the real estate commission for such sale would exceed \$2,500, then the sale should not be permitted and section 724(b) should not be invoked. Neither the occurrence of the sale nor the invocation section 724(b) would provide any benefit to the estate.

When Section 724(b) Can Be Used to Create Value for an Estate in Overencumbered Property. Section 724(b) can in certain instances, however, create value for an estate in property that is overencumbered and that would, absent section 724(b), be abandoned by the trustee. So long as the amount of the avoided tax lien exceeds the administrative costs of carrying and disposing of the property, the property has value to the estate and the trustee is justified in selling the property and avoiding the tax lien. n19 Section 724(b) has also been held relevant in a preference action against the Internal Revenue Service for having levied on property prior to a bankruptcy case. n20 One case used section 724(b) as justification for a trustee to recover from a junior lienholder who, after obtaining relief from the automatic stay but prior to foreclosing, used its own funds to pay off senior real estate taxes. n21 A subsequent, and better reasoned, case reached a contrary result. n22 It held that section 724(b) becomes applicable only upon a sale of property. It does not provide the trustee with an independent right to collect tax payments from either the governmental entity or a secured lender.

Cases Converted from Chapter 11. A few interesting issues arise when section 724 is invoked in a case that has been converted from chapter 11. Under section 726(a), claims are to be paid in accordance with the priorities established in section 507. Under section 726(b), a claim entitled to priority under section 507(a)(2) arising after conversion of the case to chapter 7 is entitled to payment ahead of a similarly situated claim arising during the predecessor chapter 11 case. Section 726(b) also provides that any claims entitled to priority are to be paid *pro rata* with other claims having the same priority.

Section 724(b), however, precludes distribution of proceeds received from subordination of a tax lien to chapter 11 administrative expenses other than wages, salaries and commissions. The effect of this exclusion is to alter the priority scheme otherwise established by section 507 and section 726(b). The result is that proceeds of subordination of a tax lien may be used to pay wages, salaries, and commissions incurred during chapter 11, but not other chapter 11 administrative expenses of equal priority, and to pay section 507(a)(3) to 507(a)(7) priority claims, but not chapter 11 administrative expenses with a higher priority. While this outcome is inconsistent with the sections 507 and 726(b), it seems mandated by the language of section 724. Similarly, section 724(b) would have the effect of undoing any superpriority administrative claim created in the chapter 11 case with respect to proceeds of the subordination of a tax lien.

Distribution Among Multiple Claims; 11 U.S.C. § 724(c). Section 724(c) provides that if more than one holder of a claim is entitled to distribution under a particular paragraph of section 724(b), then distributions to the holders of such

claims will be made in the same order as distribution would be made other than under section 724. ⁿ²³ For example, if there are three senior liens that have priority over a tax lien claim subject to section 724(b), then the proceeds of sale of the underlying property will be disbursed to those three holders in accordance with the priorities existing under applicable law. Similarly, if there are multiple junior liens, the junior lienholders will share in proceeds in accordance with priorities existing under applicable law. Those priorities will generally be established by applicable nonbankruptcy law.

The operation of section 724(c) can become confusing where there are multiple tax liens encumbering the same parcel of property. Section 724(c) refers to claims entitled to distribution under the various paragraphs of section 724(b). Yet the language of each paragraph of section 724(b) refers only to a single tax lien. If there are multiple tax liens, applying section 724(b) literally could lead to results that are inconsistent with the intent of section 724(b). It is thus necessary to invoke the principle behind section 724(c) to ensure that senior tax liens will receive payment ahead of junior tax liens, but that the junior tax liens will receive payment ahead of the estate only to the extent that there are sufficient proceeds from sale of the underlying property.

As with section 724(b), this concept is best illustrated by example. Assume the sale of property of the estate yields \$50,000 in net proceeds. The proceeds are subject to a first priority tax lien of \$4,000. Next in priority is a mortgage for \$25,000 and a tax lien for \$30,000. Assume administrative expenses are \$3,000. The first proceeds of sale are distributed to the holders of certain claims under section 507 pursuant to section 724(b)(2). The next \$1,000 is distributed to the holder of the senior tax lien pursuant to section 724(b)(3). The next \$25,000 is distributed to the holder of the mortgage pursuant to section 724(b)(4). Under section 724(b)(4), the remaining proceeds would next be distributed to the holders of junior liens that are not avoidable under the Code. The \$30,000 junior lien, if not avoidable, would thus ostensibly be entitled to receive the remaining proceeds. ⁿ²⁴

Yet this result seems inconsistent with section 724(c), which directs that distributions to holders of claims with a similar level of priority be made in the order of priority applicable other than under section 724. A more equitable outcome is to treat both tax liens as being subject to the provisions of section 724(b) and then to allocate distributions to both claims in the priority governing those claims outside of section 724. The result in the above example would be to skip application of section 724(b)(4) and distribute proceeds to both tax lien claims under section 724(b)(5). The senior tax lien would receive the next \$3,000, and the holder of the junior tax lien would receive the balance of the proceeds.

Treatment of Certain Statutory Liens; 11 U.S.C. § 724(d). Section 724(d) provides that a statutory lien the priority of which is determined in the same manner as the priority of a tax lien under *section 6323 of the Internal Revenue Code* shall be treated in the same manner under section 724(b) as a tax lien. Section 724(d) does not apply to tax liens since section 724(b) already covers tax liens. ⁿ²⁵ Section 724(d) is intended only to apply to non-tax statutory liens that have a priority determined in the same manner as the priority of tax liens under *Internal Revenue Code section 6323*.

Priority under *I.R.C. Section 6323* Varies Depending on Nature of Property and Competing Third-Party Claim. *Internal Revenue Code section 6323* establishes, among other things, the priority of federal tax liens vis-a-vis other liens and third-party interests affecting property subject to a tax lien. The section is detailed and complex and differs from priority provisions typically found in statutory schemes. The manner" of establishing priority under *section 6323 of the Internal Revenue Code* varies considerably depending on the nature of the property involved and the nature of the competing third party claim. It is unlikely that the priority of other liens are established in the same manner as those under section 6323 unless those liens specifically refer to section 6323. The only possible types of liens determining priority in a similar manner are state tax lien statutes that are based on section 6323.

The legislative history gives a single example of a type of lien that is determined in the same manner as a tax lien. ⁿ²⁶ Section 1368(c)(1) of ERISA expressly provides that the priority of the lien established by that section shall be

determined in the same manner as under Sec. 6323 of Title 26. n27 Section 1368(c)(2) provides that in a bankruptcy case, the lien under subsection (c)(1) is to be treated in the same manner as a tax owed to the United States.

When Section 724(b) May Be Invoked; 11 U.S.C. § 724(e). Before the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, there was conflicting case law concerning when section 724(b) could be invoked. Some cases held that section 724(b) should be invoked whenever it was available to the trustee. n28 Other cases held that section 724(b) should be invoked only if there was no other source available to pay priority claims. n29

The 2005 Act resolved this conflict, adding subsection (e), which follows the latter line of case. n30 Section 724(e) provides that a tax lien may not be subordinated under section 724(b) unless the trustee has first exhausted the unencumbered assets of the estate and has recovered any funds available to the trustee under section 506(c). Section 506(c) allows a trustee to surcharge a secured creditors collateral for certain costs of preserving or disposing of such collateral.

The result of section 724(e) is that a subordination under section 724(b) will be a last source of payment for the trustee. An action under section 724(b) should not be maintained by a trustee until such time as the trustee has determined that there is no other source for payment of priority claims encompassed by section 724(b)(2).

Subordination of Ad Valorem Tax Liens; 11 U.S.C. § 724(f). The subordination provided in section 724(b) is not generally applicable to *ad valorem* tax liens. Section 724(f) contains an exception to this general prohibition. n31 It allows the subordination in section 724 to be invoked to pay two kinds of priority claims. The first are claims for wages, salaries and commissions that are entitled to priority under section 507(a)(4). The second are claims for contributions to employee benefit plans under section 507(a)(5).

In a case where there are sufficient assets to pay all administrative expense claims but not to pay all section 507(a)(4) and 507(a)(5) claims, the impact of section 724(f) is straightforward. Section 724 can be used to subordinate a lien for *ad valorem* taxes and the proceeds used to pay these two categories of priority claims. But in a case where there are not sufficient assets to pay administrative expense claims, section 724(f) has the effect of altering the priorities otherwise established by section 507. The proceeds obtained from the subordination of the *ad valorem* tax lien would be used to pay claims with a lower priority than senior claims not being paid in full.

The provisions of section 724(f) are expressly made subject to the limitations in section 724(e). The trustee must first exhaust all other sources of payment of priority claims under sections 507(a)(4) and (5) before seeking to subordinate an *ad valorem* tax lien under section 724(f).

For further discussion of Code section 724, see Collier on Bankruptcy, ch. 724.

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Return to Text

n1 1. See Collier on Bankruptcy, 724.03[3].

n2

2. See *In re By-Rite Oil Co.*, 87 B.R. 905 (Bankr. E.D. Mich. 1988) (principles established under section 724(b) have no applicability in chapter 11 case); *In re Roamer Linen Supply, Inc.*, 9 C.B.C.2d 218, 30 B.R. 932 (Bankr. S.D.N.Y. 1983) (section 724(b) does not apply in a chapter 11 case, even if the chapter 11 is being used as a liquidation vehicle).

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3. Subsections (e) and (f) were added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 701 (2005), effective in cases commenced on or after October 17, 2005.

n4

4. In *Reitmeyer v. Pa. Dept. of Revenue (In re Pompeo)*, 195 B.R. 43 (Bankr. W.D. Pa. 1996) (*en banc*), the court noted that section 724(b) would extend to a lien on the debtors liquor license.

n5

5. Pub. L. No. 109-8, § 701 (2005), effective in cases commenced on or after October 17, 2005.

n6

6. *Hargrave v. Township of Pemberton (In re Tabone, Inc.)*, 32 C.B.C.2d 1239, 175 B.R. 855 (Bankr. D.N.J. 1994); *Kocurek v. Arnold (In re Thurman)*, 163 B.R. 95 (Bankr. W.D. Tex. 1994); *Richardson v. First Fed. Sav. & Loan Assn (In re Stroud Wholesale, Inc.)*, 37 B.R. 735 (Bankr. E.D.N.C. 1984), *revd on other grounds*, 47 B.R. 999 (E.D.N.C. 1985); *Perpetual American Bank, FSB v. District of Columbia (In re Carlisle Court, Inc.)*, 10 C.B.C.2d 77, 36 B.R. 209 (Bankr. D.D.C. 1983).

n7

7. See *Wasden v. Savannah (In re Owens)*, 208 B.R. 750 (Bankr. S.D. Ga. 1996) (noting that section 724(b) does not distinguish between liens created before or after the petition date).

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8. 308 F.3d 1057 (9th Cir. 2002).

n9

9. *United States v. Morgan (In re Morgan)*, 196 B.R. 758 (E.D. Ky. 1996).

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10. *Wurst v. City of New York (In re Packard Properties, Ltd.)*, 22 C.B.C.2d 1476, 112 B.R. 154 (Bankr. N.D. Tex. 1990); *Flatau v. Jackson (In re Cropper Co., Inc.)*, 63 B.R. 874 (Bankr. M.D. Ga. 1986); *Forell v. Kent Cnty. Treas. and City of Grand Rapids Treas. (In re Kamstra)*, 13 C.B.C.2d 266, 51 B.R. 826 (Bankr. W.D. Mich. 1985); *Richardson v. First Fed. Sav. & Loan Ass'n (In re Stroud Wholesale, Inc.)*, 37 B.R. 735 (Bankr. E.D.N.C. 1984), *rev'd on other grounds*, 47 B.R. 999 (E.D.N.C. 1985); *see also Flatau v. Jackson (In re Hirsch-Franklin Enters.)*, 15 C.B.C.2d 672, 63 B.R. 864 (Bankr. M.D. Ga. 1986) (upholding the subordination under section 726 upon a similar constitutional challenge).

n11

11. Determining whether liens are senior or junior under section 724(b) is to be done with reference to applicable nonbankruptcy law. *Pearlstein v. U.S. Small Bus. Admin.*, 719 F.2d 1169, 9 C.B.C.2d 1134 (D.C. Cir. 1983); *In re Soltan*, 234 B.R. 260 (Bankr. E.D.N.Y. 1999); *Richardson v. First Fed. Sav. & Loan Ass'n (In re Stroud Wholesale, Inc.)*, 37 B.R. 735 (Bankr. E.D.N.C. 1984), *rev'd on other grounds*, 47 B.R. 999 (E.D.N.C. 1985); *cf. Bavely v. United States (In re Terwilliger's Catering Plus, Inc.)*, 911 F.2d 1168, 23 C.B.C.2d 694 (6th Cir. 1990), *cert. denied*, 501 U.S. 1212, 111 S. Ct. 2815, 115 L. Ed. 2d 987 (1991) (whether purported lien attached to property is a matter to be determined by applicable nonbankruptcy law and section 724 has no effect on that determination); *Flatau v. Jackson (In re Cropper Co., Inc.)*, 63 B.R. 874 (Bankr. M.D. Ga. 1986) (incorrectly stating that section 724(b) overcomes state law priority determination, although reaching correct result).

n12

12. *See In re Grand Slam U.S.A., Inc.*, 33 C.B.C.2d 834, 178 B.R. 460 (E.D. Mich. 1995) (section 724(b)(2) is a legal proceeding within the meaning of section 363(f)(5)); *In re LMS Holding Co.*, 197 B.R. 915 (Bankr. N.D. Okla. 1996) (invoking section 724(b) where only beneficiaries are banks that held superpriority claim due to failure of adequate protection).

n13

13. The enactment of section 724(e) by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 basically renders clause (6) of section 724(b) a nullity. Pub. L. No. 109-8, § 701 (2005), effective in cases filed on or after October 17, 2005. If there are excess funds after application of proceeds to obligations covered by the first five clauses of section 724(b), section 724(e) would prohibit the trustee from invoking section 724(b) because the trustee would have another source to pay the priority claims that would have been paid under paragraph (2) of section 724(b).

n14

14. These dollar and time limits were increased from \$4,925 and 90 days by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1401 (2005), effective in cases commenced on or after April 20, 2005).

n15

15. *In re Atlas Commercial Floors, Inc.*, 125 B.R. 185 (Bankr. E.D. Mich. 1991) (directing payment to displaced tax lien claimant of funds available from sale of property after payment to priority claims of amount equal to amount of tax lien).

n16

16. *Milligan v. Davis (In re Milligan)*, 252 B.R. 465 (Bankr. E.D. Mo. 2000).

n17

17. *Marc Stuart Goldberg, P.C. v. City of New York (In re Navis Realty, Inc.)*, 193 B.R. 998 (Bankr. E.D.N.Y. 1996); see also *In re Spearman*, 124 B.R. 620 (Bankr. E.D.N.Y. 1991) (section 724(b) is not intended to affect senior liens and thus debtor could not invoke section 724(b) as basis for avoiding senior judicial lien allegedly impairing debtor's homestead exemption).

n18

18. *Oakland County Treas. v. Allard (In re Kerton Indus.)*, 151 B.R. 101 (E.D. Mich. 1991).

n19

19. See *Morgan v. K.C. Machine & Tool Co. (In re K.C. Machine & Tool Co.)*, 816 F.2d 238, 16 C.B.C.2d

702 (6th Cir. 1987) (the subordination provided for section 724(b) can make otherwise overencumbered property of value to the estate, thus rendering abandonment under section 554 inappropriate); *In re Riker Indus., Inc.*, 122 B.R. 964 (Bankr. N.D. Ohio 1990) (same); *In re Quality Health Care*, 215 B.R. 543 (Bankr. N.D. Ind. 1997) (existence of section 724(b) justified the order requiring turnover of property to the trustee).

n20

20. In *Daniel v. United States (In re R & T Roofing Structures & Commercial Framing, Inc.)*, 11 C.B.C.2d 397, 42 B.R. 908 (Bankr. D. Nev. 1984), the plaintiff used section 724(b) to demonstrate the IRS got more in a liquidation than it would have under chapter 7 because by operation of section 724(b), the proceeds of sale of the asset would be used to pay administrative claims rather than the secured claim of the IRS. *Air Florida Sys., Inc. v. United States (In re Air Florida Sys., Inc.)*, 12 C.B.C.2d 1438, 50 B.R. 653 (Bankr. S.D. Fla. 1985), reached the same conclusion.

n21

21. *Tatge v. American Sec. Bank (In re Forrest Marbury House Assoc. Ltd. P'ship)*, 26 C.B.C.2d 1270, 137 B.R. 554 (Bankr. D.D.C. 1992). The holding in *Tatge* is questionable.

n22

22. *Wasden v. Savannah (In re Owens)*, 208 B.R. 750 (Bankr. S.D. Ga. 1996).

n23

23. See *United States v. Darnell (In re Darnell)*, 834 F.2d 1263, 17 C.B.C.2d 1106 (6th Cir. 1987) (federal and state tax liens both subordinated to payment of administrative expenses; on basis of section 724(c), reversing bankruptcy court determination that funds available for distribution should be split pro rata rather than first to the more senior of the two liens); *Pearlstein v. U.S. Small Bus. Admin.*, 719 F.2d 1169, 9 C.B.C.2d 1134 (D.C. Cir. 1983) (section 724(c) not intended to affect priorities established under applicable nonbankruptcy law; applying District of Columbia law to determine that sales tax lien had priority over Small Business Administration security interest).

n24

24. *In re Soltan*, 234 B.R. 260 (Bankr. E.D.N.Y. 1999) (such a formula was applied in a matter involving multiple tax liens).

n25

25. See *United States v. Rhodney (In re R & W Enterprises)*, 181 B.R. 624 (Bankr. N.D. Fla. 1994) (rejecting argument of trustee that section 724(d) can be invoked to require state real property tax liens to be recorded in the same manner as liens under *Internal Revenue Code* §6323).

n26

26. The example can be found at H.R. Rep. 95-595 at 382 and S. Rep. 95-989 at 96.

n27

27. 29 U.S.C. § 1368(c)(1).

n28

28. *In re Southeast Railroad Contractors, Inc.*, 235 B.R. 619 (Bankr. E.D. Tenn. 1996); *In re Packard Properties, Ltd.*, 22 C.B.C.2d 1476, 112 B.R. 154 (Bankr. N.D. Tex. 1990).

n29

29. *In re Soltan*, 234 B.R. 260 (Bankr. E.D.N.Y. 1999); *In re Howard Furniture, Inc.*, 222 B.R. 795 (Bankr. N.D. Miss. 1998); *In re Dowco Petroleum, Inc.*, 137 B.R. 207 (Bankr. E.D. Tex. 1992); *In re Granite Lumber*, 63 B.R. 466 (Bankr. D. Mont. 1986); see also *In re Sherrill*, 17 C.B.C.2d 1033, 78 B.R. 804 (Bankr. W.D. Tex. 1987) (where trustee paid proceeds of sale to secured creditor that could have been retained by the trustee under section 724(b), the trustee cannot thereafter seek recovery for the trustee's expenses from the secured creditor under section 506(c)).

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30. Pub. L. No. 109-8, § 701 (2005), effective in cases commenced on or after October 17, 2005.

n31

31. Subsection (f) was added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 701 (2005), effective in cases commenced on or after October 17, 2005.

ABOUT THE AUTHOR(S):

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132 of 197 DOCUMENTS

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Collier on Contracts That Are Not Assumable under Section 365

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Collier on Contracts That Are Not Assumable under Section 365

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SUMMARY: This Emerging Issues Analysis covers the types of contracts that are not assumable under section 365, including topics such as personal service contracts, assumption by the debtor in possession, agreement by the other party to an otherwise nonassignable contract to accept the trustee's performance, and contracts to make loans or issue securities.

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ARTICLE: When an executory contract is based upon the provision of personal services or skills, or upon personal trust or confidence, or otherwise requires the debtor's performance rather than any substitute performance, the trustee has traditionally been unable to assume or assign the rights of the debtor in such contract. n1 Under the Bankruptcy Act, there was the additional question of whether such contracts would be property of the estate. n2 It seems clear that such contracts become property of the estate under section 541 of the Code. However, the trustee may not be able to assume or assign such contracts.

Two questions are of particular importance with respect to this topic: (1) whether a contract involves personal skill, trust or confidence, or is otherwise a type of contract for which substitute performance may not be permitted; n3 and (2) whether a debtor in possession can assume a contract that would not be assumable by a trustee.

Section 365(c)(1)(A) of the Bankruptcy Code precludes the assumption or assignment of an executory contract or lease if applicable nonbankruptcy law would excuse the other party from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, n4 whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties. Thus, if a contract is of a type that could not be assigned under applicable law, it may not be assumed or assigned by the trustee. The applicable law prohibition must be explicit, for example, by making clear that the identity of the contracting party is crucial. n5

Nonassignment Clause Ineffective

If a contract or lease is nonassignable solely because it contains a nonassignment clause, section 365(c) does not

prevent the assumption or assignment of the contract or lease. Instead, section 365(c) is directed to contracts that, regardless of their provisions with respect to assignment or performance, would be nonassignable under applicable nonbankruptcy law.

Personal Service Contracts

Under the common law, the duties under a contract to perform personal services could not be assigned. If a party contracted for the services of a particular person, and that person's services were unique and could not equally be performed by another, the contract could not be assigned.

Section 365(c) gives recognition to the common law restriction and provides that the trustee may not assume or assign such a contract, regardless of whether the contract contains a nonassignment clause. In this regard, section 365(c) recognizes that the trustee is not the party who originally undertook the duties under the contract and that applicable nonbankruptcy law would not accept substitute performance by the trustee.

It should be noted that a clause in the contract or lease attesting to a personal relationship will not, by itself, excuse the nondebtor party from accepting performance from the trustee. n6 Instead, section 365(c) is intended to distinguish those contracts that, generically under applicable nonbankruptcy law, would be of a type for which the nondebtor party would be entitled to insist on the debtor's performance. n7

Other Nonassignable Contracts

Section 365(c) covers considerably more contracts than those that would normally be considered personal service contracts. Several appellate decisions have found that the reference to applicable law in section 365(c) includes situations in which state or federal law can be said to bar assignment. n8 For example, in *In re West Electronics, Inc.*, n9 the court held that a government contract could not be assumed by the trustee because a federal statute barred the assignment of such contracts without the permission of the government, and in *In re CFLC, Inc.* n10 the court held patent licenses nonassignable under federal common law. In *In re Nedwick Steel Co., Inc.*, n11 the court ruled that U.C.C. section 2-210(2), which prohibits assignment where the assignment would increase materially the burden or risk imposed on him by his contract, prohibited assignment under section 365(c)(1)(A) of an exclusive distributorship agreement from the debtor to a competitor of the manufacturer. The Court of Appeals for the Fifth Circuit has held that a partnership agreement that is nonassignable under state law because of the personal relationship among the partners is not assignable under section 365(c)(1)(A). n12

Assumption by Debtor in Possession

A debtor in possession has the rights, and is subject to the limitations, of a trustee. n13 Section 365(c) provides that the trustee [which includes a debtor in possession] may not assume or assign any executory contract or unexpired lease of the debtor, if applicable law excuses a party, other than the debtor, from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession. Read strictly, section 365(c) would bar not only a third-party trustee, but the debtor in possession itself, from assuming such an executory contract or lease. Under such a strict reading of this provision, if a party would be excused from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, then the trustee, including a debtor in possession, may not assume the contract or lease even if the debtor, as debtor in possession, would be performing under the contract or lease.

This was the approach taken by the court in *In re West Electronics, Inc.* n14 In that case, the court barred the debtor in possession from assuming a nonassignable government contract even though the debtor in possession did not wish to assign the contract, but intended to perform the contract itself.

This approach is troubling, as it may prevent a debtor in possession from being able to reorganize under circumstances that do not adversely affect the other party to the contract. n15 The other party contracted for the debtor's performance and the debtor (in its capacity as debtor in possession) proposes to perform the contract after assumption. Of course, the other party is now dealing with a debtor who is in bankruptcy, but this is the same problem faced by other contracting parties. Section 365(e) prevents a party to a contract from terminating the contract merely because the debtor has commenced a bankruptcy case, and section 365(c) should not be interpreted to provide a means around that provision or its underlying policy. Only the Court of Appeals for the First Circuit has reached this conclusion. n16

What the Nonassumption Rule Was Intended to Accomplish. The nonassumption rule of section 365(c) was intended to relieve the nondebtor party to the contract from having to deal with a party other than the debtor in situations in which, under nonbankruptcy law, the nondebtor party would be relieved of any obligation to continue such dealings. The thought was that the nondebtor party contracted for the personal attention of the debtor or for a relationship with the debtor, not a third-party trustee.

Notion of Debtor and Debtor in Possession as Being the Same Entity. To the extent that the contract is dependent on the personal service or attention of the debtor, a debtor in possession, which is typically managed by the same individuals who managed the debtor, is, as a practical matter, the same entity. Similarly, although the debtor in possession may be viewed technically as a different legal entity from the debtor, the primary effect of the bankruptcy filing is to cause a change in ownership of the debtor rather than a change of structure. Thus, from the point of view of the nondebtor party, it is dealing with the same entity whether it is a debtor or a debtor in possession.

In fact, if all of the stock of the debtor in *West Electronics* had been purchased by a third party, which then took control of the debtor, the government should not have been able to terminate the contract based on an assignment, because the contract itself would not have been assigned. n17 A chapter 11 filing effects such a change of ownership; however, the debtor in possession continues the business of the debtor. Thus, there is little reason to bar the debtor in possession from assuming the contract.

The history of section 365(c) suggests that the provision may have been intended to permit a debtor in possession, as opposed to a third-party trustee, to assume executory contracts even when the contracts are nonassignable. As enacted in the Bankruptcy Reform Act of 1978, the provision barred assumption of an executory contract or lease if applicable law relieved the nondebtor party from accepting performance from or rendering performance to the trustee or an assignee of such contract or lease. In 1984, the provision was amended to replace the reference to the trustee with reference to an entity other than the debtor or the debtor in possession. n18 Apparently through an oversight, the reference to assignee of such contract or lease was retained, although it was difficult to make sense of the final product. Thus, after the 1984 amendment, the provision barred assumption if applicable law excused a party from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession or an assignee of such contract or lease. In 1986, the oversight was corrected by deleting the reference to an assignee of such contract or lease. n19 The provision now bars assumption when applicable law would relieve the other party from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession.

As originally enacted, section 365(c) clearly barred assumption by any type of trustee, presumably including a debtor in possession, if applicable law barred any assignment of the contract. The 1984 amendment, which refers to an entity other than the debtor or the debtor in possession, seems to envision that the debtor in possession could stand in the shoes of the debtor and render or receive performance, but that any other entity, including a bankruptcy trustee, could not do so. Although a literal reading of the amended version may bar assumption by a debtor in possession, there seems to be little reason for the amendment unless there was an intention to permit a debtor in possession to assume otherwise nonassignable contracts.

Further support for treating the debtor in possession as essentially the same entity as the debtor and, therefore, as capable of assuming the otherwise nonassignable contract, can be found in *NLRB v. Bildisco & Bildisco*.ⁿ²⁰ In that case, the Supreme Court determined that a chapter 11 debtor may reject a collective bargaining agreement as an executory contract. In doing so, the Court rejected arguments over whether the debtor in possession is a successor employer or the alter ego of the debtor for purposes of applying the labor laws. It observed that if the debtor in possession were a new entity, it would be unnecessary to provide for the rejection of executory contracts, since a new entity would not be bound by the old entity's contracts. Thus, the Court stated: For our purposes, it is sensible to view the debtor-in-possession as the same entity which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have done absent the bankruptcy filing.ⁿ²¹

Similarly, for purposes of determining whether a debtor in possession may assume contracts that would not be assignable under nonbankruptcy law, the debtor in possession may be treated as the same entity as the debtor, entitled to assume the contract.ⁿ²² Only if the debtor in possession sought to assign the contract would the nonbankruptcy limits apply.

One court has taken a similar approach by noting that section 365(c) applies to a trustee, not a debtor in possession.ⁿ²³ Although a debtor in possession is subject to the same limitations and restrictions on a trustee,ⁿ²⁴ a debtor in possession is not the equivalent of a trustee. Because a trustee is an entity other than the debtor in possession, section 365(c)(1) must be read differently when a debtor in possession moves to assume (although not to assign) a contract or lease. Otherwise, the limitation would effectively (and nonsensically) read a debtor in possession may not assign a contract if the counterparty is excused from accepting performance from an entity other than the debtor in possession.

Problems Present When Debtor in Possession Cannot Assume Otherwise Nonassignable Contracts. As a matter of policy, a refusal to permit debtors in possession to assume otherwise nonassignable contracts would present problems for debtors whenever the debtor's business is one in which major contracts are nonassignable under nonbankruptcy law. Such debtors will not, as a practical matter, be able to avail themselves of the benefits of chapter 11 because they will not be able to perform their prebankruptcy contracts without permission from the nondebtor parties to the contracts.

For example, in *In re Pioneer Ford Sales*,ⁿ²⁵ the debtor held a Ford Motor Company franchise that, under relevant nonbankruptcy law, was nonassignable without Ford's permission. The court properly rejected the debtor's attempt to assign the franchise, finding that subsections (c) and (f) of section 365 barred the assignment. Although the court was not faced with the question of whether the debtor in possession could continue to operate the dealership, under the reasoning of cases such as *West Electronics*, the debtor in possession could not retain the franchise, and a chapter 11 reorganization would be impossible. While it is understandable that Congress would bar assignments of contracts or leases that are nonassignable under applicable nonbankruptcy law, there appears to be no reason why a debtor should be prevented from continuing its business and reorganizing simply because it cannot assign its franchise to a third party.ⁿ²⁶ Nevertheless, other courts of appeals have followed the *West Electronics* approach.ⁿ²⁷

Of course, there must be some concern that the debtor in possession, perhaps a less financially sound entity, would be unable to perform under the contract and that, therefore, the nondebtor party should be able to terminate the contract. This concern, however, is addressed by the rules in section 365 that require the debtor in possession to cure prior defaults and provide adequate assurance of future performance before it can assume the executory contract or lease.ⁿ²⁸ If the debtor in possession is in fact in such severe financial distress that it would not be able to perform the contract, that would be a reason to oppose assumption of the contract. If the debtor in possession can meet the burden of providing assurance, there is little reason to prevent performance.

Agreement by Other Party to Accept Trustee's Performance

The other party to an otherwise nonassignable contract may consent to substituted performance, or the contract may provide such consent. In that case, the lease or contract may be assumed or assigned. n29 However, the Court of Appeals for the Fourth Circuit has ruled that a general consent in the contract or lease to assignment to a successor in interest to substantially all of the debtor's assets is not a consent to assumption because assumption and assignment are distinct concepts, and the consent to assignment was therefore inadequate. n30 It is not clear how the court would have ruled on a proposed assignment, in that an assignment in a bankruptcy case first requires assumption. n31

Termination of Nonassignable Contract

Although section 365(e) bars the termination of a contract based on the commencement of a bankruptcy case, an exception in section 365(e)(2)(A) applies to contracts under which the other party is excused from rendering performance to or accepting performance from the trustee or an assignee of the contract. n32 It appears that such contracts may be terminated upon commencement of a case.

Although a party may be authorized to terminate such a contract, the contract is still property of the estate before termination, and any termination is subject to the automatic stay of section 362. n33 Thus, the other party to the contract must obtain relief from the stay before exercising its right to terminate the contract. This requirement enables the court to determine, prior to any such termination, whether the contract is in fact a contract that would be nonassumable under section 365(c). n34

Contracts to Make Loans or Issue Securities

A contract to extend credit is usually said to be personal in nature n35 and hence not subject to assumption or assignment. Nevertheless, section 365(c) contains a specific prohibition against assumption or assignment of a contract to make a loan or extend other debt financing or financial accommodations, n36 to or for the benefit of the debtor, or to issue a security of the debtor. The prohibition is without regard to whether or not applicable law would otherwise excuse the other party from performance and will therefore apply equally to debtors in possession and trustees.

The scope of paragraph (2) is limited, however, and applies only to extensions of credit that are loans, debt financing or financial accommodations, n37 and not to all contracts to extend credit. n38 These terms are strictly construed and do not extend to an ordinary contract to provide goods or services that has incidental financial accommodations or extensions of credit. n39 Situations that do not fit within paragraph (2) must be decided under paragraph (1) with appropriate reference to applicable nonbankruptcy law. The apparent intent was to permit a trustee to assume certain contracts involving extensions of credit, such as contracts to furnish equipment. n40 Paragraph (2) also does not affect postpetition financing; thus, the trustee in a converted case, for example, may enforce a credit originally extended to the debtor in possession. n41 However, the trustee may not enforce a prepetition contract with the debtor to make a loan even if the nondebtor party to the contract consents. n42 To do so would run afoul of the carefully crafted procedures and restrictions on obtaining postpetition credit found in section 364.

For a complete discussion of Code section 365, see Collier on Bankruptcy, ch. 365 (Matthew Bender).

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n1 See *In re Miller*, 101 F.2d 323 (6th Cir. 1939); *Villar & Co., Inc. v. Conde*, 30 F.2d 588 (1st Cir. 1929); see also *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 31 C.B.C.2d 1104 (11th Cir. 1994).

n2 See 4A Collier on Bankruptcy, 70.22[3] (Matthew Bender 14th ed. 1978).

n3 See *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 31 C.B.C.2d 1104 (11th Cir. 1994).

n4 The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353 (1984), amended section 365(c)(1)(A) by deleting the words the trustee and substituting the following: an entity other than the debtor or debtor in possession. Before the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554 (1986), an assignee was listed alternatively to the debtor and debtor in possession, but this legislation deleted such reference.

n5 *In re ANC Rental Corp., Inc.*, 277 B.R. 226 (Bankr. D. Del. 2002); see *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 537 (11th Cir. 1994).

n6 See, e.g., *Headquarters Dodge, Inc. v. Leonard*, 13 F.3d 674, 684 (3d Cir. 1994); *Reiser v. Dayton Country Club Co. (In re Magness)*, 972 F.2d 689, 27 C.B.C.2d 862 (6th Cir. 1992); *Citizens & Southern Nat'l Bank v. Thomas B. Hamilton Co. (In re Thomas B. Hamilton Co.)*, 969 F.2d 1013, 27 C.B.C.2d 964 (11th Cir. 1992) (credit-card merchant agreement may be assumed); *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 10 C.B.C.2d 524 (1st Cir. 1984).

n7 *Headquarters Dodge, Inc. v. Leonard*, 13 F.3d 674, 684 (3d Cir. 1994) ([w]hether a contract is personal in nature depends upon the nature of the subject of the contract, the circumstances of the case and the intent of the parties').

n8 *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 41 C.B.C.2d 858 (9th Cir. 1999); *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673 (9th Cir. 1996) (federal patent policy warrants finding that federal law governs assignability of patent licenses; federal common law precludes such assignments); *Reiser v. Dayton Country Club Co. (In re Magness)*, 972 F.2d 689, 27 C.B.C.2d 862 (6th Cir. 1992) (country club membership may not be assigned under applicable law).

n9 852 F.2d 79 (3d Cir. 1988). *Contra In re Mirant Corp.*, 303 B.R. 319 (Bankr. N.D. Tex. 2003).

n10 89 F.3d 673 (9th Cir. 1996); accord *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 41 C.B.C.2d 858 (9th Cir. 1999).

n11 289 B.R. 95 (Bankr. N.D. Ill. 2003).

n12 *Stumpf v. McGee (In re O'Connor)*, 258 F.3d 392 (5th Cir. 2001).

n13 11 U.S.C. § 1104.

n14 852 F.2d 79 (3d Cir. 1988); accord *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004); *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 41 C.B.C.2d 858 (9th Cir. 1999); *City of Jamestown v. James Cable Partners (In re James Cable Partners)*, 27 F.3d 534, 537 (11th Cir. 1994); *In re West Electronics, Inc.*, 852 F.2d 79 (3d Cir. 1988).

n15 See *In re Cardinal Indus., Inc.*, 116 B.R. 964 (Bankr. S.D. Ohio 1990).

n16 *Summit Inv. & Dev. Corp. v. Leroux (In re Leroux)*, 69 F.3d 608, 34 C.B.C.2d 1351 (1st Cir. 1995).

n17 *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 37 C.B.C.2d 588 (1st Cir. 1997). Of course, if the contract contained a change of control provision, that provision might prevent assumption of the contract by the new owners. Change of control is not, however, explicitly barred by 41 U.S.C. § 15.

n18 Pub. L. No. 98-353, § 362(a) (1984).

n19 Pub. L. No. 99-554, § 283(e)(1); see *In re Hartec Enters., Inc.*, 117 B.R. 865, 870-71 (Bankr. W.D. Tex. 1990).

n20 465 U.S. 513, 527-28, 104 S. Ct. 1188, 1197, 79 L. Ed. 2d 482, 496-97, 9 C.B.C.2d 1219, 1229 (1984).

n21 465 U.S. 513, 527-28, 104 S. Ct. 1188, 1197, 79 L. Ed. 2d 482, 496-97, 9 C.B.C.2d 1219, 1229.

n22 See, e.g., *Texaco, Inc. v. Louisiana Land & Exploration Co.*, 136 B.R. 658 (M.D. La. 1992).

n23 *In re Footstar, Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005).

n24 11 U.S.C. § 1107(a).

n25 729 F.2d 27, 10 C.B.C.2d 524 (1st Cir. 1984); see also *Ford Motor Co. v. Claremont Acquisition Corp.* (*In re Claremont Acquisition Corp.*), 186 B.R. 977 (C.D. Cal. 1995).

n26 *In re Ontario Locomotive & Indus. Ry. Supplies (U.S.) Inc.*, 126 B.R. 146 (Bankr. W.D.N.Y. 1991) (United States moved for relief from stay to terminate government contract with debtor. Court found that debtor in possession was the same entity that filed chapter 11 petition, thus not precluding assumption on that ground, and not providing grounds for relief from the stay).

n27 *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004); *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 41 C.B.C.2d 858 (9th Cir. 1999); see *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 537 (11th Cir. 1994) (characterizing section 365(c)(1)(A) as posing a hypothetical question).

n28 11 U.S.C. § 365(b).

n29 11 U.S.C. § 365(c)(1)(B); *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004); *Metropolitan Airports Comm'n v. Northwest Airlines, Inc. (In re Midway Airlines, Inc.)*, 6 F.3d 492, 29 C.B.C.2d 914 (7th Cir. 1993).

n30 *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004).

n31 11 U.S.C. § 365(f)(2); see *Collier on Bankruptcy*, 365.08 (Matthew Bender).

n32 But see *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 612, 34 C.B.C.2d 1351 (1st Cir. 1995) (although hypothetical approach to construction of nonassignability provisions of § 365(e)(2)(A) and 365(c)(1)(A) is not *precluded* by the literal statutory language, it is at least as plausible to construe these provisions as requiring an *actual* showing--prior to any termination of the debtor's postpetition contract rights--that the nondebtor party would not be forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted) (emphasis in original).

n33 See, e.g., *TransAmerica Commercial Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.)*, 945 F.2d 1089 (9th Cir. 1991) (flooring agreement is the equivalent of a financial accommodation); *Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.)*, 824 F.2d 725, 17 C.B.C.2d 556 (9th Cir. 1987). But see *Watts v. Pennsylvania Hous. Fin. Co.*, 876 F.2d 1090, 1095, 21 C.B.C.2d 521, 527-28 (3d Cir. 1989) (the automatic stay is inapplicable to a commitment to provide financing because such a contract is nonassumable in the first instance).

n34 See, e.g., *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 34 C.B.C.2d 1351 (1st Cir. 1995).

n35 *Texas & N.O.R. Co. v. Phillips*, 196 F.2d 692 (5th Cir. 1952).

n36 See *Citizens & Southern Nat'l Bank v. Thomas B. Hamilton Co. (In re Thomas B. Hamilton Co.)*, 969 F.2d 1013, 27 C.B.C.2d 964 (11th Cir. 1992).

n37 *Chase Manhattan Bank v. Iridium Africa Corp.*, 197 F. Supp. 2d 120 (D. Del. 2002) (Support Agreement that required equity contributions to the debtor was a contract to issue a security of the debtor).

n38 *In re New Town Mall*, 5 C.B.C.2d 1530, 17 B.R. 326 (Bankr. D.S.D. 1982).

n39 124 Cong. Rec. H11,093 (daily ed. Sept. 28, 1978); see also *In re United Airlines, Inc.* 368 F.3d 720 (7th Cir. 2004) (credit card processing agreement); *American Flint Glass Workers Union v. Anchor Resolution Corp.* (*In re Anchor Resolution Corp.*), 197 F.3d 76 (3d Cir. 1999) (debtor's contract to purchase a business in exchange for its own stock is not a contract to issue a security of the debtor).

n40 On September 28, 1978, Congressman Edwards remarked that, Section 365(c)(2) does not apply to the contract to deliver equipment ." 124 Cong. Rec. H11,093 (Sept. 28, 1978).

n41 See *Tully Constr. Co. v. Cannonsburg Envtl. Assocs., Ltd.*, 72 F.3d 1260, 1265-66 (6th Cir. 1996) (collecting authorities). Likewise, such contracts are not subject to rejection. *Id.*

n42 *TransAmerica Commercial Fin. Corp. v. Citibank, N.A.* (*In re Sun Runner Marine, Inc.*), 945 F.2d 1089 (9th Cir. 1991).

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133 of 197 DOCUMENTS

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Collier on Disclosures Required of Debt Relief Agencies

2008 Emerging Issues 1340

Collier on Disclosures Required of Debt Relief Agencies

By Collier

December 5, 2007

SUMMARY: Section 527 of the Bankruptcy Code is new with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Section 527 imposes several duties on debt relief agencies that provide bankruptcy assistance to assisted persons. This Emerging Issues Analysis covers the disclosures required of debt relief agencies under the Code.

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ARTICLE: Overview of Code Section 527

Section 527 of the Bankruptcy Code is new with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act). n1 The stated intent of Congress in enacting section 527 and related provisions was to strengthen professionalism standards for attorneys and others who assist consumer debtors with their bankruptcy cases. n2 Section 527 imposes several duties on debt relief agencies that provide bankruptcy assistance to assisted persons. First, the section requires a debt relief agency to provide the written notice required under *section 342(b)(1) of the Bankruptcy Code*. n3 Second, section 527 dictates that a debt relief agency give a written notice advising the assisted person of certain filing and disclosure requirements under the Bankruptcy Code. Third, the section requires a debt relief agency to provide a statement that contains certain information about bankruptcy assistance services from an attorney or bankruptcy petition preparer. n4 Fourth, section 527 mandates that a debt relief agency, to the extent permitted by nonbankruptcy law, supply reasonably sufficient information on how to provide all of the information the assisted person is required to provide pursuant to *section 521 of the Bankruptcy Code*. Finally, the section specifies that a debt relief agency must maintain a copy of the notices required under section 527(a) for two years after the date on which the notice is given to the assisted person.

Assisted Person Defined. An assisted person is defined in the Bankruptcy Code by section 101 as any person whose debts consist primarily of consumer debts and the value of whose non-exempt property is less than \$164,250. n5

Bankruptcy Assistance Defined. The term bankruptcy assistance is defined in the Bankruptcy Code by section

101 as any goods or services sold or otherwise provided to an assisted person with the express or implied purpose of providing information, advice, counsel, document preparation, or filing, or attendance at a creditors' meeting or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding under this title. n6

Debt Relief Agency Defined. The term debt relief agency is defined in the Bankruptcy Code by section 101 as any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer under section 110. n7 Section 101 specifically excludes several persons and entities from the definition of debt relief agency. n8

Duty of a Debt Relief Agency to Provide Required Disclosures; § 527(a)

Debt Relief Agency Must Provide to the Assisted Person the Written Notice Required under Section 342(b)(1). Section 527(a)(1) requires a debt relief agency that provides bankruptcy assistance to assisted persons to give the written notice required under *section 342(b)(1) of the Bankruptcy Code*. n9 Section 342(b)(1) dictates that the bankruptcy clerk, before the commencement of a bankruptcy case, give an individual consumer debtor a written notice that describes the types of bankruptcy relief available to consumer debtors. The written notice under section 342(b)(1) must also detail the types of services available from consumer credit counseling agencies.

Section 527(a)(1) contains two interpretive ambiguities that need clarification. First, the section requires that the debt relief agency give the written notice required under section 342(b)(1). However, section 342(b)(1) requires the clerk of the bankruptcy court to give such notice in cases involving individual consumer debtors. Therefore, it is unclear whether the debt relief agency has an independent duty to provide the notice in cases involving individual consumer debtors. If the debt relief agency has such a duty, then section 527(a)(1) is duplicative, at least in those cases. Second, a related problem is the section's exclusive cross-reference to section 342(b)(1). It is unclear why section 527(a)(1) does not also cross-reference section 342(b)(2) since section 342(b)(2) contains additional information that is of relevance to all debtors in bankruptcy cases. n10

Debt Relief Agency Must Provide Written Notice Advising the Assisted Person of Certain Filing and Disclosure Requirements. Section 527(a)(2) mandates that, to the extent not covered in the written notice described in section 527(a)(1), a debt relief agency provide written notice advising the assisted person of certain filing and disclosure requirements. This notice must be supplied not later than three business days after the first date on which a debt relief agency first offers to provide any bankruptcy assistance services to an assisted person. This notice must also be clear and conspicuous.

All Required Information Filed with a Petition and Thereafter During a Bankruptcy Case Must Be Complete, Accurate and Truthful. Section 527(a)(2)(A) requires that the written notice described in section 527(a)(2) advise an assisted person that all required information that the assisted person is mandated to provide with a petition and thereafter during a case under the Bankruptcy Code must be complete, accurate and truthful.

All Assets and Liabilities Must Be Completely and Accurately Disclosed and the Replacement Value Must Be Stated in Documents Commencing a Case Where Requested. Section 527(a)(2)(B) requires that the written notice described in section 527(a)(2) advise an assisted person that all assets and liabilities must be completely and accurately disclosed in the documents filed to commence a bankruptcy case. The section also specifies that the notice advise the assisted person that the replacement value of each asset pursuant to *section 506 of the Bankruptcy Code* must be stated in those documents where requested after reasonable inquiry to establish such value.

The requirement that the notice advise the assisted person that the replacement value must be stated *where requested in the documents filed to commence a case* is unlikely to have much, if any, practical impact. The reason is that the petition is the document filed to commence a bankruptcy case and the petition does not request the replacement value. Neither do bankruptcy schedules request that the debtor list the replacement value of assets. ⁿ¹¹ Hence, it is unclear how the assisted person would be under an obligation to provide replacement value in the documents filed to commence a case.

Moreover, the reference to the replacement value of each asset pursuant to *section 506 of the Bankruptcy Code* in the same phrase is problematic and misleading because section 506 defines replacement value only for personal property acquired for personal, family or household use. ⁿ¹² Section 506 does not define replacement value for all assets in bankruptcy. Indeed, the precise meaning of replacement value for other types of assets may vary depending on several factors, including the relevant Code chapter, the type of collateral and applicable case law.

Current Monthly Income, the Amounts Specified in Section 707(b)(2) and Disposable Income in a Chapter 13 Case Must Be Stated. Section 527(a)(2)(C) requires that the written notice described in section 527(a)(2) advise an assisted person that current monthly income, the amounts specified in *section 707(b)(2) of the Bankruptcy Code* and disposable income in a chapter 13 case determined in accordance with section 707(b)(2) must be stated after reasonable inquiry. Section 707(b)(2) specifies the amounts relevant to the presumption of abuse under the means-testing provisions of the 2005 Act. ⁿ¹³

What constitutes a reasonable inquiry under subsections 527(a)(2)(B) and (C) is unclear. Since Section 527(a)(2)(C) merely requires the debt relief agency to *notify* the assisted person of certain enumerated duties (and not to perform those duties itself), the lack of a precise definition is not of immediate concern. However, an understanding of the meaning of the term reasonable inquiry will likely influence the nature of the informal advice or assistance that debt relief agencies give to assisted persons regarding how to comply with applicable duties under the Code. The term could arguably refer to the reasonable inquiry requirement of *Federal Rule of Bankruptcy Procedure 9011* and an argument could be advanced that the term should be interpreted in a manner consistent with that Rule.

Information Provided by an Assisted Person During Their Case May Be Audited, and Failure to Provide Such Information May Result in Dismissal or Other Sanctions. Section 527(a)(2)(D) requires that the written notice described in section 527(a)(2) advise an assisted person that information provided by an assisted person during their case may be audited and that failure to provide such information can result in dismissal or other sanctions, including criminal sanctions.

Presumably, the first phrase of section 527(a)(2)(D) (information that the assisted person provides during their case may be audited pursuant to this title) was added to reflect section 603 of the 2005 Act. ⁿ¹⁴ Section 603 establishes a duty on the part of the Attorney General and the Judicial Conference of the United States to promulgate procedures for conducting audits of petitions, schedules and other information filed by debtors pursuant to *sections 111, 521 and 1322 of the Bankruptcy Code*. ⁿ¹⁵ The audits are to be conducted in accordance with generally accepted auditing standards; however, the section affords gives the Attorney General and the Judicial Conference two years from the date of enactment of the 2005 Act to develop alternative auditing standards. The stated purpose of the audits is to determine the accuracy, veracity, and completeness of petitions, schedules and other information filed by debtors. ⁿ¹⁶

Duty of a Debt Relief Agency to Provide Required Statement; § 527(b)

Formalities of Statement. Section 527(b) dictates that a debt relief agency give to the assisted person a statement that contains certain information about bankruptcy assistance services from an attorney or bankruptcy petition preparer.

The statement must be provided at the same time as the notices required under section 527(a)(1). The section also specifies that the statement be clear and conspicuous and that it be in a single document separate from other documents or notices provided to the assisted person.

Section 527(b) is ambiguous and could prove unworkable in many cases. Although the section provides that the statement must be given at the same time as the notices required under section 527(a)(1), section 527(a)(1) itself does not contain a time requirement. Instead, section 527(a)(1) references section 342(b)(1), which requires a bankruptcy clerk to give an individual consumer debtor notice of certain matters before the commencement of the case. Presumably, that is the time referred to in section 527(b), though it is not entirely clear. Moreover, a consumer creditor (who qualifies as an assisted person under section 101(3)) will typically not consult an attorney (who qualifies as a debt relief agency under section 101(12)(A)) until after the commencement of the case. Logically, an attorney for such a creditor cannot be expected to comply with section 527(b).

Substance of Statement. The statement referred to in section 527(b), to the extent applicable, must contain the specific information listed in the section or must be substantially similar. The information relates generally to representation of an assisted person by an attorney or bankruptcy petition preparer, including the need for a written contract between the respective parties. The information also covers selected aspects of the bankruptcy process and it advises an assisted person about the types of services that person might need in a bankruptcy case. n17

The content of the information required by section 527(b) may be incorrect as applied to an individual debtor's bankruptcy case. For example, although the section requires that the statement say, You will have to pay a filing fee to the bankruptcy court, the fee requirement will not apply to a debtor who is able to secure a fee waiver.

The content of the information required by section 527(b) might also be misleading. Section 527(b) contains a statement which reads as follows: The following information helps you understand what must be done in a routine bankruptcy case to help you evaluate how much service you need. The information referred to in the statement is exceedingly sparse and is not likely to provide a typical debtor with the requisite data and analysis necessary to determine the degree and extent of professional services that might be necessary in even a routine bankruptcy case. Indeed, section 527(b) might have the unintended consequence of encouraging consumer debtors to utilize the services of petition preparers who engage in the unauthorized practice of law because the section requires that the statement indicate that such petition preparers can help debtors seek bankruptcy relief.

It is also unclear what constitutes a statement that is substantially similar. Of course, some debt relief agencies will adopt the statement verbatim, despite its problems. Over time, however, it is also likely that some debt relief agencies will modify the content of the required statement, thereby creating many different variations. Courts will probably have to police the boundaries of what constitutes a substantially similar statement in order to ensure compliance with the spirit of section 527(b).

Duty of a Debt Relief Agency to Provide Reasonably Sufficient Information on How to Provide Information Required under Section 521; § 527(c)

Section 527(c) obligates a debt relief agency to supply, to the extent permitted by nonbankruptcy law, reasonably sufficient information to an assisted person on how to provide all of the information the assisted person is required to provide pursuant to *section 521 of the Bankruptcy Code*. n18 Section 521 dictates the general duties of a debtor under the Bankruptcy Code. The agency is excused from this requirement to the extent that the debt relief agency provides the required information itself after reasonably diligent inquiry of the assisted person or others so as to obtain the information in a reasonably accurate fashion for the purpose of including the information on the petition, schedules or statement of financial affairs. The information must be provided at the time required for notice under section 527(a)(1). The information must also be given in a clear and conspicuous writing.

Section 527(c) may be a legal nullity. Under the terms of the section, a debt relief agency is excused from

compliance if it provides the information itself after reasonably diligent inquiry of the assisted person. n19 This means that attorneys and many other entities covered by the definition of debt relief agency would be exempt because they routinely provide the relevant information themselves after inquiry for the purpose of completing required documents in a bankruptcy case. Additionally, the section expressly provides that a debt relief agency may give such information only to the extent permitted by nonbankruptcy law. Nonbankruptcy law restricts the ability of petition preparers, for example, to give legal advice, and the information required by section 527(c) plainly constitutes legal advice, much of which is exceedingly complex. For these reasons, it is unclear whether section 527(c) is applicable to any legal actor that the section appears designed to regulate.

Section 527(c) also contains several ambiguities. First, it is unclear what the required time for notice is under section 527(a)(1) because that section does not itself contain a time requirement. Section 527(a)(1) merely refers to a time listed in section 342(b)(1). n20 Additionally, several terms are extremely vague, including, reasonably sufficient information, reasonably diligent inquiry and reasonably accurately. This will invite litigation and will necessitate judicial clarification. Finally, although the section mandates that the information be provided in a clear and conspicuous fashion, it will likely be very difficult, if not impossible, to present some of the information clearly because much of the information required under section 521 consists of complex legal information that is not easily simplified. Given these ambiguities and uncertainties, it is fair to ask whether section 527(b) will result in meaningful protection for consumer debtors.

How to Value Assets at Replacement Value and Determine Current Monthly Income and the Amounts Specified in Section 707(b)(2); How to Determine Disposable Income in a Chapter 13 Case under Section 707(b)(2).

Section 527(c)(1) requires that the information described in section 527(c) include information on how to value assets at replacement value and how to determine currently monthly income. The section also mandates that the debt relief agency provide information on how to determine the amounts specified in *section 702(b)(2) of the Bankruptcy Code*. n21 Section 707(b)(2) proscribes standards for means-testing of consumer debtors under the Code. Finally, section 527(c)(1) specifies that the information described in section 527(c) must include information on how to determine disposable income pursuant to section 702(b)(2) of the Code and related calculations.

How to Complete the List of Creditors and Determine the Amount Owed and the Creditor's Address. Section 527(c)(2) dictates that the information described in section 527(c) include information on how to complete the list of creditors. The information must also include information on how to determine what amount is owed and what address for the creditor should be shown.

Compliance with the latter phrase of section 527(c)(2) (and what address for the creditor should be shown) will likely be more difficult in light of another provision that is new with the enactment of the 2005 Act. Section 342 has now been amended to impose more stringent notice requirements on debtors and provide creditors with increased legal protection in the event that such notice is ineffective, as defined by amended section 342. n22

How to Determine What Property Is Exempt and Value Exempt Property at Replacement Value under Section 506. Section 527(c)(2) requires that the information described in section 527(c) include information on how to determine what property is exempt and how to value exempt property at replacement value under *section 506 of the Bankruptcy Code*. n23

Section 527(c)(2) contains an erroneous legal assertion. The section wrongly states that the valuation of exempt property is governed by section 506 of the Code. In fact, the valuation of exempt property is governed by section 522(a)(2) of the Code and governing law. n24

Duty of a Debt Relief Agency to Maintain a Copy of Notices Required under Section 527(a); § 527(d)

Section 527(d) requires a debt relief agency to maintain a copy of the notices required pursuant to section 527(a) for two years after the date on which the notice is given to the assisted person.

This section is ambiguous because section 527(a) refers to two different notice requirements and section 527(d) fails to make clear which notice is relevant for purposes of triggering the application of the two-year time period in section 527(d). Section 527(a)(1) does not itself contain a time period, but it instead refers to the written notice required under section 342(b)(1). As indicated earlier, section 527(a)(1) raises several difficult issues with respect to timing and applicability. n25 Section 527(a)(2) provides that to the extent not covered in the section 527(a)(1) notice, the debt relief agency must provide written notice of certain matters not later than three (3) days after the first date on which a debt relief agency first offers to provide bankruptcy services to an assisted person. Since section 527(a) makes reference to two different notice mandates, it is unclear which notice starts the running of the two-year time period on section 527(d). An argument could be advanced that the deadline in section 527(a)(2) is preferable because it is relatively easier to calculate.

For a complete discussion of Code section 527, see Collier on Bankruptcy, ch. 527 (Matthew Bender).

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Return to Text

n1 1. Pub. L. No. 109-8, § 228(a) (2005), effective in cases commenced on or after October 17, 2005.

n2

2. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005).

n3

3. 11 U.S.C. § 342(b)(1).

n4

4. 11 U.S.C. § 110.

n5

5. 11 U.S.C. § 101(3), added by Pub. L. No. 109-8, § 226(a)(1) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 101.03 (Matthew Bender). For cases commenced before April 1, 2007, the dollar amount is \$150,000. For adjustment of the dollar amount, *see 11 U.S.C. § 104(b)*; *Collier on Bankruptcy*, 104.03 (Matthew Bender).

n6

6. 11 U.S.C. § 101(4A), added by Pub. L. No. 109-8, § 226(a)(2) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 101.04A (Matthew Bender).

n7

7. 11 U.S.C. § 101(12A), added by Pub. L. No. 109-8, § 226(a)(3) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 101.12A (Matthew Bender).

n8

8. 11 U.S. C. § 101(12)(A) excludes officers, directors, employees or agents of a person who provides assistance or of a bankruptcy petition preparer, certain non-profit organizations, creditors of assisted persons to the extent they are assisting in debt restructuring, specified depository institutions, and an author, publisher, distributor, or seller of works subject to copyright protection. *See Collier on Bankruptcy*, 101.12A (Matthew Bender). For analysis of the definitions and exclusions contained in sections 526, 527 and 528, *see also Collier on Bankruptcy*, 526.01 (Matthew Bender).

n9

9. 11 U.S.C. § 342(b)(1).

n10

10. Section 342(b)(2) provides that the bankruptcy clerk should give to an individual consumer debtor a written notice containing a statement that a person who knowingly and fraudulent conceals assets or makes a false statement under the Bankruptcy Code shall be subject to penalty and that all information supplied by the debtor is subject to examination by the Attorney General. 11 U.S.C. § 342(b)(2).

n11

11. The replacement value of certain assets might be requested in form chapter 13 plans in some bankruptcy districts.

n12

12. *11 U.S.C. § 506(a)(2)*.

n13

13. Pub. L. No. 109-8, § 102 (2005), effective in cases commenced on or after October 17, 2005.

n14

14. Pub. L. No. 109-8, § 603 (2005).

n15

15. *Id.*

n16

16. *Id.*

n17

17. *11 U.S.C. § 527(b)*.

n18

18. *11 U.S.C. § 521*.

n19

19. 11 U.S.C. § 527(c).

n20

20. See Formalities of Statement *supra*.

n21

21. 11 U.S.C. § 707(b)(2).

n22

22. 11 U.S.C. § 342(c), (e)(g); see Collier on Bankruptcy, ch. 342 (Matthew Bender).

n23

23. 11 U.S.C. § 506.

n24

24. 11 U.S.C. § 522(a)(2).

n25

25. See Debt Relief Agency Must Provide to the Assisted Person the Written Notice Required under Section 342(b)(1) and Formalities of Statement *supra*.

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134 of 197 DOCUMENTS

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Collier on the Proper Valuation Standard for Determining Secured Status

2008 Emerging Issues 1343

Collier on the Proper Valuation Standard for Determining Secured Status

By Collier

December 5, 2007

SUMMARY: This Emerging Issues Analysis covers the proper valuation standard for purposes of determining secured status, including topics such as the concept of equivalent value, the value of property disposed of by sale, the Supreme Courts decision in *Associates Commercial Corp. v. Rash*, and the value of property retained or used by the debtor or trustee.

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ARTICLE: Once the court has identified the creditor's interest in the estate's interest in the relevant collateral, the court must then determine the relevant valuation standard to be applied in valuing the creditor's interest. In general, the courts agree that the relevant standard is one of fair market value. By itself, however, this reveals relatively little. In virtually every case, the determination of fair market value will depend on the particular market and means selected to gauge the value of the item in question. n1

It is possible, of course, to sell many items of property through many different markets and means, including private sales, auctions, wholesale transactions, swaps, repurchase agreements, and retail transactions. In this respect, a flea market is no less a market than a stock exchange. Yet the price realized for a particular item may vary tremendously depending on the market in which it is sold, as well as the means through which it is offered for sale. The question becomes: which market and means establish the most appropriate benchmarks for bankruptcy purposes? As section 506(a) instructs, the answer depends in the first instance on (i) the purpose of the valuation, and (ii) the proposed disposition of the collateral. n2 By themselves, however, these directives leave a number of important questions unanswered. If the relevant property securing a claim is personal property in an individual case under chapter 7 or 13, however, section 506(a)(2) of the *Bankruptcy Code*, added in 2005, n3 is more specific, directing that the value of the property shall be determined using the replacement cost method. In addition, section 506(a)(2) directs that value shall be determined without deduction for costs of sale or marketing. Further, section 506(a)(2) prescribes that, if the property was acquired for personal, family or household purposes, replacement cost means the price that a retail merchant would charge for property of that kind taking into account its age and condition at the time the valuation is performed.

Associates Commercial Corp. v. Rash

As to more precise general methodology, the Supreme Court's decision in *Associates Commercial Corp. v. Rash* n4 is instructive, if not definitive. In *Rash*, the debtors proposed a chapter 13 plan in which they sought to retain possession and use of a truck encumbered by a lien in favor of a secured creditor. The dispute centered on the value of the creditor's interest in the truck, which value would then be used to fix the amount of the creditor's secured claim. This was important because, pursuant to section 1325(a)(5), the debtors were required to pay the secured creditor payments under their plan equal to at least the present value of the amount of the creditor's secured claim. Thus, establishing the amount of the secured claim would determine how much the debtors had to pay the secured creditor in order to confirm their plan and keep the vehicle. n5

The debtors argued in favor of the lower foreclosure value standard (e.g., the amount the secured creditor would realize if it repossessed the truck and sold it at public auction), and proposed to make payments of a present value equal to this amount. In contrast, the creditor argued for the higher replacement value approach, namely what it would cost the debtor to replace the vehicle in the open market, thereby providing the secured creditor with a higher total recovery.

Viewing the matter functionally, the Supreme Court concluded that the *purpose* of the valuation was to determine how much the debtors had to pay the secured creditor in order to confirm their plan in accordance with 11 U.S.C. § 1325(a)(5). Similarly, the Court found that the proposed *disposition* was the debtors' continued retention and use of the truck in order to generate an income stream. The court of appeals (en banc) had previously sided with the debtor, concluding that the appropriate standard was foreclosure value. The Supreme Court disagreed: Of prime significance, the replacement-value standard accurately gauges the debtor's use of the property. It values the creditor's interest in the collateral in light of the proposed [repayment plan] reality: no foreclosure sale and economic benefit for the debtor derived from the collateral equal to its [replacement] value. The debtor in this case elected to use the collateral to generate an income stream. That actual use, rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property's disposition or use.' n6

The import of *Rash* is thus relatively clear: for purposes of determining the amount that must be paid to a secured creditor in the cramdown context, the question of value under section 506(a) turns on the value of the debtor's proposed use of the relevant property under the plan, not the value achievable in a foreclosure scenario that is not proposed, even though the reorganization may ultimately fail and the creditor may foreclose on its collateral as a result. n7 On the other hand, as suggested above, *Rash* does not purport to resolve every valuation question under section 506(a).

Similarly, although the Court adopted a replacement-value standard to address the issues presented in the case, it did not specify the particulars: Our recognition that the replacement-value standard, not the foreclosure-value standard, governs in cram down cases leaves to the bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented. Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property. n8

Thus, apart from identifying the purpose of the valuation and the proposed disposition or use, the Court's guidance is largely limited to the direction that, in the chapter 13 cramdown context, the trial court must focus on (i) the type of debtor in question, and (ii) the nature of the relevant property. Presumably, the import of this direction is that the trial court should focus on the price that the particular debtor would pay for the same collateral in a market available to that debtor. n9 At the same time, other than eliminating the foreclosure benchmark, the Court did not speak to the issue of the precise market or means to be utilized, such as whether the replacement value approach is to be determined by what the debtor would have to pay for the truck if the debtor were to purchase a like vehicle at retail from a dealer, or whether the standard may be set by what the debtor might have to pay for the truck if the debtor were to purchase a replacement from a seller advertising in a trade publication.

Moreover, the Court said little about how valuations are to be conducted in contexts other than the one presented in *Rash*. This leaves open the question of what standard should be employed in situations such as (i) adequate protection

requests, (ii) motions for relief from stay, (iii) valuation of collateral for purposes of redemption, (iv) the best interest of creditors test of section 1129(a)(7) and (v) the determination of whether, in the event of plan failure, a plan provides sufficient safeguards to the holder of a secured claim under the fair and equitable test of section 1129(b).

In amending section 506(a) in 2005, n10 Congress confirmed certain aspects of the Court's decision in *Rash*, and supplied additional rules governing the valuation process with respect to personal property in individual chapter 7 and 13 cases. First, if the property securing a claim is personal property in an individual case under chapter 7 or 13, section 506(a)(2), added in 2005, directs that the valuation shall be conducted using the replacement cost method. Second, section 506(a)(2) directs that value shall be determined without deduction for costs of sale or marketing, but leaves open the possibility that the value of other items may be deducted, such as those identified by the Court in *Rash* (warranties and other items that the debtor does not receive). Third, section 506(a)(2) prescribes that, if the property was acquired for personal, family or household purposes, replacement cost means the price that a retail merchant would charge for property of that kind taking into account its age and condition at the time the valuation is performed.

***Rash* and the Concept of Equivalent Value.** In considering the potential value of *Rash* in other contexts, it is useful to observe that the Court's analysis is consistent with the Code's general perspective on the treatment of secured claims. As mentioned above, the Code adopts a general equivalent value approach in the sense of requiring the preservation and protection of the value (if not the substance) of the rights bargained for by the secured creditor. Similarly, the Court explained: Tying valuation to the actual disposition or use of the property points away from a foreclosure-value standard when a Chapter 13 debtor, invoking cram down power, retains and uses the property. Under that option, foreclosure is averted by the debtor's choice and over the creditor's objection. From the creditor's perspective as well as the debtor's, surrender and retention are not equivalent acts.

When a debtor surrenders the property, a creditor obtains it immediately, and is free to sell it and reinvest the proceeds. If a debtor keeps the property and continues to use it, the creditor obtains neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use. Adjustments in the interest rate and secured creditor demands for more adequate protection, do not fully offset these risks. n11

Although certain aspects of the Court's above-quoted analysis may embrace some debatable assumptions, the analysis nevertheless underscores the general concern that a creditor receive compensation and protection in exchange for the tangible loss of valuable nonbankruptcy rights, such as the present right to foreclose and liquidate its position. n12 What remains to be seen, however, is how this concern may affect the application of section 506(a) in contexts other than cramdown.

***Rash* and the Larger Context of Section 506(a).** In reflecting on the implications of *Rash* in the larger context of section 506(a)'s role with respect to other provisions of the Code, it is also useful to consider how the valuation decision may further or impede other general bankruptcy policies, such as the policy of maximizing the value of the debtor's bankruptcy estate. One valid reason for the debtor's continued use of an asset in bankruptcy would be if the asset were worth more in the debtor's hands (both to the debtor *and* to the secured creditor, and perhaps to other creditors as well) than if transferred to the secured creditor and liquidated at public sale. Another valid consideration is that the debtor should not necessarily be able to use bankruptcy to, in essence, acquire property at *less* than its market cost, because doing so effectively permits a windfall in the form of a subsidized, below-market acquisition that may have the general effect of encouraging the use of bankruptcy proceedings in violation of the policy of bankruptcy avoidance. The standard articulated in *Rash* may effectively police both of these objectives by requiring the debtor to pay more for the property than the creditor would generally recover if the property were sold at foreclosure. n13 How much more, however, remains something of an open question. In amending section 506(a) in 2005 n14 to add section 506(a)(2), Congress provided certain answers to some of these open questions with respect to property securing a claim that is

personal property in an individual chapter 7 or 13 case. Obviously, however, section 506(a)(2) does not answer all the open questions.

Value of Property Disposed of by Sale

Before addressing the application of section 506(a) in contexts other than the one presented in *Rash*, it is important to point out that, regardless of the purpose of the valuation, if an actual sale (or equivalent disposition) is to occur, the value of the collateral should be based on the consideration to be received by the estate in connection with the sale, provided that the terms of the sale are fair and were arrived at on an arm's-length basis. n15 Inasmuch as the price and related terms of the sale will indicate the value of the property to be disposed of, valuation should not be a substantial issue in the context of an actual sale unless questions arise such as the allocation of the consideration among the debtor and holders of liens in a portion of the property sold. n16

Of course, even in instances in which the trustee or debtor intends ultimately to sell the collateral, it may be necessary to value the property at some point prior to such time for one or more purposes. Obviously, in such a context, the sales price may not be known and, hence, would not be controlling.

Following the addition of section 506(a)(2) to the Code in 2005, n17 the question arises whether the price received in an actual sale of personal property securing a claim in an individual chapter 7 or 13 case will determine the value of the property for purposes of determining the secured creditor's claim in the bankruptcy case. An actual sale may occur if the secured creditor moves for relief from stay to liquidate the collateral and actually does so, the debtor sells the collateral in a chapter 13 case, or the trustee sells the collateral in a chapter 7 case. Under section 506(a)(2), the creditor's secured claim would be limited to the value of the proceeds of the disposition. For example, suppose the secured creditor holds a claim for \$1,000 secured by personal property, and, after obtaining relief from stay, liquidates the collateral for \$500 at public auction. Suppose further that the retail value of the collateral is \$750. The secured creditor would not be entitled to both the \$500 in proceeds from the liquidation *and* a secured claim of \$250 representing the difference between the liquidation value and the retail value on the theory that the retail value of the collateral controls the determination of the creditor's secured claim. The secured creditor can only hold a secured claim with respect to the estate's interest in property securing the claim. Once the collateral is liquidated, the proceeds of the collateral are substituted for the collateral and the value of the proceeds is what determines the value of the creditor's secured claim. If the secured creditor has a deficiency claim under applicable law, this may be asserted as an unsecured claim.

Value of Property Retained or Used by Debtor or Trustee; In General

Once the purpose of the valuation is established, and the proposed use or disposition has been identified correctly, *Rash* directs that the court must then select the appropriate method of valuation that is consistent with these considerations. This is not always an easy task. Some general rules, however, can be distilled from the cases. Although these rules are summarized briefly here, reference should also be made to the ensuing discussions that examine in greater detail the application of the valuation process under section 506(a) in a number of specific contexts.

Even prior to *Rash*, many courts recognized that, if the debtor proposes to retain and use collateral under a plan, the collateral should not necessarily be valued on a forced sale basis for purposes of calculating the amount of the creditor's secured claim. n18 Nor should the estimated costs of an unanticipated sale be deducted as part of the calculation. n19 Of course, adjustments to account for certain items may be required in order to match the hypothetical transaction on which the valuation is based with the precise characteristics of the relevant collateral. n20 In addition, deduction of the costs of a sale may be appropriate in certain contexts in which the relevant standard is properly foreclosure value rather than some type of valuation that assumes continued use and possession by the debtor. n21 If the relevant property

securing a claim is personal property in an individual case under chapter 7 or 13, section 506(a)(2), added in 2005, requires that the valuation must be conducted using the replacement value method without deduction for costs of sale or marketing. No such restriction, however, applies in the chapter 11 context or with respect to real property or with respect to debtors that are not individuals, and the valuation standard will vary depending on the purposes of the valuation.

To illustrate, for purposes of whether the debtor has any equity in the collateral in the context of a motion for relief from stay, if the debtor's prospects for a successful reorganization appear dim or nonexistent, the value of the creditor's collateral may best be determined on the basis of the value that the holder of the secured claim could obtain for the property upon a commercially reasonable foreclosure. n22 In such a context, the costs of a hypothetical foreclosure may be taken into account and deducted from the value of the secured creditor's claim because these costs would be incurred as part of a hypothetical sale. n23

In contrast, if the debtor's prospects for successful reorganization are good, and there is a strong market for property of the relevant type, some courts have found that the appropriate value under the circumstances is the value of the property to the debtor assuming uninterrupted retention and use. n24 The reasoning is that, although a forced sale might constitute a commercially reasonable disposition, n25 the valuation should reflect the fact that the debtor is likely to retain and use the property, and thus enjoy the use value of the property, perhaps as part of the debtor's business operated as a going concern. n26 Nevertheless, in gauging the debtor's use value, the standard remains one of what the collateral would fetch if sold in a relevant market, even assuming, if appropriate, that it may be sold as part of a going concern. n27 Hence, the age, condition and location of the collateral should all be considered, even though the collateral may be well maintained. n28 Taking these factors into account, the value of the subject property might be characterized in general terms as its fair market value. n29

In the usual instance in which a valuation is necessary, but the nature of the debtor's prospects are not clear, such as in the case of a motion for relief from stay brought on early in the case, it may be appropriate for the court to adjust its valuation approach to reflect this uncertainty. For example, for certain types of matters, if the proceeding arises early in the case and the debtor has a reasonable but unproven prospect of reorganizing, it might not be reasonable to value the creditor's collateral exclusively on a forced sale basis. n30 Rather, the court might adjust the value upward to reflect the potential increase in the collateral's worth as a result of its inclusion as part of a successful going concern, particularly if the debtor's assets would be sold by the creditor as a going concern even if the debtor's reorganization attempt fails. At the same time, however, it must be kept in mind that, during the course of the bankruptcy proceedings and prior to actual confirmation of a plan, the debtor's retention and use of collateral is not strictly to permit reorganization, but, rather, is simply to permit an *attempt* at reorganization.

In this regard, it is important to recognize that most reorganizations are not successful. n31 Moreover, in some contexts the purpose of the valuation is either dispositive, or weighs more heavily than the debtor's proposed disposition or use of the collateral. Moreover, in determining questions of value, courts should be careful in rendering early valuations to avoid ascribing ambitious positive worth to projections or estimations concerning the debtor's ability to successfully emerge from the reorganization process. On the other hand, if the debtor's prospects for successful reorganization appear reasonably certain, there is no reason why foreclosure value should necessarily control in every context. n32

Of course, the debtor's prospects should be clear by the time the court is asked to confirm the debtor's plan. At that point, for purposes of establishing the amount of the secured creditor's claim, it will usually be unreasonable to reduce the amount of the claim on the ground that the debtor's prospects remain uncertain at the same time that the court is being asked to determine that the plan is feasible. However, as discussed below, in the context of determining whether the creditor's collateral position is properly maintained under the plan (as distinct from determining the amount of the creditor's secured claim), the court should conduct the valuation from the perspective of the creditor's position if the plan does not succeed and the creditor must foreclose. If, however, the relevant property securing a claim is personal property in an individual case under chapter 7 or 13, section 506(a)(2), added in 2005, requires that the valuation must

be conducted using the replacement value method without deduction for costs of sale or marketing.

Although the foregoing provides a general discussion of some of the more significant aspects of valuation under section 506(a), it is hardly dispositive. Moreover, close examination of the cases reveals a number of significant conflicts and disagreements. Perhaps this is inevitable: above all else, courts have sought to remain sensitive to relevant issues of context. ⁿ³³ Examination of the cases, however, is useful in distilling the conflicting use of hypothetical sale and hypothetical purchase methodologies. Those methodologies can then be examined in light of specific valuation applications in a number of discrete contexts arising under various sections of the Code.

Inconsistent Judicial Application of Valuation Concepts. Judicial application of the general valuation concepts discussed above have not been consistent, even after allowing for differences in applicable circumstances. For example, courts are frequently called upon to value claims secured by liens on automobiles or mobile homes held by financial institutions in situations in which the debtor proposes to retain and use the subject collateral. In these situations, courts have valued the underlying collateral for purposes of redemption, or in setting the allowed amount of a secured claims for plan purposes based upon (i) published wholesale value, ⁿ³⁴ (ii) the average between wholesale and retail value, as reflective of the open market between private parties, ⁿ³⁵ (iii) retail value, ⁿ³⁶ (iv) retail price, less dealer overhead, commissions and profit, ⁿ³⁷ and (v) the bid market price. ⁿ³⁸

This rather substantial difference in view may be explained, in part, by the fact that the courts have often been faced with the task of deciding the value of an item of property in the absence of adequate evidentiary showings regarding customary asset dispositions and attainable values. Thus, courts have sometimes been forced to make assumptions as to expected conduct and pricing which do not, in fact, comport with business or economic reality. Regardless of the cause, however, the existence of a true divergence in the underlying valuation approach should not be ignored or minimized. ⁿ³⁹ If the relevant property securing a claim is personal property in an individual case under chapter 7 or 13, section 506(a)(2), added in 2005, ⁿ⁴⁰ resolves some of differences of opinion by requiring that the valuation must be conducted using the replacement value method without deduction for costs of sale or marketing. In addition, section 506(a)(2) defines replacement value with respect to property acquired for personal, family or household purposes as the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined.

Hypothetical Sale or Purchase Method; Custom-Made Property. Although, courts frequently differ on precise methodology, valuation under section 506(a) will generally proceed along one of two lines: (i) establishing the price that the creditor would receive upon some form of hypothetical sale of the subject property by the secured creditor, ⁿ⁴¹ or, alternatively, (ii) determining the price to be paid by the debtor upon some form of hypothetical purchase of the subject property. ⁿ⁴² Once the court identifies the nature and characteristics of the hypothetical transaction (sale by the creditor or debtor, or purchase by the debtor), the court may more readily analyze the evidence relating to the value of the subject property, and thus arrive at a reasoned prediction of the price obtainable or payable in such a transaction. If the relevant property securing a claim is personal property in an individual case under chapter 7 or 13, section 506(a)(2), added in 2005, ⁿ⁴³ removes the choice between a purchase or sale method by requiring that the valuation must be conducted using the replacement value purchase method and by defining replacement value with respect to property acquired for personal, family or household purposes as the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined. In cases in which section 506(a)(2) does not apply, however, the choice will remain.

In general, the purchase method may often be easier to apply than the sale method. First, the debtor's intended use is often well-defined, which may not be the case in the foreclosure context. Second, the manner in which the debtor would replace the subject property is generally the same as the manner in which the debtor originally acquired the subject property in the first place, whereas, under a sale approach, the manner of disposition is often unrelated to the

manner of acquisition by the debtor. n44 Nevertheless, such is not always the case.

A common problem that has given the courts some difficulty in applying either a sale method or a purchase method arises in the context of custom-made property. If the sale method is selected and there is no potential purchaser, the relevant foreclosure value may be scrap or salvage value, which, if used, would tend to undervalue the collateral. n45 However, if the purchase method is selected, the fact that the property is specialized or custom-made may not be significant, and the inquiry will focus instead on ascertaining the cost of replacement, adjusted to reflect the used condition of the collateral. n46

Disarray of Terms Used to Describe Proper Method; General Standards. As mentioned above, courts agree that the relevant quest under section 506(a) is to determine fair market value. Similarly, courts typically label the kinds of transactions that should be used to demonstrate fair market value as those that are commercially reasonable under the circumstances, n47 meaning those that reveal the market price that would be obtained for the subject property between a willing buyer and a willing seller if the property were disposed of in the most commercially reasonable manner. n48 But in defining more precisely what is meant by fair market value, and in defining the kinds of transactions that are commercially reasonable under the circumstances of particular cases, courts have differed dramatically in the particulars of their approaches. n49 Moreover, just as there are many different ways to determine the value of any particular item of property depending on the market and means selected, there are just as many different terms that can be used to describe the different kinds of valuation procedures that take different markets and means into account. If the relevant property securing a claim is personal property in an individual case under chapter 7 or 13, section 506(a)(2), added in 2005, n50 resolves some of the controversy by directing that the valuation must be conducted using the replacement value method and by defining replacement value with respect to property acquired for personal, family or household purposes as the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined.

For example, in seeking to define fair value in a number of different contexts (whether through the use of a hypothetical sale method or a hypothetical purchase method), courts have made use of such concepts as liquidation value, going concern value, orderly liquidation value, forced sale value, replacement value, best use value" and the like. n51 In addition, depending on how these standards are defined, courts have also recognized that there be numerous ways to establish each of them based on the particular market selected. For example, liquidation value might be established through such means as the published price of an item in a trade journal or newspaper, a collection of recent auction prices, the bid price, or the retail price charged by a dealer less overhead, commissions and profit.

In an effort to lend greater precision to the relevant terminology, some courts have taken specific issue with use of the term liquidation value to mean forced sale value, or to imply that going concern values are not to be realized. n52 These courts correctly point out that any disposition is, in a sense, a liquidation. Moreover, a creditor may realize best use or going concern values upon the liquidation of the collateral. Indeed, if there is a strong market for the subject property, and transactions in this market are generally effected through contractual means without the use of dealers, brokers or other intermediaries who charge commissions or otherwise obtain profits, liquidation value, going concern value, best use value and replacement value may all be the same thing. n53 At other times, however, application of these different standards will yield quite different results.

With respect to clarifying the existing disarray in the terminology, the Supreme Court's decision in *Rash* offers relatively little assistance. As noted above, the Court adopted a replacement value standard to address the issues presented in the case. However, the Court did not define the replacement value standard (except to distinguish it from a foreclosure value standard), leaving open the question of [w]hether [replacement-value] is the equivalent of retail value, wholesale value, or some other value . n54

Instead, what the Court did was to establish the more general method for determining the proper standard by

focusing on the purpose of the valuation and the proposed disposition or use of the relevant property, and a more specific method to be used in the cramdown context for purposes of determining the amount of the secured creditor's claim, namely replacement value. Moreover, the Court clarified that the relevant choice in any given context is between one of (i) a hypothetical purchase standard, meaning the debtor's purchase of like property of the same age or condition using either wholesale, retail or some other value method depending on the circumstances), or (ii) a hypothetical sale standard, meaning the creditor's sale of the collateral through foreclosure, but not some combination of the two. n55 Hence, in searching for fair market value, courts are guided to apply section 506(a) with these principles in mind. In addition, if the relevant property securing a claim is personal property in an individual case under chapter 7 or 13, section 506(a)(2), added in 2005, does provide a definition of replacement value with respect to property acquired for personal, family or household purposes, stating that replacement value with respect to such property means the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined.

Business Practices of Seller. In general, the terms of any hypothetical sale or purchase should reflect the manner in which the seller (whether a third party vendor under a hypothetical purchase approach, or the secured creditor under a hypothetical sale approach) would be expected to dispose of the subject property to a willing buyer. Hence, the attributes of the relevant seller may properly be considered in determining what is the most reasonable disposition of the relevant item by that seller. These include the seller's customary business practices.

For example, assuming that a hypothetical foreclosure sale method is used, the fact that the holder of a claim secured by a lien on an automobile is a financial institution (as opposed to an automobile dealer) may be considered in arriving at the value that the holder could reasonably derive from the collateral upon foreclosure. n56 Other attributes of the holder that may affect the manner in which it would sell the collateral may include the investment of time and money the holder has customarily been willing to devote under comparable circumstances. n57 If, however, the relevant property securing a claim is personal property in an individual case under chapter 7 or 13, section 506(a)(2), added in 2005, n58 directs the use of the replacement value method without deduction for costs of sale or marketing, and with respect to property acquired for personal, family or household purposes, directs that replacement value means the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined. Accordingly, in such contexts, the relevant attributes are those of a retail merchant selling the type of property at issue, at least if such a merchant exists. This would include retail merchants who sell the type of property at issue in any number of markets, including markets such as eBay and Amazon.com.

Effect of Prepetition Repurchase Agreement Price. On the other hand, if the hypothetical sale method is used, consideration of the attributes of the holder of the secured claim should not extend to those arising from the availability to the holder of recourse against third parties with respect to the claim. For example, finance companies and other lenders to buyers of automobiles and other expensive consumer goods often require that the dealer who sold the goods to the debtor must agree to repurchase the goods at a specified price if the buyer defaults and the lender must foreclose. The relevant price is most often designed to prevent the finance company from suffering a loss on repossession, and is thus geared to internal financial considerations rather than extrinsic asset values. Thus, it may exceed the price that could be obtained in an arm's-length transaction, regardless of whether the price is derived through application of a wholesale, retail or other standard.

Following this approach, most courts have disregarded any repurchase agreement price in fixing the amount of a secured claim. n59 At least one court has held, however, that the repurchase agreement must be given effect in order to determine what the holder of the secured claim would obtain upon foreclosure. n60

As between the two approaches, the majority view appears to be correct. Although the value set by the court might not reflect the entirety of the bargained-for position that the secured creditor would have occupied had he been able to foreclose upon the collateral and recover the price under the repurchase agreement, section 506(a) directs that the

bankruptcy court must protect the holder of a secured claim only to the extent of the value of its interest in the estate's interest in the subject property and thereby focuses in this respect on the relationship between the creditor and the debtor, not the creditor and other third parties. The court is not directed to afford protection with respect to the creditor's contractual rights against third parties, even though the existence of those rights might have the effect of increasing the value of the collateral for the secured creditor once the creditor has reduced it to possession.

For further discussion of Code section 506, see Collier on Bankruptcy, ch. 506 (Matthew Bender).

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Return to Text

n1 1. See, e.g., *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1193, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996) (en banc) (recognizing different ways to establish fair market value and leaving the precise disposition to the trial court), *cert. denied*, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997).

n2

2. See, e.g., *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996); *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 75-76, 33 C.B.C.2d 113, 117 (1st Cir. 1995); *Coker v. Sovran Equity Mortg. Corp. (In re Coker)*, 973 F.2d 258, 260 (4th Cir. 1992).

n3

3. Pub. L. No. 109-8, § 327 (2005), effective in cases commenced on or after October 17, 2005.

n4

4. 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 37 C.B.C.2d 744 (1997).

n5

5. See 11 U.S.C. § 1325(a)(5) (providing that, in order to be confirmed, a chapter 13 plan must provide that the debtor pay the secured creditor the present value of its secured claim, unless the creditor consents to different treatment).

n6

6. *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 965 n.6, 117 S. Ct. 1879, 1886 n.6, 138 L. Ed. 2d 148, 160 n.6, 37 C.B.C.2d 744, 751 (1997) (citations omitted).

n7

7. See also *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996) (en banc) (When a Chapter 11 debtor or a Chapter 13 debtor intends to retain property subject to a lien, the purpose of a valuation under section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral. Neither the foreclosure value nor the costs of repossession are to be considered because no foreclosure is intended. Instead, when the proposed use of the property is continued retention by the debtor, the purpose of the valuation is to determine how much the creditor will receive for the debtor's continued possession.), cert. denied, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997); *Coker v. Sovran Equity Mortg. Corp. (In re Coker)*, 973 F.2d 258, 260 (4th Cir. 1992).

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8. *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 965 n.6, 117 S. Ct. 1879, 1886 n.6, 138 L. Ed. 2d 148, 160 n.6, 37 C.B.C.2d 744, 751 (1997); see also *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1193, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996) (en banc), cert. denied, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997); *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 74-75 (1st Cir. 1995).

n9

9. *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 960 n.2, 117 S. Ct. 1879, 1884 n.2, 138 L. Ed. 2d 148, 37 C.B.C.2d 744 (1997).

n10

10. Pub. L. No. 109-8, § 327 (2005), effective in cases commenced on or after October 17, 2005.

n11

11. *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 962-63, 117 S. Ct. 1879, 1885, 138 L. Ed. 2d 148,

158, 37 C.B.C.2d 744, 749 (1997) (citations omitted).

n12

12. See also *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192-93, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996); *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 74, 33 C.B.C.2d 113, 117 (1st Cir. 1995) (discussing link between adequate protection and section 506(a)). See generally *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.)*, 484 U.S. 365, 371-72, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988). As observed by the court in *Winthrop Old Farms*: [Permitting the debtor to value the collateral on a liquidation basis but retain the property] would allow a reorganizing debtor to reap a windfall by stripping down the lien to liquidation value and quickly selling the collateral at fair market value, thus pocketing equity that would have been completely beyond reach save for the filing of the bankruptcy petition. 50 F.3d at 76, 33 C.B.C.2d at 117.

n13

13. See also *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192-93, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996); *Coker v. Sovran Equity Mortg. Corp. (In re Coker)*, 973 F.2d 258, 260 (4th Cir. 1992).

n14

14. Pub. L. No. 109-8, § 327 (2005), effective in cases commenced on or after October 17, 2005.

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15. See *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860, 870 (4th Cir. 1994); *Romley v. Sun Nat'l Bank (In re Two S Corp.)*, 875 F.2d 240, 244 (9th Cir. 1989) (Evidence of other appraised values is also irrelevant, because the sale price is a better indicator of the asset's value than any estimate of value given prior to sale.); see also *Takisaki v. Alpine Group, Inc. (In re Alpine Group, Inc.)*, 151 B.R. 931, 935 (B.A.P. 9th Cir. 1993) (The offered price is conclusive evidence of the property's value.). Of course, if the terms of an offer by a third party to purchase the subject property have not been accepted by the debtor, such an offer may not be persuasive evidence as to the property's value. See *In re Smith*, 42 B.R. 198, 200 (Bankr. N.D. Ga. 1984).

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16. See *In re Fiberglass Indus., Inc.*, 74 B.R. 738 (Bankr. N.D.N.Y. 1987).

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17. Pub. L. No. 109-8, § 327 (2005), effective in cases commenced on or after October 17, 2005.

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18. See, e.g., *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192-93, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996); *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 75, 33 C.B.C.2d 113, 117 (1st Cir. 1995) (real property, to be retained and used to generate income, valued based on fair market value); *Coker v. Sovran Equity Mortg. Corp. (In re Coker)*, 973 F.2d 258, 260 (4th Cir. 1992); *Cohen v. Werner (In re Cohen)*, 13 B.R. 350, 353 (Bankr. E.D.N.Y. 1981) (The debtor is not suffering the diminution in her equity that a forced sale would produce; she remains in possession of her home, enjoying the possibility of benefit from future appreciation. Evenhandedness would seem to dictate that the creditor, likewise, escape the penalties of liquidation.). But see *In re Maddox*, 200 B.R. 546, 548 (D.N.J. 1996) (court applied the wholesale value to motor vehicles used by debtors during the term of the chapter 13 plan). For a discussion of the application of the fair market value standard and the wholesale value standard in chapter 13 cases, see *Adjustments for Certain Expenses; Costs and Other Items supra*. See generally *Collier on Bankruptcy*, ch. 1325 (Matthew Bender).

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19. Many courts have properly held that hypothetical selling costs should not be deducted from the value of property when determining the value of a creditor's security interest in that property. See *Taffi v. United States (In re Taffi)*, 96 F.3d 1190, 1192, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996) (en banc) (Hypothetical sales costs are not to be considered because no sale is intended.), cert. denied, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997); *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 74, 33 C.B.C.2d 113, 117 (1st Cir. 1995) (real property to be used to generate income in chapter 11 case valued at fair market value, as no foreclosure or other sale planned); *Metrobank v. Trimble (In re Trimble)*, 50 F.3d 530, 531 (8th Cir. 1995); *Huntington Nat'l Bank v. Pees (In re McClurkin)*, 31 F.3d 401, 405, 31 C.B.C.2d 1364, 1369 (6th Cir. 1994); *Brown & Co. Sec. Corp. v. Balbus (In re Balbus)*, 933 F.2d 246, 252, 24 C.B.C.2d 1841, 1848 (4th Cir. 1991) (for purposes of determining whether dollar limits of § 109(e) have been exceeded, costs of hypothetical sale should not be deducted where debtor intends to retain collateral); *Beacon Hill Apartments, Ltd. v. Columbia Sav. & Loan Ass'n (In re Beacon Hill Apartments, Ltd.)*, 118 B.R. 148, 150-52 (N.D. Ga. 1990).

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20. See, e.g., *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 965 n.6, 117 S. Ct. 1879, 1886 n.6, 138 L. Ed. 2d 148, 160 n.6, 37 C.B.C.2d 744, 751 n.6 (1997).

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21. See *Butters v. Mountain Side Holdings, Inc. (In re Mountain Side Holdings, Inc.)*, 142 B.R. 421, 423 (D. Colo. 1992) (Whether value is determined on a forced sale or best use basis, there is still a hypothetical sale.); *Coby v. United States (In re Coby)*, 163 B.R. 835, 837 (D. Nev. 1993); *Overholt v. Farm Credit Servs. (In re Overholt)*, 125 B.R. 202, 215 (Bankr. S.D. Ohio 1990).

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22. See *In re Demakes Enters., Inc.*, 27 C.B.C.2d 622, 625-26, 145 B.R. 362, 364-65 (Bankr. D. Mass. 1992); *In re Robbins*, 119 B.R. 1, 5 (Bankr. D. Mass. 1990); see also H.R. Rep. No. 595, 95th Cong., 1st Sess. 339 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 54 (1978); see *Collier on Bankruptcy*, 361.04 (Matthew Bender).

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23. See *Butters v. Mountain Side Holdings, Inc. (In re Mountain Side Holdings, Inc.)*, 142 B.R. 421, 423 (Bankr. D. Colo. 1992) (costs of sale of cable system deducted in determining value of creditor's interest under § 506(a)); *Coby v. United States (In re Coby)*, 163 B.R. 835, 837 (Bankr. D. Nev. 1993); *Overholt v. Farm Credit Servs. (In re Overholt)*, 125 B.R. 202, 215 (Bankr. S.D. Ohio 1990).

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24. See *Downey Sav. & Loan Ass'n v. Helionetics, Inc. (In re Helionetics, Inc.)*, 70 B.R. 433, 438-39 (Bankr. C.D. Cal. 1987); *General Elec. Credit Corp. v. QPL Components Inc. (In re QPL Components Inc.)*, 20 B.R. 342, 345 (Bankr. E.D.N.Y. 1982); see also S. Rep. No. 98-65, 98th Cong., 1st Sess. 5-6 (1983). But see *In re Claeys*, 81 B.R. 985 (Bankr. D.N.D. 1987) (valuation of property to be retained based on disposition rather than retention value, thus disregarding income to be generated from government contract).

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25. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 356 (1977). But note that the version of subsection (a) ultimately enacted was taken from S. 2266, not H.R. 8200 to which such Report is addressed. Factors militating toward a forced sale might include high carrying costs for the property or that the property is perishable, vacant or inoperable.

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26. See *Murray v. Lyon (In re Cohn)*, 16 B.R. 140, 144 (Bankr. D. Mass. 1981) (forced sale value is usually only used when the property is vacant, inoperative, or must otherwise be disposed of quickly and cheaply.); *Savloff v. Continental Bank (In re Savloff)*, 2 C.B.C.2d 56, 59, 4 B.R. 285 (Bankr. E.D. Pa. 1980) (We conclude

that, only in the rarest of circumstances, where other methods of disposition are precluded, should the property be valued at what it would bring at forced sale.); see also *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996); *Coker v. Sovran Equity Mortg. Corp. (In re Coker)*, 973 F.2d 258, 260 (4th Cir. 1992).

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27. See *In re Wabash Valley Power Ass'n, Inc.*, 77 B.R. 991 (Bankr. S.D. Ind. 1987), rev'd, 111 B.R. 752 (S.D. Ind. 1990) (in determining going concern value, court must apply willing buyer-willing seller valuation standard); *Downey Sav. & Loan Ass'n v. Helionetics, Inc. (In re Helionetics, Inc.)*, 70 B.R. 433, 438-39 (Bankr. C.D. Cal. 1987).

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28. See, e.g., *In re Methvin*, 11 B.R. 556, 557 (Bankr. S.D. Miss. 1981), aff'd, 31 B.R. 569 (S.D. Miss. 1982); *Blakey v. Pierce (In re Blakey)*, 76 B.R. 465 (Bankr. E.D. Pa.); *In re Damron*, 8 B.R. 323 (Bankr. S.D. Ohio 1980).

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29. See *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996) (en banc) (determination of fair market value based on stipulated value), cert. denied, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997); *Coker v. Sovran Equity Mortg. Corp. (In re Coker)*, 973 F.2d 258, 260 (4th Cir. 1992) (determination of fair market value based on testimony); *Lopez v. Beneficial Mut. Sav. Bank*, 75 B.R. 961 (Bankr. E.D. Pa. 1987), aff'd, 82 B.R. 712 (E.D. Pa. 1988); *In re Markowitz Bldg. Co.*, 84 B.R. 484 (Bankr. N.D. Ohio 1988); cf. *In re Foster*, 79 B.R. 906 (Bankr. D. Mont. 1987) (valuation based on debtor's proposed use, not speculative best use).

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30. Hence, some courts will consider the relevant possibilities and adjust their valuation determinations accordingly. See *In re Rankin*, 49 B.R. 565 (Bankr. W.D. Mo. 1985). Thus, it may be appropriate to view the varying bases and manners of valuation as establishing a range of possible values as opposed to a finite set of alternatives. See, e.g., *Barash v. Public Fin. Corp.*, 658 F.2d 504, 512, 4 C.B.C.2d 1548, 1557 (7th Cir. 1981) (in context of automobile valuation, choice not limited to published wholesale or retail); *In re Damron*, 8 B.R. 323 (Bankr. S.D. Ohio 1980) (valuation to be a middle ground between distressed sale valuation and retail); see also S. Rep. No. 989, 95th Cong., 2d Sess. 54 (1978).

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31. See *Rosenberg Real Estate Equity Fund III v. Air Beds, Inc. (In re Air Beds, Inc.)*, 19 C.B.C.2d 1380, 1385, 92 B.R. 419, 424 (B.A.P. 9th Cir. 1988) (It is our empirical observation that many more plans of reorganization are contemplated than are proposed; fewer still are confirmed; and even fewer are consummated.). A statistical analysis prepared by the Administrative Office of the United States Courts estimates that a plan is confirmed in only 17 percent of chapter 11 cases. Flynn, Statistical Analysis of Chapter 11, October, 1989.

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32. It should be noted that a debtor's mere prospect for reorganization, no matter how glowing, is never sufficient to establish adequate protection. Rather, adequate protection may be afforded as prescribed in section 361.

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33. See *Barash v. Public Fin. Corp.*, 658 F.2d 504, 512, 4 C.B.C.2d 1548, 1557 (7th Cir. 1981); *General Elec. Credit Corp. v. QPL Components Inc. (In re QPL Components Inc.)*, 20 B.R. 342, 345 (Bankr. E.D.N.Y. 1982); *In re Klein*, 4 C.B.C. 2d 412, 414, 10 B.R. 657, 660 (Bankr. E.D.N.Y. 1981); see also H.R. Rep. No. 595, 95th Cong., 1st Sess. 356 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 68 (1978).

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34. See *Collier on Bankruptcy*, 506.02[6][e] (Matthew Bender) for a thorough discussion of the valuation issue. For cases in which courts have applied the wholesale value standard, see *In re Maddox*, 200 B.R. 546, 548 (D.N.J. 1996) (court applied the wholesale value to motor vehicles used by debtors during the term of the chapter 13 plan); see also *Valley Nat'l Bank of Ariz. v. Malody (In re Malody)*, 102 B.R. 745, 749 (B.A.P. 9th Cir. 1989); *Grubbs v. National Bank of S.C.*, 114 B.R. 450, 451 (D.S.C. 1990); *In re Kennedy*, 177 B.R. 967 (Bankr. S.D. Ala. 1995); *In re King*, 165 B.R. 296, 300 (Bankr. M.D. Fla. 1994); For more background on the statute, see *In re Rash*, 90 F.3d 1036 (5th Cir. 1996) (en banc) (citing legislative history of the statute, which stated that the debtor should not be required to pay the creditor more than if the creditor were to actually repossess and sell the property), *rev'd*, *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 37 C.B.C.2d 744 (1997). Congress rejected a proposed amendment to section 506(a) that would have expressly adopted a replacement cost standard for valuation of a secured creditor's claim. For more information on the legislative background of wholesale value and retail value, see *Collier on Bankruptcy*, 506.LH (Matthew Bender). See generally *Collier on Bankruptcy*, ch. 1325 (Matthew Bender).

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35. See *In re Hoskins*, 183 B.R. 166 (Bankr. S.D. Ind. 1995); *In re Myers*, 32 C.B.C.2d 1818, 178 B.R. 518 (Bankr. W.D. Okla. 1995); *In re Rowland*, 166 B.R. 172, 176 (Bankr. N.D. Fla. 1994); *In re Carlan*, 157 B.R. 324 (Bankr. S.D. Tex 1993).

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36. See *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1193, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996); *Metrobank v. Trimble (In re Trimble)*, 50 F.3d 530 (8th Cir. 1995); *In re McClurkin*, 31 F.3d 401 (6th Cir. 1994).

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37. See *McQuinn v. Dial Fin. Co. (In re McQuinn)*, 6 B.R. 899 (Bankr. D. Neb. 1980).

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38. See *In re Klein*, 4 C.B.C.2d 412, 415, 10 B.R. 657, 659 (Bankr. E.D.N.Y. 1981).

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39. While the cases cannot be satisfactorily reconciled, it must be remembered that the differences, in virtually all cases, relate to the interpretation of what constitutes fair market value or a commercially reasonable disposition under the circumstances--not as to whether the fair market value or commercially reasonable disposition standard is applicable.

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40. Pub. L. No. 109-8, § 327 (2005), effective in cases commenced on or after October 17, 2005.

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41. See, e.g., *In re Frost*, 12 C.B.C.2d 990, 47 B.R. 961 (D. Kan. 1985); *Memphis Bank & Trust Co. v. Walker*, 4 C.B.C.2d 975, 976, 14 B.R. 264 (W.D. Tenn. 1981); *Windfeldner v. Rosen (In re Windfeldner)*, 82 B.R. 367 (Bankr. E.D. Pa. 1988).

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42. See, e.g., *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192, 36 C.B.C.2d 1259, 1260 (9th Cir.

1996) (en banc) (When a Chapter 11 debtor or a Chapter 13 debtor intends to retain property subject to a lien, the purpose of a valuation under section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral. Neither the foreclosure value nor the costs of repossession are to be considered because no foreclosure is intended. Instead, when the proposed use of the property is continued retention by the debtor, the purpose of the valuation is to determine how much the creditor will receive for the debtor's continued possession.), *cert. denied*, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997); *In re Reynolds*, 5 C.B.C.2d 1578, 17 B.R. 489 (Bankr. N.D. Ga. 1981); *Ford Motor Credit Co. v. Miller* (*In re Miller*), 2 C.B.C.2d 212, 4 B.R. 392 (Bankr. S.D. Cal. 1980); *McQuinn v. Dial Fin. Co.* (*In re McQuinn*), 6 B.R. 899 (Bankr. D. Neb. 1980).

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43. Pub. L. No. 109-8, § 327 (2005), effective in cases commenced on or after October 17, 2005.

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44. See *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 960 n.2, 117 S. Ct. 1879, 1884 n.2, 138 L. Ed. 2d 148, 156 n.2, 37 C.B.C.2d 744, 747 (1997).

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45. See *In re Sampson*, 51 B.R. 13, 15, n.4 (Bankr. D.D.C. 1984) (when collateral is household goods, use resale value rather than replacement value).

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46. For example, one approach would be to value the property based on the portion of its original cost attributable to its remaining useful life. See *Sears, Roebuck & Co. v. Anderson* (*In re Anderson*), 17 B.R. 521 (Bankr. S.D. Ohio 1982) (custom-made draperies).

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47. See, e.g., *In re George Ruggiere Chrysler-Plymouth*, 727 F.2d 1017, 1020, 10 C.B.C.2d 220, 223 (7th Cir. 1984) (valuing collateral based upon the creditor's customary and commercially reasonable means of disposition); *In re Claeys*, 81 B.R. 985, 991-92 (Bankr. D.N.D. 1987) (discussing proper measure of valuation as what collateral would bring in a commercially reasonable disposition by the secured creditor); *Parr v. First Alabama Bank of Hartselle* (*In re Parr*), 30 B.R. 276, 277 (Bankr. N.D. Ala. 1983) (to determine value of real property, the Court must determine what the bank would receive from the real estate upon its disposition by customary and commercially reasonable means); see also *Smith v. Associates Commercial Corp.* (*In re Clark*

Pipe and Supply Co., Inc.), 893 F.2d 693, 698, 22 C.B.C.2d 500, 505 (5th Cir. 1990) (quoting *Samson v. Alton Banking & Trust Co. (In re Ebblar Furniture and Appliances, Inc.)*, 804 F.2d 87, 92, 15 C.B.C.2d 1452, 1457 (7th Cir. 1986) (Easterbrook, J., concurring) (rejecting retail value as determinative of secured creditor's interest, Judge Easterbrook stated that [t]he value of [a secured party's] interest depends on what [it] could do, outside of bankruptcy, to realize on its security [w]hat it could do is seize and sell the inventory)); *Heritage Sav. and Loan Ass'n v. Rogers Dev. Corp. (In re Rogers Dev. Corp.)*, 1 C.B.C.2d 499, 506, 2 B.R. 679, 683 (Bankr. E.D. Va. 1980). See generally *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192 (9th Cir. 1996). The manner of disposition that is commercially reasonable for bankruptcy purposes can be determined only after considering the then current circumstances. See *Chemical Bank v. American Kitchen Foods, Inc. (In re American Kitchen Foods, Inc.)*, 2 B.C.D. 715, 722 (Bankr. D. Me. 1976) (Whatever merit commends selection of the most economically realistic collateral valuation standard available in the circumstances of a given arrangement proceeding militates just as persuasively in favor of its consistent enforcement in respect to the same collateral throughout the proceedings. Consistency in collateral valuation ordinarily does not mean that collateral will be assigned the same value throughout the proceedings as at their commencement, but merely that the most commercially reasonable disposition practicable in the circumstances should be the standard universally applicable in all cases and at every phase of each case.). It should be noted that, as used in the bankruptcy valuation context, the meaning of the phrase commercially reasonable is often strikingly different from the meaning of the same term as used under Article Nine of the Uniform Commercial Code.

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48. See *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 960 n.2, 117 S. Ct. 1879, 1884 n.2, 138 L. Ed. 2d 148, 156 n.2, 37 C.B.C.2d 744, 747 n.2 (1997) (our use of the term replacement value is consistent with the Ninth Circuit's understanding of the meaning of fair-market value; by replacement value, we mean the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of a like age and condition.); *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996); *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 74-75, 33 C.B.C.2d 113, 117 (1st Cir. 1995) (discussing concept of commercially reasonable dispositions).

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49. See *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 74-75, 33 C.B.C.2d 113, 117 (1st Cir. 1995) (discussing disagreements).

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50. Pub. L. No. 109-8, § 327 (2005), effective in cases commenced on or after October 17, 2005.

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51. See, e.g., *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192-93, 36 C.B.C.2d 1259, 1260 (9th Cir. 1996) (en banc) (noting different methods to determine fair market value), cert. denied, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997); *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 73, 33 C.B.C.2d 113, 117 (1st Cir. 1995) (mentioning fair market value, liquidation value and going concern value).

n52 52. See *In re Claeys*, 81 B.R. 985 (Bankr. D.N.D. 1987); *Murray v. Lyon (In re Cohn)*, 16 B.R. 140 (Bankr. D. Mass. 1981); *Chemical Bank v. American Kitchen Foods, Inc. (In re American Kitchen Foods, Inc.)*, 2 B.C.D. 715 (Bankr. D. Me. 1976) (chapter XI).

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53. See *Catholic Credit Union v. Siegler (In re Siegler)*, 2 C.B.C.2d 912, 914, 5 B.R. 12, 14 (Bankr. D. Minn. 1980).

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54. *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 965 n.6, 117 S. Ct. 1879, 1886 n.6, 138 L. Ed. 2d 148, 160 n.6, 37 C.B.C.2d 744, 751 (1997).

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55. See *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 965 n.5, 117 S. Ct. 1879, 1886 n.5, 138 L. Ed. 2d 148, 159 n.5, 37 C.B.C.2d 744, 750 n.5 (1997) (rejecting combination approach); see also discussion in Evidentiary Standards and Burden of Proof *infra*.

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56. See *In re Kennedy*, 177 B.R. 967 (Bankr. S.D. Ala. 1995); *Grubbs v. National Bank of S.C.*, 114 B.R. 450, 451 (D.S.C. 1990); *In re Owens*, 120 B.R. 487, 490 (Bankr. E.D. Ark. 1990); see also *Samson v. Alton Banking & Trust Co. (In re Ebblar Furniture and Appliances, Inc.)*, 804 F.2d 87, 92, 15 C.B.C.2d 1452, 1457 (7th Cir. 1986) (Easterbrook, J., concurring) ([t]he value of [a secured party's] interest depends on what [it] could do, outside of bankruptcy, to realize on its security [w]hat it could do is seize and sell the inventory).

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57. See *Catholic Credit Union v. Siegler (In re Siegler)*, 2 C.B.C.2d 912, 914, 5 B.R. 12, 14 (Bankr. D. Minn. 1980).

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58. Pub. L. No. 109-8, § 327 (2005), effective in cases commenced on or after October 17, 2005.

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59. See *Grubbs v. National Bank of S.C.*, 114 B.R. 450, 452-53 (Bankr. D.S.C. 1990); *In re Reeder*, 60 B.R. 312, 314-15 (Bankr. D. Colo. 1986); *In re Cook*, 38 B.R. 870, 875-6 (Bankr. D. Utah 1984); *Chrysler Credit Corp. v. Van Nort (In re Van Nort)*, 9 B.R. 218, 221 (Bankr. E.D. Mich. 1981) (While a particular item or type of property may have a value to a particular creditor greater than what would be realized in a reasonable commercial disposition such value does not represent collateral value protected by § 1325(a)(5)); *Lopez v. Mutual Sav. Bank*, 82 B.R. 712 (E.D. Pa. 1988) (disregards FHA regulations applicable to transfers following foreclosure); *In re Perskin*, 4 C.B.C.2d 294, 304, 9 B.R. 626, 634 (Bankr. N.D. Tex. 1981) (in context of repurchase agreement between bank creditor and automobile dealer: Any deal which the creditor can strike with a third party may be evidence of value, but it is not positive proof of value.).

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60. See *In re Stumbo*, 7 B.R. 939 (Bankr. D. Colo. 1981).

ABOUT THE AUTHOR(S):

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135 of 197 DOCUMENTS

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Collier on Requirements for Debt Relief Agencies

2008 Emerging Issues 1344

Collier on Requirements for Debt Relief Agencies

By Collier

December 5, 2007

SUMMARY: This Emerging Issues Analysis covers the requirements for "debt relief agencies," including topics such as the duty of a debt relief agency regarding a written contract with the assisted person, and the definition of an "advertisement of bankruptcy assistance services or of the benefits of bankruptcy directed to the general public."

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ARTICLE: Overview of Code Section 526

Section 526 of the Bankruptcy Code is new with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act"). n1 The stated intent of Congress in enacting section 526 and related provisions was to strengthen professionalism standards for attorneys and others who assist consumer debtors with their bankruptcy cases. n2 The section places certain restrictions on the activities of debt relief agencies. In addition, section 526 specifies that any waiver by an assisted person of any right or protection under section 526 shall not be enforceable against the debtor by any federal or state court or by any other person, but that such a waiver may be enforced against a debt relief agency. Further, this section voids a contract for bankruptcy assistance between a debt relief agency and an assisted person if the contract is not in compliance with the material requirements of sections 526, 527 or 528. In addition, section 526 renders such contracts unenforceable by any federal or state court or by any other person other than the assisted person.

Section 526 also imposes monetary liability on debt relief agencies under specified circumstances. In addition to other state law remedies, the section authorizes certain state officials to bring enforcement actions to enjoin the violation and recover actual damages, costs and reasonable attorney's fees. The section provides that if a court finds that a person intentionally violated the section or engaged in a clear and persistent pattern or practice of violating the section, the court may enjoin the violation or impose an appropriate civil penalty on the violator.

Section 526 makes clear that section 526, 527 or 528 shall not annul, alter, affect or exempt any person from complying with the law of any state, except to the extent that such law is inconsistent with those sections, and then only to the extent of the inconsistency. Section 526 provides that section 526, 527 or 528 shall not be deemed to limit or curtail the authority or ability of a state to determine and enforce qualifications for the practice of law in that state. Finally, section 526 specifies that section 526, 527 or 528 shall not be deemed to limit or curtail the authority or ability

of a federal court to determine and enforce qualifications for the practice of law before that court.

Assisted Person Defined. An assisted person is defined in the Code by section 101 as: any person whose debts consist primarily of consumer debts and the value of whose non-exempt property is less than \$164,250. n3

Bankruptcy Assistance Defined. The term bankruptcy assistance is defined in the Code by section 101 as: any goods or services sold or otherwise provided to an assisted person with the express or implied purpose of providing information, advice, counsel, document preparation, or filing, or attendance at a creditors' meeting or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding under this title. n4

Debt Relief Agency Defined. The term debt relief agency is defined in the Code by section 101 as any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer under section 110. n5 Section 101 specifically excludes several persons and entities from the definition of debt relief agency. n6

Central to any application of section 526 is the definition of three terms: assisted person, bankruptcy assistance and debt relief agency. These terms are new with the passage of the 2005 Act. n7 Although the expressed intent of Congress in enacting section 526 and related provisions was to improve the conduct of professionals and others who assist consumer debtors with their bankruptcy cases, n8 each of these definitions contain imprecise language that create problems in application. For example, the definition of assisted person in section 101(3) could be applied to most consumer debtors, even though most consumer debtors do not actually use the services of traditional debt relief agencies. Moreover, section 101(3) does not specify that the assisted person be a debtor in bankruptcy even though sections 526, 527 and 528 are ostensibly designed to protect consumer debtors in bankruptcy cases. Similarly, the definition of bankruptcy assistance broadly encompasses advice or representation that has no connection with a case where the assisted person is the debtor. The term bankruptcy assistance also could cover advice or representation that has no connection with a consumer bankruptcy case.

Additionally, the definition of debt relief agency could apply to many attorneys who represent individual landlords, small businesses, consumer creditors, and non-debtor spouses as creditors in bankruptcy cases. Moreover, because person is defined under the Bankruptcy Code to include partnerships and corporations, n9 a law firm that represents those types of clients could also be construed as a debt relief agency.

Overall, the inexact language in these definitions could sweep more cases into the reach of sections 526, 527 and 528 than Congress probably intended. Policy arguments and legislative history could be advanced in support of a narrow application of these terms.

While the definitions appear overinclusive, the specified exclusions in section 101(12A) contain interpretive ambiguities and other problems. For example, section 101(12A) specifically excludes officers, employees, directors or agents of debt relief agencies or petition preparers. This arguably implies that an attorney employed by a professional corporation (of which the attorney is an officer) that provides bankruptcy assistance can be excluded from the definition of debt relief agency when that same attorney's law firm would qualify. Such an exclusion could result in individual officers of thinly capitalized firms unfairly escaping liability under the section. Moreover, the exclusion for certain nonprofit agencies raises the possibility of strategic manipulation by for-profit debt relief firms masquerading as nonprofit exempt organizations. Such outcomes would seem plainly inconsistent with the apparent consumer protection rationale of these provisions.

Specific Restrictions on Debt Relief Agencies; § 526(a)

Section 526(a) places certain restrictions on the activities of debt relief agencies. Paragraph (1) provides that a debt relief agency shall not fail to perform any service that it informed an assisted person or prospective assisted person that it would provide in connection with a bankruptcy case or proceeding. Paragraph (2) provides that a debt relief agency shall not make any statement, or counsel or advise any assisted person or prospective assisted person to make any statement in a filed document in a bankruptcy case or proceeding, that is untrue and misleading or, upon the exercise of reasonable care, should have been known by the agency to be untrue or misleading. Paragraph (3) makes it unlawful for a debt relief agency to misrepresent to any assisted person or prospective assisted person, directly or indirectly, affirmatively or by material omission, the services the agency will provide, or the benefits and risks of becoming a debtor in a case under the Bankruptcy Code. Paragraph (4) also prohibits debt relief agencies from advising an assisted person or prospective assisted person to incur more debt in contemplation of filing a bankruptcy case or to pay an attorney or bankruptcy petition preparer ⁿ¹⁰ for services performed as part of preparing for or representing a debtor in a case under the Code.

Several aspects of section 526(a) merit discussion. First, the definition of the term prospective assisted person is unclear. Although the term is used several times throughout this section, the term is not defined elsewhere in this section or elsewhere in the Bankruptcy Code. It will be left up to the courts to define the meaning of the term. In the meantime, the lack of a definition raises an issue. When does a person cease being a prospective assisted person and become an assisted person? This is an important question because the remedial portions of section 526 appear to apply only to assisted persons and not to prospective assisted persons. ⁿ¹¹ Second, section 526(a) is largely redundant because the law of contract, laws regulating attorney conduct, and common law and statutory prohibitions against fraud already render these activities illegal. It is not clear that the remedial provisions of section 526 contain remedies that would not otherwise be available under existing statutory and common law.

Another problem with section 526(a) is that it contains inconsistent language. For example, section 526(a)(2) uses the phrases untrue *and* misleading and untrue *or* misleading in the same sentence with no apparent explanation for the difference in terminology. Additionally, section 526(a) is legally inconsistent with section 526(c)(2). Section 526(a) imposes a form of strict liability on violators, while section 526(c)(2) requires a showing of negligent or intentional misconduct. This leaves open the possibility that an assisted person who could not establish negligence or intentional conduct could be left without a remedy under this section.

Waiver; § 526(b)

Section 526(b) provides that any waiver by an assisted person of any right or protection under section 526 shall not be enforceable against the debtor by any federal or state court or by any other person, but that such a waiver may be enforced against a debt relief agency.

The first phrase of section 526(b) (Any waiver by any assisted person of any protection or right provided under this section shall not be enforceable against the debtor by any federal or state court or any other person.) represents good policy. Fairness and justice dictate that waivers should not be routinely enforced against consumer debtors who could lack the necessary sophistication and bargaining power to intentionally or voluntarily relinquish their rights. However, the second phrase of section 526(b) (but may be enforced against a debt relief agency) arguably rests on a misunderstanding of the basic concept of waiver and of its typical use. Conceptually, a waiver consists of the intentional or voluntary surrender of a known right or protection. In operation, waivers are typically asserted *against* a debtor in an effort by the other party to secure a legal advantage under circumstances where the other party argues that the debtor has relinquished a right or protection. For this reason, it is difficult to imagine a scenario in which an assisted person would *affirmatively* seek to enforce a waiver of its rights to protection against a debt relief agency. As a result, the practical impact of the second clause seems minimal.

Liability of Debt Relief Agencies; § 526(c)

Contract for Bankruptcy Assistance Void and Unenforceable. Section 526(c)(1) renders a contract for bankruptcy assistance between a debt relief agency and an assisted person void if the contract is not in compliance with the material requirements of sections 526, 527 and 528. Section 526(c)(1) also provides that such a contract may not be enforced by any federal or state court or by any other person, other than the assisted person.

By its clear terms, section 526 incorporates the material requirements of sections 527 and 528. Section 527 imposes on debt relief agencies certain duties with respect to disclosure and notification. n12 Section 528 governs retainer agreements between debt relief agencies and assisted persons and dictates requirements for selected advertising activities by debt relief agencies. n13 It is not clear what bearing compliance with section 526 or 528 should have on the enforceability of the contract. Neither of those sections governs, directly or indirectly, the contract between the debt relief agency and the assisted person. Subsections 527(a)(1) and (2) are the only sections within these provisions that related directly to the formation of the contract.

Additionally, the meaning of the term material requirements is uncertain in the context of section 526(c)(1). Neither the section nor the Bankruptcy Code defines the term material requirements for purposes of this section. Presumably, the term refers to a requirement that is so substantial and important as to influence the essential validity and enforceability of the contract pursuant to section 526 and related provisions. Courts will have to clarify the meaning of the term under section 526(c)(1).

Section 526(c)(1) creates an anomaly. It provides that a contract not in compliance with sections 526, 527 and 528 is void and cannot be enforced by anyone other than the assisted person. However, it is unclear how a contract that is rendered void by the operation of section 526(c)(1) can be enforced by the assisted person. By its very nature, the contract is null and has no legal force. One possible resolution of this problem would be for the assisted person to seek a declaratory judgment reinstating the legal validity of the contract solely for the purpose of enforcing the contract against the debt relief agency but for no other purpose.

Monetary Liability. Section 526(c)(2) authorizes courts to award to an assisted person (1) the amount of any fees or charges that the debt relief agency received in connection with providing bankruptcy assistance to the assisted person, (2) actual damages and (3) reasonable attorney's fees and costs if the agency is found, after notice and a hearing, to have committed any of the acts or omissions listed in subsection 526(c)(2)(A), (B) or (C).

The import of section 526(c)(2) is additive. It supplements monetary penalties already available under federal and state law, although it must be stressed that the imposition of liability under section 526(c)(2) requires a showing of negligence or intentional conduct. The courts will need to determine what conduct constitutes negligence or intentional acts or omissions under the section.

Intentional or Negligent Failure to Comply with Bankruptcy Code Sections 526, 527 and 528. Section 526(c)(2)(A) imposes liability on a debt relief agency if the agency intentionally or negligently fails to comply with any provision of section 526, 527 or 528 in a case or proceeding under the Bankruptcy Code for an assisted person. Section 526(c)(2)(A), by its clear terms, incorporates sections 527 and 528 of the Code. n14

Provision of Bankruptcy Assistance Where Case or Proceeding Is Dismissed or Converted Due to Intentional or Negligent Failure to File Required Documents. Section 526(c)(2)(B) imposes liability on a debt relief agency if it

provides bankruptcy assistance to an assisted person in a case or proceeding under the Bankruptcy Code that is dismissed or converted to a case under another chapter of the Code because of the agency's intentional or negligent failure to file any required document. The section specifically includes documents required under *section 521 of the Bankruptcy Code*. n15

It is important to note that section 526(c)(2)(B) specifically requires a showing of causation. The debt relief agency will not be liable under this section unless the movant can show that the case was converted or dismissed *because of* the agency's act or omission. If a case is dismissed for a reasons unrelated to its obligations to file required documents, the debt relief agency should not be liable under this section.

The section specifically includes documents required under *section 521 of the Bankruptcy Code*, but the section does not exclude other required documents. Thus, section 526(c)(2)(B) presumably applies to any other required document under the Bankruptcy Code.

Intentional or Negligent Disregard of Bankruptcy Code or of Federal Rules of Bankruptcy Procedure. Section 526(c)(2)(C) imposes liability on a debt relief agency if it intentionally or negligently disregards the material requirements of the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure that are applicable to the agency.

This section incorporates into section 526 the material requirements of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure. Neither this section nor the Bankruptcy Code defines the term material requirements pursuant to this section. An argument could be advanced that in this context, material requirement means a requirement that is so substantial and important as to influence the essential nature or ultimate outcome of the bankruptcy case. Judicial clarification will be necessary in order to sensibly determine liability under this section.

Enforcement Action by Chief Law Enforcement Officer of a State or Other State Officials or Agencies.

Section 526(c)(3) provides, in addition to other state law remedies, the chief law enforcement officer of a state, or any official or agency designated by a state, who has reason to believe that any person has violated or is violating section 526 may (1) bring an action to enjoin the violation, (2) bring an action on behalf of its residents to recover actual damages of assisted persons arising from the violation, including any liability under section 526(c)(2) and (3) costs of the action and reasonable attorney's fees in the case of a successful action for an injunction or actual damages under subsection 526(c)(3)(A) or (B).

Concurrent Jurisdiction of District Courts. Section 526(c)(4) specifies that district courts of the United States for districts located in the state have concurrent jurisdiction over any action for an injunction or actual damages under section 526(c)(3)(A) or (B).

Intentional Violations. Section 526(c)(5) provides that if a court finds that a person intentionally violated section 526 or engaged in a clear and persistent pattern or practice of violating the section, the court may enjoin the violation or impose an appropriate civil penalty against the violator. The court can take this action on its own motion or on the motion of the United States trustee or the debtor. This section applies notwithstanding any other provision of federal law and is in addition to any other remedy under federal or state law.

Section 526(c)(5) does not preempt any other remedies available under federal and state law because the last phrase specifically states that this section is in addition to remedies available under federal or state law. However, the opening phrase of section 526(c)(5) appears to preempt any other provision of federal law that would preclude a remedy. The ultimate impact of the opening phrase is uncertain because the law of preemption in bankruptcy is complex and controversial. n16 Outcomes in specific cases are difficult to predict.

Relation to Other Laws; § 526(d)

State Law. Section 526(d)(1) makes clear that no provision of section 526, 527 or 528 shall annul, alter, affect or exempt any person subject to those sections from complying with the law of any state, except to the extent that such law is inconsistent with those sections, and then only to the extent of the inconsistency. This section invites litigation over several questions. First, what constitutes an inconsistent law under section 526(d)? Second, what degree of inconsistency is required to be shown? Who has the burden of proof on these issues? Finally, if such an inconsistency exists, then to what extent does that inconsistency annul or create exemptions from compliance with sections 526, 527 and 528? All of these issues await judicial interpretation.

State or Federal Authority or Ability to Determine and Enforce Qualifications for the Practice of Law.

Section 526(d)(2)(A) provides that no provision of section 526, 527 or 528 shall be deemed to limit or curtail the authority or ability of a state, subdivision or instrumentality to determine and enforce the qualifications for the practice of law under the laws of that state. Section 526(d)(2)(B) provides that no provision of section 526, 527 or 528 shall be deemed to limit or curtail the ability of a federal court to determine and enforce the qualifications for the practice of law before that court.

Section 526(d) expressly incorporates *sections 527 and 528 of the Bankruptcy Code*.ⁿ¹⁷ Although section 526(d) is intended to mitigate conflicts between its provisions and state regulations regarding the practice of law, such conflicts are inevitable and will need to be adjudicated by courts. For example, state regulations on lawyer advertising may be affected and even preempted, by section 528(a)(3), section 528(a)(4), and section 528(b) all of which mandate the use of certain statements and descriptions in specified advertisements of bankruptcy assistance services directed to the general public.

Additionally, these sections may affect state regulation of the unauthorized practice of law by bankruptcy petition preparers.

For a complete discussion of Code section 526, see Collier on Bankruptcy, ch. 526 (Matthew Bender).

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[Return to Text](#)

ⁿ¹ 1. Pub. L. No. 109-8, § 227(a) (2005), effective in cases commenced on or after October 17, 2005.

ⁿ²

2. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 17 (2005).

ⁿ³

3. 11 U.S.C. § 101(3), added by Pub. L. No. 109-8, § 226(a)(1) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 101.03 (Matthew Bender). For cases commenced before April 1, 2007, the dollar amount is \$150,000. For adjustment of the dollar amount, see 11 U.S.C. § 104(b); *Collier on Bankruptcy*, 104.03 (Matthew Bender).

n4

4. 11 U.S.C. § 101(4A), added by Pub. L. No. 109-8, § 226(a)(2) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 101.04A (Matthew Bender).

n5

5. 11 U.S.C. § 101(12A), added by Pub. L. No. 109-8, § 226(a)(3) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 101.12A (Matthew Bender).

n6

6. 11 U.S.C. § 101(12A) excludes officers, directors, employees or agents of a person who provides assistance or of a bankruptcy petition preparer, certain non-profit organizations, creditors of assisted persons to the extent they are assisting in debt restructuring, specified depository institutions, and an author, publisher, distributor, or seller of works subject to copyright protection. See *Collier on Bankruptcy*, 101.12A (Matthew Bender).

n7

7. Pub. L. No. 109-8, § 1226(a)(1)(3) (2005).

n8

8. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 17 (2005).

n9

9. 11 U.S.C. § 101(41).

n10

10. *11 U.S.C. § 110.*

n11

11. *See 11 U.S.C. § 526(b)(c).*

n12

12. *See Collier on Bankruptcy*, ch. 527 (Matthew Bender).

n13

13. *See Collier on Bankruptcy*, ch. 528 (Matthew Bender).

n14

14. *See Collier on Bankruptcy*, chs. 527 and 528 (Matthew Bender).

n15

15. *11 U.S.C. § 521; see Collier on Bankruptcy*, ch. 521 (Matthew Bender).

n16

16. *See Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1203 (9th Cir. 2005) (holding that a preference action brought under state law by an assignee for the benefit of creditors is preempted by the Bankruptcy Code); *see also Pacific Gas & Elec. v. California Dep't of Toxic Substances Control*, 350 F.3d 932, 949, 51 C.B.C.2d 445 (9th Cir. 2003) (holding that in specifying that all chapter 11 plans must provide adequate means for their implementation notwithstanding any otherwise applicable nonbankruptcy law, Congress expressly preempted other nonbankruptcy law, but only to the extent that the nonbankruptcy law in question was one relating to financial condition).

n17

17. See *Collier on Bankruptcy*, ch. 527 and ch. 528 (Matthew Bender).

ABOUT THE AUTHOR(S):

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136 of 197 DOCUMENTS

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Collier on Restrictions on Debt Relief Agencies

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Collier on Restrictions on Debt Relief Agencies

By Collier

December 5, 2007

SUMMARY: Section 526 of the Bankruptcy Code is new with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The section places certain restrictions on the activities of debt relief agencies. This Emerging Issues Analysis covers the restrictions on "debt relief agencies," including topics such as the definition of a "debt relief agency," waiver under section 526(b), and liability of debt relief agencies.

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ARTICLE: Overview of Code Section 526

Section 526 of the Bankruptcy Code is new with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act"). n1 The stated intent of Congress in enacting section 526 and related provisions was to strengthen professionalism standards for attorneys and others who assist consumer debtors with their bankruptcy cases. n2 The section places certain restrictions on the activities of debt relief agencies. In addition, section 526 specifies that any waiver by an assisted person of any right or protection under section 526 shall not be enforceable against the debtor by any federal or state court or by any other person, but that such a waiver may be enforced against a debt relief agency. Further, this section voids a contract for bankruptcy assistance between a debt relief agency and an assisted person if the contract is not in compliance with the material requirements of sections 526, 527 or 528. In addition, section 526 renders such contracts unenforceable by any federal or state court or by any other person other than the assisted person.

Section 526 also imposes monetary liability on debt relief agencies under specified circumstances. In addition to other state law remedies, the section authorizes certain state officials to bring enforcement actions to enjoin the violation and recover actual damages, costs and reasonable attorney's fees. The section provides that if a court finds that a person intentionally violated the section or engaged in a clear and persistent pattern or practice of violating the section, the court may enjoin the violation or impose an appropriate civil penalty on the violator.

Section 526 makes clear that section 526, 527 or 528 shall not annul, alter, affect or exempt any person from complying with the law of any state, except to the extent that such law is inconsistent with those sections, and then only to the extent of the inconsistency. Section 526 provides that section 526, 527 or 528 shall not be deemed to limit or curtail the authority or ability of a state to determine and enforce qualifications for the practice of law in that state.

Finally, section 526 specifies that section 526, 527 or 528 shall not be deemed to limit or curtail the authority or ability of a federal court to determine and enforce qualifications for the practice of law before that court.

Assisted Person Defined. An assisted person is defined in the Code by section 101 as: any person whose debts consist primarily of consumer debts and the value of whose non-exempt property is less than \$164,250. n3

Bankruptcy Assistance Defined. The term bankruptcy assistance is defined in the Code by section 101 as: any goods or services sold or otherwise provided to an assisted person with the express or implied purpose of providing information, advice, counsel, document preparation, or filing, or attendance at a creditors' meeting or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding under this title. n4

Debt Relief Agency Defined. The term debt relief agency is defined in the Code by section 101 as any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer under section 110. n5 Section 101 specifically excludes several persons and entities from the definition of debt relief agency. n6

Central to any application of section 526 is the definition of three terms: assisted person, bankruptcy assistance and debt relief agency. These terms are new with the passage of the 2005 Act. n7 Although the expressed intent of Congress in enacting section 526 and related provisions was to improve the conduct of professionals and others who assist consumer debtors with their bankruptcy cases, n8 each of these definitions contain imprecise language that create problems in application. For example, the definition of assisted person in section 101(3) could be applied to most consumer debtors, even though most consumer debtors do not actually use the services of traditional debt relief agencies. Moreover, section 101(3) does not specify that the assisted person be a debtor in bankruptcy even though sections 526, 527 and 528 are ostensibly designed to protect consumer debtors in bankruptcy cases. Similarly, the definition of bankruptcy assistance broadly encompasses advice or representation that has no connection with a case where the assisted person is the debtor. The term bankruptcy assistance also could cover advice or representation that has no connection with a consumer bankruptcy case.

Additionally, the definition of debt relief agency could apply to many attorneys who represent individual landlords, small businesses, consumer creditors, and non-debtor spouses as creditors in bankruptcy cases. Moreover, because person is defined under the Bankruptcy Code to include partnerships and corporations, n9 a law firm that represents those types of clients could also be construed as a debt relief agency.

Overall, the inexact language in these definitions could sweep more cases into the reach of sections 526, 527 and 528 than Congress probably intended. Policy arguments and legislative history could be advanced in support of a narrow application of these terms.

While the definitions appear overinclusive, the specified exclusions in section 101(12A) contain interpretive ambiguities and other problems. For example, section 101(12A) specifically excludes officers, employees, directors or agents of debt relief agencies or petition preparers. This arguably implies that an attorney employed by a professional corporation (of which the attorney is an officer) that provides bankruptcy assistance can be excluded from the definition of debt relief agency when that same attorney's law firm would qualify. Such an exclusion could result in individual officers of thinly capitalized firms unfairly escaping liability under the section. Moreover, the exclusion for certain nonprofit agencies raises the possibility of strategic manipulation by for-profit debt relief firms masquerading as nonprofit exempt organizations. Such outcomes would seem plainly inconsistent with the apparent consumer protection rationale of these provisions.

Specific Restrictions on Debt Relief Agencies; § 526(a)

Section 526(a) places certain restrictions on the activities of debt relief agencies. Paragraph (1) provides that a debt relief agency shall not fail to perform any service that it informed an assisted person or prospective assisted person that it would provide in connection with a bankruptcy case or proceeding. Paragraph (2) provides that a debt relief agency shall not make any statement, or counsel or advise any assisted person or prospective assisted person to make any statement in a filed document in a bankruptcy case or proceeding, that is untrue and misleading or, upon the exercise of reasonable care, should have been known by the agency to be untrue or misleading. Paragraph (3) makes it unlawful for a debt relief agency to misrepresent to any assisted person or prospective assisted person, directly or indirectly, affirmatively or by material omission, the services the agency will provide, or the benefits and risks of becoming a debtor in a case under the Bankruptcy Code. Paragraph (4) also prohibits debt relief agencies from advising an assisted person or prospective assisted person to incur more debt in contemplation of filing a bankruptcy case or to pay an attorney or bankruptcy petition preparer ⁿ¹⁰ for services performed as part of preparing for or representing a debtor in a case under the Code.

Several aspects of section 526(a) merit discussion. First, the definition of the term prospective assisted person is unclear. Although the term is used several times throughout this section, the term is not defined elsewhere in this section or elsewhere in the Bankruptcy Code. It will be left up to the courts to define the meaning of the term. In the meantime, the lack of a definition raises an issue. When does a person cease being a prospective assisted person and become an assisted person? This is an important question because the remedial portions of section 526 appear to apply only to assisted persons and not to prospective assisted persons. ⁿ¹¹ Second, section 526(a) is largely redundant because the law of contract, laws regulating attorney conduct, and common law and statutory prohibitions against fraud already render these activities illegal. It is not clear that the remedial provisions of section 526 contain remedies that would not otherwise be available under existing statutory and common law.

Another problem with section 526(a) is that it contains inconsistent language. For example, section 526(a)(2) uses the phrases untrue *and* misleading and untrue *or* misleading in the same sentence with no apparent explanation for the difference in terminology. Additionally, section 526(a) is legally inconsistent with section 526(c)(2). Section 526(a) imposes a form of strict liability on violators, while section 526(c)(2) requires a showing of negligent or intentional misconduct. This leaves open the possibility that an assisted person who could not establish negligence or intentional conduct could be left without a remedy under this section.

Waiver; § 526(b)

Section 526(b) provides that any waiver by an assisted person of any right or protection under section 526 shall not be enforceable against the debtor by any federal or state court or by any other person, but that such a waiver may be enforced against a debt relief agency.

The first phrase of section 526(b) (Any waiver by any assisted person of any protection or right provided under this section shall not be enforceable against the debtor by any federal or state court or any other person.) represents good policy. Fairness and justice dictate that waivers should not be routinely enforced against consumer debtors who could lack the necessary sophistication and bargaining power to intentionally or voluntarily relinquish their rights. However, the second phrase of section 526(b) (but may be enforced against a debt relief agency) arguably rests on a misunderstanding of the basic concept of waiver and of its typical use. Conceptually, a waiver consists of the intentional or voluntary surrender of a known right or protection. In operation, waivers are typically asserted *against* a debtor in an effort by the other party to secure a legal advantage under circumstances where the other party argues that the debtor has relinquished a right or protection. For this reason, it is difficult to imagine a scenario in which an assisted person would *affirmatively* seek to enforce a waiver of its rights to protection against a debt relief agency. As a result, the

practical impact of the second clause seems minimal.

Liability of Debt Relief Agencies; § 526(c)

Contract for Bankruptcy Assistance Void and Unenforceable. Section 526(c)(1) renders a contract for bankruptcy assistance between a debt relief agency and an assisted person void if the contract is not in compliance with the material requirements of sections 526, 527 and 528. Section 526(c)(1) also provides that such a contract may not be enforced by any federal or state court or by any other person, other than the assisted person.

By its clear terms, section 526 incorporates the material requirements of sections 527 and 528. Section 527 imposes on debt relief agencies certain duties with respect to disclosure and notification. n12 Section 528 governs retainer agreements between debt relief agencies and assisted persons and dictates requirements for selected advertising activities by debt relief agencies. n13 It is not clear what bearing compliance with section 526 or 528 should have on the enforceability of the contract. Neither of those sections governs, directly or indirectly, the contract between the debt relief agency and the assisted person. Subsections 527(a)(1) and (2) are the only sections within these provisions that related directly to the formation of the contract.

Additionally, the meaning of the term material requirements is uncertain in the context of section 526(c)(1). Neither the section nor the Bankruptcy Code defines the term material requirements for purposes of this section. Presumably, the term refers to a requirement that is so substantial and important as to influence the essential validity and enforceability of the contract pursuant to section 526 and related provisions. Courts will have to clarify the meaning of the term under section 526(c)(1).

Section 526(c)(1) creates an anomaly. It provides that a contract not in compliance with sections 526, 527 and 528 is void and cannot be enforced by anyone other than the assisted person. However, it is unclear how a contract that is rendered void by the operation of section 526(c)(1) can be enforced by the assisted person. By its very nature, the contract is null and has no legal force. One possible resolution of this problem would be for the assisted person to seek a declaratory judgment reinstating the legal validity of the contract solely for the purpose of enforcing the contract against the debt relief agency but for no other purpose.

Monetary Liability. Section 526(c)(2) authorizes courts to award to an assisted person (1) the amount of any fees or charges that the debt relief agency received in connection with providing bankruptcy assistance to the assisted person, (2) actual damages and (3) reasonable attorney's fees and costs if the agency is found, after notice and a hearing, to have committed any of the acts or omissions listed in subsection 526(c)(2)(A), (B) or (C).

The import of section 526(c)(2) is additive. It supplements monetary penalties already available under federal and state law, although it must be stressed that the imposition of liability under section 526(c)(2) requires a showing of negligence or intentional conduct. The courts will need to determine what conduct constitutes negligence or intentional acts or omissions under the section.

Intentional or Negligent Failure to Comply with Bankruptcy Code Sections 526, 527 and 528. Section 526(c)(2)(A) imposes liability on a debt relief agency if the agency intentionally or negligently fails to comply with any provision of section 526, 527 or 528 in a case or proceeding under the Bankruptcy Code for an assisted person. Section 526(c)(2)(A), by its clear terms, incorporates sections 527 and 528 of the Code. n14

Provision of Bankruptcy Assistance Where Case or Proceeding Is Dismissed or Converted Due to Intentional or Negligent Failure to File Required Documents. Section 526(c)(2)(B) imposes liability on a debt relief agency if it provides bankruptcy assistance to an assisted person in a case or proceeding under the Bankruptcy Code that is dismissed or converted to a case under another chapter of the Code because of the agency's intentional or negligent failure to file any required document. The section specifically includes documents required under *section 521 of the Bankruptcy Code*. n15

It is important to note that section 526(c)(2)(B) specifically requires a showing of causation. The debt relief agency will not be liable under this section unless the movant can show that the case was converted or dismissed *because of* the agency's act or omission. If a case is dismissed for a reasons unrelated to its obligations to file required documents, the debt relief agency should not be liable under this section.

The section specifically includes documents required under *section 521 of the Bankruptcy Code*, but the section does not exclude other required documents. Thus, section 526(c)(2)(B) presumably applies to any other required document under the Bankruptcy Code.

Intentional or Negligent Disregard of Bankruptcy Code or of Federal Rules of Bankruptcy Procedure. Section 526(c)(2)(C) imposes liability on a debt relief agency if it intentionally or negligently disregards the material requirements of the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure that are applicable to the agency.

This section incorporates into section 526 the material requirements of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure. Neither this section nor the Bankruptcy Code defines the term material requirements pursuant to this section. An argument could be advanced that in this context, material requirement means a requirement that is so substantial and important as to influence the essential nature or ultimate outcome of the bankruptcy case. Judicial clarification will be necessary in order to sensibly determine liability under this section.

Enforcement Action by Chief Law Enforcement Officer of a State or Other State Officials or Agencies.

Section 526(c)(3) provides, in addition to other state law remedies, the chief law enforcement officer of a state, or any official or agency designated by a state, who has reason to believe that any person has violated or is violating section 526 may (1) bring an action to enjoin the violation, (2) bring an action on behalf of its residents to recover actual damages of assisted persons arising from the violation, including any liability under section 526(c)(2) and (3) costs of the action and reasonable attorney's fees in the case of a successful action for an injunction or actual damages under subsection 526(c)(3)(A) or (B).

Concurrent Jurisdiction of District Courts. Section 526(c)(4) specifies that district courts of the United States for districts located in the state have concurrent jurisdiction over any action for an injunction or actual damages under section 526(c)(3)(A) or (B).

Intentional Violations. Section 526(c)(5) provides that if a court finds that a person intentionally violated section 526 or engaged in a clear and persistent pattern or practice of violating the section, the court may enjoin the violation or impose an appropriate civil penalty against the violator. The court can take this action on its own motion or on the motion of the United States trustee or the debtor. This section applies notwithstanding any other provision of federal law and is in addition to any other remedy under federal or state law.

Section 526(c)(5) does not preempt any other remedies available under federal and state law because the last phrase specifically states that this section is in addition to remedies available under federal or state law. However, the opening phrase of section 526(c)(5) appears to preempt any other provision of federal law that would preclude a remedy. The ultimate impact of the opening phrase is uncertain because the law of preemption in bankruptcy is complex and

controversial. n16 Outcomes in specific cases are difficult to predict.

Relation to Other Laws; § 526(d)

State Law. Section 526(d)(1) makes clear that no provision of section 526, 527 or 528 shall annul, alter, affect or exempt any person subject to those sections from complying with the law of any state, except to the extent that such law is inconsistent with those sections, and then only to the extent of the inconsistency. This section invites litigation over several questions. First, what constitutes an inconsistent law under section 526(d)? Second, what degree of inconsistency is required to be shown? Who has the burden of proof on these issues? Finally, if such an inconsistency exists, then to what extent does that inconsistency annul or create exemptions from compliance with sections 526, 527 and 528? All of these issues await judicial interpretation.

State or Federal Authority or Ability to Determine and Enforce Qualifications for the Practice of Law.

Section 526(d)(2)(A) provides that no provision of section 526, 527 or 528 shall be deemed to limit or curtail the authority or ability of a state, subdivision or instrumentality to determine and enforce the qualifications for the practice of law under the laws of that state. Section 526(d)(2)(B) provides that no provision of section 526, 527 or 528 shall be deemed to limit or curtail the ability of a federal court to determine and enforce the qualifications for the practice of law before that court.

Section 526(d) expressly incorporates *sections 527 and 528 of the Bankruptcy Code*. n17 Although section 526(d) is intended to mitigate conflicts between its provisions and state regulations regarding the practice of law, such conflicts are inevitable and will need to be adjudicated by courts. For example, state regulations on lawyer advertising may be affected and even preempted, by section 528(a)(3), section 528(a)(4), and section 528(b) all of which mandate the use of certain statements and descriptions in specified advertisements of bankruptcy assistance services directed to the general public.

Additionally, these sections may affect state regulation of the unauthorized practice of law by bankruptcy petition preparers.

For a complete discussion of Code section 526, see Collier on Bankruptcy, ch. 526 (Matthew Bender).

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[Return to Text](#)

n1 1. Pub. L. No. 109-8, § 227(a) (2005), effective in cases commenced on or after October 17, 2005.

n2

2. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 17 (2005).

n3

3. 11 U.S.C. § 101(3), added by Pub. L. No. 109-8, § 226(a)(1) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 101.03 (Matthew Bender). For cases commenced before April 1, 2007, the dollar amount is \$150,000. For adjustment of the dollar amount, *see 11 U.S.C. § 104(b)*; *Collier on Bankruptcy*, 104.03 (Matthew Bender).

n4

4. 11 U.S.C. § 101(4A), added by Pub. L. No. 109-8, § 226(a)(2) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 101.04A (Matthew Bender).

n5

5. 11 U.S.C. § 101(12A), added by Pub. L. No. 109-8, § 226(a)(3) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 101.12A (Matthew Bender).

n6

6. 11 U.S.C. § 101(12A) excludes officers, directors, employees or agents of a person who provides assistance or of a bankruptcy petition preparer, certain non-profit organizations, creditors of assisted persons to the extent they are assisting in debt restructuring, specified depository institutions, and an author, publisher, distributor, or seller of works subject to copyright protection. *See Collier on Bankruptcy*, 101.12A (Matthew Bender).

n7

7. Pub. L. No. 109-8, § 1226(a)(1)(3) (2005).

n8

8. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 17 (2005).

n9

9. 11 U.S.C. § 101(41).

n10

10. 11 U.S.C. § 110.

n11

11. See 11 U.S.C. § 526(b)(c).

n12

12. See Collier on Bankruptcy, ch. 527 (Matthew Bender).

n13

13. See Collier on Bankruptcy, ch. 528 (Matthew Bender).

n14

14. See Collier on Bankruptcy, chs. 527 and 528 (Matthew Bender).

n15

15. 11 U.S.C. § 521; see Collier on Bankruptcy, ch. 521 (Matthew Bender).

n16

16. See *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1203 (9th Cir. 2005) (holding that a preference action brought under state law by an assignee for the benefit of creditors is preempted by the Bankruptcy Code); see also *Pacific Gas & Elec. v. California Dep't of Toxic Substances Control*, 350 F.3d 932, 949, 51 C.B.C.2d 445 (9th Cir. 2003) (holding that in specifying that all chapter 11 plans must provide adequate means for their implementation notwithstanding any otherwise applicable nonbankruptcy law, Congress expressly preempted other nonbankruptcy law, but only to the extent that the nonbankruptcy law in question was one relating to financial condition).

n17

17. See *Collier on Bankruptcy*, ch. 527 and ch. 528 (Matthew Bender).

ABOUT THE AUTHOR(S):

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137 of 197 DOCUMENTS

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Collier on Attorney Certifications under Section 707

2008 Emerging Issues 1347

Collier on Attorney Certifications under Section 707

By Collier

December 5, 2007

SUMMARY: Section(b)(4)(C) & (D) of the Bankruptcy Code addresses the signature of an attorney on a court document as certification that the attorney has reasonably investigated the facts and is acting in good faith. This Emerging Issues Analysis elaborates on the requirement of "reasonable investigation," and the fact that it applies to all motions and pleadings filed in chapter 7 cases but does not apply to schedules or statements.

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ARTICLE: Certification Concerning Petition, Pleading or Motion. *Section 707(b)(4)(C) of the Bankruptcy Code*, added in 2005, n1 provides that the signature of an attorney on a petition, pleading, or written motion is a certification that the attorney has performed a reasonable investigation into the circumstances giving rise to petition, pleading, or written motion; has determined that it is well grounded in fact; and has determined that it is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law; and does not constitute an abuse under paragraph (707)(b)(1). This provision applies to all attorneys, not just those representing debtors, and is applicable to all motions and pleadings filed in chapter 7 cases. n2 For example, it would apply to frivolous motions for relief from the automatic stay filed in chapter 7 cases, and would require a reasonable investigation by the attorney of amounts asserted in such motions. On the other hand, the certification does not apply to schedules or statements.

The language of this provision, except for the reference to abuse under section 707(b)(1), is quite similar to the former language of Rule 9011 and it is not clear that it adds anything to current Rule 9011. One difference is the use of the phrase reasonable investigation rather than reasonable inquiry. However, the pre-existing text of both the Moore's Federal Practice discussion of Rule 11 and this treatise's discussion of Rule 9011 use the words inquiry and investigation interchangeably. n3 In discussing the duty to investigate, Moore states: An attorney may rely on objectively reasonable representations of his or her client. n4 It elaborates that [a]ll *available* documents that are relevant to the case should be examined. n5 This would certainly include all documents in the possession of the client, but does not appear to require an attorney to obtain documents that are not easily accessible. In view of the similarities to Rule 9011, it is unlikely that courts will draw a distinction between this certification and Rule 9011. They will, at most, use it as additional ammunition to sanction bad conduct that would have been punishable in any event.

This provision also provides that an attorney signing a petition certifies that the attorney has determined it is not an abuse under section 707(b)(1). Based on its placement in the context of the attorney's good faith determination with

respect to other Rule 9011-like conclusions, courts are likely to interpret this to mean a good faith determination after reasonable inquiry under the circumstances. The provision does not say the attorney certifies that the petition is not an abuse, but only that the attorney determined that it was not an abuse. In any event, no specific remedies are provided for violations of this provision, which presumably means Rule 9011 and its standards would apply as they do to any other paper filed with the court.

Certification Concerning Schedules. Section 707(b)(4)(D) provides that the signature of the attorney for the debtor on the petition also certifies that the attorney has no knowledge, after an inquiry, that the schedules are incorrect. This is a relatively low standard that every debtor should meet; a violation requires actual knowledge, not just a belief or suspicion, that the schedules are inaccurate. It requires an inquiry, which should be no greater than for other pleadings, perhaps less, since it does not use the word reasonable.

Arguably, this more specific, and less stringent, standard for schedules overrides any other standard that now exists in the rules, especially since it was not clear whether *Rule 9011 of the Federal Rules of Bankruptcy Procedure* previously applied due to the exclusion of schedules and statements in Rule 9011(a).

Moreover, another provision of the 2005 legislation, expresses a sense of Congress that Rule 9011 should be amended to provide that all papers (including schedules) submitted by debtors or attorneys for debtors be submitted only after reasonable inquiry to verify that information is well-grounded in fact and warranted by existing law or a good faith argument for extension, modification or reversal of existing law. n6 This sense of Congress also adds to the arguments that the certifications under current Rule 9011 do not apply to the schedules.

As a practical matter, as with the other new standards, courts are unlikely to look to the nuances of the difference in language between section 707(b)(4)(D) and Rule 9011. They will simply continue to penalize those they believe to be engaged in seriously deficient conduct.

For further discussion of Code section 707, see Collier on Bankruptcy, ch. 707 (Matthew Bender).

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Return to Text

n1 1. Pub. L. No. 109-8, § 102(a) (2005), effective in cases commenced on or after October 17, 2005.

n2 2. 11 U.S.C. § 103(b).

n3

3. See *Collier on Bankruptcy*, 9011.04[2] (Matthew Bender); 2 *Moore's Federal Practice*, § 11.11[2] (3d ed. Matthew Bender).

n4

4. 2 *Moore's Federal Practice*, § 11.11[2] (3d ed. Matthew Bender).

n5

5. 2 *Moore's Federal Practice*, § 11.11[2] (3d ed. Matthew Bender) (emphasis added).

n6

6. Pub. L. 109-8, § 319 (2005), effective in cases commenced on or after October 17, 2005.

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138 of 197 DOCUMENTS

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Collier on Election of Ch 11 Trustee

2008 Emerging Issues 1348

Collier on Election of Ch 11 Trustee

By Collier

December 5, 2007

SUMMARY: Section 1104(b) of the Bankruptcy Code provides that after the appointment of a trustee by the court, the creditors may elect the trustee except in railroad reorganization cases. This Emerging Issues Analysis explains who may request an election of a trustee; the time within which a request must be made; the notice required; and the voting process.

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ARTICLE: *Section 1104(b) of the Bankruptcy Code* provides that after the court orders the appointment of a trustee, the creditors may elect the trustee except in railroad reorganization cases. n1 This provision was added to section 1104 by the Bankruptcy Reform Act of 1994, n2 which also redesignated former subsections (b) and (c) as subsections (c) and (d). Before the amendment, appointment by the United States trustee was the sole means of selecting a trustee.

Under the former Bankruptcy Act, creditors did not elect trustees in reorganization cases, but they did elect members of the creditors' committee. These elections often turned into contests between attorneys interested in placing their own candidates on the committee so that the attorney could be retained as counsel. This was one of the more abused aspects of the Bankruptcy Act. It would be unfortunate if creditors or their attorneys sought similar control over trustee elections primarily to obtain retentions.

Election of a trustee is available upon the request of a party in interest made to the United States trustee. This request must be made within 30 days after the court orders the appointment of a trustee. If no party in interest requests the election of a trustee, then the United States trustee must appoint a trustee if it has not already done so.

Who May Request an Election of a Trustee. A request for a meeting of creditors to elect a trustee must be in writing, filed with the court, and transmitted to the United States trustee. n3 The clerk (or another person directed by the court) is required to give 20 days' notice of the meeting to the debtor, all creditors, and indenture trustees. n4 The Rules do not, however, require notice of the meeting to equity security holders. n5 Once the request is made, the United States trustee must convene and preside at the meeting. n6 At the meeting, the election is conducted the same as an election for a trustee under chapter 7. n7

The request for meeting of creditors may be made by a party in interest. That term is not defined. It should include

a creditor, whether holding a secured or unsecured claim, and a committee of creditors. Because equity security holders are not required to be given notice of the election meeting and are not entitled to vote at the meeting, it does not seem that an equity security holder or a committee of equity security holders should be included as parties in interest for the purposes of requesting an election under section 1104(b). They do not have a direct interest in the *manner* of selection of a trustee, even though they have a serious interest in whether the court should order a trustee under section 1104(a).

Under section 307, the United States trustee may raise and may appear and be heard on any issue in the case. Section 105(a) authorizes the bankruptcy court to raise certain matters without request of a party in interest. Nevertheless, it would seem that these provisions do not permit the request for a meeting of creditors to be made by either the United States trustee or the court. The provision for election of a trustee was added to section 1104 to enable creditors to take control of a significant event in the case. If creditors do not choose to do so, then the United States trustee will appoint the trustee. A request by either the United States trustee or the court does not necessarily contribute to creditor control where no creditor has an interest in requesting an election.

Moreover, the court's action in requesting the election of a trustee does not fit squarely within the language of section 105 because, literally, no issue is raised by requesting an election. There is no dispute; all that section 1104(b) requires is a timely request; no one, neither the court nor the United States trustee, need decide any question of fact or issue of law. Also, the court's action is not necessary to enforce or implement any order of the court; the court has ordered the appointment of a trustee but the appointment can be carried out by the United States trustee pursuant to section 1104(d).

Time Within Which a Request Must Be Made. The request for an election must be made not later than 30 days after the court orders the appointment of a trustee under section 1104(a). The 30-day period should be considered as running from the effective date of the court order, since that is the first date on which a trustee might be appointed.

There is no provision in section 1104(b) for shortening or extending the 30-day period. This suggests that the 30-day period should be considered unalterable. In view of the ease with which a party in interest may request an election, there would seem to be little reason to extend the period during which a request may be made.

However, shortening of the 30-day period would seem contrary to the policy of the subsection to permit creditors a reasonable opportunity to request the election of a trustee, even though one can imagine circumstances in which the parties might prefer a shortening. Because the possibility of an election request exists until the end of the period, it seems that the United States trustee could await the end of the 30-day period before making an appointment. Waiting might interfere with the conduct of the case. If an appointment were not made, the case could be rudderless. If an appointment were made during that period, the appointee could not be assured that she would remain the trustee, because there could still be a request for an election. Thus, even in cases in which there is an immediate need for the appointment of a trustee, the 30-day period during which an election may be requested should not prevent appointment of an interim trustee to protect the estate, and the statute did not expressly prevent it.

To address the potential problem of an appointment followed by an election request, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended section 1104(b) to deal with the situation in which the United States trustee had appointed a trustee under subsection (d) during the 30-day period in which a creditor makes an election request, thus validating the practice under which the United States trustee appoints a trustee during that period. n8 Section 1104(b)(2)(B) provides that if creditors elect a trustee under subsection (b)(1), the service of a trustee appointed under subsection (d) terminates. Although the statute does not specify, it would not make sense for the service to terminate until the elected trustee has been approved by the court and qualifies under section 322. Otherwise, there could be a gap in service, which could be lengthy if there is a problem with either approval or qualification. The Federal Rules of Bankruptcy Procedure, which make explicit what the statute implies--the appointment of a trustee during the 30-day period--also deals with this issue. Rule Rule 2007.1(b)(1), which deals with appointment of a trustee and the request for a meeting of creditors for an election, provides: Pending court approval of the person elected, any person appointed by the United States trustee under § 1104(d) and approved in accordance with subdivision (c) of this

rule shall serve as trustee. n9

This procedure under Rule 2007.1 for service pending an election is analogous to section 701 and section 702 of the Code, which provide for the appointment of an interim trustee at the beginning of a chapter 7 case, pending the opportunity of creditors to elect a trustee at the meeting of creditors. n10 If creditors do not elect a trustee at the meeting of creditors, the appointed trustee becomes the permanent trustee in the case. n11 The same procedure should apply in a chapter 11 case in which a party in interest requests a meeting of creditors to elect a trustee but no trustee is elected. In that event, the provision of section 1104(d), which requires the United States trustee to appoint a trustee, will apply. If the United States trustee has already appointed a trustee during the 30-day period, the appointed trustee will remain as the permanent trustee.

This procedure may, however, give an advantage to the trustee appointed by the United States trustee. If the United States trustee acts quickly, as should be the case where the order to appoint was prompted by fraud, dishonesty, or gross mismanagement, that trustee will have been in office for at least 20 to 60 days before the meeting of creditors is actually held. n12 It may be disadvantageous to creditors to elect a different trustee if the appointed trustee has been doing an adequate job, because of the transition time and costs. At the same time, the United States trustee will have reason to appoint as trustee someone who will find support among the creditors requesting the election. They are the creditors most likely to be the most active. Displacement of that trustee by their candidate could be disruptive to the conduct of the case. The United States trustee is required to consult with parties in interest before making the appointment. n13 The consultation will provide the United States trustee with an opportunity to consider the creditors' candidate and thereby facilitate the transition from the debtor's management to the trustee. In this way, the Code continues its policy of encouraging consultation and cooperation among parties in interest in the case.

Notice of Meeting for Election of Trustee. If an election is requested, notice of a meeting of creditors for the purpose of electing a trustee must be given at least 20 days before the meeting. n14 As with the notice of the meeting of creditors under section 341, notice must be given to all creditors, by mail, by the clerk, or by some other person as the court directs.

Who May Vote. Section Section 1104(b), in referring to section 702 for the manner in which the election is to be conducted, would seem to incorporate the section 702(a) list of who may vote for a trustee. Under section 702(a), the parties holding the following kinds of claims may vote for a trustee: (1) *an unsecured claim that is undisputed, fixed, liquidated, and timely filed under section 501 and under Bankruptcy Rule 3002, Rule 3003, Rule 3004 or Rule 3005;* n15 (2) *a claim tardily filed, if the holder did not have notice or knowledge of the case in time to file timely and proof is filed in time to permit payment;* (3) *other tardily filed claims;* and (4) *claims for fines, penalties, forfeitures, or multiple, exemplary or punitive damages if the fine, penalty, etc. arose before the order for relief (rather than commencement of the case).* n16

Under this provision, then, only unsecured creditors are allowed to vote for a trustee. If a secured creditor has a deficiency in its collateral, to the extent of the deficiency it would be unsecured and, therefore, entitled to vote that amount. The holder of a contingent claim is not an eligible voter. The same is true of one who holds a claim that has not been liquidated. n17

Under section 702(a)(2), to be eligible to vote, the creditor must not hold a material adverse interest to the interest of creditors entitled to distribution. An exception permits the creditor to hold an equity interest in the debtor if it is not substantial in relation to its holding as a creditor. Section 702(a)(3) prohibits an insider n18 from voting for a trustee.

Manner of Election. Section 1104(b) provides that the election of a chapter 11 trustee should be conducted in the same manner as a chapter 7 trustee election. However, some of the provisions governing chapter 7 elections appear to be inconsistent with the structure of the chapter 11 election. It will, therefore, be necessary for the United States trustee overseeing a chapter 11 election, or a court resolving any disputed election, to evaluate each requirement for the chapter 7 election, and to modify, interpret or, if necessary, disregard those requirements that are inconsistent with the chapter

11 procedure.

For example, section 702(b) provides for the election to occur at the section 341 meeting of creditors. This reflects the fact that a trustee is appointed or elected in all chapter 7 cases, and the appointment or election occurs early in the case. In chapter 11, the debtor remains in possession unless and until the court orders the appointment of a trustee. Such an order may be entered long after the commencement of the case and well after the conclusion of the section 341 meeting of creditors. Thus, unlike chapter 7, there is no relationship between the section 341 meeting and appointment of a trustee in a chapter 11 case. Accordingly, it seems unlikely that a court in a chapter 11 case would require that the election occur at the section 341 meeting.

Of course, a court could reach a result consistent with the statute by continuing the creditors' meeting indefinitely. In view of the fact that a chapter 11 trustee is ordered in few chapter 11 cases, however, this seems to be an inefficient and artificial means of reconciling irreconcilable statutory provisions. The better approach would be to recognize that when section 1104(b) requires the United States trustee to convene a meeting of creditors after election of a trustee has been requested, the meeting is analogous to a section 341 meeting and satisfies the requirement of section 702(b).

Section 702(b) also provides for an election only on the request of creditors that hold 20 percent in amount of eligible claims. Although section 1104(b) provides for an election upon the request of a party in interest, the 20 percent requirement should apply to a chapter 11 election. Section 1104(b) provides only that upon request by a party in interest, the United States trustee must convene a meeting of creditors for the purpose of electing a trustee. It provides that the election should be conducted under the procedures in section 702. This should be viewed as suggesting that once the meeting is convened, which is analogous to the meeting of creditors under section 344, the section 702 procedures, including the 20 percent requirement, govern the election.

Under section 702(b), creditors may elect one disinterested person to serve as trustee. The limitation to one person is in harmony with section 1104(d), as is the requirement that the elected trustee be disinterested. When appointment of a trustee is to be made by the United States trustee, only one person may be appointed and that person must be disinterested.

The Vote. Section 702(c) provides that a trustee may be elected only if creditors holding at least 20 percent in amount of eligible claims vote and only if the candidate receives the votes of creditors holding a majority of the amount of claims held by the creditors voting in the election. Thus, in an election under section 1104(b), it will be necessary first that creditors holding 20 percent of the total amount of the kinds of unsecured claims listed in subsection (a)(1) actually vote and, second, that the candidate receive the votes of creditors holding at least a majority in amount of the claims that are actually voted by creditors at the meeting. n19 If creditors holding 20 percent of the total amount of claims do not vote at the meeting, a trustee cannot be elected. Nevertheless, even if at least 20 percent are actually voted, the candidate cannot be elected unless the candidate receives at least a majority in amount of the claims voted.

Rule *Rule 2007.1(b)(2) of the Federal Rules of Bankruptcy Procedure* regulates the use of proxies in an election of a trustee under section 1104(b). Rule 2007.1(b)(2) incorporates by reference Rule 2006, which governs the use of proxies when voting is permitted in a case under chapter 7. In addition, Rule 2007.1(b)(2) authorizes a committee of creditors appointed under section 1102 to solicit proxies. In chapter 7 cases, there are no committees appointed under the Code. Thus, Rule 2006 does not authorize a committee to solicit proxies in a chapter 7 case. Rule 2007.1(b)(2) provides the express authorization for election of a trustee under chapter 11.

A party who obtains a proxy should use Official Form 11A or 11B. These are forms for general and special powers of attorney. They contain language with respect to voting at a creditors' meeting.

Section 1104(b)(2) requires that if an eligible, disinterested person is elected at the meeting, the United States trustee must file a report with the court certifying the election n20 and provides that the report be treated effectively as a United States trustee selection and appointment of that person under subsection (d). n21 Rule 2007.1(b) provides the

procedure for filing the report as well as for filing a report of any dispute concerning the election. n22 Under the Rule, if the election is undisputed, the United States trustee files with the court a report of the election and an application for approval of the appointment, which includes a statement setting forth the person's connections with parties in interest and a verified statement from the person describing any such connections, in order to demonstrate that the person is disinterested. In an undisputed election, the report constitutes the appointment of the elected person, subject to court approval.

If any dispute arises out of a trustee election, the court must resolve it. n23 In the event of a dispute, the United States trustee files a report describing the dispute without an application for approval of the appointment. The report is to be accompanied by the candidates' verified statements of disinterestedness. The court will not, however, resolve the dispute, and any trustee appointed by the United States trustee prior to the election remain the trustee, unless, within 10 days after the filing of the report, a party in interest, by motion, requests the court to hear and resolve the disputed election. n24 Once the court resolves the dispute and approves the successful candidate, the United States trustee's report constitutes the appointment of the elected person to serve, as of the date of entry of the court's order.

Court Approval of Elected Trustee. Section 1104(b)(2)(B)(i) provides that upon the filing of the United States trustee's report of the election results, the elected trustee shall be considered to have been selected and appointed for purposes of this section. n25 This provision resolves questions over whether court approval under subsection (d) was required of an elected trustee. Because of uncertainty of this issue before the 2005 amendments, Rule 2007.1(c) expressly provides for court approval of the elected trustee.

Section 321, which prescribes requirements for eligibility to serve as a trustee, is applicable to all trustees, including a trustee elected under section 1104(b). Under section 321, if an individual is to serve as trustee, the individual must be competent to perform the duties of a trustee. If the trustee is a corporation, it must be authorized by its charter or bylaws to act as trustee. Section 321(b) also provides that in no case may an examiner serve as trustee. Consequently, creditors may not elect an examiner as trustee.

This provision also resolves other potential questions. Under section 546(a), the statute of limitations for certain avoiding powers runs from the first appointment of a trustee under specified sections, including section 1104. By treating the filing of the report as an appointment, the provision makes clear when the statute begins to run, assuming that the United States trustee has not previously appointed a trustee under section 1104(d), pending the election. Under section 1121(c)(1), the debtor's exclusive right to file a plan ends upon a trustee's appointment. Under prior law, it was unclear whether this provision applied upon the election of a trustee and if so, when. Section 1104(b)(2)(B)(i) now makes clear that in the case of an elected trustee, the debtor's exclusive right terminates upon the filing of the report. If, after the filing of the report, the court disapproves the elected trustee, the application of these provisions will be the same as if a trustee appointed by the United States trustee under subsection (d) had been disapproved.

For further discussion of Code section 1104, see Collier on Bankruptcy, ch. 1104 (Matthew Bender).

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[Return to Text](#)

n1 1. In railroad reorganization cases, pursuant to section 1163, the United States trustee appoints one trustee from a list of five recommendations made by the Secretary of Transportation. See Collier on Bankruptcy, ch. 1163 (Matthew Bender).

n2

2. Pub. L. No. 103-394.

n3

3. *Fed. R. Bankr. P. 2007.1(b)(1)*.

n4

4. *Fed. R. Bankr. P. 2002(a)(1)*.

n5

5. *See Fed. R. Bankr. P. 2002(d)*.

n6

6. *Fed.R. Bankr. P. 2007.1(b)(2)*.

n7

7. *11 U.S.C. § 1104(b), Fed. R. Bankr. P. 2007.1(b)*.

n8

8. Pub. L. No. 109-8, § 416 (2005), effective in cases filed on or after October 17, 2005. *Id.* § 1501(b).

n9

9. *Fed.R. Bankr. P. 2007.1(b)*.

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10. 11 U.S.C. §§ 701, 702.

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11. 11 U.S.C. § 702(d); see *Collier on Bankruptcy*, 702.05 (Matthew Bender).

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12. The minimum required notice of the meeting is 20 days, *Fed. R. Bankr. P. 2002(a)(1)*, and creditors have up to 30 days in which to request the meeting, *11 U.S.C. § 1104(b)*. Adding some additional time for scheduling the meeting and preparing and mailing the notices, the trustee could be in office for up to 60 days before the election meeting is actually held.

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13. 11 U.S.C. § 1104(d).

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14. *Fed. R. Bankr. P. 2002(a)(1)*.

n15

15. 11 U.S.C. § 726(a)(2).

N16

16. Section 301 provides that the filing of a voluntary petition commencing a case under the Bankruptcy Code constitutes an order for relief. When the case is commenced by an involuntary petition, the date of the order for relief is the entry of the court order (section 303(h)).

The references to holders of claims under sections 752(a) and 766(h)(i) are not significant for section

1104(b) purposes. These refer to claims held by customers of stockbroker-debtors and commodity broker-debtors who undergo liquidation pursuant to subchapter III or IV, respectively, of chapter 7. Such debtors are not eligible for chapter 11 relief, *11 U.S.C. § 109(d)*. Thus, section 1104(b) is not applicable to them.

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17. See discussion of eligible voters at *Collier on Bankruptcy*, 702.01 (Matthew Bender).

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18. Insider is defined in *11 U.S.C. § 101(41)*.

n19

19. *In re Poage*, 92 B.R. 659, 664 (*Bankr. N.D. Tex. 1988*) (Voting is done by the amount of the claim, not by heads.) (chapter 7 case).

n20

20. *11 U.S.C. § 1104(b)(2)(A)*.

n21

21. *11 U.S.C. § 1104(b)(2)(B)(i)*.

n22

22. See *Collier on Bankruptcy*, ch. 2007.1 (Matthew Bender) for a full description of the procedure for resolving contested chapter 11 trustee elections.

n23

23. *11 U.S.C. § 1104(b)(2)(C)*.

n24

24. This procedure may be inconsistent to some degree with section 1104(b)(2)(C), which requires the court to resolve any election dispute.

n25

25. 11 U.S.C. § 1104(b)(2)(B)(i), added by Pub. L. 109-8, § 416 (2005), effective in cases filed on or after October 17, 2005. *Id.* § 1501(b).

ABOUT THE AUTHOR(S):

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139 of 197 DOCUMENTS

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Collier on Limitations on State Homestead Exemption Claims

2008 Emerging Issues 1349

Collier on Limitations on State Homestead Exemption Claims

By Collier

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SUMMARY: In order to prevent abuse by some debtors, section 522 of the Bankruptcy Code added two subsections that limit the use of state homestead exemptions. This Emerging Issues Analysis explains the monetary limit when the property was acquired within 1,215 days prior to the filing of the bankruptcy case.

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ARTICLE: The Scope of Subsections 522(p) and (q)

In response to actual and perceived abuse by some debtors of state exemption statutes that protect an unlimited amount of homestead property, Congress added two new subsections to *section 522 of the Bankruptcy Code* that prevent the debtor from taking full advantage of state homestead exemptions under certain circumstances. These provisions impose a monetary limit of \$136,875ⁿ¹ on the amount of the debtor's interest in homestead property that may be exempted to the extent that there has been an acquisition of a homestead interest within a period of 1,215 days before the commencement of the case (section 522(p)) or the commission of certain bad acts by the debtor (section 522(q)).ⁿ²

The provisions contained in subsections 522(p) and (q) affect only homestead property of the kind similar to that described in section 522(d)(1). The property must fall within the following categories:

- . real or personal property that the debtor or a dependent of the debtor uses as a residence;
- . a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;
- . a burial plot for the debtor or a dependent of the debtor; or
- . real or personal property that the debtor or dependent of the debtor claims as a homestead.ⁿ³

Section 522(p) and (q) apply only when the debtor seeks to exempt an interest in homestead property under section

522(b)(3)(A) (formerly section 522(b)(2)(A)) by claiming exemptions under state law or local law. n4 The provision therefore does not restrict the ability of the debtor to exempt property under section 522(b)(2) by asserting the federal homestead exemption under section 522(d)(1), or to exempt an interest in property under section 522(b)(3)(B) (formerly section 522(b)(2)(B)) held as a tenant by the entirety or by joint tenancy to the extent that interest would have been exempt from process under nonbankruptcy law. n5

Among the three homestead limitations added by the 2005 Act, subsections 522(p) and (q) use language different from that found in subsection (o) n6 in describing when the limitations apply. Subsections (p) and (q), unlike subsection (o), state that the provisions apply only as a result of electing under subsection (b)(3)(A) to exempt property under State or local law. n7 Thus, in order to give meaning to the plain words of the phrase as a result of electing, the court in *In re McNabb* n8 held that subsections (p) and (q) are applicable only in states that have not opted out of the federal exemption scheme, because non-opt-out states are the only states in which an election is available.

A possible explanation for the electing language, not considered by the *McNabb* court, is that Congress intended the homestead limitations to apply when the debtor elects to exempt homestead property under section 522(b)(3)(A), but not when the debtor elects to exempt homestead property under section 522(b)(3)(B) that is held as a tenant by the entirety or by joint tenancy, if that interest is exempt from process under nonbankruptcy law. The existence of section 522(b)(3)(B) points to another form of election available to debtors. Moreover, the exemption under section 522(b)(3)(B) is available to debtors in all states to the extent recognized by state law, even in opt-out states, and would therefore suggest a reason why Congress may have included the electing language.

Other courts have refused to follow *McNabb*, and have largely done so by finding that the *McNabb* construction of the statutory language is contrary to the apparent legislative intent of subsections 522(p) and (q). n9 Citing references in the legislative history suggesting that the intent of Congress was to restrict the mansion loophole, these courts have held that the homestead limitations in subsections 522(p) and (q) should be construed as applying to debtors in all states, even opt-out states. n10

If subsection (p) or (q) is applicable, the debtor's exemptible interest in homestead property or the interest acquired n11 may not exceed the amount of \$136,875. n12

Homestead Cap on Interest Acquired During 1,215-Day Period Before Filing

Although Congress did not completely foreclose the type of eleventh hour acquisition of exempt property that was generally viewed with favor by the drafters of the 1978 Code, n13 in 2005 it did enact section 522(p)(1) n14 as a limitation on the debtor's exemption rights in homestead property. The debtor may not exempt any amount of interest that was acquired in homestead property during the 1,215-day period before the filing of the petition that exceeds the amount of \$136,875. n15

The dollar limit imposed by section 522(p)(1) does not apply to any amount of interest of the debtor in homestead property that was transferred from a debtor's previous principal residence to the debtor's current principal residence, provided that the debtor's previous residence was acquired before the 1,215-day period and both the previous and current residences are located in the same state. n16 In addition, the limitation does not apply to an interest claimed as exempt in a principal residence of a family farmer. n17

In *In re Wayrynen*, n18 the question was presented whether the protection in section 522(p)(2)(B) for an interest transferred from the debtor's previous principal residence should apply only to the debtor's most recent previous residence. The debtor's first home, purchased prior to the 1,215-day prepetition period, was subsequently sold by the debtor to purchase a second home 966 days before the petition was filed. Immediately prior to filing bankruptcy, the debtor sold this second home and purchased the residence he sought to exempt in his bankruptcy case. All of the homes

were located in Florida. The trustee argued that the debtor had nonexempt equity based on the then \$125,000 cap in section 522(p) because the debtor's current and previous homes were both purchased within 1,215 days of the petition, and that section 522(p)(2)(B) did not apply because the first home could not be considered the debtor's previous principal residence. The court disagreed and construed the phrase to include an interest transferred from a previous residence acquired before the 1,215-day period, even if that residence is not the most immediate prior residence. It found that the safe harbor in section 522(p)(2)(B) was intended to protect individuals such as the debtor who simply have benefited [from] the general appreciation of property values attributable to previous intra-state transactions. n19

The statutory language leaves some uncertainty as to the exact meaning of the phrase interest that was acquired. In view of the apparent purpose of section 522(p)(1), to discourage the more egregious examples of pre-bankruptcy exemption planning in which some debtors have purchased mansions in states having unlimited homestead exemption laws in contemplation of filing bankruptcy, n20 the phrase should be construed as applying to the actual purchase or acquisition of an ownership or fee interest in the homestead property. Under this view, section 522(p)(1) should not apply to the accumulation of equity in the debtor's homestead resulting from an appreciation in value of the property during the 1,215-day period. n21 Similarly, this provision should not prevent the debtor from claiming as exempt any increase in the debtor's homestead equity by more than \$136,875 attributable to the application of mortgage payments made during the lookback period. However, if the debtor converts nonexempt assets for the purpose of paying down a mortgage, with an intent to hinder, delay or defraud a creditor, such a transfer may give rise to an objection to the debtor's homestead exemption under section 522(o), n22 but should not fall within the purview of section 522(p)(1).

In addition, by referring to any amount of interest that was acquired, section 522(p) is applicable only if the debtor has acquired an ownership interest in the property that is quantifiable. This is consistent with the subsection's imposition of a monetary limit, since it would be impossible to determine whether the amount of interest exceeds the dollar limit, or whether the rollover provision in section 522(p)(2)(B) applies, if the ownership interest acquired by the debtor was not a measurable, monetary amount. Thus, the limitation under section 522(p) is not triggered when the debtor declares a homestead exemption on previously acquired property or otherwise changes the classification of property to a homestead within the 1,215-day period, even if homestead property is treated as a separate ownership interest under state law. n23

Since the allowable homestead exemption in most states is less than \$136,875, section 522(p) should have little effect in the vast majority of bankruptcy filings. Nevertheless, the combination of the 730-day domiciliary requirement in section 522(b)(3)(A) and the homestead limit in section 522(p)(1) may prove to have a deterrent effect on debtors considering a move to states with unlimited or substantial homestead exemptions before filing bankruptcy.

Homestead Cap Based on Certain Criminal or Unlawful Conduct

Felony Conviction. The debtor may not exempt any amount of interest in homestead property that exceeds \$136,875 n24 if the debtor has been convicted of certain criminal conduct. Under section 522(q)(1)(A), added by the 2005 Act, the monetary cap applies if the court determines that the debtor has been convicted of a felony (as defined in 18 U.S.C. § 3156), n25 which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of the Code. n26

Although the statutory language is less than clear, the objecting party will need to establish some connection between the felony conviction and the bankruptcy proceeding such that the bankruptcy filing would be deemed an abuse. This might be shown with proof that the debtor is attempting to discharge civil liability owing to victims of the crime, or that the bankruptcy filing may in some manner impede the debtor's obligation to pay restitution related to the felony conviction.

The 2005 Act does not specify who has standing to invoke section 522(q)(1)(A), but presumably it would include

any party in interest who may file an objection to the debtor's exemption claim. n27 However, a creditor or other party having no relation to the felony conviction may face the difficult task of proving that the bankruptcy filing was an abuse, particularly if no victim of the criminal act has objected to the debtor's exemption claim. In fact, a crime victim may oppose an objection to the debtor's homestead exemption under this provision, preferring instead to pursue the nondischargeability of any claim the victim may have against the debtor. n28

Liability on Certain Debts. The \$136,875 dollar limit on the debtor's exemptible homestead interest may also be invoked under section 522(q)(1)(B) if the court determines that the debtor owes a debt arising from certain wrongful conduct. n29 The debt must arise from one of the following categories:

- . any violation of state or federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934), n30 or any regulation or order issued under state or federal securities laws;

- . fraud, deceit or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 or under section 6 of the Securities Act of 1933;

- . any civil remedy under the Racketeer Influenced and Corrupt Organizations Act; n31 or

- . any criminal act, intentional tort or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding five years.

As under section 522(q)(1)(A), the statute leaves unanswered questions relating to requisite showing by the objecting party in order to prevail under section 522(q)(1)(B). At a minimum, the objecting party has the burden of proving that the debtor is liable on one of the listed debts. For debts that have not been reduced to judgment in a prior proceeding, or in which no findings from a prior proceeding may be given collateral estoppel effect, the objecting party will need to prove all of the elements that would establish liability on the debt.

In response to an objection to a homestead exemption under section 522(q)(1)(B), the debtor may argue that the debt in question is not of the type described in section 522(q)(1)(B). The debtor may also present evidence establishing any defenses to owing the debt. This will effectively require the bankruptcy court to conduct a trial or hearing on liability in such situations as if the matter were being heard in the first instance in the bankruptcy court. However, the bankruptcy court may prefer to abstain and permit the court in which the proceeding is pending to determine the underlying debt. In such case, the entry of the debtor's discharge may be delayed until resolution of the criminal or civil proceeding. n32

In contrast with the express language in section 522(q)(1)(A) requiring a prior criminal conviction, the homestead limitation in section 522(q)(1)(A) for a debt arising from a criminal act does not refer to a conviction. This suggests that the limitation may apply even if the debtor has not been convicted of a crime, though the objecting party will need to establish that the act giving rise to the debt constitutes a crime under applicable nonbankruptcy law. n33

Procedure for Challenging Exemption. The court's determination as to whether the debtor's exemption may be limited to \$136,875 shall be made after notice and a hearing. n34 As in the case of other grounds for objections to exemption claims, a party in interest may seek to invoke section 522(q)(1) by timely filing an objection to the debtor's exemption in accordance with the procedure contained in *Federal Rule of Bankruptcy Procedure 4003(b)(c)*. n35

No Application When Homestead Reasonably Necessary for Support. Section 522(q)(2) provides that the monetary limit contained in section 522(q)(1) shall not apply to the extent that the amount of the challenged interest in homestead property is reasonably necessary for the support of the debtor and any dependent of the debtor. n36 This

would permit the court to deny application of the cap on the debtor's exemptible homestead interest based on the reasonably necessary test found in other subsections of section 522, n37 and other sections of the Code. n38

A determination of whether the affected homestead interest is reasonably necessary would require the court to consider factors such as the debtor's (and dependent's) age, health, earning capacity, present and future financial needs and ability, other assets, future financial obligations such as alimony and child support, and any special needs of the debtor and dependents. n39 In the context of the debtor's potential loss of homestead property if the monetary cap were to be applied, courts may also wish to consider other matters such as any potential obstacles the debtor and the debtor's dependents may have in finding suitable and affordable replacement housing, the length of time the debtor has lived in the community, the costs of relocation, the safety of the debtor's current neighborhood, and the impact relocation would have on the debtor's future income and the education of the debtor's children.

Homestead Limitations Causing Discharge Delay. Sections 727(a)(12), 1141(d)(5)(C), 1228(f) and 1328(h), added as part of the 2005 Act, n40 provide that the entry of the debtor's discharge may be delayed pending the outcome of criminal and civil proceedings against the debtor referenced in section 522(q)(1). These provisions are not intended to provide grounds for the denial of a discharge, but simply provide a procedural mechanism for delaying the entry of discharge until the events that could trigger a potential exemption objection under section 522(q) are determined. n41 After notice and hearing held not more than 10 days before the date the discharge would otherwise enter, the debtor's discharge shall not be granted if the court finds that there is reasonable cause to believe that (1) section 522(q)(1) may be applicable, and (2) a proceeding is pending in which the debtor may be found guilty of a felony described in section 522(q)(1)(A) or liable for a debt described in section 522(q)(1)(B).

As to the first requirement, the debtor's discharge should not be delayed if the debtor is not claiming homestead property as exempt or has not claimed as exempt an interest in homestead property in excess of \$136,875 under a state exemption, or the debtor is claiming homestead property as exempt under section 522(b)(2) or (b)(3)(B). n42 In addition, the debtor's discharge may not be delayed if the potential felony conviction did not cause the debtor's bankruptcy filing to be abusive as required by section 522(q)(1)(A), the debt alleged to be owed is not of the type described in section 522(q)(1)(B), or the limitation under section 522(q)(1)(B) is not applicable because the homestead property is reasonably necessary for the support of the debtor and any dependent of the debtor.

As to the second requirement, the statutory language suggests that the court must have reasonable cause to believe that one of the identified types of proceedings is pending against the debtor and that the debtor may be found guilty or liable in such proceeding. The debtor therefore should have the right to be heard on any claims or defenses asserted in the proceeding that would establish that the debtor may not be criminally culpable or liable on the debt. However, for practical reasons related to the possibility that the debtor may make self-incriminating statements, it is not likely this would occur if a criminal proceeding is pending.

Application of Homestead Cap in Joint Cases

If the limitations in subsection 522(p) or (q) are applicable, a debtor may not exempt any amount of interest that exceeds in the aggregate \$136,875 in value in homestead property. Congress choice of the word aggregate in referring to the debtor's interest, consistent with its use in other subsections of section 522, n43 suggests that the dollar limit is to be applied to the combined interests of the debtor in the various forms of property listed in section 522(p)(1)(A) through (D). It is not intended to impose an overall \$136,875 cap on the interests both debtors in a joint case may exempt in property under a state homestead exemption. This construction of the statutory language is consistent with the absence in the 2005 Act of any express or implied limitation on section 522(m), which provides that section 522 applies separately with respect to each debtor in a joint case. n44 Thus, to the extent that state law permits the doubling of a state homestead exemption by joint debtors, subsection 522(p) or (q), if applicable, would not preclude debtors in a joint case from exempting their total interest up to \$273,750 in homestead property, provided that such an exemption is

available. n45

For a complete discussion of Code section 522, see Collier on Bankruptcy, ch. 522 (Matthew Bender).

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Return to Text

n1 1. This dollar amount applies in cases commenced on or after April 1, 2007. Pursuant to *11 U.S.C. § 104(b)*, the amount is adjusted every three years to account for changes in the cost of living. See Collier on Bankruptcy, 104.03 (Matthew Bender). For cases commenced before April 1, 2007, the limit is \$125,000.

n2

2. *11 U.S.C. § 522(p)(q)*, added by Pub. L. No. 109-8, § 322(a) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment.

n3

3. This final category is not provided for in section 522(d)(1) and is apparently intended to cover property that may be claimed as a homestead under state law even if not used by the debtor as a residence.

n4

4. Although the limitation in section 522(o) more broadly applies for purposes of section 522(b)(3)(A), which would suggest that exemptions claimed under federal nonbankruptcy law would also be affected, homestead property is rarely, if ever, exempted under federal nonbankruptcy law.

n5

5. *In re Buonopane*, 359 B.R. 346 (Bankr. M.D. Fla. 2007) (entireties property claimed as exempt under section 522(b)(3)(B) is not subject to dollar limit in section 522(p)); *In re Jacobs*, 342 B.R. 114 (Bankr. D.D.C. 2006) (debtor's claim of exemption under section 522(d) not is subject to section 522(q)).

n6

6. See *Collier on Bankruptcy*, 522.08[5] (Matthew Bender).

n7

7. 11 U.S.C. § 522(p), (q), added by Pub. L. No. 109-8, § 322 (2005), effective in cases commenced on or after April 20, 2005, the date of enactment.

n8

8. 326 B.R. 785 (*Bankr. D. Ariz.* 2005).

n9

9. See *In re Landahl*, 338 B.R. 920 (*Bankr. M.D. Fla.* 2006); *In re Kane*, 336 B.R. 477 (*Bankr. D. Nev.* 2006) (relying upon the court's authority to reform a statute when confronted with a scrivener's error, court concluded that Congress should be saved from its apparent drafting error by effectively striking the electing language from the statute); *In re Wayrynen*, 332 B.R. 479 (*Bankr. S.D. Fla.* 2005); *In re Kaplan*, 331 B.R. 483, 486 (*Bankr. S.D. Fla.* 2005) (court found that although the *McNabb* construction of the statutory language is supportable based on the language as drafted, it should be rejected because of clear legislative intent to the contrary).

n10

10. E.g., *In re Kaplan*, 331 B.R. 483, 488 (*Bankr. S.D. Fla.* 2005) (citing H.R. Rep. No. 109-31, at 1516 (2005) ([t]he bill also restricts the so-called mansion loophole).

n11

11. It should be noted that the limitation in section 522(p) applies only to the interest that was acquired. For example, if the debtor acquired within 1,215 days prepetition a vacant lot valued at \$200,000 adjacent to his or her existing \$500,000 residence, and both the lot and residence would otherwise be exempt under an unlimited state homestead exemption, the debtor would be permitted an exemption of \$625,000 if the cap in section 522(p)(1) were applicable.

n12

12. *See* note 1 *supra*.

n13

13. *See Collier on Bankruptcy*, 522.08[4] (Matthew Bender).

n14

14. Pub. L. No. 109-8, § 322(a) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment.

n15

15. This dollar amount applies in cases commenced on or after April 1, 2007. Pursuant to 11 U.S.C. § 104(b), the amount is adjusted every three years to account for changes in the cost of living. *See Collier on Bankruptcy*, 104.03 (Matthew Bender). For cases commenced before April 1, 2007, the limit is \$125,000.

n16

16. 11 U.S.C. § 522(p)(2)(B), added by Pub. L. No. 109-8, § 322(a) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment; *see In re Summers*, 344 B.R. 108 (Bankr. D. Ariz. 2006).

n17

17. 11 U.S.C. § 522(p)(2)(A), added by Pub. L. No. 109-8, § 322(a) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment.

n18

18. 332 B.R. 479 (Bankr. S.D. Fla. 2005).

n19

19. 332 B.R. 479, 486.

n20

20. H.R. Rep. No. 109-31, at 1516 (2005).

n21

21. *In re Chouinard*, 358 B.R. 814, 815 (Bankr. M.D. Fla. 2006) (Passive market appreciation is not an interest that a debtor acquires during the 1,215-day period.); *In re Sainlar*, 344 B.R. 669 (Bankr. M.D. Fla. 2006); *In re Blair*, 334 B.R. 374, 376 (Bankr. N.D. Tex. 2005) ([O]ne does not actually acquire equity in a home. One acquires title to a home.).

n22

22. *See, e.g., In re Maronde*, 332 B.R. 593 (Bankr. D. Minn. 2005).

n23

23. *In re Rogers*, 354 B.R. 792 (N.D. Tex. 2006) (debtor did not acquire an amount of interest by reclassifying, as a homestead real property she had inherited 11 years before filing bankruptcy); *In re Lyons*, 355 B.R. 387, 390 (Bankr. D. Mass. 2006) (debtor's recording of homestead declaration amounted to a classification of property under state law and was not the acquisition of a quantifiable property interest). *But see In re Greene*, 346 B.R. 835 (Bankr. D. Nev. 2006).

n24

24. This dollar amount applies in cases commenced on or after April 1, 2007. Pursuant to 11 U.S.C. § 104(b), the amount is adjusted every three years to account for changes in the cost of living. *See* Collier on Bankruptcy, 104.03 (Matthew Bender). For cases commenced before April 1, 2007, the limit is \$125,000.

n25

25. The term felony is defined as an offense punishable by a maximum term of imprisonment of more than one year. 18 U.S.C. § 3156.

n26

26. 11 U.S.C. § 522(p)(1)(A). Subsection (q) was added by Pub. L. No. 109-8, § 322(a) (2005), and applies to cases commenced on or after April 20, 2005, the date of enactment.

n27

27. *Fed. R. Bankr. P. 4003(b)*.

n28

28. The crime victim may actually prefer that the debtor retain the homestead after the bankruptcy proceeding is concluded. *See, e.g., Drenttel v. Jensen-Carter (In re Drenttel)*, 403 F.3d 611, 615 (8th Cir. 2005) (preservation of homestead exemption may serve long-term interests of creditors as obligations are more likely to be fulfilled by those whose connections with the community are stabilized by a protected interest in a relatively permanent place of abode than by those not so anchored).

n29

29. 11 U.S.C. § 522(q)(1)(B), added by Pub. L. No. 109-8, § 322(a) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment.

n30

30. The term securities laws means the Securities Act of 1933 (15 U.S.C. § 77a *et seq.*), the Securities Exchange Act of 1934 (15 U.S.C. § 78a *et seq.*), the Sarbanes-Oxley Act of 2002, the Public Utility Holding Company Act of 1935 (15 U.S.C. § 79 *et seq.*), the Trust Indenture Act of 1939 (15 U.S.C. § 77aaa *et seq.*), the Investment Company Act of 1940 (15 U.S.C. § 80a-1 *et seq.*), the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 *et seq.*) and the Securities Investor Protection Act of 1970 (15 U.S.C. § 78aaa *et seq.*). *See* 15 U.S.C. § 78c(a)(47).

n31

31. *See* 18 U.S.C. § 1964 *et seq.*

n32

32. See Homestead Limitations Causing Discharge Delay *infra*.

n33

33. See *In re Larson*, 340 B.R. 444 (Bankr. D. Mass. 2006) (homestead exemption may be reduced based on debt arising from negligent operation of motor vehicle, even though charge against the debtor was continued without a conviction, because debtor's admission of guilt in criminal proceeding was equivalent of a guilty plea under state law).

n34

34. 11 U.S.C. § 522(q)(1)(A), added by Pub. L. No. 109-8, § 322(a) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment.

n35

35. See *Collier on Bankruptcy*, 522.05[2] (Matthew Bender).

n36

36. 11 U.S.C. § 522(q)(2), added by Pub. L. No. 109-8, § 322(a) (2005), effective in cases commenced on or after April 20, 2005, the date of enactment. Section 522(a)(1) defines dependent as including the debtor's spouse, whether or not actually dependent. Ordinarily this definition is not relevant to the application of state exemption laws. See *Collier on Bankruptcy*, 522.03[1] (Matthew Bender). However, the use of the word dependent in section 522(q)(2) requires that the definition be applied in considering the application of the cap on a state homestead exemption.

n37

37. *E.g.*, 11 U.S.C. § 522(d)(10)(11).

n38

38. *E.g.*, 11 U.S.C. § 1325(b)(2)(A).

n39

39. See, e.g., *In re Mann*, 201 B.R. 910 (Bankr. E.D. Mich. 1996); see also *Collier on Bankruptcy*, 522.09[10][a] (Matthew Bender).

n40

40. Pub. L. No. 109-8 (2005). These provisions are effective in cases commenced on or after April 20, 2005, the date of enactment.

n41

41. These provisions were enacted by section 330 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), which is entitled: Delay of Discharge During Pendency of Certain Proceedings. Presumably, Congress added these provisions because the operation of section 522(c) upon the entry of the debtor's discharge, before a section 522(q) exemption objection is resolved, would potentially prevent any subsequent limitation on the debtor's exemption.

n42

42. See *In re Jacobs*, 342 B.R.114 (Bankr. D.D.C. 2006) (delay of discharge provision in section 727(a)(12) is not applicable because debtor claimed exemptions under section 522(d)).

n43

43. E.g., 11 U.S.C. § 522(d)(6) (The debtor's aggregate interest, not to exceed \$1,500 in value, in any implements, professional books, or tools of the trade of the debtor or the trade of a dependent of the debtor.).

n44

44. See *Collier on Bankruptcy*, 522.04[5] and [6] (Matthew Bender).

n45

45. See *In re Rasmussen*, 349 B.R. 747 (Bankr. M.D. Fla. 2006).

ABOUT THE AUTHOR(S):

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140 of 197 DOCUMENTS

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Collier on Avoidance of Setoffs

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Collier on Avoidance of Setoffs

By Collier

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SUMMARY: Though setoffs made within 90 days of a bankruptcy filing are generally not avoidable, there are exceptions to this rule. This Emerging Issues Analysis discusses covering the indirect avoidance provisions of Bankruptcy Code § 553, it also addresses § 553(b), which permits direct avoidance to the extent that the pre-petition setoff improved the creditors position. It gives several examples of how a creditors improved status is determined.

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ARTICLE: Two general avoidance issues arise in the context of setoffs under *section 553 of the Bankruptcy Code*. The first is the extent to which a prepetition setoff may constitute a preference or fraudulent transfer under section 547, section 544 or section 548. The second involves the circumstances under which the special rules of section 553(b) apply to avoid setoffs.

Setoffs as Avoidable Preferences or Fraudulent Transfers

In general, a prepetition setoff is not avoidable as a preference under section 547, ⁿ¹ or as a fraudulent transfer under section 548 or 544. ⁿ² There are two exceptions to this general rule. A prepetition setoff may be avoidable as a preference or fraudulent transfer if the setoff was invalid under applicable nonbankruptcy law and thus not a setoff. Similarly, a prepetition setoff may be invalid if the setoff does not qualify under the provisions of section 553(a)(2)(B) or 553(a)(3). A prepetition setoff is not avoidable as a preference or fraudulent transfer, however, under section 553(a)(1). ⁿ³

Setoffs as Transfers. At a minimum, a preference under section 547(b) requires a prepetition transfer of an interest of the debtor in property. ⁿ⁴ Similarly, the fraudulent transfer provisions of section 548(a) ⁿ⁵ and the strong arm provisions of section 544(b) likewise require a transfer that occurred before the commencement of the debtor's case. ⁿ⁶ The term transfer is defined in Code section 101, ⁿ⁷ and the definition intentionally omits setoffs. The legislative history to section 101 explains the omission in clear terms: Inclusion of setoff is deleted. The effect is that a setoff is not subject to being set aside as a preferential transfer but will be subject to special rules. Similarly, section 553 provides

that this title, i.e., title 11, does not affect setoff rights. Thus, setoff cannot be a preference or a fraudulent transfer. n8

Invalidity under Applicable Nonbankruptcy Law. Although a valid prepetition setoff cannot be a transfer, a prepetition setoff that was not valid under applicable nonbankruptcy law at the time it was taken may be subject to avoidance as a preference or fraudulent conveyance. For example, if the creditor and debtor each owed the other a mutual, prepetition obligation, but applicable nonbankruptcy law did not permit a setoff of their respective debts, or the setoff was procedurally invalid for some reason at the time it was ostensibly taken, the benefit obtained by the creditor may be subject to preferential attack on the ground that the transfer in question was not, in fact, a legitimate setoff. However, the failed setoff might not be subject to attack as a preference if it might still be taken if done properly after the commencement of the debtor's case. n9

Similarly, if it turns out that the creditor actually owed nothing to the debtor under applicable nonbankruptcy law, but nonetheless extinguished its debt to the debtor by seizing the debtor's property under the guise of a setoff, then the obligation to the debtor might be recoverable as a fraudulent transfer. n10 In each of these instances, application of either the preference provisions of section 547, or the fraudulent transfer provisions of section 548 or 544, depends on the threshold determination that the transfer in question was not a genuine setoff under relevant nonbankruptcy law and therefore not subject to the limitations on the Code's definition of transfer set forth in section 101.

Retroactive Invalidity under Section 553. A related issue is whether a prepetition setoff can be avoided as a preference or fraudulent transfer, not because the setoff was invalid under applicable nonbankruptcy law, but because the setoff does not qualify under the requirements of section 553(a). For example, a relevant claim and debt might not be mutual under the Code's definition, even though they might be mutual under applicable state law. Similarly, the creditor's claim might be of the type that is subject to disallowance under some provision of the Code, and, thus, if the setoff had not been taken, it would be prohibited under section 553(a)(1). Finally, the setoff might not satisfy the requirements of subsection 553(a)(2) or (a)(3).

Except for the provisions of subsections 553(a)(2)(B) and (a)(3), the requirements of section 553(a) do not apply retroactively to affect prepetition setoffs. Thus, an otherwise valid prepetition setoff is not invalid, and thereby subject to avoidance, on the ground that it was not mutual within the meaning of the Code, n11 or because the creditor's claim might have been disallowed under some provision of the Code if the claim had been presented for allowance in the debtor's bankruptcy proceedings. n12

Disallowance; § 553(a)(1). Section 553(a)(1) is not an avoidance provision. If the setoff in question has already taken place before the commencement of the debtor's case, section 553(a)(1) does not apply retroactively to avoid the claim or otherwise subject the setoff to attack as a preference. The reason for this conclusion is straightforward. If an otherwise valid prepetition setoff has been taken, the creditor's prepetition claim is extinguished to the extent of the setoff. Thus, there is no claim to disallow in the subsequent bankruptcy proceedings.

The case of *Durham v. SMI Industries Corp.* n13 illustrates this principle. *Durham* involved a prepetition setoff between two metals dealers. The trustee in the chapter 7 case of one of the dealers argued that the prepetition setoff was invalid because the creditor's claim was subject to disallowance under *Bankruptcy Code* section 502(d) on the ground that the creditor had not satisfied a previous preference judgment. n14 The Court of Appeals for the Fourth Circuit disagreed, concluding that, because the setoff had been valid under applicable law, the corresponding debts had been canceled to the extent of the setoff. n15 Thus, there was no claim to be disallowed in the debtor's bankruptcy proceedings, and, thus, section 553(a)(1) had no application.

Sections 553(a)(2) and 553(a)(3). Unlike section 553(a)(1), sections 553(a)(2) and 553(a)(3) do reach back to

affect certain prepetition transactions. n16 Under section 553(a)(2)(B), a setoff with respect to a claim that was transferred within the 90-day period before the debtor's bankruptcy case and while the debtor was insolvent does not qualify as a legitimate setoff. Thus, if a setoff of this kind occurred, it may be subject to attack as a preference. The same analysis applies with respect to section 553(a)(3). n17

Application of sections 553(a)(2)(B) and 553(a)(3) to prepetition setoffs finds general support in the legislative history. n18 If sections 553(a)(2)(B) and 553(a)(3) did not apply to prepetition setoffs, then creditors would have a clear incentive to arrange and take the setoffs that these sections prohibit as quickly as possible to avoid the prohibition, a result demonstrably at odds with the intention of the drafters of the Code.

Direct Avoidance under Section 553(b)

Unlike sections 553(a)(2)(B) and 553(a)(3), which only indirectly operate to avoid certain prepetition setoffs in tandem with section 547(b), section 553(b) is a direct avoidance provision. Section 553(b) provides that a trustee may recover from any creditor the amount of a prepetition setoff to the extent that the setoff permitted the creditor to recover more than the creditor would have recovered if the setoff had occurred at certain benchmark points in time. Section 522(h) provides the debtor with the right to utilize the trustee's power under section 553(b) to recover exemptible property if the trustee fails to do so. n19 The purpose of section 553(b) is to discourage creditors from taking setoffs against debts owed to insolvent debtors under circumstances where a creditor might be sorely tempted to take a setoff because of an improved setoff opportunity. By providing for the recovery of the amount of the improvement, section 553(b) ostensibly eliminates the temptation to seize the moment. n20

For example, suppose a bank holds a claim against the debtor in the amount of \$100,000. Suppose 90 days before bankruptcy, the debtor had on deposit with the bank the sum of \$50,000. Suppose 30 days before bankruptcy, the debtor deposits an additional \$50,000, bringing the total amount of the debtor's deposit with the bank to \$100,000. If the debtor is experiencing financial difficulty and has defaulted on its obligation to the bank, the bank might be tempted to take a setoff at the moment the debtor's deposit balance is at its highest. However, such an offset might well plunge the debtor into financial ruin. The purpose of section 553(b) is to remove the bank's temptation to take the setoff by providing for the recovery in bankruptcy of an amount equal to the value of the improvement in the bank's position.

Calculation of Avoidable Improvement in Debtor's Position. The initial benchmark used in calculating any improvement in the creditor's position under section 553(b) is the point in time that is 90 days before the commencement of the debtor's bankruptcy case. The relevant calculation of any avoidable improvement proceeds in four stages.

First, section 553(b) requires the calculation of the creditor's setoff position 90 days before the commencement of the debtor's case. This is done by comparing the creditor's claim with the creditor's debt, and determining the extent to which the creditor's claim exceeds the amount of the debt. The amount by which the creditor's claim exceeds the amount of the debt is called the insufficiency. n21

Second, if there was no insufficiency on the 90th day, section 553(b) requires the court to determine whether there was an insufficiency on any day after the initial 90-day point in time (but before the commencement of the debtor's case). This determination is also accomplished by comparing the creditor's claim with the creditor's debt. n22

Third, in order to calculate any subsequent improvement in the creditor's setoff position, section 553(b) sets the initial reference date as the *later* to occur of (a) any insufficiency existing on the 90th day and (b) any insufficiency existing on the first day during the 90 days preceding the petition date (including the 90th day) on which there was an insufficiency. Thus, if there is an insufficiency on the 90th day, and an insufficiency on any other day during the 90-day period, the point of reference would be set on the 90th day. n23

Fourth, section 553(b) requires a comparison between the creditor's setoff position at the initial reference point (as calculated in the preceding paragraph) and the day on which any setoff was actually taken. Section 553(b) permits the trustee to recover any improvement in the creditor's position measured by any decrease in the creditor's insufficiency on the date of setoff. n24

Examples Illustrating the Basic Operation of Section 553(b). Because the mechanics of section 553(b) are somewhat cumbersome in their application, it is useful to illustrate the basic operation of the section with the following six examples.

Example 1: Suppose a bank had a claim against a debtor for \$15,000. At 90 days before the commencement of the debtor's bankruptcy case, the debtor had \$10,000 on deposit with the bank. The insufficiency" at 90 days was thus \$5,000. At 30 days before the commencement of the debtor's bankruptcy case, the debtor deposited \$4,000 into the account, increasing the balance to \$14,000 on deposit and reducing the insufficiency to \$1,000. The bank took a setoff against the entire deposit on the 30th day. Because the insufficiency at the time of setoff (\$1,000) was less than the insufficiency at 90 days prior to filing (\$5,000), the bank improved its position (by \$4,000). The trustee may recover the improvement (\$4,000), but the bank may keep \$10,000 from its setoff (\$14,000 less the \$4,000 recovered by the trustee).

Example 2: Suppose a bank had a claim against a debtor for \$15,000. At 90 days before the commencement of the debtor's bankruptcy case, the debtor had \$10,000 on deposit. The insufficiency at 90 days was thus \$5,000. At 89 days before the petition date, the debtor withdrew \$2,000, leaving \$8,000 on deposit and increasing the insufficiency to \$7,000. At 30 days before the petition date, the debtor deposited \$6,000, leaving a balance of \$14,000 on deposit. Thus, at 30 days, the insufficiency was \$1,000. The bank offset the \$14,000 deposit against its \$15,000 claim on the 30th day. In calculating any recoverable improvement, section 553(b) requires use of the *later* of the insufficiency at 90 days before the petition date and the *first* date during the 90 days in which there was *any* insufficiency. Thus, in this example, section 553(b) requires use of the insufficiency at 90 days (\$5,000). It does not matter that the amount of the insufficiency increased the next day. Compare the insufficiency at 90 days (\$5,000) to the insufficiency on the actual date of setoff (\$1,000). The difference (\$4,000) is the improvement in position. Therefore, the trustee can recover \$4,000 and the bank may keep \$10,000 (\$14,000 on deposit on the date of setoff less the \$4,000 recoverable by the trustee).

Example 3: Suppose a bank had a claim against a debtor for \$15,000. At 90 days before the commencement of the debtor's bankruptcy case, the debtor had \$10,000 on deposit with the bank. The insufficiency at 90 days was thus \$5,000. On the 89th day, the debtor deposited \$5,000, resulting in a balance of \$15,000 and an insufficiency of zero. At 30 days before the commencement of the debtor's bankruptcy case, the bank offset the entire deposit against its claim. In calculating any recoverable improvement, section 553(b) requires use of the *later* of the insufficiency at 90 days before the petition date and the *first* date on which there was *any* insufficiency during the 90 day period, in this case the insufficiency on the 90th day was \$5,000. Because the insufficiency at the time of setoff (zero) was less than the insufficiency at 90 days prior to filing (\$5,000), the bank improved its position (by \$5,000). The trustee may recover the improvement (\$5,000), but the bank may keep \$10,000 from its setoff (\$15,000 less the \$5,000 recovered by the trustee). n25

Example 4: Suppose that, at 90 days before filing a bankruptcy petition, the debtor owed \$10,000 to a bank and had \$10,000 on deposit with the bank. At all times during the 90-day period, the deposit account's balance fluctuated between \$10,000 and \$15,000. Since there never was any insufficiency, the bank had no improvement in position. On any day during the 90-day period, the bank was entitled to offset \$10,000 to cover the entire amount owed to it, with no portion subject to recovery.

Example 5: Suppose that, at 90 days prior to petition, the debtor owed a bank \$100,000 and had \$100,000 on deposit. Thus, the insufficiency at 90 days was zero. At 50 days prior to the petition date, the debtor borrowed \$20,000

more, leaving a debt of \$120,000. The debtor also withdrew \$10,000 from the deposit account, leaving \$90,000 on deposit. The insufficiency at 50 days was therefore \$30,000. By the time the bank took a setoff on the 30th day, the debtor had paid down the loan to \$40,000, and had \$40,000 on deposit. Thus, the insufficiency on the date of setoff was zero. The bank improved its position by \$30,000. In calculating the amount of any recoverable improvement in this example, section 553(b) requires use of the difference between the first insufficiency within the 90 day period (\$30,000 on day 50) and the insufficiency on date of setoff (zero). The trustee may therefore recover \$30,000 and the bank may retain \$10,000.

Example 6: Suppose that, at 90 days before the commencement of the debtor's bankruptcy case, the debtor opened a deposit account for \$2,000 and took out a loan for \$12,000 to be repaid in three monthly installments of \$4,000 each. The insufficiency at 90 days was thus \$10,000. At 60 days before the petition date, the debtor paid \$4,000 on the loan, reducing the debt owed to the bank to \$8,000. At 30 days before the petition date, the debtor was able to pay only \$3,000 on the loan, reducing the debt owed to the bank to \$5,000. The \$2,000 was still on deposit, so the insufficiency at 30 days is \$3,000. The bank declared the debtor to be in default, accelerated the debt and offset the \$2,000 in the deposit account. The improvement in position was \$7,000, but the trustee cannot recover the entire improvement when the amount of the improvement is greater than the amount actually offset. The trustee may only recover \$2,000.

Applicability to Postpetition Exercise of Right. An interesting issue that has generated a split of authority among the courts is whether section 553(b) applies with respect to setoffs that were not taken prepetition but that are preserved under the provisions of section 553(a). n26 The literal language of section 553(b) suggests that its provisions apply only with respect to setoffs that were actually taken within the 90 days preceding the commencement of the debtor's bankruptcy case. n27 On the other hand, some courts have construed section 553(b) as applicable to the *right* of setoff, whether it was exercised prepetition or not. n28

The better result is to limit section 553(b) to setoffs actually taken prepetition. In addition to remaining true to the language of the text, that result is consistent with the underlying purpose of section 553, which is to encourage creditors *not* to take setoffs by generally preserving their setoff rights. Limiting section 553(b) to its express language serves this fundamental purpose, whereas extending it to creditors who have refrained from exercising their setoff rights does not.

Contingent, Unmatured or Unliquidated Obligations. An important question under section 553(b) arises in calculating the amount of any insufficiency in cases involving prepetition setoffs against contingent, unmatured or unliquidated claims and debts. The question arises because the contingent, unmatured or unliquidated status of a claim or debt may make it more difficult to determine the amount of the claim or debt and, consequently, may make it more difficult to calculate any relevant insufficiency under the section. n29

The case of *Lee v. Schweiker* n30 illustrates this point. There, the creditor (the Social Security Administration) owed the debtor monthly Social Security benefits of \$406.20. The debtor, on the other hand, owed the creditor \$746.50, representing an overpayment of prior benefits. Within the 90 days preceding the debtor's bankruptcy case, the creditor took three monthly offsets of \$102 each against the debtor's three monthly benefit checks, for a total offset of \$306. The debtor sought to recover the \$306 amount under section 553(b).

In denying recovery, the court reasoned that the creditor's debt included all of the monthly benefits that the creditor owed to the debtor during the 90-day period, for a total of \$1,218.60. The court determined this amount to be the creditor's debt, notwithstanding that this obligation was entirely contingent and unmatured 90 days prior to the date the debtor commenced her case. n31 In contrast, the creditor held a fixed claim against the debtor for \$746.50, representing the previous overpayments to the debtor. Because the amount of the debt always exceeded the amount of the claim, the court determined that there was no insufficiency and, thus, the debtor could not recover the setoffs under section 553.

Additional Rules of Application. In applying the provisions of section 553(b), four additional principles bear mention. First, courts have held that application of section 553(b) is not susceptible to equitable manipulation. As stated by one court, the language is specific, its application is mathematical, and we do not view it to be susceptible to equitable treatment. n32

Second, if the creditor is otherwise secured, it may have a complete defense to the trustee's action under section 553(b). The reason is that, if the creditor's other security is of a sufficient value, any insufficiency may be covered by other property of the estate subject to the creditor's lien, resulting in no overall net improvement to the creditor. n33

Third, the improvement in position test does not apply to setoffs of the kind treated in section 362(b)(6) (certain commodity contracts, forward contracts or security contracts); section 362(b)(7) (certain repurchase agreements); section 362(b)(14) (swap agreements); section 365(h) (time share interest purchasers or lessees remaining in possession); section 546(h) (return of unsold goods); and section 365(i)(2) (setoffs by purchaser of real property or time share interest against damages caused by the nonperformance of the debtor occurring after trustee's rejection of contract). These specific types of setoffs are explicitly carved out from the operation of section 553(b).

Finally, it should be noted that the court may award post-judgment interest under section 553(b). Interest on the judgment generally accrues from the date of the commencement of the action to recover the setoff. n34

Avoidable Postpetition Setoffs

As noted previously, a setoff taken in violation of the automatic stay is generally void. n35 In addition, certain unauthorized transactions may be avoided pursuant to the provisions of *Bankruptcy Code section 549(a)(2)(B)*. n36 Conceivably, an unauthorized postpetition setoff might be undone either as a violation of the automatic stay, or pursuant to the provisions of section 549.

Application of section 549 to unauthorized setoffs, however, raises an interesting issue. Like section 547, section 549(a) specifically applies to avoid unauthorized transfers. As noted previously, Congress intended to exclude setoffs from the definition of transfer under the Code, at least in the context of preferences. n37 Applied to section 549, this omission conceivably disables the statute. The better view, however, may be that if a postpetition setoff is not authorized by the Code, it is not a legitimate setoff, and therefore qualifies as a transfer. n38

For a complete discussion of code section 553, see Collier on Bankruptcy, ch. 553 (Matthew Bender).

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n1 1. 11 U.S.C. § 547(b); see *Braniff Airways, Inc. v. Exxon Co., U.S.A.*, 814 F.2d 1030, 1034, 16 C.B.C.2d 1447, 1451 (5th Cir. 1987); see also *In re Carnell Constr. Corp.*, 424 F.2d 296, 299 (3d Cir.), cert. denied sub nom. *Masterson v. Valley Nat'l Bank*, 400 U.S. 828, 91 S. Ct. 56, 27 L. Ed. 2d 58 (1970).

n2

2. 11 U.S.C. §§ 544(b) and 548.

n3

3. See *Durham v. SMI Indus. Corp.*, 882 F.2d 881, 882-83 (4th Cir. 1989).

n4

4. 11 U.S.C. § 547(b); see Collier on Bankruptcy, ch. 547 (Matthew Bender).

n5

5. 11 U.S.C. § 548(a); see Collier on Bankruptcy, ch. 548 (Matthew Bender).

n6

6. 11 U.S.C. § 544(b); see Collier on Bankruptcy, ch. 544 (Matthew Bender).

n7

7. 11 U.S.C. § 101.

n8

8. Although fraudulent transfers are not specifically mentioned in the legislative history, there is little reason to believe that Congress intended a different understanding of transfer to apply in the fraudulent conveyance context. See 124 Cong. Rec. H11,090 (daily ed. Sept. 28, 1978); S17,407 (daily ed. Oct. 6, 1978); *Eckles v. Petco Inc. (In re Balducci Oil Co.)*, 33 B.R. 847, 852 (Bankr. D. Colo. 1983) (11 U.S.C. § 553(b), the insufficiency test, contains the special rules and is, in essence, a miniature preference provision akin to section 547(c)(5)); see also *New York County Nat'l Bank v. Massey*, 192 U.S. 138, 147, 24 S. Ct. 199, 48 L. Ed. 380 (1904) (creation of debt by deposit does not operate to enlarge scope of statute defining preferences so as to prevent setoff in cases coming within terms of predecessor to 11 U.S.C. § 553).

n9

9. See *Durham v. SMI Indus. Corp.*, 882 F.2d 881, 882 (4th Cir. 1989) (only if setoff is invalid and no right of setoff exists in bankruptcy is 11 U.S.C. § 547 applied); 11 U.S.C. § 547(b)(5).

n10

10. See Setoffs as Transfers *supra*.

n11

11. See generally *K Town, Inc. v. Metropolitan Bank & Trust Co. (In re K Town, Inc.)*, 171 B.R. 313, 319 (Bankr. N.D. Ill. 1994).

n12

12. See *Durham v. SMI Indus. Corp.*, 882 F.2d 881, 883 (4th Cir. 1989).

n13

13. 882 F.2d 881 (4th Cir. 1989).

n14

14. 882 F.2d 881, 882-83 (4th Cir. 1989); see 11 U.S.C. § 502(d) (providing for the disallowance of the claim of a creditor that has failed to satisfy a preference judgment).

n15

15. 882 F.2d 881, 883 (4th Cir. 1989).

n16

16. See *Wooten v. Vicksburg Refining, Inc. (In re Hill Petroleum Co.)*, 95 B.R. 404, 411 (Bankr. W.D. La. 1988) (section 553(a)(2)(B) would apply to avoid setoff taken one day before commencement of debtor's case).

with respect to transferred claim).

n17

17. See *Katz v. First Nat'l Bank of Glen Head*, 568 F.2d 964, 971, 14 C.B.C. 432, 439-40 (2d Cir. 1977) (deposit intentionally made by debtor to be available to be offset against debtor's obligations to the bank is impermissible preference), *cert. denied*, 434 U.S. 1069, 98 S. Ct. 1250, 55 L. Ed. 2d 771 (1978); *Cusick v. Second Nat'l Bank*, 115 F.2d 150, 152 n.4 (D.C. Cir. 1940).

n18

18. The relevant legislative history provides:

Different treatment of setoff that occurs prepetition and postpetition may generate problems for insolvent debtor. [sic] If the restrictions placed on postpetition setoff are greater than those placed on prepetition setoff, there is an incentive for creditors with a right of setoff, especially banks, to offset during a period of financial difficulty of the debtor, rather than continuing to carry the debtor in the hopes that matters will improve. Thus, whatever limitations are adopted for postpetition setoff, it is important to apply them to prepetition setoff as well. If they are not applied equally, a creditor may attempt to avoid the postpetition limitations by offsetting prepetition, perhaps precipitating the bankruptcy of the debtor.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 186 (1978).

n19 19. See *Collier on Bankruptcy*, 522.12 (Matthew Bender).

n20

20. See *Lee v. Schweiker*, 739 F.2d 870, 877, 11 C.B.C.2d 834, 842 (3rd Cir. 1984) (explaining that concern of Congress was that creditors, primarily banks, that had mutual accounts with debtor would foresee approach of bankruptcy and scramble to secure better position for themselves by decreasing insufficiency, to detriment of other creditors); H.R. Rep. No. 595, 95th Cong. 2d Sess. at 195 (1978), (citing example of where debtor has \$5,000 on deposit ninety days before the petition is filed, and \$8,000 on deposit on the day the petition is filed); see also *In re Bakersfield Westar Ambulance, Inc.*, 123 F.3d 1243, 1245 (9th Cir. 1997) (discussing purpose of section 553(b)); *In re Turner*, 96 F.3d 465, 467-68 (10th Cir. 1996).

n21

21. 11 U.S.C. § 553(b)(2) (defining the term insufficiency). For example, using a bank for illustration purposes, suppose that 90 days before the debtor filed for bankruptcy relief the debtor owed \$100,000 to the

bank on a loan, and had on deposit with the bank the sum of \$100,000. Under 11 U.S.C. § 553(b), the bank possessed a right of setoff equal to \$100,000 on the 90th day before the debtor filed for bankruptcy relief. There is no insufficiency because the amount of the claim does not exceed the amount of the debt.

n22

22. Continuing the hypothetical in the preceding note, suppose the debtor withdrew \$50,000 from its account with the bank 75 days before filing for bankruptcy relief, leaving a deposit balance of \$50,000. The 75-day point would mark the first point in time that there was an insufficiency. Prior to the 75-day point, the amount of the bank's claim (\$100,000) equaled the amount of the bank's debt to the debtor (\$100,000), and, thus, there was no insufficiency. However, after the withdrawal on the 75th day, the bank's claim against the debtor (\$100,000) exceeded the bank's debt to the debtor (\$50,000) by \$50,000.

n23

23. In the hypothetical discussed in the preceding notes, there was no insufficiency on the 90th day. The first day on which there was an insufficiency was the 75th day. Thus, in the hypothetical, the initial reference point for determining any improvement in the bank's setoff position under section 553(b) would be the bank's setoff position on the 75th day.

n24

24. Continuing the hypothetical discussed in the three preceding notes, suppose the debtor deposited \$30,000 into its account with the bank 50 days prior to filing for bankruptcy relief, resulting in a balance in its account of \$80,000. Suppose further that the bank offset the \$80,000 account balance against its \$100,000 claim on that same day. By taking the setoff on the 50th day before bankruptcy, the bank took advantage of a \$30,000 improvement in its position from the 75th day. Because of this improvement, section 553(b) would permit the trustee to recover \$30,000 from the bank.

n25

25. When no insufficiency exists on the date of setoff, 11 U.S.C. § 553(b) still applies. See *Braniff Airways, Inc. v. Exxon Co. U.S.A.*, 814 F.2d 1030, 1040 n.12, 16 C.B.C.2d 1447, 1459 (5th Cir. 1987) (while it could be argued that section 553(b) does not apply under these circumstances, court declined to adopt such position); see also Passamano, *Setoff in Bankruptcy: An Overview of the Mechanics*, 105 *Banking L.J.* 349 (1993).

n26

26. Compare *Heckathorn Constr. Co. v. Bass Mechanical Contractors, Inc.* (*In re Bass Mechanical*

Contractors, Inc.), 88 B.R. 201, 204 (Bankr. W.D. Ark. 1988) (This court is reluctant to extend § 553(b) to allow an improvement in position test for pre-petition rights exercised post-petition.), with *Braniff Airways, Inc. v. Exxon Co., U.S.A.*, 814 F.2d 1030, 1041 n.13, 16 C.B.C.2d 1447, 1460 (5th Cir. 1987) (If Exxon wants to rely on a pre-petition right to setoff pursuant to section 553, it must comply with both sections 553(a) and 553(b).), and *Tavormina v. ITT Commercial Fin. Corp. (In re Aquasport, Inc.)*, 115 B.R. 720, 722 (Bankr. S.D. Fla. 1990), *aff'd*, 155 B.R. 245 (S.D. Fla. 1992), *aff'd without op.*, 985 F.2d 579 (11th Cir. 1993) (According to established precedent, this court can weigh the improvement of position test even in a post-petition setoff situation, and appears bound to do so where no relief from the automatic stay has been requested by the creditor.).

n27

27. The section states that it applies if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition. 11 U.S.C. § 553(b); see *Sandoz v. Conoco, Inc. (In re Delta Energy Resources, Inc.)*, 67 B.R. 8, 11 (Bankr. W.D. La. 1986); *Exxon Corp. v. Compton Corp. (In re Compton Corp.)*, 6 C.B.C.2d 1326, 1329, 22 B.R. 276, 278 (Bankr. N.D. Tex. 1982).

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28. See *Braniff Airways, Inc. v. Exxon Co. USA*, 814 F.2d 1030, 1040 n.11, 16 C.B.C.2d 1447, 1459 (5th Cir. 1987); see also *Durham v. SMI Indus. Corp.*, 882 F.2d 881, 884 (4th Cir. 1989).

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29. See *Collier on Bankruptcy*, 553.03[1][d] and [f] (Matthew Bender).

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30. 739 F.2d 870, 11 C.B.C.2d 834 (3d Cir. 1984).

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31. The obligation was contingent on the debtor's surviving to the end of each month. Only if that occurred would the debtor be entitled to any benefit. See *Lee v. Schweiker*, 739 F.2d 870, 877, 11 C.B.C.2d 834, 842 (3d Cir. 1984); see also *In re Anes*, 195 F.3d 177, 183 (3d Cir. 1999).

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32. *Assiante v. Davisville Credit Union (In re Assiante)*, 28 B.R. 903, 905 (Bankr. D.R.I. 1983).

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33. See *Quinn v. Montrose State Bank (In re Intermountain Porta Storage, Inc.)*, 74 B.R. 1011, 1017 (D. Colo. 1987); *Moody & Newton, Inc. v. Sun Bank/Suncoast, N.A. (In re Moody & Newton, Inc.)*, 64 B.R. 211, 212 (Bankr. M.D. Fla. 1986).

n34

34. See *Smith v. Mark Twain Nat'l Bank*, 805 F. 2d 278, 291-92, 15 C.B.C.2d 1160, 1176 (8th Cir. 1986).

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35. See *Collier on Bankruptcy*, 553.06[1][b] (Matthew Bender).

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36. 11 U.S.C. § 549(a)(2)(B); see ch. 549 *supra*.

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37. See *Collier on Bankruptcy*, 553.09[1][a] (Matthew Bender).

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38. See *Collier on Bankruptcy*, 553.09[1][a] (Matthew Bender); see also *Brook v. Republic Bank (In re Clearwater Discount Marine, Inc.)*, 150 B.R. 74, 75-76 (Bankr. M.D. Fla. 1993); *Putney v. Barnett Bank (In re W & T Enter. Inc.)*, 84 B.R. 838, 839-40 (Bankr. M.D. Fla. 1988).

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141 of 197 DOCUMENTS

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Collier on Non-Ordinary-Course Use, Sale or Lease of Property

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Collier on Non-Ordinary-Course Use, Sale or Lease of Property

By Collier

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SUMMARY: Though trustees and debtors in possession have the right to seek approval to use, sell or lease property of the estate outside the ordinary course of business, specific steps must be taken to obtain approval for same. This Emerging Issues Analysis discusses Bankruptcy Code § 363, covering the mandatory notice and opportunity for a hearing, objections which can be made to proposed sales and the standard for their approval.

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ARTICLE: Section 363(c) authorizes the trustee, debtor in possession or chapter 13 debtor engaged in business n1 to use, sell or lease property of the estate in the ordinary course of business n2 without the need for notice or a hearing, if the continued operation of the business was authorized n3 and the court does not order otherwise. This provision is of particular importance in chapter 11 reorganization cases and in chapter 12 or 13 cases involving businesses, wherein the continued operation is essential to the preservation of the going concern value of the business. It can also be of importance in a chapter 7 case in which the trustee needs to complete performance under particular contracts or to take other ordinary business actions that will be necessary to maximize the value of the assets to be liquidated.

The absence of a notice and hearing requirement applies to entities with an interest in the property, such as a lien, as well as to general unsecured creditors. Under this provision, therefore, the trustee or debtor in possession may continue to use, sell, or lease property in the ordinary course of business even if the property is subject to a security interest or other encumbrance. n4 Of course, the trustee must provide adequate protection if requested by an entity with an interest in the property.

Ordinary Course of Business

In order for the trustee or debtor in possession to use, sell or lease property of the estate without the need for prior notice and a hearing, the proposed use, sale, or lease must be in the ordinary course of business. If the action is not in the ordinary course of business, it may be avoidable under section 549, which permits avoidance of postpetition transfers of property that were not authorized under section 363 or by the court. n5 Thus, in any case in which the parties are unsure about whether their transaction is in the ordinary course of business, it is advisable to comply with the notice and hearing requirement of section 363(b) rather than to rely on the ordinary course of business authorization

under section 363(c).

Courts have developed two commonly used tests for determining whether a transaction is in the ordinary course of business: (1) horizontal dimension test; and (2) vertical dimension (also known as the reasonable expectations) test. n6

Horizontal Dimension Test. The horizontal dimension test looks to similarly situated businesses and determines whether the transaction at issue is one that would normally be entered into by similar businesses. n7 In effect, this test is aimed at determining whether the transaction is abnormal or unusual, in which case it is probably not in the ordinary course of business, or whether it is a reasonably common type of transaction. n8 Significantly, a transaction may be considered reasonably common even if it does not occur frequently, provided that it is an ordinary type of transaction within the business and the industry. n9

Vertical Dimension Test. The vertical dimension test reviews the transaction from the perspective of creditors, asking whether the transaction is one that creditors would reasonably expect the debtor or trustee to enter into. n10 This test measures the types of risks that creditors impliedly agreed to when they extended credit to the debtor and determines whether the transaction at issue is within the range of risks reasonably expected by creditors. n11 Under this test, even a transaction that might be ordinary for similar businesses might not be ordinary for the debtor's business. n12 For example, it might be unusual for a relatively small business to undertake a particularly large transaction, even if other larger businesses in the same industry might do so as a matter of course. On the other hand, transactions of a type that the debtor commonly engaged in, or which the debtor might have reasonably been expected to engage in prepetition, are likely to be within the ordinary course of business after the commencement of a case, whether or not common in the debtor's industry.

Limitation on Trustee's Right to Use, Sell or Lease Property

There are at least four other significant limitations on the trustee's rights to use, sell or lease property in the ordinary course of business. First, while the business of the debtor is presumed to operate postpetition in chapter 11, n13 chapter 12 n14 and chapter 13, n15 the court may tailor the trustee's rights and powers to the needs of the case. In chapter 7 cases, where operation is the exception, the order authorizing continued operation of the business may limit the right of the trustee to sell, use or lease property. n16 Secondly, in chapter 11 cases, the trustee is subject to certain rights of secured parties with interests in aircraft or rolling stock. n17 Third, the trustee may not use, sell, or lease in any manner inconsistent with any relief from the automatic stay that the court has granted to a party with an interest in the property. n18 Fourth, the court may impose restrictions on use, sale, or lease as necessary to provide adequate protection of a party's interest in property of the estate. n19 The final and most important exception is when the property is cash collateral. Recognizing that cash and cash equivalents are easily dissipated, the Code places strict limitations on a trustee's ability to use such property.

Cash Collateral; Definition; § 363(a)

Section 363(a) defines cash collateral as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest. The term security is defined in section 101 to include a variety of investment claims or interests, including stocks, bonds, notes, and interests in limited partnerships. Because securities are included in the definition of cash collateral, a trustee is subject to the rules with respect to cash collateral when seeking to use or sell these investment vehicles. n20 Under this provision, cash and cash equivalents subject to a security interest or to other interests are cash collateral. Cash collateral also includes proceeds, products, offspring, rents, or profits of property in which the entity has a security interest. n21 Cash collateral does not include non-cash assets that can be converted to cash, no matter how

easily. n22 In addition, resolving a split among courts as to the proper treatment, n23 the Bankruptcy Reform Act of 1994 n24 amended section 363(a) to include fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties.

After-Acquired Property. If collateral that is not cash collateral is converted to cash or cash equivalents during the case, and if the resulting cash or cash equivalents become collateral under applicable nonbankruptcy law and section 552, the collateral becomes cash collateral subject to the provisions of section 363(c). n25 Although section 552(a) abrogates after-acquired property clauses in security agreements, after-acquired property is subject to a prepetition security interest if the agreement covers such property and the property is proceeds, products, offspring, rents or profits of property subject to the prepetition agreement or hotel revenues generated by such property, unless the court orders otherwise. Thus, for example, the trustee may sell inventory or collect accounts in the ordinary course of business without court approval, since these are not cash collateral, but the cash proceeds will be cash collateral, even if acquired by the trustee after the commencement of the case, because the cash is proceeds of the inventory or receivables, unless the court orders otherwise under section 552(b). n26 Property that the debtor acquires postpetition that is not proceeds, product, offspring, rents or profit of property of the estate is not cash collateral even when deposited with the creditor. n27

The language of section 363(a) is intentionally broad to deal with situations in which an entity has an interest, other than a security interest, in the cash or cash equivalents. n28 To illustrate, a bank with a right of setoff is treated as the holder of a secured claim under section 506(a) n29 notwithstanding that it does not have a security interest. n30 Under section 363(a), the deposit account that is subject to the setoff right is considered cash collateral.

Hotel Revenues: After-Acquired Revenues. The Bankruptcy Reform Act of 1994 n31 amended section 363(a) to include fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties in the definition of cash collateral. A parallel amendment was made to section 552(b) to recognize interests in after acquired hotel revenues. n32

Before the 1994 amendments, a majority of bankruptcy courts had held the view that hotel revenues were accounts, rather than rents or profits; thus, a creditor's interest therein did not carry forward to revenues generated postpetition. n33 The trend among the appellate courts, however, was to classify hotel revenues as rents or profits. n34 Authority was further split on the issue whether state or federal law governed classification of hotel revenues as rents, proceeds, profits or the like. The majority followed *Butner v. United States* n35 for the proposition that state law defines a party's interest in property. n36 In *In re Tollman-Hundley Dalton, L.P.*, n37 however, the court held that federal law defined the nature of the property interest. The court concluded that section 552(b) was intended to cover, as a matter of federal law, a wide range of derivative interests; therefore, hotel revenues, however characterized under state law, fell within the broad definition of rents. The 1994 amendments to sections 363(a) and 552(b) clarified that after-acquired hotel revenues could be subjected to a prepetition security interest and are cash collateral for purposes of section 363.

Significantly, however, the 1994 amendments did not resolve the question whether these revenues are rents or accounts. This issue is of some importance in terms of the proper perfection device. n38 If the revenues are rents, an interest in them must be perfected under real estate law. If they are accounts, the interest must be perfected under the Uniform Commercial Code. Because this issue is unresolved, a careful lender will perfect an interest in hotel revenues under both systems, filing in the real estate records and in the U.C.C. records.

Perfection of Interest in Hotel Revenues. Section 552(b) was also amended to delete the requirement that the right to rents and hotel revenues depends on applicable nonbankruptcy law. n39 This requirement led to considerable litigation n40 about whether applicable nonbankruptcy law might require seizure of the property, or appointment of a receiver, in order to perfect an interest in the revenue from the property. The revision was intended to clarify that lenders may have a valid interest in rents and hotel revenues notwithstanding their failure to have fully perfected under

state law. n41 Nevertheless, because the interest remains subject to the trustee's avoidance powers, including the trustee's status as a judicial lien creditor and a bona fide purchaser of real property, the interest will need to be properly recorded in order to be effective against the trustee.

Perfection of Interest in Rents. A creditor taking a mortgage on real estate will often also take an interest in the rents generated by the real estate. Although pursuant to section 552(a) security interests generally do not extend to property acquired after the commencement of a bankruptcy case, section 552(b) provides that an interest in rents may continue.

Before the 1994 amendments, however, the interest continued only if it was perfected under applicable nonbankruptcy law. Courts disagreed about whether this required simply recordation in the real estate records, or whether a lender might have to gain control over the rents, such as by the appointment of a receiver. n42

The Bankruptcy Reform Act of 1994 amended section 552(b) to delete the reference to applicable nonbankruptcy law, clarifying that absolute perfection is not required. n43 The intent is to provide that lenders may have a valid interest in rents notwithstanding their failure to have fully perfected as to the rents under state law. n44 Nevertheless, recordation is still required as to the mortgage, since the lender's right to the rents remains subject to the trustee's avoidance powers, which include the power to avoid interests that are ineffective against a bona fide purchaser. n45

Absolute Assignments of Rents. In some states, an assignment of rents may be considered absolute, with title to the rents passing to the assignee and the assignor retaining no interest in the rents. n46 Under such an arrangement, the estate may have no interest in the rents. This would preclude the treatment of the rents as cash collateral under section 363. n47 Where the debtor retains an interest in the rents, however, they may be cash collateral and subject to use, even if in the secured creditor's possession. n48 When the lender has received a purported absolute assignment of rents, careful review of the intent and practices of the parties and of applicable nonbankruptcy law will be appropriate to determine whether the assignment is truly absolute or is absolute only in form. n49

Use of Cash Collateral; § 363(c)(2)

Section 363(c)(2) provides that the trustee or debtor in possession may not use, sell or lease cash collateral without either (1) the consent of the creditor with an interest in the collateral or (2) court authorization, granted after notice and a hearing. n50 In the absence of the creditor's consent, n51 the trustee may use cash collateral only with the approval of the court which will normally require adequate protection for the holder of the adverse interest. n52

The requirements of notice and a hearing, and of court authorization, before cash collateral may be used, sold or leased may at first blush appear to be particularly onerous to a debtor in possession faced with a genuine emergency. However, often a secured party will consent to limited use of the cash collateral in order to preserve the value of its interest in other collateral. Payment of expenses of preserving non-cash collateral, payroll expenses to keep the business operating and other immediate cash needs may be as important to a secured party early in a case as it is to the debtor in possession.

Sometimes a secured party will seek, in conjunction with an agreement to authorize the debtor in possession to use cash collateral, an agreement cross-collateralizing its prepetition debt with postpetition collateral. In addition, the secured party may seek administrative priority for its entire claim as the price of agreeing to the debtor in possession's use of cash collateral. In general, such use of cross-collateralization or administrative priority is questionable at best. n53 Although the secured party is entitled to protection of its interest in the cash collateral, it is not entitled to improve its position with respect to any unsecured claim that it holds. Such an improvement would be at the expense of other unsecured creditors and would violate the underlying bankruptcy notion of equality of treatment among similarly

situated creditors.

Even in the absence of the secured party's consent, the court has ample power to act quickly on a request to use cash collateral. The term notice and a hearing means appropriate notice and perhaps no hearing at all, unless there is an objection. n54 When a hearing is required it may in some cases be prompt and somewhat informal. For example, in the case of a genuine emergency, such as an impending payroll, the notice may be telephonic and the hearing, if necessary, may be quite informal.

Section 363(c)(3) provides that the hearing shall be scheduled in accordance with the needs of the debtor and that the court shall act promptly on any request for authorization to use cash collateral. n55 This supports the notion that the court can quickly grant authority to use cash collateral for pressing needs.

Procedure for Hearing on Use of Cash Collateral. *Federal Rule of Bankruptcy Procedure 4001(b)* governs the procedure to be followed in seeking authorization to use cash collateral. Rule Rule 4001(b) provides that a motion for authority to use cash collateral is made as a contested matter under Rule 9014. Notice of the motion and of the time and place of the preliminary and final hearing must be given to all entities that have an interest in the cash collateral, to any committee appointed under the Code or, if no committee has been appointed, to the holders of the 20 largest unsecured claims, Bankruptcy Rule 1007(d) excluding insiders, who will be included in the list filed by the debtor under), and to such other entities as the court may direct. The Advisory Committee Note to Rule 4001(b) offers guidance as to what should be set forth in the notice, which includes the name and address of the parties with an interest in the cash collateral, a proposed budget and the nature of the adequate protection which is to be offered. The Bankruptcy Reform Act of 1994 n56 amended Bankruptcy Rule 7004 to require that service of process on a bank in an adversary proceeding or a contested matter be by certified mail addressed to an officer of the bank except in limited circumstances. This should not preclude telephonic notice in emergencies, but will apply to situations in which a contested matter is initiated by service by mail under Rule 7004. n57

While section 363(c)(3) and Rule 4001 recognize that a hearing for authority to use cash collateral may be a preliminary or a final hearing, when a hearing is held on short notice in an emergency situation, the hurried nature of the hearing suggests the wisdom of having a later final hearing for which the participants will have had more preparation time. In this regard, Rule 4001(b) provides that a final hearing may be held on no less than 15 days' notice. Prior to the final hearing, if the trustee needs authority to use cash collateral, authority may be granted at a preliminary hearing. However, the rule provides that the court may authorize the use of only that cash collateral as may be necessary to avoid immediate and irreparable harm to the estate. At the final hearing, cash collateral usage that has been authorized or consented to may be further adjusted or conditioned. Although generally an order authorizing use of property is automatically stayed for 10 days, an order authorizing use of cash collateral is excepted from the rule. n58

Segregation of Cash Collateral. Section 363(c)(4) provides that a trustee is required to segregate and account for any cash collateral in the trustee's possession, custody or control. In the absence of authorization to use cash collateral, the trustee is responsible for maintaining the collateral for the protection of the creditor with an interest in the collateral. Segregation of cash collateral is also important to secured creditors in view of the requirement of nonbankruptcy law that a creditor be able to identify cash proceeds in order to maintain an interest in the proceeds. n59

This requirement will, in most circumstances, apply to cash collateral on hand at the time of filing and cash generated during the case through the accumulation of after-acquired cash, such as rents or hotel revenues or from the use, sale or lease of non-cash collateral and payments for inventory or receivables. n60 When the trustee has previously been authorized to use cash collateral, a common component of the adequate protection afforded the affected entity is an appropriate accounting.

Purpose of Cash Collateral Rules. The protection offered by the cash collateral provisions does not implement any nonbankruptcy law limitations inherent to cash collateral, ⁿ¹ but rather is intended to recognize the unique nature of cash collateral, and the risk to the entity with an interest in such collateral, arising from the dissipation or consumption of the collateral in a rehabilitative effort in bankruptcy. ⁿ² The protection applies whether or not there has been a default that would limit the trustee's use of such collateral.

Chapter 13 Cases. Section 1303 grants a chapter 13 debtor the right of a trustee, pursuant to section 363(b), to use, sell or lease property of the estate out of the ordinary course of business. This requires notice and a hearing prior to such use, sale or lease and, pursuant to section 363(e), provision of adequate protection of an interest held by another entity, upon request by that entity. In addition, section 1304 grants a business debtor the power of a trustee, pursuant to section 363(c), to use, sell or lease, in the ordinary course of business, property of the estate. This latter authorization is subject to the limitations on the use of cash collateral found in section 363(c)(2).

A question that has arisen is whether a chapter 13 debtor who is not engaged in business may be authorized to use cash collateral out of the ordinary course of business. In general, courts have found that although the cash collateral rules are found in section 363(c), which is referred to only in conjunction with the use of property by chapter 13 business debtors, a nonbusiness debtor may use cash collateral, with the consent of the secured party or with court approval after furnishing adequate protection. ⁿ³ This approach recognizes that section 363(b) authorizes the use of any property of the estate, including cash collateral, after notice and a hearing. Thus, for example, a debtor whose automobile is destroyed and who receives an insurance recovery may obtain authorization to acquire a different vehicle with the insurance proceeds, even though the proceeds are cash collateral. The security interest would, of course, attach to the newly acquired vehicle.

Although it appears that the chapter 13 debtor should be entitled to use the cash collateral after notice and a hearing, and section 102 provides that the term after notice and a hearing does not mandate a hearing if none is requested, the better approach is for a court to review any such transaction even in the absence of an objection, and to approve or disapprove the use of cash collateral out of the ordinary course of business, based on whether the secured party is adequately protected. The cash collateral rules developed because cash is so easily dissipated. This danger is no less apparent when property is used out of the ordinary course of business than it is when property is used in the ordinary course. Thus, court approval should be obtained before the debtor uses cash collateral even if the use is not in the ordinary course of business.

For a complete discussion of Code section 363, see Collier on Bankruptcy, ch. 363 (Matthew Bender).

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[Return to Text](#)

ⁿ¹ 1. See 11 U.S.C. §§ 1107 (chapter 11), 1304 (chapter 13); see also 11 U.S.C. §§ 1203, 1204 (chapter 12).

ⁿ²

2. H.R. Rep. No. 595, 95th Cong., 1st Sess. 344 (1977) [hereinafter House Report]; S. Rep. No. 989, 95th

Cong., 2d Sess. 55 (1978) [hereinafter Senate Report]; see *Burlington Northern R.R. Co. v. Dant & Russell, Inc.* (*In re Dant & Russell, Inc.*), 853 F.2d 700, 20 C.B.C.2d 369 (9th Cir. 1988) (discussion of what constitutes the ordinary course of business).

n3

3. 11 U.S.C. § 721, which concerns the authorization to operate the business in a chapter 7 case, provides: The court may authorize the trustee to operate the business of the debtor for a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate. See *Collier on Bankruptcy*, ch. 721 (Matthew Bender). 11 U.S.C. § 1108, which pertains to the authorization to operate the business in a chapter 11 case, states: Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor's business. See *Collier on Bankruptcy*, ch. 1108 (Matthew Bender). Pursuant to 11 U.S.C. § 1107(a), a debtor in possession in a chapter 11 case has the rights, powers and duties of a trustee. See *Collier on Bankruptcy*, ch. 1107 (Matthew Bender).

n4

4. See 11 U.S.C. § 363(f)(1) (sale may be free and clear of such other interest if applicable nonbankruptcy law permits sale of such property free and clear of such interest); *Collier on Bankruptcy*, 363.06[2] (Matthew Bender).

n5

5. *Rajala v. Langer (In re Lodge Am., Inc.)*, 239 B.R. 580 (Bankr. D. Kan. 1999) (repayment of unauthorized loan wasn't in the ordinary course, even though loan proceeds were used to pay ordinary course expenses).

n6

6. See, e.g., *In re Roth Am., Inc.*, 975 F.2d 949 (3d Cir. 1992); *In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988).

n7

7. See *In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988).

n8

8. *See id.*; *see also Johnston v. First Street Cos., Inc.*, 56 B.R. 31 (D. Minn. 1985).

n9

9. *In re Roth Am., Inc.*, 975 F.2d 949 (3d Cir. 1992); *In re Johns-Manville Corp.*, 60 B.R. 612, 618 (S.D.N.Y. 1986), *rev'd on other grounds*, 801 F.2d 60 (2d Cir. 1986).

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10. *See In re Watford*, 159 B.R. 597 (M.D. Ga. 1993).

n11

11. *See In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988); *In re James A. Phillips, Inc.*, 29 B.R. 391 (S.D.N.Y. 1983).

n12

12. *Johnston v. First Street Cos., Inc.*, 56 B.R. 31 (D. Minn. 1985).

n13

13. 11 U.S.C. § 1108; *see also Amdura Nat'l Distrib. Co. v. Amdura Corp. (In re Amdura Corp.)*, 75 F.3d 1447 (10th Cir. 1996).

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14. 11 U.S.C. §§ 1203, 1204.

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15. 11 U.S.C. § 1304.

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16. 11 U.S.C. § 721 (authorization to operate business for limited period when it is in the best interests of the estate and consistent with an orderly liquidation of the estate).

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17. See 11 U.S.C. §§ 1110, 1168; *Collier on Bankruptcy*, 1110.01 et seq. and 1168.01 et seq. (Matthew Bender).

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18. 11 U.S.C. § 363(d); see *Collier on Bankruptcy*, 363.04 (Matthew Bender).

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19. 11 U.S.C. § 363(e); see *Collier on Bankruptcy*, 363.05 (Matthew Bender).

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20. See, e.g., *In re Weisberg*, 193 B.R. 916 (B.A.P. 9th Cir. 1996).

n21

21. It has also been held that cash collateral includes fees charged for self storage units, *Wattson Pacific Ventures v. Valley Fed. Savs. Loan (In re Safeguard Self-Storage Trust)*, 2 F.3d 967, 29 C.B.C.2d 997 (9th Cir. 1993), cash dividends paid on stock pledged as collateral, *FDIC v. Hastie (In re Hastie)*, 2 F.3d 1042 (10th Cir. 1993), and funds received from the collection of accounts, *In re Bumper Sales, Inc.*, 907 F.2d 1430, 23 C.B.C.2d 498 (4th Cir. 1990).

n22

22. *Agency Servs., Inc. v. Keck Mahin & Cate (In re Keck Mahin & Cate)*, 1999 U.S. Dist. LEXIS 5056 (N.D. Ill. Mar. 30, 1999) (unearned insurance premium).

n23

23. *Financial Sec. Assurance, Inc. v. Days California Riverside Ltd. P'ship (In re Days California Riverside Ltd. P'ship)*, 27 F.3d 374, 31 C.B.C.2d 877 (9th Cir. 1994); *T-H New Orleans Ltd. P'ship v. Financial Sec. Assurance, Inc. (In re T-H New Orleans Ltd. P'ship)*, 10 F.3d 1099, 30 C.B.C.2d 478 (5th Cir. 1993), cert. denied, 511 U.S. 1083, 114 S. Ct. 1833, 128 L. Ed. 2d 461 (1994); see also *Financial Sec. Assurance, Inc. v. Tollman-Hundley Dalton, L.P.*, 74 F.3d 1120, 1124 (11th Cir. 1996) (under pre-1994 law, federal, not state, law controlled scope of rents, profits, product, offspring and proceeds, and under federal law hotel revenues constitute rents within meaning of section 552(b) because section 552(b) was intended to cover a wide range of derivative property; in support of this view, court looked to the 1994 amendments).

n24

24. Pub. L. No. 103-394, § 214 (1994).

n25

25. S. Rep. No. 989, 95th Cong., 2d Sess. 55 (1978).

n26

26. *Unsecured Creditors Committee v. Marepcon Fin. Corp. (In re Bumper Sales, Inc.)*, 907 F.2d 1430, 23 C.B.C.2d 498 (4th Cir. 1990); *In re Kerner Printing Co.*, 178 B.R. 363 (Bankr. S.D.N.Y. 1995).

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27. *Agricultural Fed. Credit Union v. Harris (In re Harris)*, 260 B.R. 753 (Bankr. D. Md. 2001) (credit union share account deposit).

n28

28. See, e.g., *National Bank of Ga. v. Air Atlanta, Inc. (In re Air Atlantic, Inc.)*, 74 B.R. 426 (Bankr. N.D. Ga.), *aff'd*, 81 B.R. 724 (N.D. Ga. 1987).

n29

29. See *Collier on Bankruptcy*, 506.02 (Matthew Bender).

n30

30. See *In re Quality Interiors, Inc.*, 24 C.B.C.2d 1823, 127 B.R. 391 (Bankr. N.D. Ohio 1991).

n31

31. Pub. L. No. 103-394, § 214(a) (1994).

n32

32. Pub. L. No. 103-394, § 214(b) (1994).

n33

33. See, e.g., *In re Punta Gorda Assocs.*, 137 B.R. 535 (Bankr. M.D. Fla. 1992); *In re Shore Haven Motor Inn, Inc.*, 124 B.R. 617 (Bankr. S.D. Fla. 1991); *In re GGVXX Ltd.*, 130 B.R. 322 (Bankr. D. Colo. 1991); *In re Investment Hotel Props., Ltd.*, 109 B.R. 990 (Bankr. D. Colo. 1990).

n34

34. *Financial Sec. Assurance, Inc. v. Days California Riverside Ltd. P'ship* (*In re Days California Riverside Ltd. P'ship*), 27 F.3d 374, 31 C.B.C.2d 877 (9th Cir. 1994); *T-H New Orleans Ltd. P'ship v. Financial Sec. Assurance, Inc.* (*In re T-H New Orleans Ltd. P'ship*), 10 F.3d 1099, 30 C.B.C.2d 478 (5th Cir. 1993), cert. denied, 511 U.S. 1083, 114 S. Ct. 1833, 128 L. Ed. 2d 461 (1994); *Great West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd.*, 33 C.B.C.2d 217, 177 B.R. 843 (N.D. Ohio 1994) (federal law determines meaning of proceeds, products, profits, rents, offspring or product, and hotel room revenues and receipts constitute profits; state law determines perfection in such interests); *S.F. Drake Assocs. v. Security Pacific Nat'l Bank* (*In re S.F. Drake Hotel Assocs.*), 147 B.R. 538 (N.D. Cal. 1992); see also *In re Churchill Props. VIII Ltd. P'ship*, 164 B.R. 607 (Bankr. N.D. Ill. 1994) (postpetition hotel revenues constitute rents); *In re Miami Center Assocs. Ltd.*, 144 B.R. 937 (Bankr. S.D. Fla. 1992) (postpetition hotel revenues constitute profits). But see *In re HRC Joint Venture*, 175 B.R. 948 (Bankr. S.D. Ohio 1994), in which the court held that payments received from a hotel operator under a management agreement which entitled the operator to receive the hotel revenues and obligated the operator to make payments to the owner were not room revenues, but were merely remittances under the agreement between the debtor in possession hotel owner and the hotel operator. As such, the mortgagee's interest could not attach to the remittances to which the debtor in possession became entitled after

commencement of the chapter 11 case because the remittances were after acquired property under section 552(a) and the mortgagee's interest was not protected by section 552(b).

n35

35. 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979).

n36

36. See, e.g., *Financial Sec. Assurance, Inc. v. Days California Riverside Ltd. P'ship* (*In re Days California Riverside Ltd. P'ship*), 27 F.3d 374, 31 C.B.C.2d 877 (9th Cir. 1994) (under California law hotel revenues constitute rents within the scope of section 552(b)); *T-H New Orleans Ltd. P'ship v. Financial Sec. Assurance, Inc.* (*In re T-H New Orleans Ltd. P'ship*), 10 F.3d 1099, 30 C.B.C.2d 478 (5th Cir. 1993), cert. denied, 511 U.S. 1083, 114 S. Ct. 1833, 128 L. Ed. 2d 461 (1994) (same outcome under Louisiana law).

n37

37. 74 F.3d 1120 (11th Cir. 1996); see also *Great West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd.*, 33 C.B.C.2d 217, 177 B.R. 843 (N.D. Ohio 1994) (federal law determines meaning of proceeds, products, profits, rents, offspring or product and hotel room revenues and receipts constitute profits; state law determines perfection in such interests).

n38

38. See *Great West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd.*, 33 C.B.C.2d 217, 177 B.R. 843 (N.D. Ohio 1994).

n39

39. Pub. L. No. 103-394, § 214 (1994).

n40

40. See, e.g., *In re Bellevue Place Assocs.*, 173 B.R. 1009 (Bankr. N.D. Ill. 1994).

n41

41. Section-by-Section Description of H.R. 5116, 140 Cong. Rec. H10,764 (daily ed. Oct. 4, 1994).

n42

42. Compare *In re Wheaton Oaks Office Partners Ltd. P'ship*, 27 F.3d 1234, 31 C.B.C.2d 840 (7th Cir. 1994) (Illinois law requires recordation of mortgage to perfect assignment of rents), *Vienna Park Props. v. United Postal Sav. Ass'n (In re Vienna Park Props.)*, 976 F.2d 106 (2d Cir. 1992) (under Virginia law creditor need not have taken any steps to enforce security interest), and *In re Baltic Assocs., L.P.*, 170 B.R. 568 (E.D. Pa. 1994) (under Delaware law interest in rents is perfected upon recordation of executed security agreements), with *Casbeer v. State Fed. Savs. & Loan of Lubbock (In re Casbeer)*, 793 F.2d 1436 (5th Cir. 1986) (under Texas law, assignment is not effective until mortgagee obtains possession of the property, impounds rents, secures appoint of receiver or takes similar action), and *In re Turtle Creek, Ltd.*, 194 B.R. 267 (Bankr. N.D. Ala. 1996) (mortgagee must take additional steps such as foreclosure, sequestration of rents [appointment of a receiver to collect rent], or some similar action in order to perfect a lien in rents generated by a mortgagor's property in Alabama.), and *In re Concord Mill Ltd. P'ship*, 136 B.R. 896 (Bankr. D. Mass. 1992) (notice to tenants plus entry or attempted entry if thwarted by debtor).

n43

43. See *Lyons v. Federal Savs. Bank (In re Lyons)*, 193 B.R. 637, 649 (Bankr. D. Mass. 1996).

n44

44. 140 Cong. Rec. H10,764 (daily ed. Oct. 4, 1994) (section-by-section analysis of H.R. 5116).

n45

45. See, e.g., *Scottsdale Medical Pavilion v. Mutual Benefit Life Ins. Co. in Rehabilitation (In re Scottsdale Medical Pavilion)*, 159 B.R. 295 (B.A.P. 9th Cir. 1993), *aff'd*, 52 F.3d 244 (9th Cir. 1995).

n46

46. See *Commercial Bank v. Mountain View Village, Inc.*, 5 F.3d 34, 29 C.B.C.2d 1241 (3d Cir. 1993) (Pennsylvania); *First Fidelity Bank, N.A. v. Jason Realty, L.P. (In re Jason Realty, L.P.)*, 59 F.3d 423 (3d Cir. 1995) (New Jersey); *Wolters Village, Ltd. v. Village Props., Ltd. (In re Village Props., Ltd.)*, 723 F.2d 441 (5th Cir. 1984) (absolute assignment of rents transfer title to rents; Texas courts reluctant to construe assignments as absolute).

n47

47. See *In re Villamont-Oxford Assocs. Ltd. P'ship*, 230 B.R. 445 (Bankr. M.D. Fla. 1998).

n48

48. *In re Dupell*, 235 B.R. 783 (Bankr. E.D. Pa. 1999).

n49

49. See, e.g., *Condor One, Inc. v. Turtle Creek, Ltd. (In re Turtle Creek, Ltd.)*, 194 B.R. 267 (Bankr. N.D. Ala. 1996) (close reading of assignment required); *In re Dacey*, 80 B.R. 206 (D. Nev. 1987).

n50

50. *In re Cross Baking Co., Inc.*, 818 F.2d 1027, 17 C.B.C.2d 236 (1st Cir. 1987).

n51

51. *Freightliner Mkt. Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368-69 (9th Cir. 1987) (implied consent is not sufficient).

n52

52. *In re Goode*, 235 B.R. 584 (Bankr. E.D. Tex. 1999) (debtor's need for funds could not substitute for adequate protection).

n53

53. See, e.g., *In re Willingham Investments, Inc.*, 203 B.R. 75 (Bankr. M.D. Tenn. 1996); see also *In re Saybrook Mfg. Co., Inc.*, 963 F.2d 1490, 27 C.B.C.2d 277 (11th Cir. 1992) (refusing to permit cross-collateralization of prepetition debt with unencumbered estate property in the context of debtor in possession financing).

n54

54. 11 U.S.C. § 102.

n55

55. *Armstrong v. Norwest Bank*, 964 F.2d 797 (8th Cir. 1992) (authority given *ex parte* to use cash collateral when necessary for debtor to maintain operations); *Owens-Corning Fiberglass Corp. v. Center Wholesale, Inc. (In re Center Wholesale, Inc.)*, 759 F.2d 1440, 1449 & n.21, 12 C.B.C.2d 1107, 1118 & n.21 (9th Cir. 1985); *Travelers Ins. Co. v. Plaza Family P'ship (In re Plaza Family P'ship)*, 95 B.R. 166 (E.D. Cal. 1989) (cash collateral hearing on seven days notice not an abuse of discretion).

n56

56. Pub. L. No. 103-394, § 114 (1994).

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57. Notice by certified mail is also not required when the institution has appeared by its attorney, in which case the attorney may be served by first class mail.

n58

58. *Fed. R. Bankr. P. 6004(g)*.

n59

59. See U.C.C. § 9-306(2) (1995) (provides, in part, that a security interest continues in any *identifiable* proceeds including collections received by the debtor. (emphasis supplied)); see also *In re Patio & Porch Sys., Inc.*, 194 B.R. 569 (Bankr. D. Md. 1996).

n60

60. *Scottsdale Medical Pavilion v. Mutual Benefit Life Ins. in Rehabilitation (In re Scottsdale Medical*

Pavilion), 159 B.R. 295 (B.A.P. 9th Cir. 1993), *aff'd*, 52 F.3d 244 (9th Cir. 1995) (rents collected prepetition are cash collateral and subject to the use limitations of section 363).

n61

61. See *Reconstruction Fin. Corp. v. Kaplan*, 185 F.2d 791 (1st Cir. 1950). Section 552(a) limits the effect of after-acquired property clauses in bankruptcy, but section 552(b) validates, unless inequitable, the secured creditor's right to proceeds to the extent provided by contract and applicable law. *In re J. Catton Farms, Inc.*, 779 F.2d 1242 (7th Cir. 1985); Section 9-315(d)(3) of the Uniform Commercial Code limits the security interest of a secured creditor in second generation proceeds acquired with cash proceeds to proceeds of a type as to which the security interest attaches and the secured creditor has already perfected its security interest or perfects within 20 days after it attaches.

n62

62. *Freightliner Mkt. Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368 (9th Cir. 1987).

n63

63. See, e.g., *In re Carey*, 202 B.R. 796 (Bankr. M.D. Ga. 1996); *Woods v. John Fox Oldsmobile (In re Woods)*, 97 B.R. 850 (Bankr. W.D. Va. 1989).

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142 of 197 DOCUMENTS

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Collier on Notice Requirements of Section 342

2008 Emerging Issues 1352

Collier on Notice Requirements of Section 342

By Collier

December 5, 2007

SUMMARY: Section 342 of the Bankruptcy Code provides several avenues for creditors to designate where notices in a bankruptcy action are to be sent to them. This Emerging Issues Analysis discusses the methods to designate an address, the time that such designation becomes effective, and the conditions in which notice to a creditor, while not sent to the address specified by it, is still deemed effective.

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ARTICLE: Notice from Clerk That Presumption of Abuse Exists. Section 342(d) added by the 2005 amendments to the Bankruptcy Code, n1 requires the clerk to give notice to all creditors in a chapter 7 case in which the debtor is an individual if the presumption of abuse arises in the case. The notice is to be given within ten days after the filing of the petition. n2 This language is somewhat redundant, because the presumption of abuse can only arise in a chapter 7 case and only in a case of an individual debtor. n3

Presumably, the clerk will determine whether a presumption of abuse arises from the debtor's statement of whether a presumption of abuse exists, which is required to be provided as part of calculations in the debtor's schedules filed with the clerk under section 521. n4 If the clerk is not informed by the debtor's filings that a presumption of abuse arises, the clerk need not give any notice. Certainly, the clerk is in no position to do calculations under the complicated means test in individual cases.

The notice under section 342(d) is only one of several notices creditors may receive concerning the presumption of abuse. The United States trustee, after reviewing all materials filed by the debtor in each individual chapter 7 case, must within 10 days after the meeting of creditors file with the court a statement of whether the presumption of abuse arises. n5 The court must then, within five days after receiving the statement, provide a copy of it to all creditors. n6 Within thirty days after filing this statement, if the presumption of abuse exists, the United States trustee must either file a motion to dismiss the case or file another statement that indicates why such a motion is not being filed. n7 Creditors, or at least those who receive electronic notices of each document filed, will receive notice of this statement as well.

Creditor Request for Address to Be Used in Particular Case. New section 342(e) allows a creditor to file with the court and serve on the debtor notice of an address that it wants used for notices in a particular case. n8 Any notice

provided by the court or the debtor more than five days after such an address request is filed and served must use the requested address. n9 Section 342(e) is clear that the creditor's address request must be both filed and served on the debtor to be operative.

This provision appears to override the more general address provision discussed above, n10 though it does not expressly so state. Because the drafters of the bill were focused on notices by the debtor or the court to creditors in consumer cases, they failed to include in this provision notices from other parties, such as the trustee, United States trustee or other creditors. Apparently, these parties, and participants in chapter 9, 11, and 12 cases, to which the provision does not apply, do not have to follow the dictates of this subsection. In any event, *Federal Rule of Bankruptcy Procedure 2002(g)* already afforded creditors the right to designate an address for notices in a particular case n11 and, with the advent of electronic filing and noticing, most notices will soon be electronic and available to any creditor.

Creditor Request for Address to Be Used for All Cases in Designated Courts. Section 342(f)(1), added by the 2005 amendments to the Bankruptcy Code, n12 gives creditors the right to file a notice in any bankruptcy court designating an address to be used for all chapter 7 and chapter 13 cases in all courts or in particular designated courts. Beginning no later than 30 days after such a notice is filed, all notices to the creditor that are required to be provide by the designated courts in such cases must be provided at the address in the notice filed under section 342(f), unless a notice has been filed under section 342(e) requesting a different address to be used in a particular case. n13 It appears that the address filed under section 342(e) prevails over the address filed under section 342(f) even if the latter address is filed subsequent to the former address.

This provision may require some adjustments by the bankruptcy clerks' offices and by the judiciary's Bankruptcy Noticing Center. The Bankruptcy Noticing Center already uses some form of address matching software, but that software may or may not be able to accommodate creditors' requests if those requests demand that different addresses be used for different courts.

The advent of electronic notices has greatly diminished the significance of these provisions. Not only are electronic notices provided by the court, but also many creditors subscribe to private vendors who provide notice virtually immediately when their customers file bankruptcy cases, probably the most important event of which creditors receive notice. Indeed, nothing in section 342(f) would preclude a creditor from providing an address for electronic notices in all cases, at least if the courts are equipped to fulfill that request; the section speaks of notices provided, not mailed.

Effective Notice. The import of the notice provisions added by the 2005 amendments to the Bankruptcy Code is dictated by section 342(g), also added by those amendments. n14 Subsection (g)(1) states that notice provided to a creditor other than in accordance with section 342 is not effective notice unless brought to attention of the creditor.

The first question raised by this provision is when it should be applicable. Many notices given by a debtor, especially early in the case, do not come within the ambit of section 342(c) because they are not notices that are required by the Code, rules, court order, or other applicable laws. For example, notice from a debtor to a creditor that a case has been filed, intended to prevent an imminent foreclosure or repossession, is not required by any rule or Code provision. Presumably, then, it is in accordance with section 342 because the section simply does not set any particular requirements for such notice unless a creditor has requested a particular address for that particular case under section 342(e), which is unlikely to have happened in the first few days a case is pending. Read any other way, section 342 would not provide any way for such notice to a creditor to be given in accordance with section 342, since the section simply does not apply to such notices. It is almost inconceivable that courts would adopt a reading that makes it impossible for debtors to effectively notify creditors about the automatic stay. So for purposes of a debtor immediately notifying creditors of the automatic stay, the provision regarding the address at which a creditor requests correspondence and the other provisions of section 342 are irrelevant.

Brought to the attention also is not defined, except by exclusion. Under section 342(g)(1), n15 if a creditor has established reasonable procedures to deliver notices to a responsible person or department, then notice is not considered

brought to the attention of such creditor until it reaches that person or department. This provision will give debtor's fertile ground for discovery into a creditor's reasonable procedures, including whether the creditor has given an address to the Bankruptcy Noticing Center for notices, whether it uses BANKO (an online service that notifies creditors of bankruptcy filings) to check on filings, and what mechanisms are in place to transmit timely notices to appropriate departments. If a debtor gives reasonable notice, a creditor should have procedures that transmit it almost instantly. It is hard to imagine how a creditor that does not have a procedure for immediate transmission of notices received by its attorneys, collection staff, repossession agents, and collection agents could be deemed to have reasonable procedures. And presumably, by negative implication, if such reasonable procedures do not exist, any actual notice given to a creditor should be deemed brought to the creditor's attention. So, in the end, any reasonable notice should be sufficient to be effective notice for purposes of section 342(g). Thus, the only effect of section 342(g) is to give creditors who have developed reasonable procedures protection in cases in which unreasonable notice is given, such as handing notice of the bankruptcy case to a sales employee in an unrelated facility.

In any event, the only apparent relevance of lack of effective notice is that no monetary penalty for violation of the section 362 automatic stayⁿ¹⁶ or the section 542ⁿ¹⁷ and section 543ⁿ¹⁸ turnover requirements can be imposed on a creditor who has not received effective notice. Section 342 does not affect the discharge of debts or violations of the discharge injunction. Nor does it preclude other remedies against the creditor, or remedies against other entities, such as a creditor's attorney. Thus, amended section 342 is likely to have little practical effect.

For a complete discussion of Code section 342, see Collier on Bankruptcy, ch. 342 (Matthew Bender).

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ⁿ¹ 1. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

ⁿ²

2. 11 U.S.C. § 342(d), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

ⁿ³

3. 11 U.S.C. § 707(b)(2), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 707 (Matthew Bender).

n4

4. 11 U.S.C. § 707(b)(2)(C), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 521 and ch. 707 (Matthew Bender).

n5

5. 11 U.S.C. § 704(b)(1), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 704 (Matthew Bender).

n6

6. *Id.*

n7

7. 11 U.S.C. § 704(b)(2), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 704 (Matthew Bender).

n8

8. 11 U.S.C. § 342(e), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n9

9. *Id.*

n10

10. 11 U.S.C. § 342(c)(2); *see Collier on Bankruptcy*, 342.05 (Matthew Bender).

n11

11. *Fed. R. Bankr. P. 2002(g)*; *see Collier on Bankruptcy*, 2002.08 (Matthew Bender).

n12

12. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n13

13. 11 U.S.C. § 342(f)(2), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n14

14. 11 U.S.C. § 342(g), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n15

15. 11 U.S.C. § 342(g)(1), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n16

16. 11 U.S.C. § 362, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see* Collier on Bankruptcy, ch. 362 (Matthew Bender).

n17

17. 11 U.S.C. § 542; *see* Collier on Bankruptcy, ch. 542 (Matthew Bender).

n18

5. 11 U.S.C. § 543; *see* Collier on Bankruptcy, ch. 543 (Matthew Bender).

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143 of 197 DOCUMENTS

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Collier on Continuing Validity of Security Interests in Proceeds etc.

2008 Emerging Issues 1364

Collier on Continuing Validity of Security Interests in Proceeds etc.

By Collier

December 5, 2007

SUMMARY: This Emerging Issues Analysis covers the continuing validity of security interests in proceeds, products, offspring or profits, including topics such as the distinction between after-acquired property and proceeds; the limitation or elimination of prepetition security interest in proceeds based on equities of the case; and the rights asserted as a result of an avoidance action.

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ARTICLE: Modern security agreements typically cover proceeds, products, offspring or profits generated by collateral. Under the Uniform Commercial Code, sections 9-203 and 9-315, the security interest in proceeds is automatic and need not be specified in the agreement or financing statement.

Subsection (b)(1) of *section 552 of the Bankruptcy Code* recognizes this fact and creates an exception to the general rule of section 552(a), n1 providing that, when a prepetition security agreement covering prepetition property extends to proceeds, products, offspring or profits of that collateral, the terms of the security agreement and applicable nonbankruptcy law will be enforced against proceeds, products, offspring or profits, acquired after the date of the filing of the petition, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise. n2 It must be emphasized that subsection (b)(1) creates an exception for proceeds, products, offspring or profits generated by prepetition collateral, and not for after-acquired property obtained by the debtor or the estate postpetition. n3 Applicable nonbankruptcy law will normally be Article 9 of the Uniform Commercial Code.

It is most common for courts, when applying section 552(b)(1), to determine issues respecting the nature and definition of proceeds, although some courts have also dealt with the definition and nature of products, offspring and profits. n4

Distinction Between After-Acquired Property and Proceeds

The distinction between after-acquired property and proceeds is not always clear. Courts have formulated several tests for distinguishing them. To distinguish the concepts of after-acquired property and proceeds, some courts have

invoked *Local Loan Co. v. Hunt*,ⁿ⁵ which forbade the creation of an enforceable lien upon a subject not existent when the bankruptcy became effective or even arising from, or connected with, preexisting property, but brought into being solely as the fruit of the subsequent labor of the bankrupt.ⁿ⁶ Other courts, taking their cue from *Local Loan*, emphasize the fresh start or rehabilitative policy underlying section 552.ⁿ⁷

The reference to nonbankruptcy law in section 552(b)(1) has also been used by courts to distinguish the concepts of after-acquired property and proceeds. These courts have employed the familiar but no less amorphous terminology of the Uniform Commercial Code, which authorizes after-acquired property clauses in section 9-204 and defines proceeds in section 9-102.ⁿ⁸ Finally, some courts apply a broad definition of proceeds, relying primarily on the following legislative history to section 552: The term proceeds is not limited to the technical definition of that term in the U.C.C., but covers any property into which property subject to the security interest is converted.ⁿ⁹

Section 552(b) is intended to cover after-acquired property that is directly attributable to prepetition collateral, without addition of estate resources. Under all the tests, there have been variations on the themes of receipt, vesting, generation, conversion and substitution, intended to pinpoint the timing and manner of acquisition of the collateral prepetition and its transmutation into proceeds postpetition.ⁿ¹⁰ For example, it is well established that a creditor's prepetition security interest in a debtor's crops or in rents, income, and profits from a debtor's farmland does not encompass proceeds generated by a crop planted postpetition.ⁿ¹¹ On the other hand, some courts have held that milk produced postpetition by livestock collateralizing a prepetition lien is a product of the livestock that should not be considered to be after-acquired property.ⁿ¹² Other courts have held that second generation proceeds, such as inventory purchased with proceeds of prepetition inventory and accounts, qualify as proceeds under section 552(b)(1) if they are perfected and traceable to the original collateral.ⁿ¹³ This may turn on applicable nonbankruptcy law definitions of proceeds.ⁿ¹⁴

Section 9-315 of the Uniform Commercial Code pertains to a secured creditor's right to proceeds upon the debtor's disposition of underlying collateral. In applying section 9-315 to debtors who have filed petitions under the Bankruptcy Code, the courts have struggled with the application of section 9-315(c), which gives rise to automatic perfection of proceeds.ⁿ¹⁵

Extent of Security Interest in Proceeds; Security Agreement and Applicable Nonbankruptcy Law

Section 552(b)(1) specifies that a prepetition security interest extends to after-acquired proceeds, products, offspring or profits *to the extent* provided by such security agreement and by applicable nonbankruptcy law.ⁿ¹⁶ Applicable nonbankruptcy law includes case law as well as statutory law. Although state law is generally applicable under section 552(b), the United States Supreme Court has interpreted nonbankruptcy law to include federal as well as state law.ⁿ¹⁷

The extent of the security interest is generally expressed in the security agreement, although if applicable nonbankruptcy law expressly creates a security interest in proceeds, it should not matter that the security agreement fails to contain such an express provision because the law should be considered to be part of the agreement.ⁿ¹⁸

Limitation or Elimination of Prepetition Security Interest in Proceeds Based on Equities of Case

Notwithstanding the application of section 552(b)(1), the continued validity of a security interest in proceeds, products, offspring or profits of prepetition collateral under section 552(b)(1) can be limited or eliminated if ordered by the court based on the equities of the case.

Equity Exception: Protection of Interests of Secured and Unsecured Creditors. This equity exception permits the court to preserve valid security interests in proceeds and the like but, at the same time, allows the court to protect the interests of unsecured creditors. n19 If a creditor's collateral is processed and sold or proceeds are otherwise collected, either the creditor or the trustee (or the debtor in possession) may request that the court determine whether the creditor's interest in proceeds should be limited based on the equities of the case. Depending upon the court's evaluation of these equities, profit or loss may be given to the estate or to the secured party, or apportioned between them.

Another example would be when the estate puts effort into selling inventory, proceeds of which go to the secured party. Equity might require that a portion of the proceeds be used to compensate the estate for the sales effort. n20

Professionals have resorted to so-called carve out agreements or arguments for court-ordered carve outs in order to fund the costs and fees associated with representing estates in bankruptcy. These arrangements, which are designed to give professional fees priority over liens and priority claims, often rely upon Code sections 552, 506(c) and the like for statutory support. Absent consent or demonstrable benefit to the secured creditor, however, the hoped for carve out may be difficult to obtain. n21

Equity Exception: Consideration of Trustee's Use of Estate Funds to Complete Inventory. Under the equity exception in section 552(b)(1), the secured party should not receive a windfall benefit when the trustee uses assets of the estate--for example, to finish uncompleted inventory (which is proceeds of collateral acquired by the debtor prepetition) subject to a prepetition security interest. n22

The trustee may recover from the inventory or its proceeds whatever amounts, after notice and a hearing, the court deems equitable under the circumstances of the case. n23 Additionally, the trustee may recover from inventory or proceeds the reasonable, necessary costs of preserving or disposing of the collateral under section 506(c) to the extent the secured party is benefitted, whether such costs arose prepetition or postpetition. n24 Section 506(c) applies by its express terms, even if the value of the collateral has declined through use or market fluctuations, and even if the creditor is not fully secured. n25

Section 552(b)(1) does not limit the estate's recovery to costs recoverable under section 506(c). Section 552(b)(1) applies to proceeds of prepetition collateral. Section 506(c) applies to pre- or postpetition collateral or proceeds. Section 552(b)(1), unlike section 506(c), is not limited to reasonable, necessary costs and expenses of preserving, or disposing of property, which costs or expenses benefit the holder of the secured claim.

Equity Exception: Partially Secured Creditors. If the creditor is partially secured prior to the investment of free assets by the estate, it is possible that all of the profit should inure to the benefit of the estate to prevent the creditor from benefitting ahead of other creditors holding unsecured claims. n26 Section 506(a) does not specify the time at which collateral is to be valued to determine the amount of an allowed secured claim. On the other hand, if the creditor is fully secured, some portion of the profit may be allocated to pay the creditor's postpetition interest and attorney's fees under section 506(b), unless equity requires the profit to inure to the benefit of unsecured creditors before the secured party recovers interest or costs.

Equity Exception: Consideration of Improvement or Decline in Proceeds Value. A court applying section 552(b)(1) may give more or less weight to some or all of these factors, but its decision must be made according to the equities of the case. In addition to a trustee or debtor in possession's use of estate funds to complete inventory or preserve or dispose of collateral, the court's equity analysis may include considerations of any improvement or decline in value of the proceeds and whether this improvement or decline is caused by any party or is the result of impersonal forces, such as the vagaries of nature or fluctuations in the market, or the efficiencies or inefficiencies of the administration of the estate. n27

Effect of Other Code Sections; § 552(b)(1)

Although subsection 552(b)(1) preserves a secured party's prepetition security interest in postpetition proceeds, products, offspring or profits of that security interest, the subsection is explicitly subject to other sections of title 11.

Trustee's Use of Proceeds under Section 363 and Surcharge under Section 506(c). For example, the trustee or debtor in possession may use, sell or lease proceeds, products, offspring or profits under section 363. n28 Section 552(b)(1) is also subject to section 506(c), under which the trustee or debtor in possession may recover from the collateral the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the secured party. This is so even if the trustee's use of collateral results in a diminution in value of the collateral.

Trustee as Hypothetical Lien Creditor under Section 544. Section 552(b)(1) is also subject to section 544, n29 governing the trustee's hypothetical lien creditor and *bona fide* purchaser status. If the trustee may use the avoiding powers under subsections 544(a) or (b) to avoid the secured party's security interest, the secured party's lien will not extend to proceeds under section 552(b). n30 For example, if a secured party has an unperfected security interest in collateral that is subject to the rights of a judicial lien creditor under applicable nonbankruptcy law, the trustee can exercise rights as a hypothetical judicial lien creditor to avoid the security interest under section 544(a). n31 Some courts have suggested that a party seeking the protection of section 552(b)(1) must prove that its security interest is not avoidable. n32

Statutory Lien Avoided under Section 545. Section 552(b)(1) is also subject to section 545, n33 which sets forth the trustee's power to avoid certain statutory liens. On rare occasions, a secured party's collateral will be subject to the trustee's avoiding power under section 545. Of course, a security interest is not itself a statutory lien. But there may be a statutory lien avoidable under section 545 that encumbers the collateral and is prior to the security interest. If so, the avoided statutory lien is automatically preserved for the benefit of the estate ahead of the security interest both as to the collateral and as to proceeds.

For example, a landlord may have a rent lien against personal property of a debtor under state law. Suppose also that the rent lien is superior to any prior or subsequent security interest of a secured party in such personal property. If the debtor files a bankruptcy petition and sells the personal property free and clear of liens, the secured party's claim to proceeds under section 552(b) is subject to the rights of the trustee under section 545. The trustee will assert section 545(3) to avoid the rent lien and the rent lien is automatically preserved for the benefit of the estate under section 551.

Relationship of Section 552(b)(1) to Sections 547 and 548; Rights Asserted as a Result of Avoidance Action. Section 552(b)(1) is also subject to section 547, n34 regarding preferences, and section 548, n35 regarding fraudulent transfers. If the security interest is avoided, the secured party will not have rights in proceeds, products, offspring or profits under section 552(b)(1). In this situation, the avoided transfer is automatically preserved for the estate and can be asserted against proceeds for the benefit of the estate as against junior lienors. n36

Yet, assuming that a creditor has a valid, unavoidable prepetition security interest, the interplay between *section 552* and *sections 544, 547 and 548 of the Bankruptcy Code* arises when the creditor asserts a right under its security interest to any property recovered by the debtor in possession or the trustee as a result of an avoidance action.

Some courts have ruled that, where the creditor has an independent right to recover the property in question, the

creditor may claim an interest in that same property if and when it is recovered by the trustee pursuant to an avoiding power under the Bankruptcy Code. n37 Under this reasoning, monies recovered as the result of a fraudulent transfer action sometimes are found to be proceeds of the creditor's independent right to follow such monies when they are traceable into the hands of the transferee. n38

Other courts have distinguished these rulings when the avoiding action arises under the preference statute. According to these courts, preference recoveries are not proceeds of the creditor's collateral within the meaning of section 552(b)(1), because the right to recover a preference, unlike a chose in action for fraudulent transfer, occurs only in bankruptcy and is vested, with few exceptions, in a trustee. n39

Once bankruptcy ensues, however, since all recoveries under the avoiding powers are property of the estate, n40 administered almost exclusively by the trustee for the benefit of the estate as a whole rather than for any creditor individually, n41 it is difficult to see how such recoveries can be other than after-acquired property within the meaning of section 552(a), rather than proceeds of prepetition collateral under section 552(b)(1). This is true for fraudulent transfers as well as preferences, and no persuasive distinction seems possible along these lines. Prebankruptcy state law preferences exist, and may be asserted postbankruptcy under section 544(b) of the Code. And the assertion by a trustee of state fraudulent transfer law under section 544(b) allows for an expanded recovery under the rule of *Moore v. Bay*, as well as section 550, underscoring the fact that the recoveries that are property of the estate under section 541(a)(3) are peculiarly postpetition in nature. Indeed, a creditor may not sue to recover a state law fraudulent transfer once a case in bankruptcy is commenced, because this would be taking a chose in action from the estate, thereby violating the automatic stay. n42 On the whole, therefore, the more persuasively reasoned opinions do not permit creditors to share in recoveries obtained by bankruptcy trustees or estate representatives pursuant to the avoiding powers, even where such creditors may have independent, traceable rights to those funds. n43

For a complete discussion of Code section 552, see *Collier on Bankruptcy*, ch. 552 (Matthew Bender).

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n1 1. *In re Bering Trader, Inc.*, 944 F.2d 500, 502 (9th Cir. 1991) (characterizing exception as narrow).

n2

2. Subsection (b)(1) was created by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394. This subsection is identical to former section 552(b) except that all references to rent were deleted from it. Treatment of a creditor's interest in rent and similar revenues generated from a debtor's prepetition property is separately governed by subsection (b)(2) of section 552. See *Collier on Bankruptcy*, 552.03 (Matthew Bender).

n3

3. See 124 Cong. Rec. H11,09711,098 (daily ed. Sept. 28, 1978); S17,414 (daily ed. Oct. 6, 1978) (Proceeds coverage, but not after acquired property clauses, are valid under title 11); see also *Wolinsky v. Vermont Fed.*

Bank (In re Vermont Knitting Co.), 22 C.B.C.2d 1576, 111 B.R. 464 (Bankr. D. Vt. 1990); *First Nat'l Bank of Lafayette v. Texas Tri-Collar, Inc. (In re Texas Tri-Collar, Inc.)*, 8 C.B.C.2d 970, 29 B.R. 724 (Bankr. W.D. La. 1983) (equitable grounds did not justify allowing prepetition lien to attach to accounts receivable generated postpetition; see *Collier on Bankruptcy*, 552.01 (Matthew Bender).

n4

4. See, e.g., *In re Mintz*, 192 B.R. 313, 319 (Bankr. D. Mass. 1996) (defining proceeds by reference to the U.C.C. and also defining and analyzing product and profits).

n5

5. 292 U.S. 234, 54 S. Ct. 695, 78 L. Ed. 1230 (1934).

n6

6. 292 U.S. 234, 243, 54 S. Ct. 695, 698-699, 78 L. Ed. 1230, 1235; see *In re Soto*, 667 F.2d 235, 237, 5 C.B.C.2d 1277 (1st Cir. 1981). Cf. *Johnson v. Cottonport Bank*, 259 B.R. 125 (W.D. La. 2000) (debtor's monthly per capita distributions as member of Indian tribe remain subject postpetition to prepetition security interest of bank notwithstanding section 552(a).

n7

7. See *Smoker v. Hill & Assocs., Inc.*, 204 B.R. 966 (N.D. Ind. 1997); *In re Rumker*, 184 B.R. 621 (Bankr. S.D. Ga. 1995); cf. *In re Lawrence*, 41 B.R. 36, 38 (Bankr. D. Minn.), *aff'd*, 56 B.R. 727 (D. Minn. 1984).

n8

8. See, e.g., *In re Bumper Sales, Inc.*, 907 F.2d 1430, 23 C.B.C.2d 498 (4th Cir. 1990); *Smith v. Dairymen, Inc.*, 790 F.2d 1107 (4th Cir. 1986); *In re Mintz*, 192 B.R. 313, 319 (Bankr. D. Mass. 1996); *In re Wiegmann*, 20 C.B.C.2d 1472, 95 B.R. 90 (Bankr. S.D. Ill. 1989).

n9

9. H.R. Rep. No. 595, 95th Cong., 1st Sess. 376-77 (1977); see *Bradt v. Woodlawn Autoworkers, F.C.U.*, 757 F.2d 512 (2d Cir. 1985); *Breuer v. State Bank of Young Am. (In re Kohls)*, 94 B.R. 1006 (Bankr. D. Minn. 1987); *In re Jackels*, 55 B.R. 67 (Bankr. D. Minn. 1985); *In re Lawrence*, 41 B.R. 36, 37 (Bankr. D. Minn. 1984),

aff'd, 56 B.R. 727 (D. Minn. 1984); *In re Sunberg*, 35 B.R. 777 (Bankr. S.D. Iowa 1983), *aff'd*, 729 F.2d 561 (8th Cir. 1984). *But cf.* *American Bankers Ins. Co. v. Maness*, 101 F.3d 358, 364 (4th Cir. 1996) (applying state law to determine that liability insurance bought postpetition was not proceeds of prepetition home destroyed by fire after commencement of case for purposes of section 541(a)(6), and noting that legislative history of proceeds language in section 541(a)(6), like congressional comments on meaning of the term proceeds in section 552, is vague and isolated, quoting *Unsecured Creditors Comm. v. Marepcon Fin. Corp. (In re Bumper Sales, Inc.)*, 907 F.2d 1430, 1437 (4th Cir. 1990)). *But compare* *FarmPro Servs., Inc. v. Brown (In re FarmPro Servs., Inc.)*, 276 B.R. 620 (D.N.D. 2002) (crop disaster benefits as proceeds under section 541(a)(6) and by implication under section 552(b)(1)).

n10

10. *See, e.g., In re Wabash Valley Power Ass'n, Inc.*, 72 F.3d 1305, 1322, 34 C.B.C.2d 877, 896 (7th Cir. 1995) (*dictum* concluding that blanket lien on power generation assets and attendant rights did not capture postpetition income as collateral); *First Nat'l Bank v. Willis (In re Jones)*, 908 F.2d 859, 23 C.B.C.2d 763 (11th Cir. 1990) (debtor's postpetition contributions to whole life policy not subject to prepetition lien on policy); *Brandt v. Fleet Capital Corp. (In re TMCI Elec.)*, 279 B.R. 552 (Bankr. N.D. Cal. 2000) (tax refund is after-acquired property rather than proceeds because debtor's rights vested at end of tax year, which was postpetition); *In re Megamarket of Lexington, Inc.*, 207 B.R. 527 (Bankr. E.D. Ky. 1997); *American President Lines, Ltd. v. Lykes Bros. S.S. Co. (In re Lykes Bros. S.S. Co.)*, 216 B.R. 856, 863-64 (Bankr. M.D. Fla. 1996) (steamship charter line payments generated postpetition are not proceeds under security agreement arising prepetition); *Englander v. First Union Nat'l Bank of Fla.*, 202 B.R. 326 (Bankr. M.D. Fla. 1995); *In re Pigeon*, 49 B.R. 657, 660 (Bankr. D.N.D. 1985); *In re Fowler*, 41 B.R. 962 (Bankr. N.D. Iowa 1984).

n11

11. *See In re Olsen*, 87 B.R. 148 (Bankr. D. Colo. 1988); *Bird v. Plains State Bank*, 86 B.R. 660 (Bankr. D. Kan. 1988); *In re Smith*, 72 B.R. 344 (Bankr. S.D. Ohio 1987), *aff'd*, 119 B.R. 558 (S.D. Ohio 1989); *In re Wallman*, 71 B.R. 125 (Bankr. D.S.D. 1987); *In re Stallings*, 290 B.R. 777, 780-84 (Bankr. D. Idaho 2003), the bankruptcy court ruled that a United States program created to compensate farmers for crop losses due to BLM herbicides was not property of the estate under section 541(a), where the debtor farmer's entitlement to program participation arose after the filing of a chapter 12 petition. The bankruptcy court applied the same analysis as under section 552, holding that the program entitlement was neither prepetition property nor converted from prepetition property and, hence, must be after-acquired property and not proceeds for purposes of a lender's prepetition crop lien under section 552, even though the herbicide losses (for which program payments were forthcoming) were suffered in relation to prepetition farming. The bankruptcy court noted that the government payment was not something Debtors acquired, or became entitled to acquire, upon or in exchange for the sale or disposition of their [prepetition] crops, and that, although the record was less than clear, [i]n effect the government payment was intended by Congress to partially reimburse them for crops *not* produced because of the [herbicide] problem. In light of this reasoning, the payment, according to the bankruptcy court, was after-acquired property, rather than proceeds. *But cf. FDIC v. Coones (In re Coones)*, 954 F.2d 596, 601 (10th Cir. 1992), *vacated and remanded*, 506 U.S. 802; 113 S. Ct. 31, 121 L. Ed. 2d 4 (1992), *reaffirmed on remand*, 996 F.2d 250 (10th Cir. 1993), *cert. denied*, 510 U.S. 1041, 114 S. Ct. 684, 126 L. Ed. 2d 651 (1994).

n12

12. See *Smith v. Dairymen, Inc.*, 790 F.2d 1107 (4th Cir. 1986); *In re Wiegmann*, 20 C.B.C.2d 1472, 95 B.R. 90 (Bankr. S.D. Ill. 1989). But see *In re Flowers*, 78 B.R. 774 (Bankr. D.S.C. 1986) (milk is not product of livestock); *In re Jackels*, 55 B.R. 67 (Bankr. D. Minn. 1985). See also *In re Thacker*, 291 B.R. 831 (Bankr. S.D. Ill. 2003) (creditor with prepetition lien on seed gets benefit of section 552(b)(1) on postpetition crop deemed proceeds of that seed).

n13

13. *FDIC v. Coones (In re Coones)*, 954 F.2d 596, 601 (10th Cir. 1992), vacated and remanded, 506 U.S. 802, 113 S. Ct. 31, 121 L. Ed. 2d 4 (1992), reaffirmed on remand, 996 F.2d 250 (10th Cir. 1993), cert. denied, 510 U.S. 1041, 114 S. Ct. 684, 126 L. Ed. 2d 651 (1994); *In re Bumper Sales, Inc.*, 907 F.2d 1430, 1439, 23 C.B.C.2d 498, 509-10 (4th Cir. 1990); *In re Package Design & Supply Co.*, 217 B.R. 422 (Bankr. W.D.N.Y. 1998) (analyzing circumstances under which secured creditor may see its collateral roll out from under lien by operation of section 552).

n14

14. See *Distinction Between After-Acquired Property and Proceeds supra* (discussion of the tests used by the courts to distinguish proceeds and after-acquired property).

n15

15. See, e.g., *Cadle Co. v. Schlichtmann*, 267 F.3d 14 (1st Cir. 2001) (bank's security interest in law firm's contingent fee contract continues in escrowed funds that are proceeds of such contract, notwithstanding dissolution of firm, transfer of contract to partner, bankruptcy of partner and postbankruptcy services of debtor attorney in order to confirm settlement that vested funds); *In re Bumper Sales, Inc.*, 907 F.2d 1430, 1438, 23 C.B.C.2d 498, 508 (4th Cir. 1990) (U.C.C. § 9-306 is *per se* inapplicable after petition 1983); cf. *Solfanelli v. CoreStates Bank N.A.*, 203 F.3d 197, 203 (3d Cir. 2000) (stay lifted allowed execution against collateral, but, since postpetition funds were not proceeds of collateral under section 552(b)(1), levy against them by bank violated stay).

n16

16. 11 U.S.C. § 552(b)(1) (emphasis added). One bankruptcy court looked to the definition of proceeds under California's version of the Uniform Commercial Code, finding that rental income from equipment collateral did not qualify for purposes of the section 552(b) exception. See *Perris Valley Rentals, Inc. v. Textron Fin. Corp. (In re Rebel Rents, Inc.)*, 307 B.R. 171 (Bankr. C.D. Cal. 2004). Another bankruptcy court examined federal telecommunications law to validate a security interest in a broadcast license, awarding the proceeds of sale to a prepetition secured creditor. See *Wells Fargo Foothill, Inc. v. Kepler (In re Media Props.)*, 311 B.R.

244 (*Bankr. W.D. Wis. 2004*).

n17

17. *Patterson v. Shumate*, 504 U.S. 753, 112 S. Ct. 2242, 119 L. Ed. 2d 519, 26 C.B.C.2d 1119 (1992).

n18

18. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 377 (1977). (Extends to as used [in section 552(b)] would include an automatically arising security interest in proceeds, as permitted under the 1972 version of the Uniform Commercial Code.); see also U.C.C. §§ 9-203(3), 9-315(c); *In re Keneco Fin. Group, Inc.*, 131 B.R. 90 (*Bankr. N.D. Ill. 1991*).

n19

19. See *In re Colonial Realty Inv. Co.*, 516 F.2d 154, 159-160 (1st Cir. 1975) (court carefully considered what expenses rental income should be used for, in effort to find a middle ground, going beyond the use of rental income for the immediate and direct benefit of several creditors, but not approaching a treatment as general assets, which serves the rehabilitative goal of Chapter XII while respecting the property rights of the secured creditors). According to one court, the equities exception of section 552(b)(1) applies mainly to further the rehabilitative purposes of chapter 11, where the secured party is oversecured, and in order to prevent a windfall improvement in value to the secured party as a result of the use of unencumbered estate assets. See *In re Tower Air, Inc.*, 268 B.R. 404, 408 (*Bankr. D. Del. 2001*). The equities exception is not a general grant of equitable discretion that may be used to protect secured creditors from their own mistakes, for example, by giving them a retroactive replacement lien. See, e.g., *In re Three Partners, Inc.*, 199 B.R. 230, 239 (*Bankr. D. Mass. 1995*) (citing *New Hampshire Bus. Dev. Corp. v. Cross Baking Co. (In re Cross Baking Co.)*, 818 F.2d 1027 (1st Cir. 1987)). Indeed, according to one court, this clause was inserted by Congress for the protection of unsecured creditors and may not be invoked by a second party with a collateral position at issue. See *In re Ledis*, 259 B.R. 472, 479-80 (*Bankr. D. Mass. 2001*).

n20

20. See, e.g., *In re Patio & Porch Sys., Inc.* 194 B.R. 569, 575 (*Bankr. D. Md. 1996*), and cases cited therein.

n21

21. See, e.g., *In re Hotel Syracuse, Inc.*, 275 B.R. 679 (*Bankr. N.D.N.Y. 2002*). See generally James S. Cole, *The Carve Out from Liens and Priorities Guarantee Payment of Professional Fees in Chapter 11*, 1993 Det. C.L. Rev. 1499 (1993); Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 Am.

Bankr. L.J. 445 (2002); cf. *Gold Coast Asset Acquisition, L.P. v. 1441 Veteran St. Co.* (*In re 1441 Veteran St. Co.*), 144 F.3d 1288, 1292 (9th Cir. 1998).

n22

22. See *In re First Nat'l Bank v. Willis* (*In re Jones*), 908 F.2d 859, 23 C.B.C.2d 763 (11th Cir. 1990) (although equity exception not mentioned, creditor's security interest in debtor's life insurance policy did not extend to increase in cash surrender value of policy that was attributable to postpetition premium payments).

n23

23. See 124 Cong. Rec. H11,09711,098 (daily ed. Sept. 28, 1978); S17,414 (daily ed. Oct. 6, 1978). (This provision allows the court to consider the equities in each case. In the course of such consideration the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party.). The equities language in section 552(b), as enacted, superseded different, arguably narrower, proposals in the House and Senate bills. See, e.g., S. Rep. No. 989, 95th Cong., 2d Sess. 91; see also *J. Catton Farms, Inc. v. First Nat'l Bank of Chicago* (*In re J. Catton Farms, Inc.*), 779 F.2d 1242 (7th Cir. 1985); *In re Village Props., Ltd.*, 723 F.2d 441, 444, 10 C.B.C.2d 224, 26 C.B.C.2d 224 (5th Cir.), cert. denied, *Wolters Village, Ltd. v. Village Props., Ltd.*, 466 U.S. 974, 104 S. Ct. 2350, 80 L. Ed. 2d 823 (1984); *In re Patio & Porch Sys., Inc.* 194 B.R. 569, 575 (*Bankr. D. Md.* 1996) (section 506(c) permits a broad range of surcharges, including surcharge against postpetition security interests).

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24. See Collier on Bankruptcy, ch. 506 (Matthew Bender).

n25

25. *In re Sequential Info. Sys.*, 4 C.C.H. Sec. Trans. Guide [1969-73 Transfer Binder] 51,479 (S.D.N.Y. 1970); *De Gayner Homes, Inc.*, 1 B.C.D. 532 at 533 (W.D. Wis. 1975); see also *In re Kahl Iron Foundry, Inc.*, 21 B.R. 372 (*Bankr. E.D. Mich.* 1982).

N26

26. One court has discussed, at some length, the potential effect of value added by unsecured creditors and the possibility of such value diluting the liens of fully secured or partially secured creditors. *In re Package Design & Supply Co.*, 39 C.B.C.2d 931, 217 B.R. 422 (*Bankr. W.D.N.Y.* 1998). See also *In re Cafeteria Operators, L.P.*, 299 B.R. 400 (*Bankr. N.D. Tex.* 2003).

n27

27. *In re Package Design & Supply Co.*, 39 C.B.C.2d 931, 217 B.R. 422 (Bankr. W.D.N.Y. 1998) (discussing the effect of value, added by debtor or unsecured creditors, on secured lender's asserted security in postpetition proceeds); *Wood v. LA Bank (In re Wood)*, 35 C.B.C.2d 275, 190 B.R. 788 (Bankr. M.D. Pa. 1996) (finding security interest did not attach to increase in value of collateral where value derived solely from debtor's effort). For examples of the manner in which courts have applied the equities formula of section 552(b), see, e.g., *United Virginia Bank v. Slab Fork Coal Co.*, 784 F.2d 1188, 14 C.B.C.2d 471 (4th Cir.), cert. denied, 477 U.S. 905, 106 S. Ct. 3275, 91 L. Ed. 2d 565 (1986); *J. Catton Farms v. First Nat'l Bank of Chicago*, 779 F.2d 1242 (7th Cir. 1985).

n28

28. 124 Cong. Rec. H11,09711,098 (daily ed. Sept. 28, 1978); S17,414 (daily ed. Oct. 6, 1978).

n29

29. See Collier on Bankruptcy, ch. 544 (Matthew Bender).

n30

30. See, e.g., *Ohio Cas. Group of Ins. Cos. v. Professional Ins. Mgmt. (In re Professional Ins. Mgmt.)*, 130 F.3d 1122, 1128-31 (3d Cir. 1997).

n31

31. See, e.g., *In re Hartman*, 102 B.R. 90 (Bankr. N.D. Tex. 1989); *Cohen v. Spinelli (In re Simonelli)*, 33 B.R. 777 (Bankr. M.D. Fla. 1983).

n32

32. See, e.g., *In re Bennett Funding Group Inc.*, 203 B.R. 30 (Bankr. N.D.N.Y. 1996), *aff'd in part, rev'd and remanded in part, In re Bennett Funding Group, Inc.*, 255 B.R. 616 (N.D.N.Y. 2000) (secured creditor must establish that it holds validly perfected security interest); *In re Lykes Bros. S.S. Co.*, 216 B.R. 856 (Bankr. M.D. Fla. 1996) (to avail itself of section 552(b)(1), secured party must prove that statutory exception under section 544 does not apply).

n33

33. See Collier on Bankruptcy, ch. 545 (Matthew Bender).

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34. See Collier on Bankruptcy, ch. 547 (Matthew Bender).

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35. See Collier on Bankruptcy, ch. 548 (Matthew Bender).

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36. See Collier on Bankruptcy, 551.01 (Matthew Bender).

n37

37. These rulings are summarized in *Barber v. McCord Auto Supply, Inc. (In re Pearson Indus., Inc.)*, 178 B.R. 753, 764 (C.D. Ill. 1995). For examples of approaches taken by courts following these rulings, see, e.g., *Angeles Real Estate Co. v. Kerxton (In re Constr. Gen., Inc.)*, 737 F.2d 416 (4th Cir. 1984); *Mellon Bank (East) N.A. v. Glick (In re Integrated Testing Prod. Corp.)*, 69 B.R. 901 (D.N.J. 1987); *Hennessy v. Kennedy (In re Sun Island Foods)*, 125 B.R. 615 (Bankr. D. Haw. 1991).

n38

38. See, e.g., *Claussen Concrete Co. v. Walker (In re Lively)*, 74 B.R. 238 (S.D. Ga. 1987), *aff'd without op.*, 851 F.2d 363 (11th Cir. 1988); *John Hancock Life Ins. Co. v. Jankowski (In re Hospitality Inv. Corp.)*, 49 C.B.C.2d 413, 283 B.R. 451 (Bankr. E.D. Mich. 2002).

n39

39. See, e.g., *Mellon Bank (East) N.A. v. Glick (In re Integrated Testing Prods. Corp.)*, 69 B.R. 901 (D.N.J. 1987); *Matson v. Grease Monkey Int'l, Inc. (In re Bev, Inc.)*, 237 B.R. 311, 316 (Bankr. E.D. Va. 1998).

(implying this result); *Hennessey v. Kennedy (In re Sun Island Foods)*, 125 B.R. 615 (Bankr. D. Haw. 1991). But see *In re Hospitality Inv. Corp.*, 283 B.R. 451 (Bankr. E.D. Mich. 2002) (monies recovered by trustee under section 547 were subject to creditor's prepetition security interest); *In re Ellingsen MacLean Oil Co.*, 98 B.R. 284 (Bankr. W.D. Mich. 1989) (same).

n40

40. 11 U.S.C. § 541(3)(4).

n41

41. See, e.g., *In re Mako, Inc.*, 985 F.2d 1052, 1056 (10th Cir. 1993); *Delgado Oil Co. v. Torres*, 785 F.2d 857, 861-62 (10th Cir. 1986). Where a representative of the estate performs this office, rather than a trustee, the representative still must serve the estate generally rather than a creditor selectively. See, e.g., *In re Sweetwater*, 884 F.2d 1323, 1328 (10th Cir. 1989); cf. *Hartford Underwriters Ins. Co. v. Union Planters Bank N.A.*, 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1, 43 C.B.C.2d 861 (2000) (standing of trustee under section 506(c)).

n42

42. See, e.g., *In re MortgageAmerica Corp.*, 714 F.2d 1266, 1277-78 (5th Cir. 1986).

n43

43. See, e.g., *In re First Capital Mortgage Loan Corp.*, 917 F.2d 424, 428 (10th Cir. 1990) (*en banc*); cf. *Frank v. Michigan ex rel. Michigan Unemployment Agency*, 263 B.R. 538 (E.D. Mich. 2000) (state statutory lien does not attach to preference recovery); *Frank v. Michigan ex rel. Mich. Unemployment Agency*, 261 B.R. 909 (E.D. Mich. 1999) (same); *In re Southeast R.R. Contractors, Inc.*, 235 B.R. 619 (Bankr. E.D. Tenn. 1996) (tax lien and preference recovery).

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144 of 197 DOCUMENTS

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Collier on the Prohibition on Sharing Compensation

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SUMMARY: This Emerging Issues Analysis covers the prohibition against sharing compensation, including topics such as the parties included in the prohibition, procedure under Federal Rule of Bankruptcy Procedure 2016, the case-by-case basis on which improper fee sharing is decided, and the role of professionals in bankruptcy administration.

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ARTICLE: The prohibition against a professional sharing compensation has two components. A person receiving compensation or reimbursement pursuant to Bankruptcy Code subsection 503(b)(2) or (b)(4) may neither share nor agree to share that compensation with another person, nor may he or she share or agree to share in any compensation received by another person under subsection 503(b)(2) or (b)(4). n1

While the legislative history of section 504 is sparse, stating only that the section prohibits the sharing of compensation or fee splitting among attorneys, other professionals or trustees, n2 there can be no doubt that *section 504(a) of the Bankruptcy Code* is intended to be mandatory and preemptory. The section illustrates a congressional intent to preserve the integrity of the bankruptcy process so that professionals engaged in bankruptcy cases attend to their duty as officers of the bankruptcy court, rather than treat their interest in bankruptcy cases as matters of traffic. n3

Parties Included in Prohibition

The prohibition against fee sharing operates by defining those persons who are subject to it. There are two categories of persons who may not share, or agree to share, their fees: those who are compensated pursuant to section 503(b)(2) and those who are compensated pursuant to section 503(b)(4). Section 503(b)(2) allows the administrative expenses for compensation under section 330(a), which provides for the compensation of a trustee, examiner or the trustee's (or debtor in possession's) and committee's professionals employed under section 327 or section 1103, as well as reimbursement of their expenses. n4 Section 503(b)(4) allows administrative expenses for the reasonable compensation for legal or accounting services rendered to a person whose expense is allowed under section 503(b)(3), a provision generally allowing expenses for creditors making substantial contributions to the estate, and the expenses of

committee members. n5

No Fee Sharing with Subcontractors

By prohibiting fee sharing without regard to whether services have been provided, section 504 also ensures that professionals whose retention should be reviewed and determined by the bankruptcy court under section 327 cannot avoid that review by subcontracting with a retained professional to assist in providing services. Indeed, there is overlap in the application of sections 327 and 330, requiring court approval of the compensation paid to professionals retained in a bankruptcy case, and section 504. n6 A professional cannot be compensated under section 330 for amounts the professional has paid to a subcontractor rendering professional services unless retention of the subcontractor has also been approved by the court. n7 Likewise, the professional whose compensation is approved under section 330(a) cannot recoup the cost of a subcontractor providing professional services without violating section 504. n8

Relation to Allowance of Fees under Section 330

Although there is overlap, sections 504 and 330 are not identical. Section 330 requires a bankruptcy court, when awarding compensation, to take into consideration whether fees paid to an attorney in the year preceding the filing were reasonable. If the fees are not reasonable, the court can order that they be disgorged or reduce the compensation paid from the estate. n9 This power to review compensation arrangements for prior periods does not exist under section 504. To the contrary, by referencing subsections 503(b)(2) and (4), section 504 is explicitly limited to compensation paid from the estate. Courts have occasionally blurred the distinction between section 329 and section 330, on the one hand, and 504 on the other, by borrowing the power under section 329 to review compensation received by debtor's counsel in the year preceding the commencement of a case to prohibit all fee sharing for the same one-year period, or by reaching the same result without discussion. n10 There are sufficient means under the Code for voiding transfers made before the commencement of a case to recover an excessive payment made in the year before the filing without expanding the scope of section 504. In addition, fee sharing arrangements are always subject to state ethical rules; the proscription of section 504 (as well as the limitations on compensation under sections 329 and 330) are in addition to and not in substitution for state ethical obligations. n11

Treatment of Nonprofessionals

Generally, the persons who are restricted by section 504 are professionals. The prohibition is nevertheless not expressly limited to professionals and includes those who are reimbursed for expenses under section 330(a). To the extent a professional has hired a nonprofessional to assist in rendering the professional's services, professionals may be prohibited from fee sharing with the nonprofessionals. A more reasoned approach, though, recognizes that if the retention of the nonprofessional would not have required court approval under section 327 and the sharing is for services actually provided by the nonprofessional, expanding the prohibition to the nonprofessional would not accomplish any of the purposes of section 504. Thus, an attorney may not share fees with a paralegal completing a debtor's schedules but may share with a paralegal assisting in the preparation of the schedules under the attorney's supervision. n12 Services rendered by a professional may even be excluded from the fee sharing prohibition if the services themselves were not professional in nature. n13

Procedure under Rule 2016

Federal Rule of Bankruptcy Procedure 2016, Compensation for Services Rendered and Reimbursement of Expenses, provides that any entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate must:

- . file an application giving a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested;

- . include a statement as to what payments have been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case;

- . identify the source of the compensation so paid or promised;

- . reveal whether any compensation previously received has been shared; and

- . reveal whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case and the particulars of any sharing of compensation or agreement or understanding.

In addition, pursuant to Rule 2016(b), every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 15 days after the order for relief, or at another time as the court may direct, the statement required by section 329 of the Code, including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney, but the details of any agreement for sharing of compensation with a member or regular associate of the attorney's law firm are not required. In addition, Rule 2016(b) imposes a continuing duty to supplement the Rule 2016(b) statement within 15 days after any payment or agreement not previously disclosed.

Professionals and Ethics: Interpretation by the Courts

Although many jurisdictions do not prohibit fee splitting among attorneys, *section 504 of the Bankruptcy Code* expressly does so. Thus, although attorneys, under varying rules, ⁿ¹⁴ are generally permitted, in limited circumstances, to share fees with attorneys outside their firms, they may not do so if they seek reimbursement or compensation under subsection 503(b)(2) or (b)(4) of the Code. In order to obtain such reimbursement, attorneys not in the same firm but who represent a single entity would thus be required to separately obtain court approval of their retention and fees.

However, the fact that the bankruptcy court approves retention of each attorney does not obviate application of the state-imposed requirements for fee sharing. Thus, the attorney should consider whether the state-imposed requirements for fee sharing must also be met. ⁿ¹⁵

Section 504(a) applies the general prohibition against fee splitting, imposed upon attorneys by various ethics rules, to virtually all professional persons who seek compensation in bankruptcy cases. ⁿ¹⁶ In this manner, the Bankruptcy Code extends the protections of the duty of loyalty to the client and the rules precluding conflicts of interest to non-lawyers as well as lawyers. Accordingly, counsel seeking to obtain approval for the retention of nonlawyer professionals (e.g., auctioneers, accountants) should advise those professionals that they should not enter into fee-splitting agreements.

Neither of the exceptions to the prohibition in section 504(b) permits fee sharing with a nonlawyer professional. An attorney would also be prohibited by such fee sharing by either Model Rule 5.4(a) or DR 3-102(a).

Improper Fee Sharing Decided on Case-by-Case Basis

For the most part, the facts supporting a determination of improper sharing of compensation in cases construing section 504 are straightforward. For example, in *In re Codesco Inc.*,ⁿ¹⁷ the debtor's appraiser retained, without court approval, an outside consultant who was to be paid from the compensation the appraiser would receive from the debtor. The *Codesco* court concluded that this agreement violated section 504. Similarly, in *In re Anderson*,ⁿ¹⁸ the debtor employed an attorney who, in turn, hired his son with whom he did not practice. The attorney paid his son a \$10,000 retainer. The son's separate employment to assist in various lawsuits, however, was not authorized by the court at that time. The court upheld the bankruptcy court's partial denial of the son's fee application due to his failure to be employed.ⁿ¹⁹ The court also held in the alternative that even if the retainer was paid from the father's funds rather than from funds of the estate, payment of the retainer violated the section prohibition against sharing compensation.

In the context of consumer bankruptcy, fee sharing can arise in a variety of ways. The most common problem involves payment of referral fees to attorneys or non-attorneys who generate business for the bankruptcy attorney.ⁿ²⁰ The evils of fee sharing were vividly illustrated in *In re Soulisak*,ⁿ²¹ a case in which the bankruptcy court reviewed an arrangement between a debt counseling firm, which was a one-man shop run by a disbarred attorney, and a lawyer operating as a sole practitioner. The counseling firm would offer financial and legal counseling to clients for a fixed fee. The principal of the counseling firm then contracted with the lawyer to provide the legal services and agreed to share the fee. Clients did not meet with the attorney until the section 341 meeting, and the disbarred lawyer performed all work, including legal work, prior to that meeting. The United States trustee noticed that this arrangement between the same professionals appeared in four separate cases and asked the bankruptcy court to review the arrangement on behalf of each of the estates. The court was troubled by every aspect of the arrangement. The court noted that the individual providing the financial counseling had already been required to disgorge fees in six other bankruptcy cases in a neighboring jurisdiction and had entered into a consent decree agreeing not to appear before the other bankruptcy court and his license had been suspended. He had already been disbarred in yet another jurisdiction for completely different misconduct. The bankruptcy court underscored the cumulative effect of local ethical rules and section 504, and found that both professionals had violated the state ethical rules for the unauthorized practice of law and impermissible fee sharing and had violated section 504 as well. Both professionals were required to disgorge all fees from all four cases.

The court in *In re Willman*ⁿ²² noted another example of malfeasance in the consumer bankruptcy context--the bankruptcy petition for a no-asset case under chapter 7. The firm included work of an attorney in its services. It charged the debtor \$950, but only reported fees totaling \$125 to the court. Besides finding that the tax advisors filed a misleading disclosure of compensation under Code section 110(h)(1), the court also held that the fee-sharing arrangement violated section 504.

Fee Sharing May Be Allowed

In other cases, the issue of improper sharing of compensation is not so clear-cut. In *In re Warner*,ⁿ²³ the government objected to an award of attorney's fees that included reimbursement for a payment to an outside attorney. The debtor's attorney explained that in the course of representing the debtor it was necessary to subpoena a material witness in another state, which required the retention of an attorney licensed to practice in that state in order to obtain the subpoena. The *Warner* court overruled the government's objection, concluding that the arrangement to pay the outside attorney was merely a payment for a necessary service. The court noted that if the subpoena could have been obtained and served by a non-attorney, section 504 would not be applicable and that the need to retain an attorney for the matter did not change the nature of the payment.ⁿ²⁴

Similarly, in *In re Statewide Pools, Inc.*,ⁿ²⁵ the trustee sought to employ special counsel for the limited purpose of collecting certain of the debtor's accounts receivables and prosecuting a lawsuit. The application to employ the special counsel proposed that special counsel would pay a former officer of the debtor on an hourly basis for assistance in collecting some of the debtor's accounts receivable. The *Statewide* court found that special counsel's proposal to compensate the former officer did not constitute an impermissible fee-splitting arrangement. The fact that the former officer would not receive any payments directly from the estate and would not receive a predetermined percentage of

the special counsel's fees was determinative. Notably, the court did not consider the former officer a professional whose employment would have to be approved by the court.

Compensation Disallowed or Disgorged upon Finding of Improper Fee Sharing

Generally, a finding of improper sharing of compensation results in a denial or disgorgement of compensation. The predecessor to section 504, Section 62d of the Bankruptcy Act, provided that the court shall withhold all compensation if the court concluded that an attorney improperly shared or agreed to share compensation. Former Rule 219, the predecessor to Rule 2016, also provided that, if a person violated the rule's proscription against sharing compensation, the court may deny him compensation, or may enter such other order as may be appropriate. Neither section 504 nor Rule 2016 provides for withholding compensation. The bankruptcy court in *In re Matis*,ⁿ²⁶ after finding a violation of section 504(a), looked to former Rule 219 as support for the denial of compensation. Recognizing that neither the current rule nor the current Code section specifically provides the court with a remedy as did the predecessor provisions, the *Matis* court opined that there is no reason to conclude that the Court does not still retain such discretion to deny compensation.ⁿ²⁷ The *Matis* court found further support for this conclusion in Code section 329(b), which authorizes the court to order the return of compensation.

Other courts have likewise either denied compensation or required disgorgement for fee sharing in violation of section 504 or for failure to disclose sharing arrangements under Rule 2016.ⁿ²⁸ Nor can professionals avoid this penalty by seeking authority to be retained *nunc pro tunc*,ⁿ²⁹ although retention of the second professional, if approved by the court, will avoid impermissible fee sharing going forward.ⁿ³⁰

Related Statutory Provisions

An understanding of several other Bankruptcy Code sections is helpful to a complete understanding of section 504. First, a professional must be employed with court approval in order to be compensated by the estate. Section 327 prescribes the basis for employment and Rule 2014 prescribes the procedure. The compensation requested by the professional must be authorized by the court. Section 330 covers the compensation of officers of the court. Section 503, which is explicitly referenced in section 504, makes reasonable compensation for professional services an administrative expense. Finally, 18 U.S.C. § 155 is the criminal counterpart to section 504. Section 155 provides for criminal penalties for fee-fixing agreements that contemplate payment from the estate.ⁿ³¹

11 U.S.C. § 503. Section 503 of the Code prescribes the standards for the allowance of administrative expense status, a status which confers a priority in distribution under section 507(a)(1) of the Code.ⁿ³² Section 503(b)(2), to which section 504(a) refers, provides that administrative expense status is an entitlement to those awarded compensation and reimbursement by section 330(a) of the Code.

11 U.S.C. § 330. Section 330(a) authorizes compensation to a trustee, an examiner or a professional person employed under section 327 or section 1103 or to the debtor's attorney.ⁿ³³ It follows from the language of section 503(b)(2) and section 330(a) that the term person, as used in section 504(a), includes the trustee, an examiner, or an attorney, accountant or other professional person. Section 330(a) sets forth the standards for court awards of reasonable compensation to professionals in bankruptcy cases. The various factors contained in section 330(a) may include the time spent on the services, the rates charged for such services, the benefit to the estate and the necessity of such services, and the customary compensation paid in nonbankruptcy cases. The intent was to help foster greater uniformity

in the application for and processing and approval of fee applications.

11 U.S.C. § 327. The provisions of section 327, which allow the employment of professionals by the trustee, also relate to the application of section 504. n34

The reference in section 330(a) to employment of a professional person under section 1103 of the Code refers to the authority conferred by the latter section for the selection by a creditors' committee of one or more attorneys, accountants or other agents to represent or to perform services for that committee. n35

Reading section 503(b)(2) with sections 330 and 327 makes it clear that the section 504(a) prohibition against sharing or agreeing to share compensation or reimbursement is applicable to all persons receiving compensation, including the statutory compensation of a trustee entitled to administrative expense status. The same holds true with regard to persons entitled to administrative status pursuant to section 503(b)(4)--attorneys and accountants--for professional services rendered to entities described by section 503(b)(3). Section 503(b)(4) refers to: reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under paragraph (3) of this subsection, based on the time, the nature, the extent, and the value of such services, and the cost of comparable services other than in a case under this title, and reimbursement for actual, necessary expenses incurred by such attorney or accountant.

18 U.S.C. § 155. *Section 155 of title 18 of the United States Code* provides criminal penalties for fee-fixing agreements under which compensation is to be paid from assets of the estate. The penalties for violation of the statute are a monetary fine, imprisonment or both. The statute does not, however, authorize a forfeiture of reasonable compensation, actually earned, for services performed. n36 The provision, which was originally enacted in 1937, states as follows:

Whoever, being a party in interest, whether as a debtor, creditor, receiver, trustee or representative of any of them, or attorney for any such party in interest, in any receivership or case under title 11 in any United States court or under its supervision, knowingly and fraudulently enters into any agreement, express or implied, with another such party in interest or attorney for another party in interest, for the purpose of fixing the fees or other compensation to be paid to any party in interest or to any attorney for any party in interest for services rendered in connection therewith, from the assets of the estate, shall be fined not more than \$5,000 or imprisoned not more than one year, or both.

The language of the statute does not manifest an intent to create a civil action for damages, and the legislative history of the section does not demonstrate that the creation of such a civil action was contemplated. n37 The purpose of section 155 has been described as to keep the fees under the control of the court to prevent trustees, creditors and others, and their counsel, from playing fast and loose with other people's money in courts of bankruptcy. n38

The Role of Professionals in Bankruptcy Administration

A brace of decisions emanating from the Court of Appeals for the Second Circuit in late 1979 and into the mid 1980s is instructive. Although they interpret and apply predecessor Section 62 of the 1898 Act and Rule 219 in light of then newly enacted section 504, they reveal the view the courts adopted regarding the role of the attorney in the administration of a bankruptcy case and the standards to which the attorney would be held in the discharge of such duties. It is noteworthy that virtually all of the cases that address section 504 and its statutory and common law predecessors discuss the role of the attorneys in the context of their professional ethics, rather than merely addressing the scope of the statute or other rule, thereby highlighting the importance of these considerations in the bankruptcy context. As in all circumstances regarding fees and applications to retain, attorneys must strictly consider their ethical obligations because the Bankruptcy Code imposes upon the court a duty to scrutinize the actions of professionals who appear, file claims or provide services in the bankruptcy context. n39

Matter of Arlan's Department Stores Inc. The first of these opinions is *Matter of Arlan's Department Stores, Inc.* n40 Recognizing that counsel for the debtor is an officer of the court and is bound by fiduciary standards, n41 and noting that the debtor's counsel had flatly denied being a court-appointed officer or fiduciary, the Arlan's court stated that counsel's position is untenable and it is indeed shocking that experienced bankruptcy attorneys would consider their relationship to the court or the estate of the debtor in such a light. n42 The court's emphasis on the role and fiduciary responsibilities of attorneys in a bankruptcy case remains applicable to the present law, particularly in light of the more restrictive prohibition set forth in section 504. The words of then-Judge Cardozo, as quoted by the Arlan's court, are especially apropos: Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. n43

Matter of Futuronics Corporation. The second case was *Matter of Futuronics Corporation.* n44 The United States District Court for the Southern District of New York stated at the outset of its opinion that attorneys are officers of the court and must conduct themselves accordingly. It further recognized that, as professionals, attorneys are to be held to a higher standard in the discharge of their duties, especially where an attorney is counsel to a debtor and acts as a fiduciary. These standards of conduct were emphasized by the *Futuronics* court in light of the fact that, in the context of a bankruptcy case, it is necessary for the court to depend upon the integrity of the debtor's counsel in the handling and administration of the debtor's assets.

The debtor's counsel in *Futuronics* had retained special counsel to prosecute certain claims involving government contracts. Although the bankruptcy court subsequently permitted the retention of special counsel, it rejected a proposed retention order calling for special counsel to pay to the debtor's counsel one-third of all fees special counsel received. Four years later, a statement of services rendered by special counsel, submitted at the direction of the court, revealed that special counsel had paid to debtor's counsel fees in excess of \$60,000. The fees paid had never been revealed to the court, despite numerous hearings, conferences and questions of the court with regard to the fee arrangement between debtor's counsel and special counsel. Based on the conduct of debtor's counsel and special counsel, which the district court described as totally unprofessional and in breach of their respective duties as fiduciaries and officers of the court, n45 the district court ordered the attorneys to pay to the debtor all fees collected to date with interest and denied them any further compensation.

Despite the fact that the *Futuronics* court applied the former law with regard to impermissible fee sharing, the commentary of the district court in denying all compensation remains an important consideration with regard to attorneys acting in bankruptcy cases. In light of the circumstances surrounding the case, it is not surprising that Congress incorporated a mandatory tone in section 504(a), recognizing a strong public policy against fee splitting and the dangers likely to result therefrom. In affirming the decision, the court of appeals opined that given the egregiousness of the conduct here, it was an abuse of discretion [on the part of the bankruptcy court] to permit the appellants to retain any of the fees they had received, let alone to allow any further compensation. n46

Matter of Consolidated Bancshares. The relationship between the fiduciary duties of attorneys and compensation in bankruptcy cases was also discussed in *Matter of Consolidated Bancshares*, n47 in which the Court of Appeals for the Fifth Circuit recognized the tendency of attorneys to enter into a conspiracy of silence with regard to contesting each other's fee applications. The *Consolidated Bancshares* court, citing the opinion of the Second Circuit in *Arlan's*, emphasized that such a failure to contest fee applications is a violation of their duties as fiduciaries not only to their specific clients but to the interests of the debtor's estate. n48

For a complete discussion of Code section 504, see Collier on Bankruptcy, ch. 504 (Matthew Bender).

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n1 1. See *In re Matis*, 73 B.R. 228 (Bankr. N.D.N.Y. 1987); *In re Maller Restaurant Corp.*, 14 C.B.C.2d 320, 57 B.R. 72 (Bankr. E.D.N.Y. 1985).

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2. H.R. Rep. No. 595, 95th Cong., 1st Sess. 356 (1977); S. Rep. No 989, 95th Cong., 2d Sess. 67 (1978).

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3. This statement paraphrases an expression of concern over the abuses in bankruptcy proceeding made by Lord Eldon in 1801, as Lord Chancellor: Instead of solicitors attending to their duty as ministers of the court, for they are so, commissions of bankruptcy are treated as matters of traffic . This quotation is discussed in *Matter of Arlan's Department Stores, Inc.*, 615 F.2d 925, 943-44 (2d Cir. 1979) (quoting *In re Drake*, 7 F. Cas. 1046 (D.N.J. 1876)).

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4. See *Collier on Bankruptcy*, 330.01 (Matthew Bender).

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5. See *Collier on Bankruptcy*, 503.10 (Matthew Bender). For a discussion as to whether committee members should be reimbursed for payment of their professionals, see *Collier on Bankruptcy*, 503.11[6] (Matthew Bender).

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6. See *Collier on Bankruptcy*, 504.07 (Matthew Bender) for discussion of these and other related statutory provisions.

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7. See *In re United Companies Financial Corp.*, 241 B.R. 521 (Bankr. D. Del. 1999) (restructuring subsidiary of retained accounting firm should have been retained separately; cannot avoid section 327 through subcontracting arrangement).

n8

8. See *Quesada v. United States Trustee*, 222 B.R. 193 (D.P.R. 1998) (contract lawyers whose services were billed out by counsel at attorney rates were not paraprofessionals; counsel may not share compensation with them); *In re Grenoble Apartments, II*, 152 B.R. 608 (D.S.D. 1993) (counsel retained by debtor could not be compensated for services rendered by his son, whose legal practice was separate from his father's); *In re Maller Restaurant Corp.*, 57 B.R. 72 (Bankr. E.D.N.Y. 1985) (law firm could not share fees with former associate who left to start own firm but continued to provide services); *In re The Liberal Market Inc.*, 24 B.R. 653 (Bankr. S.D. Ohio 1982) (amount paid from debtor's counsel to co-counsel from retainer not allowed, impermissible fee sharing). But see *In re Worldwide Direct, Inc.*, 316 B.R. 637 (Bankr. D. Del. 2004) (contract lawyers operating under firm supervision are essentially associates within exception to section 504(a), but amount reimbursable from estate is cost to firm).

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9. See *Collier on Bankruptcy*, 329.01 and 330.01 (Matthew Bender).

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10. See *In re Soulisak*, 227 B.R. 77 (Bankr. E.D. Va. 1998) (discussing section 504 and state ethical rules without distinguishing between pre- and postpetition periods); *In re Matis*, 73 B.R. 228 (Bankr. N.D.N.Y. 1987) (applying section 504 to fee sharing arrangement in year prior to commencement of case).

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11. See *Collier on Bankruptcy*, ch. 8 (Matthew Bender).

n12

12. Compare *In re Tarasiak*, 280 B.R. 791 (Bankr. D. Mass. 2002) (paralegal functioning as professional cannot share in fees), with *In re Van Dyke*, 296 B.R. 591 (Bankr. D. Mass. 2003) (paralegal working under attorney's supervision not professional and may share in fees). See also *In re Artra Group, Inc.*, 308 B.R. 858 (Bankr. N.D. Ill. 2003) (denying application to retain expert witness because approval was not required, court

advised that attorney could seek reimbursement of expenses for expert witness).

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13. See *United States v. Miller, Cassidy, Larocca & Levin (In re Warner)*, 141 B.R. 762 (M.D. Fla. 1992) (retained counsel could be compensated for cost of local counsel when local rules required attorney to perform the administrative task of serving subpoena). But see *Quesada v. United States Trustee*, 222 B.R. 193 (D.P.R. 1998) (services provided by attorneys billed out at attorney levels could not be treated as paralegal services).

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14. See Model Rules of Prof'l Conduct, Rule 1.5(e) (1983); Model Code of Prof'l Responsibility, DR 2-107 (1980). Some jurisdictions impose lesser and/or greater standards for fee sharing than the Model Code or Rules. See, e.g., California Rule 2-200(A) (permitting more circumstances of fee splitting, but requiring greater client participation). See generally *Collier on Bankruptcy*, 8.02[2] (Matthew Bender).

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15. For example, Model Rule 1.5(e) requires that any division be in proportion to the services performed or that each lawyer assumes joint responsibility for the representation; that the client is advised and does not object to the involvement of all the attorneys; and the total fee is reasonable. DR 2-107 is somewhat more restrictive in that it also requires that the client consent after full disclosure that a division will be made, and that the division of fee be in proportion to the services *and* each attorney assumes responsibility for the representation.

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16. See, e.g., *In re Soulisak*, 227 B.R. 77, 82 (Bankr. E.D. Va. 1998) (fee sharing between debt clinic and attorney violated section 504 and Va. Code of Prof. Resp. DR 3-102).

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17. 15 B.R. 351 (Bankr. S.D.N.Y. 1981).

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18. 936 F.2d 199 (5th Cir. 1991).

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19. The *Anderson* court held that the bankruptcy court had acted within its discretion in awarding the son a portion of the fees he had requested, based on the benefit of his services to the estate. Although the son was not approved as an attorney for the debtor at the time the retainer was paid, the debtor's application to employ the son was granted *nunc pro tunc* four years later.

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20. Note that under new section 504(c), added by Pub. L. No. 109-8, § 326 (2005), fee sharing with certain public service attorney referral programs is no longer be prohibited. *See Collier on Bankruptcy*, 504.04 (Matthew Bender). Subsection (c) applies in cases commenced on or after October 17, 2005. Pub. L. No. 109-8, § 1501.

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21. 227 B.R. 77 (*Bankr. E.D. Va.* 1998).

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22. 1997 *Bankr. LEXIS* 2056 (*Bankr. E.D. Pa.* Dec. 18, 1997).

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23. *United States v. Miller, Cassidy, Larroca & Lewin (In re Warner)*, 141 B.R. 762 (*M.D. Fla.* 1992).

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24. Compare the result in *Warner* with that in *In re Larsen*, 190 B.R. 713 (*Bankr. D. Me.* 1996), in which reimbursement of \$250 payment to an outside attorney was denied as a violation of Bankruptcy Rule 2016(a). The difference between these two cases is that the outside attorney in *Larsen* made a court appearance on behalf of the debtors, while the outside attorney in *Warner* merely performed an administrative service.

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25. 79 B.R. 312 (*Bankr. S.D. Ohio* 1987).

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26. 73 B.R. 228 (*Bankr. N.D.N.Y.* 1987).

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27. 73 B.R. 228, 234.

n28

28. See *Quesada v. United States Trustee*, 222 B.R. 193, 198 (*D.P.R.* 1998) (court denied compensation to chapter 7 trustee who shared fees with temporary associates, holding that trustee's failure to disclose retention of associates violated Rule 2016); *In re ACandS, Inc.*, 297 B.R. 395 (*Bankr. D. Del.* 2003) (professional who, among other things, failed to disclose that most of services were rendered by its subsidiary required to disgorge \$2.4 million in fees); *In re Cupboards, Inc.*, 190 B.R. 969, 971 (*Bankr. M.D. Fla.* 1996) (court required forfeiture of actual compensation of debtor's attorney who violated Rule 2016 by under-reporting and sharing fees with unauthorized advisor).

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29. See, e.g., *Lemonedes v. Balaber-Strauss (In re Coin Phones, Inc.)*, 226 B.R. 131 (*S.D.N.Y.* 1998) (*nunc pro tunc* not authorized and separate retention not appropriate when held self out as subcontractor for another firm); *In re ACandS, Inc.*, 297 B.R. 395 (*Bankr. D. Del.* 2003) (no extraordinary circumstances warranting *nunc pro tunc* approval of retention of professional). But see *In re Grenoble Apartments, II*, 152 B.R. 608 (*D.S.D.* 1993) (United States trustee was not opposed to curing violation through *nunc pro tunc* application; remanded).

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30. See *In re United Companies Financial Corp.*, 241 B.R. 521 (*Bankr. D. Del.* 1999) (no compensation will be allowed for affiliate until it is retained).

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31. For a discussion of bankruptcy crimes, see *Collier on Bankruptcy*, ch. 7 (Matthew Bender).

n32

32. See *Collier on Bankruptcy*, 503.05 (Matthew Bender).

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33. For a discussion of section 330 of the Code, see *Collier on Bankruptcy*, 330.03 *et seq.* (Matthew Bender).

n34

34. See 11 U.S.C. § 327(a), (b).

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35. For a discussion of the creditors' committee authorized by section 1102 and the committee's selection of professional persons to assist it, see *Collier on Bankruptcy*, 1103.03 *et seq.* (Matthew Bender).

n36

36. *Zweifel, Tuohy & Crager v. Trans-State Oil Co.*, 99 F.2d 650 (5th Cir. 1938).

n37

37. See *Ateser v. Bopp*, 29 F.3d 630 (table), 1994 U.S. App. LEXIS 18014 (9th Cir. 1994).

n38

38. *Lutheran Hosps. & Homes Soc'y of Am. v. Ducey*, 422 F.2d 200 (9th Cir. 1970) (citing *In re Trans-State Oil Co.*, 24 F. Supp. 454 (S.D. Tex. 1938)).

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39. For a discussion of codes and rules of conduct applicable to professional appearing in bankruptcy courts, see *generally* Collier on Bankruptcy, ch. 8 (Matthew Bender).

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40. 615 F.2d 925 (2d Cir. 1979).

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41. 615 F.2d 925, 932 (citing *Brown v. Gerdes*, 321 U.S. 178, 182, 64 S. Ct. 487, 88 L. Ed. 659 (1944); *Finn v. Childs Co.*, 181 F.2d 431, 441 (2d Cir. 1950) (in all cases persons who seek compensation for services or reimbursement are held to fiduciary standards)).

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42. 615 F.2d 925, 932 (citing *Brown v. Gerdes*, 321 U.S. 178, 182, 64 S. Ct. 487, 88 L. Ed. 659 (1944)); *Finn v. Childs Co.*, 181 F.2d 431, 441 (2d Cir. 1950)).

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43. 615 F.2d 925, 933 (quoting *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928)).

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44. 23 C.B.C. 542, 5 B.R. 489 (S.D.N.Y. 1980), *aff'd*, 655 F.2d 463, 24 C.B.C.2d 1277 (2d Cir. 1981).

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45. 5 B.R. 489, 499.

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46. 655 F.2d 463, 24 C.B.C. 417 (2d Cir. 1981).

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47. 785 F.2d 1249 (5th Cir. 1986).

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48. 785 F.2d 1249, 1255.

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145 of 197 DOCUMENTS

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Collier on Standing and Authority to Pursue Preference Recoveries

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Collier on Standing and Authority to Pursue Preference Recoveries

By Collier

December 5, 2007

SUMMARY: This Emerging Issues Analysis covers standing and authority to pursue preference recoveries, including the authority to pursue the avoidance of transfers in the trustee under Bankruptcy Code section 547; examiners appointed in chapter 11 proceedings; postconfirmation appointed representatives; secured lenders and other purported assignees; and the ability of creditors committees and other parties in interest to pursue preference actions.

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ARTICLE: Bankruptcy Trustees. Under its literal terms, *Bankruptcy Code section 547* vests the authority to pursue the avoidance of preferential transfers in "the trustee." n1 The bestowal of such authority upon the trustee is consistent with the Code's general recognition of the trustee as the "representative" of the bankruptcy estate n2 and the entity possessing the capacity to sue on behalf of the bankruptcy estate. n3

Whereas the appointment of a trustee occurs automatically in a chapter 7, chapter 12 or chapter 13 case, a trustee will be appointed in a chapter 9 or chapter 11 case only if the bankruptcy court finds sufficient cause. n4 Ordinarily, a trustee assumes the authority to bring preference actions immediately upon being appointed or, if elected, upon being elected. A trustee appointed in a chapter 12 proceeding, however, is generally not recognized as having standing to bring preference actions unless and until the bankruptcy court divests the chapter 12 debtor(s) of such power. n5

Although the power to initiate preference actions is ordinarily reserved for the trustee, in certain circumstances, other parties may also possess or obtain authority to bring such actions.

Debtors

Chapter 7 Debtors. Because they do not function as representatives of the bankruptcy estate, chapter 7 debtors generally lack standing to pursue the avoidance and recovery of preferential transfers. Under the provisions of section 522(h), however, individual chapter 7 debtors are entitled to avoid certain types of "preferential transfers" in order to protect their exemption rights in the property so transferred if the trustee does not seek to avoid those transfers. n6 The exercise of this power is generally restricted to instances in which the debtor did not voluntarily transfer or conceal the

property at issue. n7

Chapter 9 Debtors. The preference provisions set forth in section 547 are made applicable to chapter 9 proceedings pursuant to section 901(a). The power to bring preference actions in a chapter 9 proceeding is bestowed in the first instance upon the chapter 9 debtor. n8 In the event, however, that a chapter 9 debtor improperly fails or refuses to pursue a preference claim, the bankruptcy court may—upon the request of a creditor—appoint a trustee solely for the purpose of bringing such a claim. n9

Chapter 11 Debtors

Preconfirmation. In its capacity as a debtor in possession, a chapter 11 debtor may seek to avoid and recover preferential transfers. Specifically, section 1107 places a debtor in possession in the shoes of the trustee, with the same essential powers and duties of the trustee (except investigative duties), including the power to initiate and prosecute preference actions. n10

In the event a trustee is appointed in a chapter 11 proceeding, the chapter 11 debtor is stripped of its status as a debtor in possession and, thus, loses the authority to pursue the recovery of preferential transfers. n11 Instead, such authority resides in the chapter 11 trustee.

Similarly, a chapter 11 debtor may be divested of the general power to pursue preference actions if the bankruptcy court appoints an examiner and bestows upon the individual or entity so appointed the exclusive right to bring and prosecute such actions. n12

Postconfirmation. Under *Bankruptcy Code section 1123(b)(3)(B)*, a chapter 11 plan may provide for the postconfirmation retention and enforcement of various causes of action existing in favor of the debtor or the bankruptcy estate, including preference claims. n13 Section 1123(b)(3)(B) further provides that such postconfirmation actions may be pursued by a debtor, a trustee or a "representative of the estate appointed for such purpose."

Courts have differed on the issue of how specific and detailed the language in a chapter 11 plan and accompanying disclosure statement must be in order to effectively preserve the right to bring postconfirmation preference actions. Some courts maintain that such language must specifically and unequivocally reserve such claims. n14 Under this standard, a reorganized debtor or other postconfirmation representative may be barred under *res judicata* principles from initiating a postconfirmation preference action against a party whose potential preference liability was not expressly disclosed as part of the chapter 11 plan and accompanying disclosure statement. n15

Most courts, however, do not insist that potential preference defendants be individually identified as part of a chapter 11 plan and disclosure statement in order for preference claims to be effectively preserved postconfirmation. Instead, such claims will be treated as having been sufficiently preserved so long as the chapter 11 plan expressly preserves the general right to bring preference actions after the plan is confirmed. n16 This more liberal approach is often justified on the basis that in many chapter 11 proceedings (particularly, those in which the debtor is seeking to reorganize on a "fast-track"), confirmation may occur before the chapter 11 debtor in possession or its professionals have had a sufficient opportunity to analyze potential preference claims. n17 In such situations, it would be impractical to insist that potential preference defendants be individually identified prior to confirmation. n18

Even courts adopting the latter approach, however, may find that preference claims have not been effectively preserved under section 1123(b)(3)(B) if it is evident that the chapter 11 plan provisions relied upon by the plaintiff in bringing the postconfirmation action were not designed to preserve such claims but, rather, were intended to address other or related issues. n19

Chapter 12 Debtors. Although a trustee is automatically appointed in a chapter 12 proceeding, a chapter 12 debtor normally continues as a "debtor in possession" and, as such, is given authority to pursue preference and other avoidance actions. n20 Under the provisions of section 1204(a), however, a bankruptcy court may divest a chapter 12 debtor of its debtor in possession status, whereupon the chapter 12 debtor's authority to initiate and prosecute preference and other avoidance actions may be reassigned to the chapter 12 trustee. n21

Chapter 13 Debtors. There is a clear split in the case law as to whether a chapter 13 debtor has authority to bring a preference action outside the context of section 522(h). One line of cases—generally professing to employ a "holistic approach" to statutory construction—maintains that a chapter 13 debtor possesses standing to pursue such claims. n22 The other line of cases—typically advocating a "plain meaning" construction—holds that such standing does not exist. n23

Examiners Appointed in Chapter 11 Proceedings. Some courts maintain that an examiner appointed under the provisions of section 1106(b) may be authorized to initiate and prosecute preference and other avoidance actions on behalf of the bankruptcy estate. n24 Other courts, however, hold that section 1106(b) does not contemplate or permit such powers to be bestowed upon an examiner and that the exercise of such powers would be incompatible with the proper role and function of an examiner. n25

Postconfirmation Appointed Representative. Under the provisions of section 1123(b)(3)(B), a chapter 11 plan may provide for the appointment of a third-party "representative of the estate" to pursue the postconfirmation enforcement and collection of claims belonging to the debtor or the estate, including preference claims. Traditionally, courts have applied a two-prong test to determine whether a third party has authority to pursue a claim or action as a postconfirmation representative under section 1123(b)(3)(B): (1) the third party must have been "appointed"; and (2) the third party must qualify as a "representative of the estate." n26

The first prong of the test will be satisfied so long as the confirmed plan (and possibly a document executed in conjunction with the confirmed plan) clearly identifies or designates the third party as an entity who will be entitled to pursue claims and actions postconfirmation. n27 In the event that the provisions of a chapter 11 plan regarding such an appointment are vague or otherwise unclear, the third party will not be regarded as having been properly appointed under section 1123(b)(3)(B) and, thus, will lack standing to pursue claims or actions postconfirmation. n28

Appearing to overlap to some extent with section 550(a)'s requirement that preference and other avoidance action be pursued "for the benefit of the estate," application of the second prong of the above-referenced test is generally recognized as entailing a "case-by-case analysis" of "whether a successful recovery by the appointed representative would benefit the debtor's estate and, particularly, the debtor's unsecured creditors." n29 Notwithstanding the stress the latter language seems to place on the interests of the debtor's unsecured creditors, it is generally not considered necessary that the amounts recovered by a postconfirmation representative be distributed directly (either in whole or in part) to unsecured creditors. Instead, a third party can still qualify as an appropriate "representative of the estate" for purposes of section 1123(b)(3)(B) provided the estate and its unsecured creditors derive some form of either direct or indirect benefit from the third party's postconfirmation exercise and enforcement of the claims reserved under the chapter 11 plan.

Thus, for instance, courts have found a third party granted avoidance powers under chapter 11 plan may be a proper "representative of the estate" under section 1123(b)(3)(B) even though any amounts recovered by the third party were earmarked exclusively for the payment of administrative expense claims. n30 Similarly, a successor entity formed pursuant to a chapter 11 plan may qualify as a "representative of the estate" for purposes of section 1123(b)(3)(B) if

creditors of the estate receive equity interests, for the creditors will presumably benefit from the successor entity's successful pursuit of avoidance recoveries by the resulting impact such recoveries have on the successor entity's net worth. n31

Indeed, some courts have even held that a third party may provide sufficient benefit to the estate to qualify as a "representative of the estate" under section 1123(b)(3)(B) by providing some form of up-front consideration to the estate. n32 Under these authorities, it would appear that a chapter 11 estate could use the provisions of section 1123(b)(3)(B) to engage in an outright sale of its avoidance powers to a third party who has no prior involvement with or relation to the debtor or the bankruptcy proceeding.

Secured Lenders and Other Purported Assignees. Outside the context of section 1123(b)(3)(B), a number of courts have rejected the notion that the estate's right to initiate and prosecute preference claims can be validly transferred or assigned to a third party. n33 Thus, preference actions initiated by such third parties have been dismissed for lack of standing even in circumstances where it appeared that the bankruptcy court had previously approved the purported assignment of the preference claims to the third party. n34

Adopting a more permissive position, other courts-while not necessarily allowing for an outright assignment of the right to bring preference actions-have permitted a trustee or chapter 11 debtor in possession to pledge the proceeds of preference actions to a postpetition lender or other secured party. n35 Often, in such situations, the resulting preference recoveries will ultimately end up exclusively in the pocket of the secured creditor. Nevertheless, courts approving such arrangements have been able to find that the preference actions still generate a sufficient benefit to the estate for purposes of section 550(a). n36

Departing from other circuits and embracing a position that appears difficult at best to reconcile with the literal language of the Bankruptcy Code, the Court of Appeals for the Ninth Circuit has held that a trustee or chapter 11 debtor in possession may make an outright assignment of its right to bring and prosecute preference claims. Specifically, in *Duckor Spradling & Metzger v. Baum Trust (In re P.R.T.C., Inc.)*, n37 the court upheld the validity of a chapter 7 trustee's proposed assignment of certain preference and related avoidance actions to the bankruptcy estate's largest creditor. Under the terms of the assignment, the assignee obtained "sole discretion to pursue, not pursue, settle, compromise or collect upon" the assigned claims. In addition to not having any difficulty with the fact that the assigned actions would be prosecuted in the name of and at the sole discretion of the assignee (rather than a representative of the bankruptcy estate), the Court in *P.R.T.C.* also did not regard the assignment as violating section 550(a)'s requirement that the avoidance action be prosecuted "for the benefit of the estate," for the assignee in the case had expressly agreed to remit 50 percent of any net recoveries back to the bankruptcy estate. n38

Although not appearing to go quite as far as the Ninth Circuit in *P.R.T.C.*, a growing number of courts have approved so-called "joint prosecution agreements" or similar types of arrangements. n39 Typically, under such an arrangement, a trustee (or chapter 11 debtor in possession) facing an administratively insolvent estate agrees to relinquish some (but not necessarily complete) control over the prosecution of preference or other avoidance actions to a creditor or other third party, who-in exchange for agreeing to fund the prosecution of the avoidance actions-is effectively assigned a portion (or, possibly, all) of the anticipated recoveries resulting from the actions. n40

To avoid potential standing challenges, the third party under such an arrangement will often bring the avoidance action either in the name of the estate or jointly in the name of itself and the trustee or chapter 11 debtor in possession. n41 Again, because the third party typically agrees to share a portion of the net recoveries with the estate, those courts approving such arrangements are able to conclude that the arrangements do not run afoul of section 550(a)'s requirement that avoidance actions be prosecuted for the benefit of the estate. n42

In most (if not all) of the foregoing cases, the third party and the trustee (or debtor in possession) will agree to

divide up the net preference recoveries in a manner that does not give the third party any more than it would otherwise be entitled to receive under the Code's priority scheme. n43 On the contrary, the third party—who is often a superpriority administrative claimant or a secured creditor that has been granted a lien on avoidance action recoveries—will agree to sacrifice its priority over a portion of the avoidance action recoveries in order to provide the trustee (or debtor in possession) with sufficient economic incentive not to abandon the avoidance actions or otherwise allow them to remain unprosecuted. n44

At least one court has found statutory support in the provisions of section 503(b)(3)(B) for the practice of permitting joint prosecution arrangements that provide for a creditor to

receive compensation and reimbursement of its expenses from the estate for recovering property that has been transferred by the debtor. n45

Ability of Creditors' Committees and Other Parties in Interest to Pursue Preference Actions Derivatively on Behalf of the Estate. In *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.*, n46 the Supreme Court expressly declined to opine on "the practice of some courts of allowing creditors or creditors' committees a derivative right to bring avoidance actions when the trustee refuses to do so." n47 As suggested in the *Hartford Underwriters* decision, most lower courts today recognize the concept of derivative standing and, in accordance therewith, will allow a creditors' committee or other party in interest to initiate and prosecute a preference or other avoidance action on behalf of the estate, that is, provided such parties obtain prior approval from the bankruptcy court to do so. n48 Generally, such approval requires a showing that the trustee or chapter 11 debtor in possession is either unwilling or unable to bring the action n49 or has otherwise agreed to allow the action to be initiated and prosecuted by the third party seeking derivative standing. n50

Conceptually, the notion of derivative standing can be distinguished from the joint prosecution arrangements referenced above in that under the latter arrangements, there is ordinarily an agreement in advance as to how the avoidance action recoveries will be allocated among the respective parties, whereas in the case of derivative standing, the net recoveries simply flow into the estate and are subject to distribution in accordance with the Bankruptcy Code's priority scheme and the terms of a confirmed plan.

Although the concept of derivative standing is not expressly provided for or addressed in the Code, some authorities and commentators have found statutory support for derivative standing in Code sections 503(b)(1)(B) (providing for the award of compensation and reimbursement to a creditor who successfully recovers property transferred or concealed by the debtor), 1103(c)(5) (authorizing an official committee to "perform such other services as are in the interest of those represented") and 1109(b) (permitting a party in interest to appear and be heard on any issue arising in a chapter 11 proceeding). n51

While the statutory foundations for derivative standing may remain subject to debate, it is clear that derivative standing provides a very prudent and practical means of contending with the fact that trustees and debtors in possession often lack sufficient incentive or resources to pursue significant preference and other avoidance recoveries.

Ability of Preference Defendants to Implead Third Parties. Under the provisions of section 550(a), the potential parties against whom a bankruptcy trustee or chapter 11 debtor in possession may seek to impose preference liability include (1) the initial transferee of the allegedly preferential transfer, (2) the entity for whose benefit the transfer was made and (3) immediate and mediate transferees of the initial transferee. n52 Which of the foregoing parties are ultimately pursued for such liability is a matter of discretion left to the bankruptcy trustee or chapter 11 debtor in possession. n53

Neither section 550 nor any other provision of the Code creates an independent right in favor of a defendant named in a preference action to seek contribution, reimbursement or contribution from any of the other parties potentially liable under section 550. n54 Thus, for instance, a mediate transferee cannot seek contribution or indemnity under section

550(a) against an initial transferee and/or the party whose benefit the initial transfer was made.

Preference defendants, however, may have an independent basis under nonbankruptcy law (e.g., state contract law) to seek contribution, reimbursement or indemnification against a third party. *Rule 14 of the Federal Rules of Civil Procedure*—the procedural rule governing the impleading of third parties in federal civil actions—is expressly incorporated and made applicable to adversary proceedings (including preference actions) pursuant to *Rule 7014 of the Federal Rules of Bankruptcy Procedure*.ⁿ⁵⁵ Notwithstanding the applicability of this procedural rule, most bankruptcy courts maintain that they do not have jurisdiction over third-party claims asserted by preference defendants.ⁿ⁵⁶

Pursuit of Preference Claims Against Creditors Whose Claims Have Already Been Allowed or Resolved. A line of decisions emanating from the District of Delaware holds that in the event a bankruptcy court enters an order or approves a stipulation resolving a dispute as to the allowed amount of a creditor's claim, the bankruptcy estate is thereafter precluded by the provisions of section 502(d) from attempting to obtain a preference recovery against the creditor.ⁿ⁵⁷ Specifically, these courts construe the provisions of section 502(d) as preventing bankruptcy trustees and debtors in possession from effectively "sandbagging" a creditor "by, first, objecting to and obtaining a stipulated order allowing the claim in a reduced amount and, after the claim objection is resolved, commencing an adversary proceeding alleging that the creditor received an avoidable preference."ⁿ⁵⁸ Thus, these courts maintain that "a voidable transfer, such a preference, must be determined as part of the claims process and not at a later time."ⁿ⁵⁹

A growing majority of courts including fellow bankruptcy courts in the District of Delaware, have rejected the foregoing line of cases.ⁿ⁶⁰ Courts falling into this latter camp correctly recognize that section 502(d) was not intended to shield allegedly unsuspecting creditors from unanticipated preference actions but, instead, to provide the bankruptcy estate with a means of withholding distribution to those creditors who refuse to relinquish preferences and other voidable transfers to the estate.ⁿ⁶¹

For further discussion of Code section 547, see Collier on Bankruptcy, ch. 547.

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[Return to Text](#)

ⁿ¹ 1. 11 U.S.C. §§ 547(b), 550(a).

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2. 11 U.S.C. § 323(a).

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3. 11 U.S.C. § 323(b).

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4. 11 U.S.C. §§ 926(a), 1104.

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5. *Hoeger v. Teigen (In re Teigen)*, 123 B.R. 887, 888 (Bankr. D. Mont. 1991) ("until the Chapter 12 Trustee triggers a Court order authorizing the Trustee, as opposed to the Debtor-in-Possession, to bring this avoidance proceeding, the Chapter 12 Trustee has no standing as a Plaintiff in this cause"). Although the roles of a chapter 12 trustee and a chapter 13 trustee are often analogized to one another, in contrast to a chapter 12 trustee, it is generally agreed that a chapter 13 trustee has standing to pursue the avoidance of preferential transfers immediately upon being appointed. See, e.g., *Ryker v. Current (In re Ryker)*, 315 B.R. 664, 670 (Bankr. D.N.J. 2004) ("a Chapter 13 trustee is empowered to use all of the avoidance powers found in Chapter 5"); *Wood v. Mize (In re Wood)*, 301 B.R. 558, 562 (Bankr. W.D. Mo. 2003) (only the chapter 13 trustee has standing in a chapter 13 proceeding to pursue the avoidance of preferential transfers); *Ledford v. Avco Finance (In re Durham)*, 56 B.R. 145, 147 (Bankr. S.D. Ohio 1985). But see *McRoberts v. S.I.V.I. (In re Bequette)*, 184 B.R. 327, 334-35 (Bankr. S.D. Ill. 1995) (chapter 13 trustee lacked constitutional standing to bring avoidance action); *Russo v. Ciaverella (In re Ciaverella)*, 28 B.R. 823, 827-828 (Bankr. S.D.N.Y. 1983) (chapter 13 trustee cannot bring avoidance action over the objection of a chapter 13 debtor).

n6 6. See Collier on Bankruptcy-15th Edition Rev. 522.12[2]--[3].

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7. *Id.*

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8. See 11 U.S.C. § 902(5) (providing that in the context of a chapter 9 proceeding the term "trustee" shall generally be construed to mean the debtor).

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9. 11 U.S.C. § 926(a); see Collier on Bankruptcy, 926.02.

n10

10. See H.R. Rep. No. 595, 404; see also *Yellowhouse Mach. Co. v. Mack (In re Hughes)*, 704 F.2d 820 (5th Cir. 1983) (debtor in possession may avoid preferential transfer even though debtor's misdeeds caused circumstances leading to avoidance); *Herman Cantor Corp. v. Central Fidelity Bank (In re Herman Cantor Corp.)*, 15 B.R. 747, 749 (Bankr. E.D. Va. 1981) ("A debtor-in-possession enjoys the trustee's right to avoid a preferential transfer of the debtor's property."). See generally Collier on Bankruptcy, ch. 1107.

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11. *Rooney v. Thorson (In re Dawnwood Properties/78)*, 209 F.3d 114, 116 (2d Cir. 2000).

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12. See generally Collier on Bankruptcy, 547.11[3].

n13

13. See generally Collier on Bankruptcy, 1123.02[3].

n14

14. See, e.g., *Harstad v. First American Bank (In re Harstad)*, 155 B.R. 500, 509 (Bankr. D. Minn. 1993) *aff'd*, *Harstad v. First American Bank*, 39 F.3d 898 (8th Cir. 1994) ("A plan of reorganization must specifically and unequivocally retain preference actions.").

n15

15. *Southtrust Bank N.A. v. WCI Outdoor Products (In re Huntsville Small Engines)*, 228 B.R. 9, 14 (Bankr. N.D. Ala. 1998) (postconfirmation preference action barred by doctrine of *res judicata* because "debtor's disclosure statement and plan .. did not specifically reference any potential cause of action against the defendant and merely contained a general retention clause"); *Mickey's Enters., Inc. v. Saturday Sales, Inc. (In re Mickey's Enters., Inc.)*, 165 B.R. 188, 194 (Bankr. W.D. Tex. 1994) ("disclosure statement must give those creditors holding allowed claims who are entitled to participate (vote and object) in the confirmation process adequate notice of and information regarding the claims that the debtor as reorganized will be bringing against them under the plan").

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16. See, e.g., *Kmart Corp. v. Intercraft Co. (In re Kmart Corp.)*, 310 B.R. 107, 119-26 (Bankr. N.D. Ill. 2004); *Ringel Valuation Servs. v. Shamrock Foods Co. (In re Arizona Fast Foods, LLC)*, 299 B.R. 589, 595-96 (Bankr. D. Ariz. 2003); *Cohen v. TIC Financial Sys. (In re Ampace Corp.)*, 279 B.R. 145, 156-162 (Bankr. D. Del. 2002).

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17. *Ringel Valuation Servs. v. Shamrock Foods Co. (In re Arizona Fast Foods, LLC)*, 299 B.R. 589 (Bankr. D. Ariz. 2003); *Cohen v. TIC Financial Sys. (In re Ampace Corp.)*, 279 B.R. 145, 159 (Bankr. D. Del. 2002) ("In most of the large Chapter 11 cases in this Court, the plan of reorganization and/or liquidation is often confirmed before the debtor and/or a trustee has undertaken a detailed investigation of the potential preference actions.").

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18. *Elk Horn Coal Co., LLC v. Conveyor Mfg. & Supply, Inc. (In re Pen Holdings, Inc.)*, 316 B.R. 495, 504 (Bankr. M.D. Tenn. 2004) ("It is not practicable, especially in larger cases, for the debtor to identify by name in the plan or disclosure statement every entity that may have received a preferential payment."); *Peltz v. Worldnet Corp. (In re USN Communications, Inc.)*, 280 B.R. 573, 591 (Bankr. D. Del. 2002) ("it is both impractical and unnecessary for a Disclosure Statement and/or Plan to list each and every possible defendant against a debtor or its representative may bring an avoidance action").

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19. *Kmart Corp. v. Intercraft Co. (In re Kmart Corp.)*, 310 B.R. 107, 124 (Bankr. N.D. Ill. 2004) ("[a]ttempts to manufacture an 1123(b)(3) reservation by resorting to other plan provisions, such as those relating to reservation of jurisdiction or appointment of an estate representative, are vulnerable to failure").

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20. 11 U.S.C. § 1203.

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21. *Hoeger v. Teigen (In re Teigen)*, 123 B.R. 887, 888 (Bankr. D. Mont. 1991) ("until the Chapter 12 Trustee triggers a Court order authorizing the Trustee, as opposed to the Debtor-in-Possession, to bring this avoidance proceeding, the Chapter 12 Trustee has no standing as a Plaintiff in this cause").

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22. See, e.g., *Houston v. Eiler* (*In re Cohen*), 305 B.R. 886, 895 (B.A.P. 9th Cir. 2004); *Thacker v. United Cos. Lending Corp.* (*In re Thacker*), 256 B.R. 724 (W.D. Ky. 2000); *In re Freeman*, 72 B.R. 850 (Bankr. E.D. Va. 1987); *In re Ottaviano*, 68 B.R. 238 (Bankr. D. Conn. 1986); *In re Einoder*, 55 B.R. 319 (Bankr. N.D. Ill. 1985).

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23. See, e.g., *LaBarge v. Benda* (*In re Merrifield*), 214 B.R. 362 (B.A.P. 8th Cir. 1997); *Ryker v. Current* (*In re Ryker*), 315 B.R. 664 (Bankr. D.N.J. 2004); *In re Binghi*, 299 B.R. 300 (Bankr. S.D.N.Y. 2003); *Kildow v. EMC Mortg. Corp.* (*In re Kildow*), 232 B.R. 686 (Bankr. S.D. Ohio 1999).

n24

24. See, e.g., *Williamson v. Roppollo*, 114 B.R. 127, 129 (W.D. La. 1990); *Franklin-Lee Homes, Inc. v. First Union Bank of North Carolina, N.A.* (*In re Franklin-Lee Homes, Inc.*), 102 B.R. 477, 480-81 (E.D.N.C. 1989); *NBD Park Ridge Bank v. SRJ Enters., Inc.* (*In re SRJ Enters.*), 151 B.R. 189, 195 (Bankr. N.D. Ill. 1993) (the "broad grant of authority" under section 1106(b) "may include allowing the examiner the discretion to avoid a preference"); *In re Carnegie Int'l Corp.*, 51 B.R. 252, 256 (Bankr. S.D. Ind. 1984).

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25. *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 577 (3d Cir. 2003) (*en banc*), cert. denied, 540 U.S. 1002, 124 S. Ct. 530, 157 L. Ed. 2d 406 (2004) (pursuit of avoidance action does not comport with examiner's proper role in a chapter 11 proceeding); *Official Comm. of Asbestos Personal Injury Claimants v. Sealed Air Corp.* (*In re W.R. Grace & Co.*), 285 B.R. 148, 156 (Bankr. D. Del. 2002) ("the basic job of an examiner is to examine, not to act as a protagonist in the proceedings").

n26

26. See *McFarland v. Leyh* (*In re Texas General Petroleum Corp.*), 52 F.3d 1330, 1335 (5th Cir. 1995); *Citicorp Acceptance Co., Inc. v. Robison* (*In re Sweetwater*), 884 F.2d 1323, 1326-27 (10th Cir. 1989); *AFD Fund v. Transmed Foods, Inc.* (*In re AmeriServe Food Distrib., Inc.*), 315 B.R. 24, 31 (Bankr. D. Del. 2004); *Official Committee of Unsecured Creditors of Maxwell Newspapers, Inc. v. MacMillan, Inc.* (*In re Maxwell Newspapers, Inc.*), 189 B.R. 282, 287 (Bankr. S.D.N.Y. 1995); *Winston & Strawn v. Kelly* (*In re Churchfield Mgmt. & Investment Corp.*), 122 B.R. 76, 81 (Bankr. N.D. Ill. 1990).

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27. See, e.g., *McFarland v. Leyh (In re Texas Gen. Petroleum Corp.)*, 52 F.3d 1330, 1335 (5th Cir. 1995) ("The bankruptcy court's approval of a plan that clearly appoints a [third-party] satisfies the first element."); *Norberg v. Sanchez (In re Chase & Sanborn Corp.)*, 813 F.2d 1177, 1180, n.1 (11th Cir. 1987) ("Although the [bankruptcy] court did not formally and specifically appoint the [third party representative] to enforce [avoidance] claims, the reorganization plan approved by the [bankruptcy] court recognized that the [third party representative] would have the responsibility of pursuing such claim of the debtor [and, thus,] .. was sufficient, under the Bankruptcy Code, to confer on the [third party representative] standing to assert this claim."); *Kroh Brothers Development Co. v. United Missouri Bank of Kansas City, N.A. (In re Kroh Brothers Development Co.)*, 100 B.R. 487, 497 (Bankr. W.D. Mo. 1989), appeal denied, *In re Kroh Brothers Development Co.*, 101 B.R. 1000 (W.D. Mo. 1989) (chapter 11 plan's appointment of postconfirmation representative pursuant to section 1123(b)(3)(B) does not require any "magic words").

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28. See, e.g., *Retail Marketing v. King (In re Mako, Inc.)*, 985 F.2d 1052, 1055 (10th Cir. 1993) (postconfirmation avoidance action brought by third party claiming to have been appointed under section 1123(b)(3)(B) dismissed for lacking of standing because "the provision of the plan purporting to confer authority on [the third party] to initiate avoidance actions after confirmation of the plan is vague")

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29. *McFarland v. Leyh (In re Texas Gen. Petroleum Corp.)*, 52 F.3d 1330, 1335 (5th Cir. 1995); *Retail Marketing v. King (In re Mako, Inc.)*, 985 F.2d 1052, 1054 (10th Cir. 1993); see also *Official Committee of Unsecured Creditors of Maxwell Newspapers, Inc. v. MacMillan, Inc. (In re Maxwell Newspapers, Inc.)*, 189 B.R. 282, 287 (Bankr. S.D.N.Y. 1995) ("The primary consideration in determining whether the [third party] is a representative of the estate' is the benefit bestowed upon the estate as a result of the transfer, in particular the benefit to the unsecured creditors."); *Winston & Strawn v. Kelly (In re Churchfield Mgmt. & Investment Corp.)*, 122 B.R. 76, 82 (Bankr. N.D. Ill. 1990) (same).

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30. *Citicorp Acceptance Co., Inc. v. Robison (In re Sweetwater)*, 884 F.2d 1323, 1329-1330 (10th Cir. 1989); see also *Kroh Brothers Development Co. v. United Missouri Bank of Kansas City, N.A. (In re Kroh Brothers Development Co.)*, 100 B.R. 487, 500 (Bankr. W.D. Mo. 1989) (right retained by the estate to receive 50% of the net recoveries was sufficient benefit to qualify third party as "representative of the estate" for purposes of section 1123(b)(3)(B)).

n31

31. See, e.g., *Temex Energy, Inc. v. Hastie & Kirschner (In re Amarex, Inc.)*, 96 B.R. 330, 334-335 (W.D. Okla. 1989); *DuVoisin v. East Tennessee Equity, Ltd. (In re Southern Indus. Banking Corp.)*, 59 B.R. 638, 641

n.4 (*Bankr. E.D. Tenn. 1986*).

n32 32. *Burlington Motor Carriers Inc. v. Comdata Network, Inc. (In re Burlington Motor Holdings, Inc.)*, 2002 U.S. Dist. LEXIS 805 (D. Del. Jan. 18, 2002) (purchaser of assets of the estate-including, the estate's avoidance powers-provided sufficient benefit to the estate by paying purchase price to debtor and assuming certain administrative expense and priority claim obligations); *Burlington Motor Carriers Inc. v. MCI Telecommunications (In re Burlington Motor Holdings, Inc.)*, 2002 U.S. Dist. LEXIS 804 (D. Del. Jan. 18, 2002) (same); *All Star Int'l Trucks, Inc. v. Burlington Motor Carriers, Inc. (In re Burlington Motor Holdings, Inc.)*, 2002 U.S. Dist. LEXIS 718 (D. Del. Jan. 17, 2002) (same); *Winston & Strawn v. Kelly (In re Churchfield Mgmt. & Investment Corp.)*, 122 B.R. 76, 82 (*Bankr. N.D. Ill. 1990*) (up-front consideration paid by third party to bankruptcy estate in exchange for, *inter alia*, right to pursue avoidance action conferred sufficient benefit upon the estate to qualify third party as "representative of the estate"); *see also Official Committee of Unsecured Creditors of Maxwell Newspapers, Inc. v. MacMillan, Inc. (In re Maxwell Newspapers, Inc.)*, 189 B.R. 282, 286-288 (*Bankr. S.D.N.Y. 1995*) (wherein a group of creditors was found to qualify as "representatives of the estate" for purposes of section 1123(b)(3)(B) when they agreed as part of a chapter 11 plan to waive their claims against the estate in exchange for obtaining the right to exercise and enforce certain of the estate's avoidance powers following the confirmation of the debtor's plan).

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33. *Syndicate Exchange Corp. v. Duffy (In re Pro Greens, Inc.)*, 297 B.R. 850, 855-56 (*Bankr. M.D. Fla. 2003*); *Met-Al, Inc. v. Gabor (In re Metal Brokers Int'l Inc.)*, 225 B.R. 920, 922-23 (*Bankr. E.D. Wis. 1998*); *Fleet Nat'l Bank v. Doorcrafters (In re North Atlantic Millwork Corp.)*, 155 B.R. 271, 281 (*Bankr. D. Mass. 1993*); *Consolidated Pet Foods, Inc. v. Millard Refrigerated Servs., Inc. (In re S & D Foods Inc.)*, 110 B.R. 34, 36 (*Bankr. D. Colo. 1990*).

n34

34. *Syndicate Exchange Corp. v. Duffy (In re Pro Greens, Inc.)*, 297 B.R. 850, 852 (*Bankr. M.D. Fla. 2003*); *Fleet Nat'l Bank v. Doorcrafters (In re North Atlantic Millwork Corp.)*, 155 B.R. 271, 275-76 (*Bankr. D. Mass. 1993*); *Consolidated Pet Foods, Inc. v. Millard Refrigerated Servs., Inc. (In re S & D Foods Inc.)*, 110 B.R. 34, 35 (*Bankr. D. Colo. 1990*).

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35. *In re Qualitech Steel Corp.*, 276 F.3d 245 (7th Cir. 2001) (court upheld chapter 11 debtor's pledge of preference recoveries to secured creditors as form of adequate protection); *Trans World Airlines, Inc. v. Travellers Int'l AG (In re Trans World Airlines, Inc.)*, 163 B.R. 964, 968-973 (*Bankr. D. Del. 1994*) (court refused to dismiss preference action on basis that the proceeds of any recovery had been pledged to secure a postpetition loan). *But see Congress Credit Corp. v. AJC Int'l*, 186 B.R. 555 (*D.P.R. 1995*) (preference action brought by chapter 7 trustee would be dismissed because secured creditor had claim to any proceeds resulting

from action). A prepetition security interest in a debtor's existing and after-acquired property ordinarily does not extend to the proceeds of preference and other avoidance actions because of the operation of section 552(b). See *In re Integrated Testing Products Corp.*, 69 B.R. 901, 904-905 (D.N.J. 1987); *In re Tek-Aids Indus. Inc.*, 145 B.R. 253, 256 (Bankr. N.D. Ill. 1992); *In re Ludford Fruit Products Inc.*, 99 B.R. 18, 24-25 (Bankr. C.D. Cal. 1989). See generally 552.02[5][d] *infra*.

n36

36. *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003) (notwithstanding the fact that preference recoveries would be paid exclusively to a group of secured creditors, the estate received sufficient "ex ante" benefit for purposes of section 550(a) by virtue of the fact that the pledge of the preference recoveries provided the secured creditor group with "adequate protection" and, thereby, enabled the debtor to continue operating in the short-run and attempt a reorganization); *Trans World Airlines, Inc. v. Travellers Int'l AG (In re Trans World Airlines, Inc.)*, 163 B.R. 964, 972 (Bankr. D. Del. 1994) (although recoveries were pledged to postpetition lender, pursuit of preference claim would still benefit the estate for purposes of section 550(a) as recoveries reduce the outstanding balance of the postpetition lender's debt); cf. *Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A., Ltd. (In re Payless Cashways, Inc.)*, 290 B.R. 689, 697 (Bankr. W.D. Mo. 2003) (even though preference recoveries might be used exclusively to pay administrative expense claims, pursuit of preference action still provided sufficient benefit for purpose of section 550(a) as section 550(a) requires benefit to the "estate" not "unsecured creditors").

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37. 177 F.3d 774, 780-84 (9th Cir. 1999) (relying, in part, upon the Ninth Circuit's earlier decision in *Briggs v. Kent (In re Professional Investment Properties of America)*, 955 F.2d 623 (9th Cir. 1992)).

n38 38. 177 F.3d 774, 782.

n39

39. See *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003); *Glinka v. Federal Plastics Mfg. (In re Housecraft Indus. USA, Inc.)*, 310 F.3d 64 (2d Cir. 2002); *Gonzales v. Nabisco Div. of Kraft Foods, Inc. (In re Furr's)*, 294 B.R. 763 (Bankr. D.N.M. 2003).

n40

40. See, e.g., *Glinka v. Federal Plastics Mfg. (In re Housecraft Indus. USA, Inc.)*, 310 F.3d 64, 67 (2d Cir. 2002) (court approved joint prosecution agreement between chapter 7 trustee and the debtor's primary secured lender under which (a) the secured lender agreed to fund the litigation; (b) the trustee agreed not compromise or

settle any claim without the secured lender's express consent; and (c) any amounts recovered would be used first to reimburse the secured lender for its fees and expenses, with the next \$15,000 being paid to the trustee and the remaining balance being split with 80% going to the secured lender and 20% going to the trustee); *Qualitech Steel Holdings v. GE Supply Co. (In re Qualitech Steel Corp.)*, 2003 U.S. Dist. LEXIS 9427 (S.D. Ind. May 9, 2003), *rev'd on other grounds, Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003) (describing joint prosecution arrangement ultimately upheld by the Seventh Circuit); *Gonzales v. Nabisco Div. of Kraft Foods, Inc. (In re Furrs)*, 294 B.R. 763 (Bankr. D.N.M. 2003) (approving joint prosecution arrangement between chapter 7 trustee and secured lenders under which secured lenders agreed to fund trustee's litigation of avoidance action in exchange for trustee's agreement that two-thirds of any recoveries would be paid to secured lenders and that if the trustee sought to obtain court approval of a proposed settlement over the secured lender's objection, the trustee would not be entitled to the "business judgment" presumption that is ordinarily afforded in such situations).

n41

41. See, e.g., *Glinka v. Federal Plastics Mfg. (In re Housecraft Indus. USA, Inc.)*, 310 F.3d 64, 70-71 (2d Cir. 2002) (avoidance actions filed jointly by trustee and secured creditor); *Qualitech Steel Holdings v. GE Supply Co. (In re Qualitech Steel Corp.)*, 2003 U.S. Dist. LEXIS 9427, at *5 (S.D. Ind. May 9, 2003) (secured creditors authorized to commence and prosecute adversary proceedings in the name of the debtors).

n42

42. *Glinka v. Federal Plastics Mfg. (In re Housecraft Indus. USA, Inc.)*, 310 F.3d 64, 71-72 (2d Cir. 2002); *Gonzales v. Nabisco Div. of Kraft Foods, Inc. (In re Furrs)*, 294 B.R. 763, 776-77 (Bankr. D.N.M. 2003).

n43

43. See, e.g., *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293-94 (7th Cir. 2003) (noting that unsecured creditors were not prejudiced by fact that preference recoveries would be paid to secured creditors since unsecured creditors and equity were out of the money from the outset); *Gonzales v. Nabisco Div. of Kraft Foods, Inc. (In re Furrs)*, 294 B.R. 763, 774 (Bankr. D.N.M. 2003) (payment of 80% of preference recoveries to secured creditors did not prejudice other creditors and/or administrative expense claimants as secured creditors had \$2.3 million superpriority claim that had to be paid before there would be any distribution to these other parties); *Trans World Airlines, Inc. v. Travellers Int'l AG (In re Trans World Airlines, Inc.)*, 163 B.R. 964, 972 (Bankr. D. Del. 1994) (payment of preference recoveries to postpetition lender did not prejudice other creditors as postpetition lender's claim had priority over other creditors).

n44

44. See, e.g., *Glinka v. Federal Plastics Mfg. (In re Housecraft Indus. USA, Inc.)*, 310 F.3d 64, 67 (2d Cir. 2002) (in addition to funding avoidance litigation, secured creditor agrees to pay to the bankruptcy estate the

first \$15,000 of net recoveries and 20% of any net recoveries beyond initial \$15,000); *Gonzales v. Nabisco Div. of Kraft Foods, Inc. (In re Furrs)*, 294 B.R. 763, 767 (Bankr. D.N.M. 2003) (in addition to funding avoidance litigation, secured lenders agree to pay chapter 7 trustee the first 3% of any recoveries as a commission and one-third of the remaining balance of any recoveries).

n45

45. *In re Godon, Inc.*, 275 B.R. 555, 560-561 (Bankr. E.D. Cal. 2002) (court relied upon section 503(b)(3)(B) to approve proposed arrangement under which secured creditor and trustee agreed to jointly pursue avoidance actions, with secured creditor receiving approximately 90% of any amounts recovered and the trustee receiving the other 10% and secured creditor having discretion to initiate and settle preference actions subject only to trustee's right to object to a proposed settlement on the basis that it is not "fair and equitable"). *But see NBD Park Ridge Bank v. SRJ Enters., Inc. (In re SRJ Enters., Inc.)*, 151 B.R. 189, 193 n.1 (Bankr. N.D. Ill. 1993) ("§ 503(b)(3)(B) does not confer standing").

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46. 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1 (2000).

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47. 530 U.S. 1, 13 n.5, 120 S. Ct. 1942, 1951 n.5, 147 L. Ed. 2d 1, 11 n.5.

n48

48. *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir.) (*en banc*), cert. dismissed, 540 U.S. 1002, 124 S. Ct. 530, 157 L. Ed. 2d 406 (2003); *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96, 99-110 (2d Cir. 2001); *Canadian Pac. Forest Prods. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436, 1438 (6th Cir. 1995). *But see United Phosphorus, Ltd. v. Fox (In re Fox)*, 305 B.R. 912 (B.A.P. 10th Cir. 2004) (concluding that Court's reasoning in *Hartford Underwriters* mandates that concept of derivative standing be rejected).

n49

49. *Nangle v. Lauer (In re Lauer)*, 98 F.3d 378, 388 (8th Cir. 1996); *Canadian Pac. Forest Prods. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436, 1446 (6th Cir. 1995) (setting forth detailed steps that must be followed before creditor or creditors' committee can obtain derivative standing to bring avoidance action on behalf of the estate); *Official Unsecured Creditors Committee of Suffola, Inc. v. U.S. National Bank (In re Suffola, Inc.)*, 2 F.3d 977, 979 n.1 (9th Cir. 1993) (committee may obtain derivative standing to bring preference

action when trustee or chapter 11 debtor in possession unjustifiably fails to do so); *Unsecured Creditors Committee of Debtor STN Enters., Inc. v. Noyes (In re STN Enters., Inc.)*, 779 F.2d 901, 904 (2d Cir. 1985) (same).

n50

50. *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96, 991-100 (2d Cir. 2001) (debtor in possession may stipulate to creditors' committee's prosecution of avoidance action derivatively on behalf of the estate); *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1362-1363 (5th Cir. 1986) (chapter 11 debtor may stipulate to unsecured creditors committee's derivative standing to bring preference action).

n51

51. See, e.g., *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 559-566 (3d Cir. 2003); A. Lepene & S. Gordon, *The Case for Derivative Standing in Chapter 11: "It's the Plain Meaning, Stupid"*, 11 *Am. Bankr. Inst. L. Rev.* 313 (Winter 2003).

n52

52. See generally Collier on Bankruptcy, ch. 550.

n53

53. See, e.g., *Gibbons v. First Fidelity Bank, N.A. (In re Princeton-New York Investors, Inc.)*, 255 B.R. 376, 384 (Bankr. D.N.J. 2000) (a trustee "is entitled to recover from any combination of [potential defendants], as long as there is no double recovery"); *Miller v. T.C. Sheet Metal Control Board Trust Fund (In re Curran V. Neilsen Co.)*, 1995 Bankr. LEXIS 1713, at *6 n.1 (Bankr. D. Minn. Nov. 29, 1995) ("§ 550 effectively gives the trustee the discretion to determine who recovery may be had from and therefore permits the trustee to pursue the deep pockets."); *Marlow v. United States (In re Julien Co.)*, 136 B.R. 760, 765 (Bankr. W.D. Tenn. 1991).

n54

54. *Cassirer v. Sterling Nat'l Bank & Trust Co. of New York (In re Schick)*, 223 B.R. 661, 663 (Bankr. S.D.N.Y. 1998); *Mayka v. Dollar Bank (In re Biggs, Inc.)*, 159 B.R. 737, 747 (Bankr. W.D. Pa. 1993).

n55

55. See Collier on Bankruptcy, ch. 7014.

n56

56. See, e.g., *Buchanan v. Berman, Roberts & Kelly (In re Spaulding & Co.)*, 131 B.R. 84, 89 (D.N.D. 1990); *Adams v. Prudential Securities, Inc. (In re Foundation for New Era Philanthropy)*, 201 B.R. 382, 391 (Bankr. E.D. Pa. 1996); *Rouse v. Pinegar Chevrolet, Inc. (In re Chambers)*, 125 B.R. 788, 793-794 (Bankr. W.D. Mo. 1991); *Borreson v. Peterson (In re John Peterson Motors, Inc.)*, 56 B.R. 588, 596 (Bankr. D. Minn. 1986). But see *Joseph v. Wilcox & Gibbs, Inc. (In re Wilcox & Gibbs, Inc.)*, 314 B.R. 541, 545 (Bankr. D. Del. 2004); *Burns v. First Citizen Bank & Trust Co. (In re Rainbow Security Inc.)*, 173 B.R. 508, 512 (Bankr. M.D.N.C. 1994).

n57

57. *Caliolo v. Saginaw Bay Plastics, Inc. (In re Cambridge Indus. Holdings, Inc.)*, 2003 Bankr. LEXIS 1200 (Bankr. D. Del. Sept. 25, 2003); *Caliolo v. Azdel, Inc. (In re Cambridge Indus. Holdings, Inc.)*, 50 C.B.C.2d 731, 2003 Bankr. LEXIS 794 (Bankr. D. Del. July 18, 2003); *Caliolo v. TKA Fabco Corp. (In re Cambridge Indus. Holdings, Inc.)*, 50 C.B.C.2d 866, 2003 Bankr. LEXIS 577 (Bankr. D. Del. Apr. 2, 2003); *LaRoche Indus., Inc. v. Gen. Am. Transp. Corp. (In re LaRoche Indus., Inc.)*, 284 B.R. 406 (Bankr. D. Del. 2002).

n58

58. *Caliolo v. TKA Fabco Corp. (In re Cambridge Indus. Holdings, Inc.)*, 50 C.B.C.2d 866, 2003 Bankr. LEXIS 577, *6 (Bankr. D. Del. Apr. 2, 2003).

n59

59. *LaRoche Indus., Inc. v. Gen. Am. Transp. Corp. (In re LaRoche Indus., Inc.)*, 284 B.R. 406, 408-09 (Bankr. D. Del. 2002).

n60

60. *AFD Fund v. Transmed Foods, Inc. (In re AmeriServe Food Distrib., Inc.)*, 315 B.R. 24, 34 (Bankr. D. Del. 2004); *In re Polaroid Corp.*, 2004 Bankr. LEXIS 841 (Bankr. D. Del. June 22, 2004); *In re TWA Inc. Post Confirmation Estate*, 305 B.R. 221, 226-227 (Bankr. D. Del. 2004); *Rhythms NetConnections Inc. v. Cisco Sys. (In re Rhythms Netconnections Inc.)*, 300 B.R. 404, 408 (Bankr. S.D.N.Y. 2003); *Peltz v. Gulfcoast Workstation*

Group (In re Bridge Information Sys., Inc.), 293 B.R. 479, 487-88 (Bankr. E.D. Mo. 2003).

n61

61. See, e.g., *AFD Fund v. Transmed Foods, Inc. (In re AmeriServe Food Distrib., Inc.)*, 315 B.R. 24, 34 (Bankr. D. Del. 2004) ("Section 502(d) addresses the allowability of a creditor's proof of claim where the creditor has received a voidable transfer, not the debtor's ability to commence a preference action where the debtor fails to object to the creditor's claim."); *Rhythms NetConnections Inc. v. Cisco Sys. (In re Rhythms Netconnections Inc.)*, 300 B.R. 404, 409 (Bankr. S.D.N.Y. 2003) ("Section 502(d) is intended to coerce creditors to comply with judicial orders"); *Peltz v. Gulfcoast Workstation Group (In re Bridge Information Sys., Inc.)*, 293 B.R. 479, 488 (Bankr. E.D. Mo. 2003) ("the better position is that §502(d) is in essence an affirmative defense to a creditor's claim against the estate").

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146 of 197 DOCUMENTS

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Collier on Obtaining Credit on a Superpriority or Secured Basis

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Collier on Obtaining Credit on a Superpriority or Secured Basis

By Collier

December 4, 2007

SUMMARY: This Emerging Issues Analysis discusses topics such as non-exclusive alternatives, terms of the loan, the procedure for obtaining credit under 364(c), and the application of nonbankruptcy law filing or recording requirements to liens authorized under 364.

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ARTICLE: If credit cannot be obtained by the offering of a simple administrative priority, n1 the trustee or debtor in possession may, with court approval after notice and a hearing, offer greater protection and incentives to lenders. Under *section 364(c) of the Bankruptcy Code*, the trustee or debtor in possession may obtain credit or incur debt with: (1) a superpriority over any or all administrative expenses; (2) security in the form of a lien on free assets; or (3) security in the form of a junior lien on assets that are already encumbered.

Non-Exclusive Alternatives

The alternatives set forth in section 364(c) are not exclusive. The trustee (or debtor in possession) may offer more than one of the protections. However, when a lender extends credit only under section 364(c)(2) and the collateral proves insufficient, it has been held that the creditor cannot fall back on section 364(c)(1) to claim a superpriority over administrative expense claimants. n2 Moreover, the trustee need not exhaust one alternative before the next alternative becomes available. n3 The trustee is free to pick from the various alternatives or any combination thereof as the needs of the case may dictate. However, the trustee should not be offering greater protection than is necessary to enable the trustee to borrow on reasonable business terms. n4

Some courts apply a three-part test to assess requests under section 364(c), requiring a showing that (1) the debtor cannot obtain credit unencumbered or without superpriority status, (2) the credit transactions are necessary to preserve assets of the estate and (3) the terms of the credit agreements are fair, reasonable and adequate. n5

Terms of Loan

The power of the court to authorize the incurring of indebtedness with a priority over existing indebtedness, even indebtedness entitled to its own priority, is well recognized. Similarly, the authorization of borrowing with and without

security has long been permitted. n6 Section 364(c) permits the court to authorize such borrowing.

Superpriority Borrowing. The court may authorize borrowing with a priority over any or all administrative expenses. The order should state that the priority given is over all administrative claims and section 507(b) claims. When such borrowing is authorized, the extent of the priority must be dealt with specifically in the court order and in the notice of the hearing, in order to provide appropriate protection to other priority claimants. n7 Borrowing under section 364(c)(1), of course, remains subordinate to both preexisting secured claims and any efforts to charge secured lenders' collateral under section 506(c). n8

Secured Borrowing. The court may authorize borrowing secured by a lien on otherwise unencumbered property, or a junior lien on property already encumbered. With respect to such secured borrowing, the power under section 364(c) is limited to situations in which the status of existing liens and property rights are not affected by the proposed borrowing. n9 Thus, the trustee may grant a security interest on unencumbered property or may grant a junior lien on encumbered property. Section 364(c) does not authorize the granting of liens senior to liens or interests already existing on the property. However, section 364(c) does authorize the grant of a junior lien on property notwithstanding a restriction on the granting of such liens contained in the terms of the senior loan agreement.

If the court authorizes secured borrowing, the lender should thereafter be entitled, upon appropriate request, to adequate protection of its interest under section 362 n10 and section 363, n11 and to receive notice of, and adequate protection with respect to, subsequent credit extensions under subsection (c) or (d). n12 In particular, once a lien has been authorized under section 364(c), future extensions of credit cannot be afforded an equal or senior lien priority without compliance with the more stringent standards of section 364(d) n13 requiring, among other things, adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted. n14

The priority and lien afforded to the lender may in the appropriate case be subject to surcharge under section 506(c) n15 for expenditures by the estate which directly benefit the secured lender. n16

Cross-Collateralization. When an existing prepetition lender is willing to extend financing to the trustee or debtor in possession, issues may arise concerning whether the terms of the financing are fair to the estate. The most common problem arises when the lender attempts to take a security interest in previously unencumbered property of the estate to secure not only the postpetition extension of credit, as contemplated by section 364(c), but also to secure previously unsecured prepetition claims against the debtor. This practice is often called cross-collateralization.

While several cases have implicitly upheld cross-collateralization, n17 they have typically relied on section 364(e), holding the appeal moot without actually reaching the merits of the transaction. n18 The first appellate court to address the issue of cross-collateralization on the merits rejected its use under the Code. In *Shapiro v. Saybrook Manufacturing Co. (In re Saybrook Manufacturing Co.)*, n19 the court rejected both the mootness argument and the cross-collateralization. The court rejected the mootness argument notwithstanding that the objecting creditor had failed to obtain a stay pending appeal. n20 The court found that considering cross-collateralization as authorized for purposes of section 364(e) would put the cart before the horse, because to qualify for the safe harbor of section 364(e), the lien priority must be authorized under section 364(c). n21

With respect to the cross-collateralization, the court concluded that the practice was inconsistent with the Code for two reasons. First, the Code does not expressly sanction cross-collateralization as an acceptable means of postpetition financing. In fact, subsections (c) and (d) of section 364 both speak in terms of future or new credit. n22 Second, the court found that cross-collateralization was beyond the court's equitable powers because it conflicted with the explicit priority scheme set forth in the Code. n23

A more recent decision from the Seventh Circuit, however, might support cross-collateralization in extraordinary circumstances, by analogy to the treatment of so-called critical vendors. n24 Cross-collateralization involves the use of property of the estate to pay a prepetition obligation that is at least arguably unsecured before plan confirmation in a chapter 11 case or before an interim distribution in a chapter 7 case. A similar situation arises when a chapter 11 debtor in possession seeks court authority to pay critical vendors in the early stages of a reorganization effort. The debtor in possession seeks authority to use property of the estate to pay a prepetition general unsecured claim to induce the vendor to continue to do business with the estate, arguing that the vendor's products are critical to the success of the reorganization and that the vendor will not ship unless its prepetition claim is paid. The Seventh Circuit, in *dictum*, indicated that such payments may be authorized in extraordinary circumstances where the debtor in possession could show that the vendor would not ship without payment of the prepetition debt and that, overall, the estate and therefore creditors in general would be better off with the reduction in cash resulting from the payment offset by the increase in the value of the estate by continued, uninterrupted operation. n25 A similar logic could presumably be applied to cross-collateralization under section 364, if the debtor in possession could show that the lender was the only source of funds to keep the business going, that doing so would enhance the recoveries of general unsecured creditors who would be sacrificing the estate's unencumbered assets in the short term for the longer term gain, and that the lender would not provide postpetition financing otherwise. However, in this situation, the debtor in possession would also have to show that the use of the lender's cash collateral under section 363(c)(2) would not suffice.

Economic Terms. In any extension of debt financing under section 364, traditional issues such as borrowing conditions, interest rates, loan fees, covenants and remedies upon default will have to be negotiated. n26 Often the debtor in possession will be able to obtain only onerous terms, which the bankruptcy court must balance against the debtor in possession's apparent lack of alternatives. n27

On the other hand, a prepetition secured lender is often at risk if the debtor in possession is not able to obtain financing and must cease operations. Typically, a creditor's collateral will liquidate for more if sold as part of a going concern business. So a prepetition lender who is providing postpetition financing to protect its collateral position has an incentive to make sure that it does not demand too much, lest the bankruptcy court not approve the postpetition financing and cause the business to close and the collateral value to be lost. Although the debtor in possession may not have sufficient leverage to push back too hard, the bankruptcy court, in its role as final arbiter of whether the financing should be approved, often acts as the last and perhaps most effective negotiator against the secured lender. It is an awkward position for a judge who is supposed to resolve disputes and not become involved in the administration of the business of the estate, but it perhaps has become essential given the nature of the process.

A lender to a debtor in possession, no less than a lender to an ordinary borrower, seeks as much protection as the circumstances will allow. In lending to a debtor in possession, a lender may also seek protections specific to the chapter 11 context. The protections for which a debtor in possession lender may negotiate are limited not only by the market but also by what a bankruptcy court will approve under section 364. For example, a lender might seek control over the chapter 11 plan that a debtor may file. In one case, the court permitted a loan term that required the debtor to file a plan acceptable to two-thirds in amount and a majority in number of the debtor's prepetition secured lenders by a specified date, finding that the term was not an impermissible lock-up agreement or vote solicitation, because the only consequence of noncompliance was to permit the lenders to stop funding under the loan agreement, not to require filing or confirmation of a particular plan. n28 In another case, the lender provided a line of credit to four affiliated debtors for which each would be jointly and severally liable, but giving each debtor claims against the others, subordinated to the lender's claims, to the extent that a debtor made payments to the lender in excess of the funds that it received. The court permitted the lending arrangement, overruling an objection that it amounted to a de facto substantive consolidation of the four estates, because the claims over against the other debtors preserved the indicia of separateness. n29

In addition, because of the nature of bankruptcy cases, the parties may give substantial attention to so-called carve outs for professional fees, employees and trade creditors. n30 This is because secured or superpriority financing may result in a situation in which no assets are available to satisfy even first priority administrative claims. If the secured or superpriority lender does not consent to a carve out for certain administrative claims, the claimants will be subordinate to the lender with respect to the lender's collateral.

The trustee may recover from the lender for the benefit of the estate and all administrative claimants the costs and expenses incurred in preserving the lender's collateral for the benefit of the lender. n31 But any other administrative expense claimant may not recover from the lender directly, in its own name, no matter what benefit it may have provided to the lender or the collateral. n32 If the trustee is unwilling to pursue the lender, however, a claimant might seek court authority to sue on behalf of the estate, n33 but not to recover only for itself. These economic issues must be considered on a case-by-case basis; although courts must be concerned with provisions that create disguised priorities for certain administrative claimants or which effectively divest the court of jurisdiction upon default. n34

Roll-Over of Prepetition Debt. With apparently increasing frequency, postpetition working capital lenders under all subsections of section 364 demand that the debtor satisfy prepetition secured indebtedness to avoid the need for contentious adequate protection or priming litigation. When the debtor's prepetition lender is acting as the postpetition lender, the elimination of prepetition debt--termed a roll-over--often attracts intense scrutiny from the court and the United States trustee. n35

Roll-overs come in two basic forms. First, a gradual roll-over occurs when a prepetition lender agrees to advance postpetition funds with the agreement that proceeds of prepetition accounts receivables will be applied to reduce the prepetition loan. Alternatively, a postpetition lender can simply lend enough postpetition to pay off the prepetition loan, whether owing to the postpetition lender or a different lender, immediately converting all of the lender's prepetition debt to postpetition debt.

Neither approach should be controversial from the technical perspective of the priority or satisfaction of liens if the prepetition lender is fully secured on the petition date, although the postpetition lender often bargains for substantial procedural protections that are not available to protect its prepetition liens. These protections can sometimes shift the dynamics of a chapter reorganization dramatically, because of the increased rights that the holder of an administrative claim may have over the holder of a prepetition secured claim. For example, the holder of a prepetition claim risks cramdown treatment under a chapter 11 plan, that is, confirmation of a plan without the holder's consent. n36 By contrast, administrative claims must be paid in cash in full upon confirmation, n37 giving the postpetition lender greater leverage and control over the case.

The value of the debtor's assets is often unclear on the petition date, and parties may therefore assume that the lender is attempting to improve upon its undersecured position. While the debtor could seek a provision requiring a roll-back of any debt that is ultimately found to be undersecured, the debtor often has limited bargaining power on the eve of bankruptcy. The creditors' committee may want to argue for this type of protection before entry of the final financing order. If the potential benefits to the lender from the roll-over are relatively modest, however, the parties will have to weigh the costs of the roll-over against the costs of providing adequate protection if an alternative lender is utilized.

Concession of Validity of Prepetition Liens. Another point of contention in postpetition lending agreements are clauses waiving the debtor in possession's--and sometimes other parties'--ability to challenge the enforceability of the lender's prepetition loan agreements. Blanket waivers have been the subject of several blistering opinions, which generally describe these waivers as violations of the debtor in possession's fiduciary duty to creditors. n38 More modest waivers, binding on nondebtor parties only after the passage of a reasonable amount of time, are routinely approved.

Often, the form of the more modest waiver will authorize the creditors' committee to investigate and pursue an action against the lender if warranted. Where it does so, the provision is adequate to authorize the action without the need for a separate formal request from the committee to the debtor in possession to bring the action, denial of the request, and separate court authorization for the committee to bring the action. n39

Procedure for Obtaining Credit under Section 364(c)

Whether or not borrowing under section 364(c) is an ordinary course transaction, both the loan and its terms must be approved by the court, after notice and a hearing. The term after notice and a hearing requires such notice as is appropriate and requires a hearing only if requested by a party in interest. n40 In practice there is almost always a hearing held on a request for authorization under section 364(c).

Bankruptcy Bankruptcy Rule 4001(c) provides that a motion for authority to incur debt or obtain credit under section 364(c) must be made in accordance with Rule 9014 as a contested matter. Notice must be given to any committee appointed under section 1102 or elected under section 705 or, if no committee is appointed under section 1102 or in a chapter 9 case, to the creditors included on the list filed pursuant to Bankruptcy Rule 1007(d) and to such other parties as the court may direct. In addition, Bankruptcy Rule 9034(f) requires that the motion be served on the United States trustee in chapter 11 cases. The motion must be accompanied by a copy of the agreement. n41

Rule 4001(c)(2) provides for an emergency hearing, when necessary, and a final hearing at least 15 days after service of the motion. At the emergency hearing, the obtaining of credit may be authorized only to the extent necessary to avoid immediate and irreparable harm to the estate.

Application of Nonbankruptcy Law Filing or Recording Requirements to Liens Authorized under Section 364

A lender extending credit to a trustee or debtor in possession will usually require adequate documentation of the transaction. The parties to the transaction may generally document it as they see fit, subject to court approval where otherwise required. Indeed, adequate documentation is generally necessary to detail the terms of the transaction and the parties' rights and remedies. With respect to remedies, however, the court ultimately has power and jurisdiction over property of the estate and may limit enforcement of remedies provided for under the agreement.

A difficult question for the parties to the transaction, and particularly for the lender, is to determine the extent to which normal, i.e., nonbankruptcy, documentation practices should be followed. If, for example, the lien authorized under section 364(c) is one which, absent bankruptcy, must be perfected by filing or recording to be valid against or gain priority over liens or interests, such action should not be necessary as long as the bankruptcy case is extant. Instead, the authorized acts of the trustee should be binding upon any successor in interest, n42 and the bankruptcy court, as a court holding custody of the *res*, should have paramount authority to determine the rights of the claimants thereto. n43

Nevertheless, the lender would be well advised to insist on appropriate documentation, including recording or filing, even if not strictly required in bankruptcy transactions. n44 After all, subsequent events may adversely affect an interest that was not properly taken or perfected under nonbankruptcy law. For example, the case might be dismissed. n45 Unless the court for cause orders otherwise, under section 349(b)(3) dismissal revests property of the estate in the entity in which the property was vested immediately before the commencement of the case. While normally the dismissal should be conditioned upon protection of the rights of parties with interests which have vested by reason of prior court determinations and orders, this may be scant protection after the case has been dismissed, particularly if the dismissal is under section 305 and, hence, not subject to appeal. Thus, the better practice is for the lender to document

its loan fully and to comply with applicable nonbankruptcy recording statutes.

For a complete discussion of Code section 364, see Collier on Bankruptcy, ch. 364 (Matthew Bender).

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n1 1. See *Collier on Bankruptcy*, 364.03 (Matthew Bender); *Bray v. Ingersoll-Rand Fin. Credit Corp. (In re Snowshoe Co., Inc.)*, 789 F.2d 1085, 1088 (4th Cir. 1986) (no duty to seek credit from every possible lender).

n2

2. *In re Sobiech*, 125 B.R. 110, 115 (Bankr. S.D.N.Y.), *aff'd*, 131 B.R. 917 (S.D.N.Y. 1991) (The subdivisions of Code § 364(c) are in the alternative; the authorization of credit under one does not imply authorization under another absent application for such additional relief.).

n3

3. Under section 102(5), or is not exclusive.

n4

4. *Cf. In re AMT Inv. Corp.*, 53 B.R. 274 (Bankr. E.D. Va. 1985) (section 364(c) is not available as a means of providing adequate protection to a cash collateral creditor, for to grant such relief would place the cash collateral creditor in a higher priority than what is accorded to such creditor under section 363); *In re 360 Inns, Ltd.*, 76 B.R. 573 (Bankr. N.D. Tex. 1987).

n5

5. See, e.g., *In re Crouse Group, Inc.*, 71 B.R. 544 (Bankr. E.D. Pa.), *aff'd*, 75 B.R. 553 (E.D. Pa. 1987).

n6

6. 8 Collier on Bankruptcy, 6.40 (Matthew Bender 14th ed. 1978); *see also* *Warren v. Palmer*, 310 U.S. 132, 60 S. Ct. 865, 84 L. Ed. 1118 (1940).

n7

7. *In re Sobiech*, 125 B.R. 110 (Bankr. S.D.N.Y.), *aff'd*, 131 B.R. 917 (S.D.N.Y. 1991). The extent of the priority or lien is limited to the credit extension approved by the court. *William B. Schnach Retirement Trust v. Unified Capital Corp. (In re Bono Dev., Inc.)*, 8 F.3d 720, 29 C.B.C.2d 1634 (10th Cir. 1993).

n8

8. *See Debbie Reynolds Hotel & Casino, Inc. v. Calstar Corp. (In re Debbie Reynolds Hotel & Casino, Inc.)*, 255 F.3d 1061 (9th Cir. 2001).

n9

9. *See, e.g., KS Invs. v. T.M. Sweeney & Sons LTL Servs., Inc. (In re T.M. Sweeney & Sons LTL Servs., Inc.)*, 25 C.B.C.2d 962, 968, 131 B.R. 984, 989 (Bankr. N.D. Ill. 1991).

n10

10. *See* Collier on Bankruptcy, ch. 362 (Matthew Bender).

n11

11. *See* Collier on Bankruptcy, ch. 363 (Matthew Bender).

n12

12. *See, e.g., KS Invs. v. T.M. Sweeney & Sons LTL Servs., Inc. (In re T.M. Sweeney & Sons LTL Servs., Inc.)*, 25 C.B.C.2d 962, 968, 131 B.R. 984, 989 (Bankr. N.D. Ill. 1991).

n13

13. See *Collier on Bankruptcy*, 364.05 (Matthew Bender).

n14

14. Cf. *In re Penn Central Transp. Co.*, 494 F.2d 270 (3d Cir. 1974), cert. denied, 419 U.S. 883, 95 S. Ct. 147, 42 L. Ed. 2d 122 (1974).

n15

15. See *Collier on Bankruptcy*, ch. 506 (Matthew Bender).

n16

16. See *In re Flagstaff Foodservice Corp.*, 739 F.2d 73, 10 C.B.C.2d 1309 (2d Cir. 1984) (surcharge not appropriate for payment of attorneys fees); *United States v. Boatmen's First Nat'l Bank of Kansas City*, 5 F.3d 1157 (8th Cir. 1993) (surcharge is appropriate for taxes incurred in course of business). But see *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1 (2000) (Bankruptcy Code does not provide an administrative claimant direct standing to seek payment of its claim from property encumbered by a secured creditors lien).

n17

17. See *In re Keystone Camera Prods. Corp.*, 126 B.R. 177 (Bankr. D.N.J. 1991) (cross-collateralization is valid exercise if, at time of entry of cross collateralization order, lender advances to the debtor a new loan which would otherwise be unobtainable); *In re Beker Indus., Corp.*, 58 B.R. 725 (Bankr. S.D.N.Y. 1986); *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983) (yet describing cross collateralization as a disfavored means of financing).

n18

18. *Burchinal v. Central Wash. Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 17 C.B.C.2d 1132 (9th Cir. 1987); *In re Ellingsen MacLean Oil Co.*, 65 B.R. 358 (W.D. Mich. 1986), aff'd sub nom. *Unsecured Creditors' Comm. v. First Nat'l Bank and Trust Co. of Escanaba (In re Ellingsen MacLean Oil Co.)*, 834 F.2d 599, 17 C.B.C.2d 1402 (6th Cir. 1987), cert. denied, 488 U.S. 817, 109 S. Ct. 55, 102 L. Ed. 2d 33 (1988).

n19

19. 963 F.2d 1490, 27 C.B.C.2d 277 (11th Cir. 1992).

n20

20. 963 F.2d 1490, 1493, 27 C.B.C.2d 277, 280-81. The court rejected the approach adopted by the courts in *Burchinal v. Central Wash. Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 17 C.B.C.2d 1132 (9th Cir. 1987), and *Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. of Escanaba (In re Ellingsen MacLean Oil Co.)*, 834 F.2d 599, 17 C.B.C.2d 1402 (6th Cir. 1987), cert. denied, 488 U.S. 817, 109 S. Ct. 55, 102 L. Ed. 2d 33 (1988), that concluded the appeals were moot because cross-collateralization was authorized under section 364 for the purpose of section 364(e) mootness.

n21

21. To shield postpetition financing arrangements from appeal, observed the court, would afford lenders additional leverage in making emergency loans, thus facilitating insulation of their prepetition claims from attack postpetition. 963 F.2d 1490, 27 C.B.C.2d 277.

n22

22. Both subsections state that, after notice and hearing, the court may authorize the obtaining of credit or the incurring of debt, not the securing of prepetition unsecured or undersecured debt. 963 F.2d 1490, 1495, 27 C.B.C.2d 277, 283.

n23

23. 963 F.2d 1490, 1496, 27 C.B.C.2d 277, 285.

n24

24. *In re Kmart, Corp.*, 359 F.3d 866, 51 C.B.C.2d 1076 (7th Cir. 2004).

n25

25. *In re Kmart Corp.*, 359 F.3d 866, 51 C.B.C.2d 1076 (7th Cir. 2004).

n26

26. *Resolution Trust Co. v. Official Unsecured Creditors' Comm. (In re Defender Drug Stores, Inc.)*, 145 B.R. 312 (B.A.P. 9th Cir. 1992) (postpetition financing arrangement provided that upon event of default under postpetition financing order, debtor would be given 30 days to find alternative financing for, or a buyer of, the business; if the debtor sold its assets, the lender would be entitled to an enhancement fee of 10% of the gross consideration for the assets).

n27

27. *See In re Western Pacific Airlines, Inc.*, 223 B.R. 567 (Bankr. D. Colo. 1997), appeal dismissed, 216 B.R. 437 (D. Colo. 1998), appeal dismissed, 181 F.3d 1191 (10th Cir. 1999).

n28

28. *Official Comm. of Unsecured Creditors of New World Pasta Co. v. New World Pasta Co.*, 322 B.R. 560 (M.D. Pa. 2005).

n29

29. *Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.)*, 250 F.3d 955, 46 C.B.C.2d 381 (5th Cir. 2001).

n30

30. *In re Channel Master Holdings, Inc.*, 309 B.R. 855 (Bankr. D. Del. 2004) (court maintains control over distribution of carve-out amounts, despite express terms to the contrary in loan agreement); *Harvis Trien & Beck, P.C. v. Federal Home Loan Mortgage Corp. (In re Blackwood Assocs., L.P.)*, 187 B.R. 856, 860 (Bankr. E.D.N.Y. 1995) (advised that if attorneys really want to be paid they had best insist upon a real carve out--An agreed upon term in a cash collateral stipulation where a specific amount of the cash collateral, either in existence or to be generated, is earmarked for the payment of counsel fees and disbursements where the payment thereof is not conditioned upon a specific event or occurrence.); *In re Ames Dep't Stores, Inc.*, 22 C.B.C.2d 1500, 115 B.R. 34 (Bankr. S.D.N.Y. 1990) (noting practice of district to insist on carve out fees in order to preserve adversary system). *See generally* Richard Levin, *Almost All You Ever Wanted to Know About Carve-Out*, 76 Am. Bankr. L.J. 445 (2002); James S. Cole, *The Carve Out from Liens and Priorities to Guarantee Payment of Professional Fees in Chapter 11*, 1993 Det. C. L. Rev. 1499 (1993). *But see Unsecured Creditors' Comm. v. Jones Truck Lines, Inc. (In re Jones Truck Lines, Inc.)*, 156 B.R. 608 (W.D. Ark. 1992) (carve out for creditors' committee expenses and fees not required).

n31

31. 11 U.S.C. § 506(c).

n32

32. *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.* 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1, 43 C.B.C.2d 861 (2000).

n33

33. *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003) (*en banc*).

n34

34. *In re FCX, Inc.*, 54 B.R. 833 (Bankr. E.D.N.C. 1985); *cf. United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed.2d 506, 35 C.B.C.2d 463 (1996); *United States v. Noland*, 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748, 35 C.B.C.2d 1 (1996).

n35

35. *See, e.g.*, Delaware L. Bankr. R. 4001-2(a)(i)(E) (requiring these provisions to be highlighted in any motion seeking approval of postpetition financing).

n36

36. *See* 11 U.S.C. § 1129(b).

n37

37. 11 U.S.C. § 1129(a)(9)(A).

n38

38. See, e.g., *In re Tenney Village Co.*, 104 B.R. 562, 568 (Bankr. D.N.H. 1989); *In re Roblin Indus., Inc.*, 52 B.R. 241 (Bankr. W.D.N.Y. 1985).

n39

39. *Official Comm. of Unsecured Creditors v. Clark (In re Nat'l Forge Co.)*, 51 C.B.C.2d 919, 304 B.R. 214 (Bankr. W.D. Pa. 2004).

n40

40. As discussed in *Collier on Bankruptcy*, 364.03[1] (Matthew Bender), an actual hearing will be necessary only if one has been requested after the giving of notice. However, the lender will often insist that a hearing will be held to, among other things, standards of the sufficiency of the notice as determined by the court. Section 102(1) requires simply that the notice and opportunity for a hearing be appropriate in the particular circumstances.

N41

41. *Fed. R. Bankr. P. 4001(c)(1)*.

n42

42. See *Tully Constr. Co. v. Cannonsburg Envtl. Assocs., Ltd. (In re Cannonsburg Envtl. Assocs., Ltd.)*, 72 F.3d 1260, 1267 (6th Cir. 1996) (trustee stands in the debtor's shoes and has all the rights, duties, and powers of the debtor in possession); *In re Hartec Enters., Inc.* 117 B.R. 865 (Bankr. W.D. Tex. 1990), *vacated on other grounds*, 130 B.R. 329 (W.D. Tex. 1991) (a trustee appointed in chapter 11 or upon a conversion to chapter 7 will be bound as a successor in interest with respect to all terms of the contract assumed by the debtor in possession); see also *Nicholas v. United States*, 384 U.S. 678, 86 S. Ct. 1674, 16 L. Ed. 2d 853 (1966). But see *Otte v. Manufacturers Commercial Corp. (In re Texlon)*, 596 F.2d 1092, 20 C.B.C. 621 (2d Cir. 1979).

n43

43. Cf. *Small v. Beverly Bank*, 936 F.2d 945 (7th Cir. 1991) (equitable liens are disfavored in bankruptcy); *Monfort, Inc. v. Kunkel (In re Morken)*, 182 B.R. 1007 (Bankr. D. Minn. 1995).

n44

44. See U.C.C. §§ 9-203, 9-303, 9-401 *et seq.*

n45

45. See 11 U.S.C. §§ 305, 349, 707, 927, 1112 and 1307. *Production Credit Ass'n of the Midlands v. Farm & Town Indus., Inc.*, 518 N.W.2d 339 (Iowa 1994), illustrates the problems that may arise when no steps are taken to protect postpetition financing from the effects of dismissal. There, the lender provided the debtor, a family farmer, with funds to plant the 1992 crop. The bankruptcy court authorized a credit that primed a first lien on the debtor's 1992 crops. The case was subsequently dismissed. After the dismissal, the prepetition lender (whose lien had been primed) took action to foreclose on its collateral, and sought a determination that its lien was superior to all others, including that of the postpetition lender. The state court held, among other things, that upon dismissal of [debtor's] case, subsection 349(b)(3) effectively reinstated [prepetition lender's] prior security interest in the 1992 crop. Because the bankruptcy court failed to order otherwise, we also hold that the priority status of [postpetition lender's] lien under bankruptcy law was not preserved. This conclusion, however, does not resolve the question of the validity of [postpetition lender's] security interest under state law." 518 N.W.2d 339, 343-44.

ABOUT THE AUTHOR(S):

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147 of 197 DOCUMENTS

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Collier on Ordinary-Course Use, Sale or Lease of Property

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Collier on Ordinary-Course Use, Sale or Lease of Property

By Collier

December 4, 2007

SUMMARY: This Emerging Issues Analysis covers topics under section 363 such as the ordinary course of business requirement; the limitation on the trustee's right to use, sell, or lease property; the definition of "cash collateral"; and the use of cash collateral.

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ARTICLE: Section 363(c) authorizes the trustee, debtor in possession or chapter 13 debtor engaged in business n1 to use, sell or lease property of the estate in the ordinary course of business n2 without the need for notice or a hearing, if the continued operation of the business was authorized n3 and the court does not order otherwise. This provision is of particular importance in chapter 11 reorganization cases and in chapter 12 or 13 cases involving businesses, wherein the continued operation is essential to the preservation of the going concern value of the business. It can also be of importance in a chapter 7 case in which the trustee needs to complete performance under particular contracts or to take other ordinary business actions that will be necessary to maximize the value of the assets to be liquidated.

The absence of a notice and hearing requirement applies to entities with an interest in the property, such as a lien, as well as to general unsecured creditors. Under this provision, therefore, the trustee or debtor in possession may continue to use, sell, or lease property in the ordinary course of business even if the property is subject to a security interest or other encumbrance. n4 Of course, the trustee must provide adequate protection if requested by an entity with an interest in the property.

Ordinary Course of Business

In order for the trustee or debtor in possession to use, sell or lease property of the estate without the need for prior notice and a hearing, the proposed use, sale, or lease must be in the ordinary course of business. If the action is not in the ordinary course of business, it may be avoidable under section 549, which permits avoidance of postpetition transfers of property that were not authorized under section 363 or by the court. n5 Thus, in any case in which the parties are unsure about whether their transaction is in the ordinary course of business, it is advisable to comply with the notice and hearing requirement of section 363(b) rather than to rely on the ordinary course of business authorization under section 363(c).

Courts have developed two commonly used tests for determining whether a transaction is in the ordinary course of business: (1) horizontal dimension test; and (2) vertical dimension (also known as the reasonable expectations) test. n6

Horizontal Dimension Test. The horizontal dimension test looks to similarly situated businesses and determines whether the transaction at issue is one that would normally be entered into by similar businesses. n7 In effect, this test is aimed at determining whether the transaction is abnormal or unusual, in which case it is probably not in the ordinary course of business, or whether it is a reasonably common type of transaction. n8 Significantly, a transaction may be considered reasonably common even if it does not occur frequently, provided that it is an ordinary type of transaction within the business and the industry. n9

Vertical Dimension Test. The vertical dimension test reviews the transaction from the perspective of creditors, asking whether the transaction is one that creditors would reasonably expect the debtor or trustee to enter into. n10 This test measures the types of risks that creditors impliedly agreed to when they extended credit to the debtor and determines whether the transaction at issue is within the range of risks reasonably expected by creditors. n11 Under this test, even a transaction that might be ordinary for similar businesses might not be ordinary for the debtor's business. n12 For example, it might be unusual for a relatively small business to undertake a particularly large transaction, even if other larger businesses in the same industry might do so as a matter of course. On the other hand, transactions of a type that the debtor commonly engaged in, or which the debtor might have reasonably been expected to engage in prepetition, are likely to be within the ordinary course of business after the commencement of a case, whether or not common in the debtor's industry.

Limitation on Trustee's Right to Use, Sell or Lease Property

There are at least four other significant limitations on the trustee's rights to use, sell or lease property in the ordinary course of business. First, while the business of the debtor is presumed to operate postpetition in chapter 11, n13 chapter 12 n14 and chapter 13, n15 the court may tailor the trustee's rights and powers to the needs of the case. In chapter 7 cases, where operation is the exception, the order authorizing continued operation of the business may limit the right of the trustee to sell, use or lease property. n16 Secondly, in chapter 11 cases, the trustee is subject to certain rights of secured parties with interests in aircraft or rolling stock. n17 Third, the trustee may not use, sell, or lease in any manner inconsistent with any relief from the automatic stay that the court has granted to a party with an interest in the property. n18 Fourth, the court may impose restrictions on use, sale, or lease as necessary to provide adequate protection of a party's interest in property of the estate. n19 The final and most important exception is when the property is cash collateral. Recognizing that cash and cash equivalents are easily dissipated, the Code places strict limitations on a trustee's ability to use such property.

Cash Collateral; Definition; § 363(a)

Section 363(a) defines cash collateral as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest. The term security is defined in section 101 to include a variety of investment claims or interests, including stocks, bonds, notes, and interests in limited partnerships. Because securities are included in the definition of cash collateral, a trustee is subject to the rules with respect to cash collateral when seeking to use or sell these investment vehicles. n20 Under this provision, cash and cash equivalents subject to a security interest or to other interests are cash collateral. Cash collateral also includes proceeds, products, offspring, rents, or profits of property in which the entity has a security interest. n21 Cash collateral does not include non-cash assets that can be converted to cash, no matter how easily. n22 In addition, resolving a split among courts as to the proper treatment, n23 the Bankruptcy Reform Act of 1994 n24 amended section 363(a) to include fees, charges, accounts or other payments for the use or occupancy of

rooms and other public facilities in hotels, motels, or other lodging properties.

After-Acquired Property. If collateral that is not cash collateral is converted to cash or cash equivalents during the case, and if the resulting cash or cash equivalents become collateral under applicable nonbankruptcy law and section 552, the collateral becomes cash collateral subject to the provisions of section 363(c).ⁿ²⁵ Although section 552(a) abrogates after-acquired property clauses in security agreements, after-acquired property is subject to a prepetition security interest if the agreement covers such property and the property is proceeds, products, offspring, rents or profits of property subject to the prepetition agreement or hotel revenues generated by such property, unless the court orders otherwise. Thus, for example, the trustee may sell inventory or collect accounts in the ordinary course of business without court approval, since these are not cash collateral, but the cash proceeds will be cash collateral, even if acquired by the trustee after the commencement of the case, because the cash is proceeds of the inventory or receivables, unless the court orders otherwise under section 552(b).ⁿ²⁶ Property that the debtor acquires postpetition that is not proceeds, product, offspring, rents or profit of property of the estate is not cash collateral even when deposited with the creditor.ⁿ²⁷

The language of section 363(a) is intentionally broad to deal with situations in which an entity has an interest, other than a security interest, in the cash or cash equivalents.ⁿ²⁸ To illustrate, a bank with a right of setoff is treated as the holder of a secured claim under section 506(a)ⁿ²⁹ notwithstanding that it does not have a security interest.ⁿ³⁰ Under section 363(a), the deposit account that is subject to the setoff right is considered cash collateral.

Hotel Revenues: After-Acquired Revenues. The Bankruptcy Reform Act of 1994ⁿ³¹ amended section 363(a) to include fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties in the definition of cash collateral. A parallel amendment was made to section 552(b) to recognize interests in after acquired hotel revenues.ⁿ³²

Before the 1994 amendments, a majority of bankruptcy courts had held the view that hotel revenues were accounts, rather than rents or profits; thus, a creditor's interest therein did not carry forward to revenues generated postpetition.ⁿ³³ The trend among the appellate courts, however, was to classify hotel revenues as rents or profits.ⁿ³⁴ Authority was further split on the issue whether state or federal law governed classification of hotel revenues as rents, proceeds, profits or the like. The majority followed *Butner v. United States*ⁿ³⁵ for the proposition that state law defines a party's interest in property.ⁿ³⁶ In *In re Tollman-Hundley Dalton, L.P.*,ⁿ³⁷ however, the court held that federal law defined the nature of the property interest. The court concluded that section 552(b) was intended to cover, as a matter of federal law, a wide range of derivative interests; therefore, hotel revenues, however characterized under state law, fell within the broad definition of rents. The 1994 amendments to sections 363(a) and 552(b) clarified that after-acquired hotel revenues could be subjected to a prepetition security interest and are cash collateral for purposes of section 363.

Significantly, however, the 1994 amendments did not resolve the question whether these revenues are rents or accounts. This issue is of some importance in terms of the proper perfection device.ⁿ³⁸ If the revenues are rents, an interest in them must be perfected under real estate law. If they are accounts, the interest must be perfected under the Uniform Commercial Code. Because this issue is unresolved, a careful lender will perfect an interest in hotel revenues under both systems, filing in the real estate records and in the U.C.C. records.

Perfection of Interest in Hotel Revenues. Section 552(b) was also amended to delete the requirement that the right to rents and hotel revenues depends on applicable nonbankruptcy law.ⁿ³⁹ This requirement led to considerable litigationⁿ⁴⁰ about whether applicable nonbankruptcy law might require seizure of the property, or appointment of a receiver, in order to perfect an interest in the revenue from the property. The revision was intended to clarify that lenders may have a valid interest in rents and hotel revenues notwithstanding their failure to have fully perfected under state law.ⁿ⁴¹ Nevertheless, because the interest remains subject to the trustee's avoidance powers, including the

trustee's status as a judicial lien creditor and a bona fide purchaser of real property, the interest will need to be properly recorded in order to be effective against the trustee.

Perfection of Interest in Rents. A creditor taking a mortgage on real estate will often also take an interest in the rents generated by the real estate. Although pursuant to section 552(a) security interests generally do not extend to property acquired after the commencement of a bankruptcy case, section 552(b) provides that an interest in rents may continue.

Before the 1994 amendments, however, the interest continued only if it was perfected under applicable nonbankruptcy law. Courts disagreed about whether this required simply recordation in the real estate records, or whether a lender might have to gain control over the rents, such as by the appointment of a receiver. n42

The Bankruptcy Reform Act of 1994 amended section 552(b) to delete the reference to applicable nonbankruptcy law, clarifying that absolute perfection is not required. n43 The intent is to provide that lenders may have a valid interest in rents notwithstanding their failure to have fully perfected as to the rents under state law. n44 Nevertheless, recordation is still required as to the mortgage, since the lender's right to the rents remains subject to the trustee's avoidance powers, which include the power to avoid interests that are ineffective against a bona fide purchaser. n45

Absolute Assignments of Rents. In some states, an assignment of rents may be considered absolute, with title to the rents passing to the assignee and the assignor retaining no interest in the rents. n46 Under such an arrangement, the estate may have no interest in the rents. This would preclude the treatment of the rents as cash collateral under section 363. n47 Where the debtor retains an interest in the rents, however, they may be cash collateral and subject to use, even if in the secured creditor's possession. n48 When the lender has received a purported absolute assignment of rents, careful review of the intent and practices of the parties and of applicable nonbankruptcy law will be appropriate to determine whether the assignment is truly absolute or is absolute only in form. n49

Use of Cash Collateral; § 363(c)(2)

Section 363(c)(2) provides that the trustee or debtor in possession may not use, sell or lease cash collateral without either (1) the consent of the creditor with an interest in the collateral or (2) court authorization, granted after notice and a hearing. n50 In the absence of the creditor's consent, n51 the trustee may use cash collateral only with the approval of the court which will normally require adequate protection for the holder of the adverse interest. n52

The requirements of notice and a hearing, and of court authorization, before cash collateral may be used, sold or leased may at first blush appear to be particularly onerous to a debtor in possession faced with a genuine emergency. However, often a secured party will consent to limited use of the cash collateral in order to preserve the value of its interest in other collateral. Payment of expenses of preserving non-cash collateral, payroll expenses to keep the business operating and other immediate cash needs may be as important to a secured party early in a case as it is to the debtor in possession.

Sometimes a secured party will seek, in conjunction with an agreement to authorize the debtor in possession to use cash collateral, an agreement cross-collateralizing its prepetition debt with postpetition collateral. In addition, the secured party may seek administrative priority for its entire claim as the price of agreeing to the debtor in possession's use of cash collateral. In general, such use of cross-collateralization or administrative priority is questionable at best. n53 Although the secured party is entitled to protection of its interest in the cash collateral, it is not entitled to improve its position with respect to any unsecured claim that it holds. Such an improvement would be at the expense of other

unsecured creditors and would violate the underlying bankruptcy notion of equality of treatment among similarly situated creditors.

Even in the absence of the secured party's consent, the court has ample power to act quickly on a request to use cash collateral. The term notice and a hearing means appropriate notice and perhaps no hearing at all, unless there is an objection. n54 When a hearing is required it may in some cases be prompt and somewhat informal. For example, in the case of a genuine emergency, such as an impending payroll, the notice may be telephonic and the hearing, if necessary, may be quite informal.

Section 363(c)(3) provides that the hearing shall be scheduled in accordance with the needs of the debtor and that the court shall act promptly on any request for authorization to use cash collateral. n55 This supports the notion that the court can quickly grant authority to use cash collateral for pressing needs.

Procedure for Hearing on Use of Cash Collateral. *Federal Rule of Bankruptcy Procedure 4001(b)* governs the procedure to be followed in seeking authorization to use cash collateral. Rule Rule 4001(b) provides that a motion for authority to use cash collateral is made as a contested matter under Rule 9014. Notice of the motion and of the time and place of the preliminary and final hearing must be given to all entities that have an interest in the cash collateral, to any committee appointed under the Code or, if no committee has been appointed, to the holders of the 20 largest unsecured claims, Bankruptcy Rule 1007(d) excluding insiders, who will be included in the list filed by the debtor under), and to such other entities as the court may direct. The Advisory Committee Note to Rule 4001(b) offers guidance as to what should be set forth in the notice, which includes the name and address of the parties with an interest in the cash collateral, a proposed budget and the nature of the adequate protection which is to be offered. The Bankruptcy Reform Act of 1994 n56 amended Bankruptcy Rule 7004 to require that service of process on a bank in an adversary proceeding or a contested matter be by certified mail addressed to an officer of the bank except in limited circumstances. This should not preclude telephonic notice in emergencies, but will apply to situations in which a contested matter is initiated by service by mail under Rule 7004. n57

While section 363(c)(3) and Rule 4001 recognize that a hearing for authority to use cash collateral may be a preliminary or a final hearing, when a hearing is held on short notice in an emergency situation, the hurried nature of the hearing suggests the wisdom of having a later final hearing for which the participants will have had more preparation time. In this regard, Rule 4001(b) provides that a final hearing may be held on no less than 15 days' notice. Prior to the final hearing, if the trustee needs authority to use cash collateral, authority may be granted at a preliminary hearing. However, the rule provides that the court may authorize the use of only that cash collateral as may be necessary to avoid immediate and irreparable harm to the estate. At the final hearing, cash collateral usage that has been authorized or consented to may be further adjusted or conditioned. Although generally an order authorizing use of property is automatically stayed for 10 days, an order authorizing use of cash collateral is excepted from the rule. n58

Segregation of Cash Collateral. Section 363(c)(4) provides that a trustee is required to segregate and account for any cash collateral in the trustee's possession, custody or control. In the absence of authorization to use cash collateral, the trustee is responsible for maintaining the collateral for the protection of the creditor with an interest in the collateral. Segregation of cash collateral is also important to secured creditors in view of the requirement of nonbankruptcy law that a creditor be able to identify cash proceeds in order to maintain an interest in the proceeds. n59

This requirement will, in most circumstances, apply to cash collateral on hand at the time of filing and cash generated during the case through the accumulation of after-acquired cash, such as rents or hotel revenues or from the use, sale or lease of non-cash collateral and payments for inventory or receivables. n60 When the trustee has previously been authorized to use cash collateral, a common component of the adequate protection afforded the affected entity is an appropriate accounting.

Purpose of Cash Collateral Rules. The protection offered by the cash collateral provisions does not implement any nonbankruptcy law limitations inherent to cash collateral, n61 but rather is intended to recognize the unique nature of cash collateral, and the risk to the entity with an interest in such collateral, arising from the dissipation or consumption of the collateral in a rehabilitative effort in bankruptcy. n62 The protection applies whether or not there has been a default that would limit the trustee's use of such collateral.

Chapter 13 Cases. Section 1303 grants a chapter 13 debtor the right of a trustee, pursuant to section 363(b), to use, sell or lease property of the estate out of the ordinary course of business. This requires notice and a hearing prior to such use, sale or lease and, pursuant to section 363(e), provision of adequate protection of an interest held by another entity, upon request by that entity. In addition, section 1304 grants a business debtor the power of a trustee, pursuant to section 363(c), to use, sell or lease, in the ordinary course of business, property of the estate. This latter authorization is subject to the limitations on the use of cash collateral found in section 363(c)(2).

A question that has arisen is whether a chapter 13 debtor who is not engaged in business may be authorized to use cash collateral out of the ordinary course of business. In general, courts have found that although the cash collateral rules are found in section 363(c), which is referred to only in conjunction with the use of property by chapter 13 business debtors, a nonbusiness debtor may use cash collateral, with the consent of the secured party or with court approval after furnishing adequate protection. n63 This approach recognizes that section 363(b) authorizes the use of any property of the estate, including cash collateral, after notice and a hearing. Thus, for example, a debtor whose automobile is destroyed and who receives an insurance recovery may obtain authorization to acquire a different vehicle with the insurance proceeds, even though the proceeds are cash collateral. The security interest would, of course, attach to the newly acquired vehicle.

Although it appears that the chapter 13 debtor should be entitled to use the cash collateral after notice and a hearing, and section 102 provides that the term after notice and a hearing does not mandate a hearing if none is requested, the better approach is for a court to review any such transaction even in the absence of an objection, and to approve or disapprove the use of cash collateral out of the ordinary course of business, based on whether the secured party is adequately protected. The cash collateral rules developed because cash is so easily dissipated. This danger is no less apparent when property is used out of the ordinary course of business than it is when property is used in the ordinary course. Thus, court approval should be obtained before the debtor uses cash collateral even if the use is not in the ordinary course of business.

For a complete discussion of Code section 363, see Collier on Bankruptcy, ch. 363 (Matthew Bender).

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n1 1. See 11 U.S.C. §§ 1107 (chapter 11), 1304 (chapter 13); see also 11 U.S.C. §§ 1203, 1204 (chapter 12).

n2

2. H.R. Rep. No. 595, 95th Cong., 1st Sess. 344 (1977) [hereinafter House Report]; S. Rep. No. 989, 95th

Cong., 2d Sess. 55 (1978) [hereinafter Senate Report]; see *Burlington Northern R.R. Co. v. Dant & Russell, Inc.* (*In re Dant & Russell, Inc.*), 853 F.2d 700, 20 C.B.C.2d 369 (9th Cir. 1988) (discussion of what constitutes the ordinary course of business).

n3

3. 11 U.S.C. § 721, which concerns the authorization to operate the business in a chapter 7 case, provides: The court may authorize the trustee to operate the business of the debtor for a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate. See Collier on Bankruptcy, ch. 721 (Matthew Bender). 11 U.S.C. § 1108, which pertains to the authorization to operate the business in a chapter 11 case, states: Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor's business. See Collier on Bankruptcy, ch. 1108 (Matthew Bender). Pursuant to 11 U.S.C. § 1107(a), a debtor in possession in a chapter 11 case has the rights, powers and duties of a trustee. See Collier on Bankruptcy, ch. 1107 (Matthew Bender).

n4

4. See 11 U.S.C. § 363(f)(1) (sale may be free and clear of such other interest if applicable nonbankruptcy law permits sale of such property free and clear of such interest); Collier on Bankruptcy, 363.06[2] (Matthew Bender).

n5

5. *Rajala v. Langer* (*In re Lodge Am., Inc.*), 239 B.R. 580 (Bankr. D. Kan. 1999) (repayment of unauthorized loan wasn't in the ordinary course, even though loan proceeds were used to pay ordinary course expenses).

n6

6. See, e.g., *In re Roth Am., Inc.*, 975 F.2d 949 (3d Cir. 1992); *In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988).

n7

7. See *In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988).

n8

8. *See id.*; *see also Johnston v. First Street Cos., Inc.*, 56 B.R. 31 (D. Minn. 1985).

n9

9. *In re Roth Am., Inc.*, 975 F.2d 949 (3d Cir. 1992); *In re Johns-Manville Corp.*, 60 B.R. 612, 618 (S.D.N.Y. 1986), *rev'd on other grounds*, 801 F.2d 60 (2d Cir. 1986).

n10

10. *See In re Watford*, 159 B.R. 597 (M.D. Ga. 1993).

n11

11. *See In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988); *In re James A. Phillips, Inc.*, 29 B.R. 391 (S.D.N.Y. 1983).

n12

12. *Johnston v. First Street Cos., Inc.*, 56 B.R. 31 (D. Minn. 1985).

n13

13. 11 U.S.C. § 1108; *see also Amdura Nat'l Distrib. Co. v. Amdura Corp. (In re Amdura Corp.)*, 75 F.3d 1447 (10th Cir. 1996).

n14

14. 11 U.S.C. §§ 1203, 1204.

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15. 11 U.S.C. § 1304.

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16. 11 U.S.C. § 721 (authorization to operate business for limited period when it is in the best interests of the estate and consistent with an orderly liquidation of the estate).

n17

17. See 11 U.S.C. §§ 1110, 1168; *Collier on Bankruptcy*, 1110.01 et seq. and 1168.01 et seq. (Matthew Bender).

n18

18. 11 U.S.C. § 363(d); see *Collier on Bankruptcy*, 363.04 (Matthew Bender).

n19

19. 11 U.S.C. § 363(e); see *Collier on Bankruptcy*, 363.05 (Matthew Bender).

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20. See, e.g., *In re Weisberg*, 193 B.R. 916 (B.A.P. 9th Cir. 1996).

n21

21. It has also been held that cash collateral includes fees charged for self storage units, *Wattson Pacific Ventures v. Valley Fed. Savs. Loan (In re Safeguard Self-Storage Trust)*, 2 F.3d 967, 29 C.B.C.2d 997 (9th Cir. 1993), cash dividends paid on stock pledged as collateral, *FDIC v. Hastie (In re Hastie)*, 2 F.3d 1042 (10th Cir. 1993), and funds received from the collection of accounts, *In re Bumper Sales, Inc.*, 907 F.2d 1430, 23 C.B.C.2d 498 (4th Cir. 1990).

n22

22. *Agency Servs., Inc. v. Keck Mahin & Cate (In re Keck Mahin & Cate)*, 1999 U.S. Dist. LEXIS 5056 (N.D. Ill. Mar. 30, 1999) (unearned insurance premium).

n23

23. *Financial Sec. Assurance, Inc. v. Days California Riverside Ltd. P'ship (In re Days California Riverside Ltd. P'ship)*, 27 F.3d 374, 31 C.B.C.2d 877 (9th Cir. 1994); *T-H New Orleans Ltd. P'ship v. Financial Sec. Assurance, Inc. (In re T-H New Orleans Ltd. P'ship)*, 10 F.3d 1099, 30 C.B.C.2d 478 (5th Cir. 1993), cert. denied, 511 U.S. 1083, 114 S. Ct. 1833, 128 L. Ed. 2d 461 (1994); see also *Financial Sec. Assurance, Inc. v. Tollman-Hundley Dalton, L.P.*, 74 F.3d 1120, 1124 (11th Cir. 1996) (under pre-1994 law, federal, not state, law controlled scope of rents, profits, product, offspring and proceeds, and under federal law hotel revenues constitute rents within meaning of section 552(b) because section 552(b) was intended to cover a wide range of derivative property; in support of this view, court looked to the 1994 amendments).

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24. Pub. L. No. 103-394, § 214 (1994).

n25

25. S. Rep. No. 989, 95th Cong., 2d Sess. 55 (1978).

n26

26. *Unsecured Creditors Committee v. Marepcon Fin. Corp. (In re Bumper Sales, Inc.)*, 907 F.2d 1430, 23 C.B.C.2d 498 (4th Cir. 1990); *In re Kerner Printing Co.*, 178 B.R. 363 (Bankr. S.D.N.Y. 1995).

n27

27. *Agricultural Fed. Credit Union v. Harris (In re Harris)*, 260 B.R. 753 (Bankr. D. Md. 2001) (credit union share account deposit).

n28

28. See, e.g., *National Bank of Ga. v. Air Atlanta, Inc. (In re Air Atlantic, Inc.)*, 74 B.R. 426 (Bankr. N.D. Ga.), *aff'd*, 81 B.R. 724 (N.D. Ga. 1987).

n29

29. See *Collier on Bankruptcy*, 506.02 (Matthew Bender).

n30

30. See *In re Quality Interiors, Inc.*, 24 C.B.C.2d 1823, 127 B.R. 391 (Bankr. N.D. Ohio 1991).

n31

31. Pub. L. No. 103-394, § 214(a) (1994).

n32

32. Pub. L. No. 103-394, § 214(b) (1994).

n33

33. See, e.g., *In re Punta Gorda Assocs.*, 137 B.R. 535 (Bankr. M.D. Fla. 1992); *In re Shore Haven Motor Inn, Inc.*, 124 B.R. 617 (Bankr. S.D. Fla. 1991); *In re GGVXX Ltd.*, 130 B.R. 322 (Bankr. D. Colo. 1991); *In re Investment Hotel Props., Ltd.*, 109 B.R. 990 (Bankr. D. Colo. 1990).

n34

34. *Financial Sec. Assurance, Inc. v. Days California Riverside Ltd. P'ship* (*In re Days California Riverside Ltd. P'ship*), 27 F.3d 374, 31 C.B.C.2d 877 (9th Cir. 1994); *T-H New Orleans Ltd. P'ship v. Financial Sec. Assurance, Inc.* (*In re T-H New Orleans Ltd. P'ship*), 10 F.3d 1099, 30 C.B.C.2d 478 (5th Cir. 1993), cert. denied, 511 U.S. 1083, 114 S. Ct. 1833, 128 L. Ed. 2d 461 (1994); *Great West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd.*, 33 C.B.C.2d 217, 177 B.R. 843 (N.D. Ohio 1994) (federal law determines meaning of proceeds, products, profits, rents, offspring or product, and hotel room revenues and receipts constitute profits; state law determines perfection in such interests); *S.F. Drake Assocs. v. Security Pacific Nat'l Bank* (*In re S.F. Drake Hotel Assocs.*), 147 B.R. 538 (N.D. Cal. 1992); see also *In re Churchill Props. VIII Ltd. P'ship*, 164 B.R. 607 (Bankr. N.D. Ill. 1994) (postpetition hotel revenues constitute rents); *In re Miami Center Assocs. Ltd.*, 144 B.R. 937 (Bankr. S.D. Fla. 1992) (postpetition hotel revenues constitute profits). But see *In re HRC Joint Venture*, 175 B.R. 948 (Bankr. S.D. Ohio 1994), in which the court held that payments received from a hotel operator under a management agreement which entitled the operator to receive the hotel revenues and obligated the operator to make payments to the owner were not room revenues, but were merely remittances under the agreement between the debtor in possession hotel owner and the hotel operator. As such, the mortgagee's interest could not attach to the remittances to which the debtor in possession became entitled after

commencement of the chapter 11 case because the remittances were after acquired property under section 552(a) and the mortgagee's interest was not protected by section 552(b).

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35. 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979).

n36

36. See, e.g., *Financial Sec. Assurance, Inc. v. Days California Riverside Ltd. P'ship* (*In re Days California Riverside Ltd. P'ship*), 27 F.3d 374, 31 C.B.C.2d 877 (9th Cir. 1994) (under California law hotel revenues constitute rents within the scope of section 552(b)); *T-H New Orleans Ltd. P'ship v. Financial Sec. Assurance, Inc.* (*In re T-H New Orleans Ltd. P'ship*), 10 F.3d 1099, 30 C.B.C.2d 478 (5th Cir. 1993), cert. denied, 511 U.S. 1083, 114 S. Ct. 1833, 128 L. Ed. 2d 461 (1994) (same outcome under Louisiana law).

n37

37. 74 F.3d 1120 (11th Cir. 1996); see also *Great West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd.*, 33 C.B.C.2d 217, 177 B.R. 843 (N.D. Ohio 1994) (federal law determines meaning of proceeds, products, profits, rents, offspring or product and hotel room revenues and receipts constitute profits; state law determines perfection in such interests).

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38. See *Great West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd.*, 33 C.B.C.2d 217, 177 B.R. 843 (N.D. Ohio 1994).

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39. Pub. L. No. 103-394, § 214 (1994).

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40. See, e.g., *In re Bellevue Place Assocs.*, 173 B.R. 1009 (Bankr. N.D. Ill. 1994).

n41

41. Section-by-Section Description of H.R. 5116, 140 Cong. Rec. H10,764 (daily ed. Oct. 4, 1994).

n42

42. Compare *In re Wheaton Oaks Office Partners Ltd. P'ship*, 27 F.3d 1234, 31 C.B.C.2d 840 (7th Cir. 1994) (Illinois law requires recordation of mortgage to perfect assignment of rents), *Vienna Park Props. v. United Postal Sav. Ass'n (In re Vienna Park Props.)*, 976 F.2d 106 (2d Cir. 1992) (under Virginia law creditor need not have taken any steps to enforce security interest), and *In re Baltic Assocs., L.P.*, 170 B.R. 568 (E.D. Pa. 1994) (under Delaware law interest in rents is perfected upon recordation of executed security agreements), with *Casbeer v. State Fed. Savs. & Loan of Lubbock (In re Casbeer)*, 793 F.2d 1436 (5th Cir. 1986) (under Texas law, assignment is not effective until mortgagee obtains possession of the property, impounds rents, secures appoint of receiver or takes similar action), and *In re Turtle Creek, Ltd.*, 194 B.R. 267 (Bankr. N.D. Ala. 1996) (mortgagee must take additional steps such as foreclosure, sequestration of rents [appointment of a receiver to collect rent], or some similar action in order to perfect a lien in rents generated by a mortgagor's property in Alabama.), and *In re Concord Mill Ltd. P'ship*, 136 B.R. 896 (Bankr. D. Mass. 1992) (notice to tenants plus entry or attempted entry if thwarted by debtor).

n43

43. See *Lyons v. Federal Savs. Bank (In re Lyons)*, 193 B.R. 637, 649 (Bankr. D. Mass. 1996).

n44

44. 140 Cong. Rec. H10,764 (daily ed. Oct. 4, 1994) (section-by-section analysis of H.R. 5116).

n45

45. See, e.g., *Scottsdale Medical Pavilion v. Mutual Benefit Life Ins. Co. in Rehabilitation (In re Scottsdale Medical Pavilion)*, 159 B.R. 295 (B.A.P. 9th Cir. 1993), *aff'd*, 52 F.3d 244 (9th Cir. 1995).

n46

46. See *Commercial Bank v. Mountain View Village, Inc.*, 5 F.3d 34, 29 C.B.C.2d 1241 (3d Cir. 1993) (Pennsylvania); *First Fidelity Bank, N.A. v. Jason Realty, L.P. (In re Jason Realty, L.P.)*, 59 F.3d 423 (3d Cir. 1995) (New Jersey); *Wolters Village, Ltd. v. Village Props., Ltd. (In re Village Props., Ltd.)*, 723 F.2d 441 (5th Cir. 1984) (absolute assignment of rents transfer title to rents; Texas courts reluctant to construe assignments as absolute).

n47

47. See *In re Villamont-Oxford Assocs. Ltd. P'ship*, 230 B.R. 445 (Bankr. M.D. Fla. 1998).

n48

48. *In re Dupell*, 235 B.R. 783 (Bankr. E.D. Pa. 1999).

n49

49. See, e.g., *Condor One, Inc. v. Turtle Creek, Ltd. (In re Turtle Creek, Ltd.)*, 194 B.R. 267 (Bankr. N.D. Ala. 1996) (close reading of assignment required); *In re Dacey*, 80 B.R. 206 (D. Nev. 1987).

n50

50. *In re Cross Baking Co., Inc.*, 818 F.2d 1027, 17 C.B.C.2d 236 (1st Cir. 1987).

n51

51. *Freightliner Mkt. Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368-69 (9th Cir. 1987) (implied consent is not sufficient).

n52

52. *In re Goode*, 235 B.R. 584 (Bankr. E.D. Tex. 1999) (debtor's need for funds could not substitute for adequate protection).

n53

53. See, e.g., *In re Willingham Investments, Inc.*, 203 B.R. 75 (Bankr. M.D. Tenn. 1996); see also *In re Saybrook Mfg. Co., Inc.*, 963 F.2d 1490, 27 C.B.C.2d 277 (11th Cir. 1992) (refusing to permit cross-collateralization of prepetition debt with unencumbered estate property in the context of debtor in possession financing).

n54

54. 11 U.S.C. § 102.

n55

55. *Armstrong v. Norwest Bank*, 964 F.2d 797 (8th Cir. 1992) (authority given *ex parte* to use cash collateral when necessary for debtor to maintain operations); *Owens-Corning Fiberglass Corp. v. Center Wholesale, Inc. (In re Center Wholesale, Inc.)*, 759 F.2d 1440, 1449 & n.21, 12 C.B.C.2d 1107, 1118 & n.21 (9th Cir. 1985); *Travelers Ins. Co. v. Plaza Family P'ship (In re Plaza Family P'ship)*, 95 B.R. 166 (E.D. Cal. 1989) (cash collateral hearing on seven days notice not an abuse of discretion).

n56

56. Pub. L. No. 103-394, § 114 (1994).

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57. Notice by certified mail is also not required when the institution has appeared by its attorney, in which case the attorney may be served by first class mail.

n58

58. *Fed. R. Bankr. P. 6004(g)*.

n59

59. See U.C.C. § 9-306(2) (1995) (provides, in part, that a security interest continues in any *identifiable* proceeds including collections received by the debtor. (emphasis supplied)); see also *In re Patio & Porch Sys., Inc.*, 194 B.R. 569 (Bankr. D. Md. 1996).

n60

60. *Scottsdale Medical Pavilion v. Mutual Benefit Life Ins. in Rehabilitation (In re Scottsdale Medical*

Pavilion), 159 B.R. 295 (B.A.P. 9th Cir. 1993), *aff'd*, 52 F.3d 244 (9th Cir. 1995) (rents collected prepetition are cash collateral and subject to the use limitations of section 363).

n61

61. *See Reconstruction Fin. Corp. v. Kaplan*, 185 F.2d 791 (1st Cir. 1950). Section 552(a) limits the effect of after-acquired property clauses in bankruptcy, but section 552(b) validates, unless inequitable, the secured creditor's right to proceeds to the extent provided by contract and applicable law. *In re J. Catton Farms, Inc.*, 779 F.2d 1242 (7th Cir. 1985); Section 9-315(d)(3) of the Uniform Commercial Code limits the security interest of a secured creditor in second generation proceeds acquired with cash proceeds to proceeds of a type as to which the security interest attaches and the secured creditor has already perfected its security interest or perfects within 20 days after it attaches.

n62

62. *Freightliner Mkt. Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368 (9th Cir. 1987).

n63

63. *See, e.g., In re Carey*, 202 B.R. 796 (Bankr. M.D. Ga. 1996); *Woods v. John Fox Oldsmobile (In re Woods)*, 97 B.R. 850 (Bankr. W.D. Va. 1989).

ABOUT THE AUTHOR(S):

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148 of 197 DOCUMENTS

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Collier on Postpetition Disclosure Requirements (Ch. 11)

2008 Emerging Issues 1294

Collier on Postpetition Disclosure Requirements (Ch. 11)

By Collier

December 4, 2007

SUMMARY: This Emerging Issues Analysis discusses topics covered by section 1125, including the requirement that the written disclosure statement be transmitted to holders of claims and interests, the requirement that the disclosure statement contain adequate information, solicitation after commencement of the case, special provisions on disclosure statements applicable in small business cases, and types of information to be addressed in the disclosure.

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ARTICLE: Section 1125 Requirements

Section 1125 of the Bankruptcy Code deals with the requirements for the disclosure of information to those whose votes on a plan are being solicited.

Written Disclosure Statement Required to Be Transmitted to Holders of Claims and Interests. Section 1125 requires that, other than in small business cases under section 1125(f), a written disclosure statement approved by the court after notice and hearing be transmitted to holders of claims and interests together with the plan or a summary of the plan. Postpetition solicitation of acceptances or rejections of a plan may be made only at the time of, or after transmission of, the disclosure statement.

Disclosure Statement Must Contain Adequate Information." Section 1125(a)(1) requires that the disclosure statement contain adequate information in sufficient detail as far as reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's financial records. It must be such information as would enable a hypothetical reasonable investor (typical of the holders of claims and interest of the relevant class) to make an informed judgment about the plan. Adequate information includes a discussion of the potential material federal tax consequences of the plan to the debtor, any successor to the debtor and the hypothetical reasonable investor. n1 However, adequate information need not include information about any other possible or proposed plan. n2 Section 1125(a)(2) defines the hypothetical investor referred to in subsection (a)(1) as an investor having a claim or interest of the relevant class; such a relationship with the debtor as the holders of other claims or interests of such class generally have; and such ability to obtain such information from sources other than the disclosure required by section 1125 as holders of claims or interests

in such class generally.

Ultimately the bankruptcy court will determine whether the requirement of adequate information has been met, and the court in making the determination is required to conduct a cost-benefit analysis, weighing the benefit of additional information against the cost of providing such information. The statute does not indicate what constitutes additional information, but it may be assumed that the additional information referred to in section 1125(a)(1) would include the federal tax information specified in amended section 1125(a)(1). n3

Solicitation after Commencement of Case. Section 1125(b) forbids solicitation of an acceptance or rejection of a plan after the commencement of a case unless the entity whose vote is being solicited has an opportunity to review the plan, or a summary of the plan, and a disclosure statement approved by the court after notice and a hearing.

Section 1125(g), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act"), n4 provides that, [n]otwithstanding subsection (b), an acceptance or rejection of a plan may be solicited without an approved disclosure statement if the solicitation complies with applicable nonbankruptcy law and the holder of the claim or interest was solicited before the case in a manner complying with applicable nonbankruptcy law.

Different Disclosure Statement May Be Transmitted to Different Classes. Section 1125(c) recognizes that information necessary for an informed judgment may differ among classes and therefore permits different disclosure statements for different classes, provided that the same statement be transmitted to each member of a particular class.

Disclosure Statement Information Need Not Follow Otherwise Applicable Federal or State Law. Section 1125(d) provides that the information contained in a disclosure statement need not follow otherwise applicable federal or state law. It also provides that an agency, such as the Securities and Exchange Commission, may be heard on the issue of adequacy of information. The agency, however, may not appeal from or otherwise seek review of an order approving a disclosure statement.

Person Soliciting Acceptance or Rejection of Plan Provided with Safe Harbor" from Liability. Section 1125(e) provides any person who solicits acceptance or rejection of a plan on the basis of an approved disclosure statement with a safe harbor from liability for violation of state or federal securities laws or regulations.

Special Provisions on Disclosure Statements Applicable in Small Business Cases. Section 1125(f)(1), as amended in 2005, n5 provides that if the case is a small business case, as that term is defined in *section 101 of the Bankruptcy Code*, n6 the court may determine that the plan itself provides adequate information and that a separate disclosure statement is not necessary. In addition, section 1125(f)(2), also added in 2005, provides that the court may approve a disclosure statement submitted on standard forms approved by the court or adopted under section 2075 of title 28, which is the Rules Enabling Act. n7

Finally, under section 1125(f)(3), the court, subject to final approval after notice and a hearing, may conditionally approve a disclosure statement as the basis for solicitation of votes on a plan. Provided that the conditionally approved disclosure statement is mailed not later than 25 days before the date of the hearing on confirmation of the plan, the court may conduct a combined hearing for final approval of the disclosure statement and confirmation of the plan.

Federal Rules of Bankruptcy Procedure and Local Rules. Section 1125 must be read in conjunction with the relevant *Federal Rules of Bankruptcy Procedure* 2002, 2019, 3016 and 3017 and any applicable local rules.

Disclosure Requirements

Disclosure is the pivotal concept in reorganization practice under the Bankruptcy Code. n8 As described in the House Report:

If adequate disclosure is provided to all creditors and stock holders whose rights are to be affected, then they should be able to make an informed judgment of [sic] their own rather than having a court or the Securities and Exchange Commission inform them in advance whether the proposed plan is a good plan. Therefore, the key to the consolidated chapter is the disclosure section. n9

In a plan, the proponent is offering cash or securities to a captive group consisting of the creditors and equity holders of the debtor. To protect those who are entitled to vote to accept or reject the proposed plan, the Code requires that a plan proponent transmit to these captive investors information adequate to enable a hypothetical reasonable investor, typical of the holders of claims or interests of the relevant class, to make an informed judgment about the plan. The Code attempts to define both adequate information and a typical investor.

Adequate Information Defined. The definition of adequate information in section 1125(a)(1) requires that a disclosure statement include information in sufficient reasonable detail as far as is practicable. One court has said that the disclosure statement must clearly and succinctly inform the average unsecured creditor what it is going to get, when it is going to get it, and what contingencies there are to getting its distribution. n10 That analysis would seem to comport with the flexibility envisioned by the drafters of section 1125. As stated in the legislative history:

Precisely what constitutes adequate information in any particular instance will develop on a case-by-case basis. Courts will take a practical approach as to what is necessary under the circumstances of each case, such as the cost of preparation of the statements, the need for relative speed in solicitation and confirmation, and, of course, the need for investor protection. There will be a balancing of interests in each case. In reorganization cases, there is frequently great uncertainty. Therefore the need for flexibility is greatest. n11

The 2005 Act n12 amended section 1125(a)(1) to require that adequate information include a discussion of federal tax consequences of the plan to the debtor, any successor to the debtor and a hypothetical investor typical of the holders of claims or interests in the case. As amended, subsection (a)(1) further provides that in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information. n13

Practical Approach as to What Is Necessary under the Circumstances. The legislative history concepts of taking a practical approach, considering what is necessary under the circumstances, such as the cost of preparation and the need for speed were heeded in the early experiences under the Code which sought to retain the advantages of Chapter XI of the former Bankruptcy Act. n14 Increasingly, however, the legislative history concept of the need for investor protection has induced courts to promulgate disclosure statement standards which, if complied with, would all but doom the small and medium size businesses which might have been able to make use of former Chapter XI.

Congress may have been aware of this trend when, in amending section 1125(a)(1) in 2005 to require a discussion

of the federal tax consequences of the plan, it also required that the the court weigh the benefit of supplying additional information against the cost of obtaining it. n15

Recognition of Plan Proponent's Potential Inaccessibility to Accurate Debtor Financial Data. The definition of adequate information recognizes that the proponent of a plan may not have access to accurate present or past financial data concerning the debtor, particularly in those cases where the plan may be proposed by a creditor or other party in interest. n16 Thus, section 1125(a)(1) qualifies the concept of adequate information so as to require only such information as may reasonably be furnished, particularly if the debtor's books and records are unavailable, the accuracy of the books and records are in doubt or the debtor is under the control of a trustee who is unable to produce the kind of information concerning the debtor's business which ordinarily might be expected from a debtor's management. n17

Types of Information to Be Addressed in Disclosure Statement. A number of courts have provided lists of the type of information which they believe should be addressed by a disclosure statement. One court indicated that the following information should be included:

- . the circumstances that gave rise to the filing of the chapter 11 petition;
- . a complete description of the available assets and their value;
- . the anticipated future of the debtor;
- . the source of the information provided in the disclosure statement;
- . a disclaimer, which typically indicates that no statements or information concerning the debtor or its assets or securities are authorized, other than those set forth in the disclosure statement;
- . the condition and performance of the debtor while in chapter 11;
- . information regarding claims against the estate;
- . a liquidation analysis setting forth the estimated return that creditors would receive under chapter 7;
- . the accounting and valuation methods used to produce the financial information in the disclosure statement;
- . information regarding the future management of the debtor, including the amount of compensation to be paid to any insiders, directors, and/or officers of the debtor;
- . a summary of the plan of reorganization;
- . an estimate of all administrative expenses, including attorney's fees and accountant's fees;
- . the collectibility of any accounts receivable;
- . any financial information, valuations or pro forma projections that would be relevant to creditors' determinations of whether to accept or reject the plan;
- . information relevant to the risks being taken by the creditors and interest holders;
- . information relevant to the risks being taken by the creditors and interest holders;

- . the actual or projected value that can be obtained from avoidable transfers;
- . the existence, likelihood and possible success of nonbankruptcy litigation;
- . the tax consequences of the plan; n18 and
- . the relationship of the debtor with affiliates. n19

It should be emphasized that these standards appear in reported cases that involve medium to large reorganizations, often where securities are to be issued. Seldom reported are the small and medium-size business cases where the creditor body is made up of a landlord, a financial institution with a blanket lien and several vendors. The plans in such cases usually consist of either a composition or an extension or a combination of both and would not require the kind of detailed and expensive disclosure contemplated by these lists. Even the judges who promulgate these detailed standards may not strictly impose them on small and medium businesses.

It has been stated that, at a minimum, the disclosure statement should contain:

- . a description of the business;
- . its history;
- . financial information;
- . a description of the plan;
- . facts respecting its execution;
- . a liquidation analysis;
- . identification of management and its compensation;
- . transactions with insiders; and
- . tax consequences of the plan. n20

The presence of internal inconsistencies within the disclosure statement should not be an automatic bar to its approval since the inconsistencies serve to illustrate to the voter the problems inherent in the proposed plan. n21

One court has said that it would approve supplemental solicitation materials provided by proponents and opponents to a plan to be transmitted with the disclosure statement if the materials focus on the strengths or weaknesses of the plan (or elements of the plan), rather than the plan's proponents or supporters not be *ad hominem*, and not purport to describe the thinking, motives, strategies or states of mind, of their opponents. While [the supplemental materials] should not talk about the purpose of an opponent's plan position, they can properly talk about its *effect*. n22

A chapter 11 plan proponent has a duty to disclose potential adversary proceedings against creditors before they vote on the plan. n23 While some courts have said that it is not necessary for the disclosure statement to reveal the debtor's plans respecting recovery of preferences, n24 a statement that there are no preference actions impliedly means the debtor may not, postconfirmation, commence such an action for its own benefit. n25 Courts have emphasized that disclosure statements must contain factual support for any opinions contained therein since opinions alone do not provide the parties voting on the plan with sufficient information upon which to formulate decisions. n26

Section 1125(a)(1) was amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984 n27 to

address the issue of the sufficiency of a disclosure statement which does not discuss other plans filed in a case when the exclusivity period had expired or been terminated. The amendment supports those cases which hold that a disclosure statement does not have to disclose the existence of other plans or the terms of such plans. n28

Consideration of Investor Typical of Holders of Claims or Interest of the Relevant Class. The definition of adequate information contained in section 1125(a)(1) must be considered in conjunction with the phrase investor typical of holders of claims or interest of the relevant class, defined in section 1125(a)(2). That definition acknowledges that the quality of information available to members of a given class will vary as will the sophistication of members of various classes. n29

For example, a trade creditor may have a general unsecured claim for \$1,000 and be a member of a class which includes a commercial bank holding a claim of \$1 million. The bank presumably will be more sophisticated in financial matters than the trade creditor and, depending on the circumstances of the case, may have access to detailed current and historical financial information concerning the debtor's business which is not, and has not been, available to the trade. Trade creditors, on the other hand, may have information with respect to the debtor's business and the sophistication necessary to interpret such information which is not enjoyed by the debtor's debenture holders or shareholders.

Therefore, with respect to each class, the court should consider the needs of the claims or interests of the class as a whole and not the needs of its most sophisticated or least sophisticated members. n30 The court must also consider whether the typical member of a class is able to obtain sufficient information to make a reasonable judgment from sources other than the disclosure statement. n31

Adequacy of Disclosure Is Not Governed by Otherwise Applicable Nonbankruptcy Law. Section Section 1125(d) specifically provides that the adequacy of disclosure is not to be governed by any otherwise applicable nonbankruptcy law, rule or regulation. n32 As stated in the House Report:

The bill also permits the disclosure statement to be approved without the necessity for compliance with the very strict rules of Section 5 of the Securities Act of 1933, section 14 of the Securities Exchange Act of 1934, or relevant State securities laws. Without such a provision, the court would have no discretion in approving disclosure statements that go to public classes, but would be required in every case to require a full proxy statement or prospectus whenever public classes were solicited [*sic*]. Such a statement requires certified audited financial statements and extensive information. The cost of developing a prospectus or proxy statement for a large company often runs well over \$1 million. That cost would be nearly prohibitive in a bankruptcy reorganization. In addition, the information normally required under section 14 may simply be unavailable, because of the condition of the debtor. Finally, court supervision of the contents of the disclosure statement will protect the public investor from any serious inadequacies in the disclosure statement.

The provision does not prohibit a section 14-type statement or a prospectus. In some cases it may indeed be appropriate to go to that length in disclosure. The courts will have to determine the need on a case-by-case basis. The section merely does not require it in every public case. n33

Obviously, in the case of a company that has outstanding public securities, the Securities and Exchange Commission will be an important participant in a chapter 11 case. n34

For a complete discussion of Code section 1125, see Collier on Bankruptcy, ch. 1125 (Matthew Bender).

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n1 1. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub L. No. 109-8, § 717 (2005), effective in cases commenced on or after October 17, 2005, added language requiring a discussion of the federal tax consequences to the debtor and other parties.

n2

2. The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353 (1984), added to the definition of adequate information set forth in section 1125(a)(1), but adequate information need not include such information about any other possible or proposed plan.

n3

3. *See* note 1.

n4

4. Pub L. No. 109-8, § 408 (2005), effective in cases commenced on or after October 17, 2005.

n5

5. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 431(2) (2005), effective in cases commenced on or after October 17, 2005. Section 1125(f) was added to the Bankruptcy Code by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994).

n6

6. *101 U.S.C. § 101(51C)*, as amended by Pub. L. No. 109-8, § 432(a) (2005), effective in cases commenced on or after October 17, 2005.

n7

7. The language of section 1125(f)(2), by referring to section 2075 of title 28, appears to require that the

Supreme Court promulgate the disclosure statement form. However, *Rule 9009 of the Federal Rules of Bankruptcy Procedure*, a rule promulgated by the Supreme Court under the Rules Enabling Act, delegates the promulgation of Official Forms to the Judicial Conference of the United States. This raises the question whether section 1125(f)(2) would be satisfied if the disclosure statement form is adopted by the Judicial Conference, but not the Supreme Court. This question appears to have been answered, however, by section 433 of the 2005 Act, which directs that within a reasonable time after the Act's effective date the Judicial Conference of the United States shall prescribe official standard form disclosure statements and plans of reorganization for small business debtors, balancing the needs of the court with economy and simplicity for debtors. Therefore, the better view is that that a disclosure statement form approved by the Judicial Conference will satisfy the requirement under section 1125(f)(2) that the form be adopted under section 2075 of title 28.

8. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 226-31 (1977). The congressional intent to require full disclosure for reorganization purposes is made abundantly clear in chapter 11. *In re Cyr Bros. Meat Packing, Inc.*, 1 C.B.C.2d 426, 2 B.R. 620 (Bankr. D. Me. 1980).

n9

9. H.R. Rep. No. 95-595, 95th Cong., 1st Sess., 226 (1977).

n10

10. *In re Ferretti*, 128 B.R. 16 (Bankr. D.N.H. 1991). The court in *In re Texas Extrusion Corp.*, 844 F.2d 1142, 1156-57 (5th Cir.), cert. denied, 488 U.S. 926, 109 S. Ct. 311, 30 L. Ed.2d 330 (1988), held that what is adequate is decided on a case by case basis and is left largely to the discretion of the bankruptcy court. *Mabey v. Southwestern Elec. Power Co. (In re Cajun Elec. Power Coop., Inc.)*, 150 F.3d 503, 518 (5th Cir. 1998); see also *In re River Village Assocs.*, 181 B.R. 795, 804 (E.D. Pa. 1995); *In re Applegate Property, Ltd.*, 133 B.R. 827 (Bankr. W.D. Tex. 1991).

n11

11. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 409 (1977).

n12

12. Pub L. No. 109-8, § 717 (2005), effective in cases commenced on or after October 17, 2005.

n13

13. Pub. L. No. 109-8, § 431(1) (2005). The term additional information, to which the court must apply a

cost-benefit test is not defined in the Code, and it is unclear whether it includes the tax information required by amended section 1125(a)(1).

n14

14. Chapter XI was originally designed for use by the nonpublic, small business. It contains a quick procedure for an arrangement of a business unsecured debts. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 222 (1977); *cf. In re Bel Air Assocs.*, 2 C.B.C.2d 103, 4 B.R. 168 (Bankr. W.D. Okla. 1980), where the court suggested that a plan could function as a disclosure statement.

n15

15. Pub. L. No. 109-8, §§ 717, 431(1) (2005).

n16

16. *In re Michelson*, 141 B.R. 715 (Bankr. E.D. Cal. 1992).

n17

17. *See In re Werth*, 8 C.B.C.2d 480, 29 B.R. 220 (D. Colo. 1983); *In re Stanley Hotel, Inc.*, 5 C.B.C.2d 64, 13 B.R. 926 (Bankr. D. Colo. 1981).

n18

18. As noted above, *see Adequate Information Defined supra*, amended section 1125(a)(1) provides that adequate information includes discussion of the potential material Federal tax consequences of the plan.

n19

19. *In re Scioto Valley Mortgage Co.*, 88 B.R. 168 (Bankr. S.D. Ohio 1988); *see also In re A.C. Williams Co.*, 25 B.R. 173 (Bankr. N.D. Ohio 1982). The list of 19 factors also appears in *In re U.S. Brass Corp.*, 194 B.R. 420, 424 (Bankr. E.D. Tex. 1996) (also holding that the proponent of a disclosure statement need not speculate about the value of litigation which involves complex legal and factual issues.). When a disclosure statement did not give a secured creditor adequate notice that its security interest would be altered by the chapter 11 plan, its claims were not affected by the plan. *American Bank & Trust Co. v. Jarrdine Ins. Servs. Tex., Inc. (In re Barton Indus., Inc.)*, 104 F.3d 1241, 1246 (10th Cir. 1997) (distinguishing *Turney v. Federal Deposit Ins. Corp.*, 18

F.3d 865 (10th Cir. 1994) in which disclosure statement notice was held to be adequate).

n20

20. *In re Malek*, 10 C.B.C.2d 189, 35 B.R. 443 (Bankr. E.D. Mich. 1983).

n21

21. See *In re A.C. Williams Co.*, 25 B.R. 173 (Bankr. N.D. Ohio 1982); *In re Stanley Hotel, Inc.*, 5 C.B.C.2d 64, 13 B.R. 926 (Bankr. D. Colo. 1981); *In re Hughes Marina, Inc.*, 16 B.R. 6 (Bankr. W.D.N.Y. 1980).

n22

22. *In re Adelphia Communications Corp.*, 352 B.R. 592, 602 (Bankr. S.D.N.Y. 2006) (emphasis in original).

n23

23. *In re Coastal Group Inc.*, 13 F.3d 81 (3d Cir. 1994).

n24

24. *In re Jennings, Inc.*, 12 C.B.C.2d 130, 46 B.R. 167 (Bankr. E.D. Pa. 1985). But see *In re H.R.P. Auto Ctr., Inc.*, 130 B.R. 247 (Bankr. N.D. Ohio 1991), holding that the failure to disclose potential litigation in the disclosure statement precludes its subsequent prosecution.

n25

25. *In re Galerie Des Monnaies of Geneva Ltd.*, 13 C.B.C.2d 1176, 55 B.R. 253 (Bankr. S.D.N.Y. 1985); see *Payless Wholesale Distribs., Inc. v. Alberto Culver (P.R.), Inc.*, 989 F.2d 570 (1st Cir.), cert. denied, 510 U.S. 931, 114 S. Ct. 344, 126 L. Ed. 2d 309 (1993) (a debtor who represented that it had no claims other than those listed in the petition was estopped from asserting claims not disclosed on the schedules or in the disclosure statement); see also *Krystal Cadillac-Oldsmobile GMC Truck, Inc. v. General Motors Corp.*, 337 F.3d 314, 321 (3d Cir. 2003) (disclosing claims as, Tort, contract, and violation of automatic stay claims against General Motors Acceptance Corporation was boilerplate language not adequate to provide the level of notice required); *Oneida Motor Freight, Inc. v. United Jersey Bank*, 848 F.2d 414, 416-18 (3d Cir.), cert. denied, 488 U.S. 967, 109 S. Ct. 495, 102 L. Ed. 2d 532 (1988); *In re Kelley*, 199 B.R. 698, 703 (B.A.P. 9th Cir. 1996) (adequate information should also include potential counterclaims against a secured lender which would extinguish that

lender's entire claim; the court held that a blanket reservation is insufficient to prevent the application of *res judicata* to a specific action); *In re Metrocraft Publishing Servs., Inc.*, 10 C.B.C.2d 1182, 39 B.R. 567 (Bankr. N.D. Ga. 1984) (statement should indicate value of recoverable preferences, tax attributes, relationship with affiliates). *But see In re Envirodyne Indus.*, 183 B.R. 812, 822 (Bankr. N.D. Ill. 1995), in which a creditor sued postpetition could not be said to have relied upon the disclosure statement because it was unimpaired and was to be paid in full under the plan.

n26

26. *See In re Fierman*, 21 B.R. 314 (Bankr. E.D. Pa. 1982); *In re East Redley Corp.*, 16 B.R. 429 (Bankr. E.D. Pa. 1982); *In re Civitella*, 15 B.R. 206 (Bankr. E.D. Pa. 1981).

n27

27. Pub. L. No. 98-353, § 509(a) (1984).

n28

28. *See, e.g., In re Brandon Mill Farms, Ltd.*, 10 C.B.C.2d 283, 37 B.R. 190 (Bankr. N.D. Ga. 1984); *In re Civitella*, 14 B.R. 151 (Bankr. E.D. Pa. 1981), *reh'g denied*, 15 B.R. 206 (Bankr. E.D. Pa. 1981); *In re Stanley Hotel, Inc.*, 5 C.B.C.2d 64, 68, 13 B.R. 926 (Bankr. D. Colo. 1981).

n29

29. *In re Bloomingdale Partners*, 28 C.B.C.2d 1600, 155 B.R. 961 (Bankr. N.D. Ill. 1993).

n30

30. *Cf. In re Tenn-Fla Partners*, 170 B.R. 946 (Bankr. W.D. Tenn. 1994) (information is material and should be in the disclosure statement if a hypothetical reasonable investor typical of its class would want to know it to make an informed decision). As the court said in *In re Barton Industries, Inc.*, 104 F.3d 1241, 1245 (10th Cir. 1997), In order to satisfy due process [the creditors] had to receive notice that specified the treatment of their class of claim and allowed them to make an informed judgment about [the] Chapter 11 plan.

n31

31. *In re Bloomingdale Partners*, 28 C.B.C.2d 1600, 155 B.R. 961 (Bankr. N.D. Ill. 1993) (information held

by insiders or an undersecured creditor in its own class from sources other than the disclosure statement, did not have to appear in the disclosure statement); *see also In re Northwest Recreational Activities, Inc.*, 8 B.R. 10 (Bankr. N.D. Ga. 1980); *In re Bel Air Assocs.*, 2 C.B.C.2d 103, 4 B.R. 168 (Bankr. W.D. Okla. 1980).

n32

32. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 227-29 (1977); *see Kirk v. Texaco, Inc.*, 18 C.B.C.2d 331, 82 B.R. 678 (S.D.N.Y. 1988).

n33

33. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 227-29 (1977); *see 11 U.S.C. § 1109(a)*.

n34

34. *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 229 (1977).

ABOUT THE AUTHOR(S):

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149 of 197 DOCUMENTS

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Collier on the Power to Dismiss or Convert a Ch 13 Case

2008 Emerging Issues 1306

Collier on the Power to Dismiss or Convert a Ch 13 Case

By Collier

December 4, 2007

SUMMARY: This Emerging Issues Analysis discusses the power to dismiss or convert a chapter 13 case to chapter 7 under section 1307 of the Bankruptcy Code, including topics such as unreasonable delay by the debtor, nonpayment of filing fees or other charges, failure to make timely filing of a plan, failure to commence making timely payments, denial of confirmation of an original plan, and material default in a term of the confirmed plan.

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ARTICLE: In cases in which dismissal or conversion is not a matter of right under the Bankruptcy Code, upon the request of the debtor, a creditor, the chapter 13 trustee n1 or the United States trustee, n2 the court may dismiss n3 or convert a chapter 13 case to chapter 7, n4 whichever is in the best interests of creditors and the estate. n5 The court may act under *section 1307(c) of the Bankruptcy Code*, which was amended in 2005, n6 only on the request of a party in interest n7 or the United States trustee n8 and after notice and a hearing, n9 for cause. n10 Although it has been held that the chapter 13 trustee is not a party in interest who may file such a motion, n11 courts generally have held otherwise. n12 Dismissal may also be obtained, on motion of a party in interest or the United States trustee, if the debtor fails to file a tax return required under section 1308, another provision added in 2005. n13

Most courts have held that a bankruptcy court cannot dismiss a case *sua sponte* under section 1307 or analogous sections in other chapters of the Code. n14 However, a 1986 amendment to section 105(a) of the Code gives the court the power to *sua sponte* take any action necessary to enforce or implement court orders or rules, or to prevent an abuse of process, and that section, as amended, presumably would give the court the power to dismiss a case *sua sponte*. n15 In any case, with the presence of the United States trustee, whose duty it is to monitor such matters and make appropriate motions to dismiss, this extraordinary power of the court should rarely be exercised. In such cases in which the court does consider *sua sponte* dismissal, the principles underlying section 1307 dictate that all parties in interest should be given notice and an opportunity for a hearing.

The court may not convert the chapter 13 case of a farmer n16 to chapter 7, except at the request of the farmer-debtor. n17 Furthermore, although not specifically mentioned in section 1307(c), the court may not convert a case *originally* commenced under chapter 13 to chapter 7 pursuant to section 1307(c) if the debtor has requested dismissal of the chapter 13 case under section 1307(b). n18

The procedure for dismissals that are not a matter of right is governed by *Federal Rule of Bankruptcy Procedure 1017*. The rule requires a hearing on notice in all such cases. n19 Unless the debtor has already filed a list of creditors, the debtor must provide the court with the names and addresses of all creditors so notice of the hearing may be given to them. n20

The only exceptions to this rule are a motion to dismiss for failure to pay filing fees and a motion under section 1307(c)(9) for failure to timely file required documents. n21 In such cases, *Federal Rule of Bankruptcy Procedure 1017(b)* and (c), as amended in 1991 and 1999, speaks only of notice to the debtor and the trustee, which seems to limit the more general language of Rule 1017(a). However, if the case is dismissed, notice of the dismissal must be given to all creditors pursuant to *Federal Rule of Bankruptcy Procedure 2002*. n22

Notice of a dismissal hearing is important because creditors' interests may differ; some creditors may oppose a dismissal sought by other creditors, the trustee, the United States trustee or the debtor. A motion to dismiss a case, other than one filed by the debtor as a matter of right, is treated by the rules as a contested matter under *Federal Rule of Bankruptcy Procedure 9014*, n23 which incorporates many of the rules governing adversary proceedings, providing for discovery and other procedures. n24 It is incumbent upon a debtor opposing dismissal or conversion to controvert evidence submitted by the moving party, or such evidence may be deemed uncontested. n25

However, especially with respect to the debt limitations of section 109(e), n26 the courts have differed as to the extent of the hearing which should be held to consider the motion. The Court of Appeals for the Sixth Circuit held that the court should rely solely on the debtor's representations in the Chapter 13 Statement, as long as they are made in good faith. n27 This conclusion seems logical, since the hearing might otherwise require the resolution of numerous disputed claims at the very outset of the case and an inquiry into good faith should expose those cases in which debtors are clearly ineligible for relief. It is also in accord, as the Sixth Circuit court pointed out, with the procedure for disputes as to other monetary jurisdictional requirements in the federal courts. n28 However, other courts have demanded a more searching inquiry into the amount of claims against the debtor to determine initial eligibility under chapter 13. n29 In any event, if the court finds the debtor to be ineligible for chapter 13, the court has discretion either to dismiss or to convert the case, depending on the best interests of the creditors and the estate. n30 Once a chapter 13 plan has been confirmed, any motion to dismiss based on eligibility would be barred by *res judicata*. n31

Subsection Subsection 1307(c) as amended in 2005, enumerates 11 specific occurrences which constitute sufficient cause for the dismissal or conversion of a chapter 13 case to chapter 7. n32 The grounds enumerated in subsections 1307(c)(1) through (11) are not exhaustive. n33 For example, the court also has the power to dismiss the case if the debtor is not eligible to be a debtor under chapter 13 because of failure to meet the requirements of subsection 109(a), (e) or (g) of the Bankruptcy Code. n34 In addition, most courts have held that a chapter 13 case can be dismissed or converted if it is not filed in good faith. n35 Section 1307(e), added in 2005, states an additional ground for dismissal, based on failure to file required tax returns with taxing authorities. n36

Unreasonable Delay by the Debtor. The court may dismiss a chapter 13 case or convert it to chapter 7 if the debtor has been guilty of unreasonable delay prejudicial to the interests of creditors. n37 For example, in *Howard v. Lexington Investments, Inc.*, n38 the Court of Appeals for the First Circuit affirmed the dismissal of a case in which the debtor, even having been granted extensions of time by the court, had failed to comply with a court order that he file tax returns necessary to compute taxing authorities' proofs of claim, without which a plan could not be confirmed. n39 Unreasonable delay in the filing of necessary modifications of a plan, in obtaining necessary acceptances from the holders of allowed secured claims or in taking actions required under the plan are other examples of delays warranting conversion or dismissal under this paragraph. n40

Nonpayment of Filing Fees or Other Charges. Nonpayment of the \$220 filing fee prescribed by section 1930(a)(1) n41 of title 28 or of any additional charges which may be imposed pursuant to regulations prescribed by the Judicial Conference of the United States and section 1930(b) n42 of title 28, is sufficient reason for the dismissal or conversion of a chapter 13 case. n43

The procedure for dismissals based upon failure to pay the filing fee is set forth in *Federal Rule of Bankruptcy Procedure 1017(b)*. The case may be dismissed only after a hearing on notice to the debtor and the trustee. n44 If the case is dismissed, notice of the dismissal must be given within 30 days to all creditors on the list of creditors and to all creditors who have filed claims in the manner provided in *Federal Rule of Bankruptcy Procedure 2002*. n45

Failure to Make Timely Filing of Plan. Chapter 13 permits only the debtor to file a plan. n46 The failure of the debtor to cause a chapter 13 plan to be timely filed may warrant the dismissal or conversion of the chapter 13 case. n47 However, when a plan is filed in time to be reviewed by creditors without delaying other steps in the case, and no creditor is prejudiced by the delay, dismissal is rarely appropriate. n48 Only when the delay in filing the plan is prejudicial, or is part of a larger pattern of unreasonable delay, should the court exercise its discretion to dismiss the case. n49

Failure to Commence Making Timely Payments. In accord with the requirement of amended section 1326 n50 that the debtor commence making payments proposed in a chapter 13 plan, as well as other payments, within 30 days of the filing of the order for relief, n51 section 1307(c)(4) n52 adds as grounds for dismissal or conversion the debtor's failure to comply with that requirement. Such a dismissal or conversion can occur upon request of the United States trustee n53 or a party in interest, who will normally be a creditor, or the chapter 13 trustee, and may occur only after notice and a hearing. n54

As under the other subsections of section 1307(c), the court's power to dismiss or convert is discretionary. n55 The court should do neither if the default in timely commencement of payments is a minor one. Similarly, if there are extenuating circumstances, or if the reason for the default can be cured by a permissible modification of the plan, to lower the payments for example, the debtor should normally be given a second chance. Likewise, if the debtor has failed to make payments to a secured creditor or personal property lessor required by section 1326(a), the more appropriate relief, if any, would be to grant that entity relief from the automatic stay. Since the dismissal would be without prejudice in such cases, n56 a debtor intent on proceeding in chapter 13 could simply file a new case and achieve the same result as would be obtained if the court excused the default. To impose upon the debtor the added expense that would be involved in a second petition, i.e., the additional filing and attorney's fees, would serve no legitimate purpose. The filing of a second petition could also prejudice creditors with claims incurred after the first petition, which would be dischargeable in a second case, a result hardly intended by Congress.

Serious and repeated defaults, of course, may very well warrant dismissal or conversion, particularly if it appears that the plan is unworkable or the case has been filed with no *bona fide* intention of proceeding. n57 In such cases, it is also appropriate to examine the debtor's payment of his or her attorney, n58 since an attorney who knowingly submits a plan that has no chance of succeeding should not be compensated for those actions. For this reason, some courts routinely order a hearing on attorney's fees after a plan is dismissed under such circumstances.

Denial of Confirmation and of Additional Time. A chapter 13 plan may be denied confirmation by reason of failure to comply with the standards set by section 1325 n59 or a confirmed plan may no longer be feasible, thereby necessitating the submission of a new plan or of modifications to a plan. n60 The debtor should normally be given at least one opportunity to submit a modified plan in such circumstances. n61 The denial of confirmation of an original or modified plan, coupled with a final refusal by the court to grant further time for filing another plan or modifications, will result in dismissal or conversion of the chapter 13 case. n62

Material Default under Confirmed Plan. Upon the request of a party in interest or the United States trustee n63 and after notice and a hearing, n64 the court may dismiss the chapter 13 case or convert it to chapter 7 if the debtor is guilty of a material default in a term of the confirmed plan. n65 It is the burden of the moving party to present evidence of the amount of the default so that the court may evaluate it under this provision. n66 The court must determine what constitutes a material default, but the mutuality of interests in most chapter 13 cases between the holders of unsecured claims and the debtor seems likely to prompt a common effort to facilitate the curing of defaults, rather than insistence by creditors on dismissal or conversion of the case to chapter 7. When the default is caused by unexpected

circumstances beyond the debtor's control that have been remedied, the court may find that it is not a material default. n67 And even if there is a material default, dismissal or conversion is not automatic, but rather a matter of the court's discretion. n68 Generally, dismissal or conversion is appropriate only when efforts to cure a default are unsuccessful and when the plan cannot be modified to make it feasible for the debtor to complete it.

Revocation of Order of Confirmation for Fraud and Denial of Confirmation of a Modified Plan. If the order of confirmation has been revoked by the court on grounds of fraud n69 and a modified plan proposed pursuant to section 1330(b) is denied confirmation, the court may dismiss or convert the chapter 13 case to chapter 7. n70 Section 1307(c)(7) is to be read together with section 1330(b).

Section 1330(b) permits the court to allow time within which the debtor may propose a modified plan after the order confirming an earlier plan has been revoked for fraud. n71 Normally, the debtor should be given at least one opportunity to propose an acceptable modified plan. If the court refuses to grant time for the filing of a modified plan or the debtor fails to file or obtain confirmation of a modified plan within the time fixed by the court under section 1330(b), the court is required either to dismiss or to convert the case to chapter 7 in accordance with section 1307(c)(7). n72

Termination of Confirmed Plan Due to Condition Specified in Plan. A confirmed chapter 13 plan may include a provision that the plan be terminated or terminable upon the occurrence of one or more conditions specified by the plan other than completion of payments under the plan. n73 The plan may call for the termination of the plan in the event the debtor fails to comply with any one or more of the terms of the confirmed plan, such as its payment terms, provisions restricting postpetition property transfers, restrictions on obtaining postpetition credit or requirements concerning compliance with credit obligations incurred after confirmation of the plan.

Section 1307(c)(8) confers discretionary power upon the court, acting on the request of a party in interest or the United States trustee, n74 after notice and a hearing, to dismiss or convert the chapter 13 case. n75 Therefore, the violation of a termination provision in the confirmed chapter 13 plan may not result in the automatic dismissal or conversion of the chapter 13 case to chapter 7. The inclusion of any such automatic dismissal or conversion provision in a chapter 13 plan would contravene section 1307(c) and the plan would not be eligible for confirmation by reason of section 1325(a)(1). n76

Debtor's Failure to File Section 521 Information. The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 n77 added to section 1307(c) two additional paragraphs that may result in either the dismissal or conversion of the chapter 13 case to chapter 7 when the debtor has failed to comply with section 521(1) or (2).

Section 1307(c)(9) provides that, only upon the request of the United States trustee, the court may dismiss or convert a chapter 13 case to chapter 7 upon the debtor's failure to file, within 15 days or such additional time as the court may allow, the information required by section 521(1). n78 As with the failure to file a plan in a timely manner, the court should exercise its discretion to dismiss or convert a case under this section only when there has been a substantial delay in filing the necessary papers and the delay is prejudicial to creditors. n79

Section 1307(c)(10) states that, only upon the request of the United States trustee, the court may dismiss or convert a chapter 13 case to chapter 7 if the debtor fails to comply with section 521(2). n80 However, since a chapter 13 debtor is not required to file a statement of intention under section 521(2), which by its terms applies only to chapter 7 debtors, n81 this subsection should never be applied, except perhaps in the case of a debtor who has converted a case from chapter 7 to chapter 13. n82 It is an inadvertent legislative enactment and should be deleted.

Other Cause, Including Lack of Good Faith. Section 1307 (c) states that the court may dismiss or convert a case for cause, including the 10 types of cause enumerated in the section. Because the word including is not exhaustive, n83 the court may dismiss for causes other than those enumerated. Most courts have held that lack of good faith can be

cause for dismissal or conversion of a chapter 13 case. n84

It seems clear that a debtor who simply seeks to benefit from the provisions of the statute should rarely, if ever, be found to be lacking in good faith for that reason. Thus, the mere fact that a debtor has filed a previous case, n85 or seeks to discharge debt not dischargeable in chapter 7, n86 does not mean that a case is filed in bad faith. Similarly, a delay in filing until the debtor needs the automatic stay is not bad faith. n87

Courts have employed standards of good faith similar to those used in determining whether a chapter 13 plan has been proposed in good faith.⁸⁸ *In re Leavitt*,⁸⁹ the Court of Appeals for the Ninth Circuit listed the following factors as relevant in considering the totality of the circumstances:

- . whether the debtor misrepresented facts in his [petition or] plan, unfairly manipulated the Bankruptcy Code, or otherwise [filed] his Chapter 13 [petition or] plan in an inequitable manner;

- . the debtor's history of filings and dismissals;

- . whether the debtor only intended to defeat state court litigation; n90 and

- . whether egregious behavior is present. n91

In re Love, n92 the Court of Appeals for the Seventh Circuit listed a similar set of factors relevant in considering the totality of the circumstances, including:

- . the nature of the debt including the question of whether the debt would be nondischargeable in a chapter 7 proceeding;

- . the timing of the petition;

- . how the debt arose;

- . the debtors motive in filing the petition;

- . how the debtor's actions affected creditors;

- . the debtor's treatment of creditors both before and after the petition was filed; and

- . whether the debtor has been forthcoming with the bankruptcy court and the creditors. n93

Section 1325(a) was amended in 2005 by the addition of a new confirmation standard, based on the debtor having filed the petition in good faith. n94 This specific mention of good faith in filing the petition might be read to indicate that Congress intended it to be considered as a factor for plan confirmation rather than dismissal. It remains to be seen whether courts that have found lack of good faith to be grounds for dismissal will alter their rulings based upon this more recent enactment.

If courts do continue to hold that dismissal can be based upon lack of good faith, they may apply a different standard. Because dismissal is a harsher remedy than denial of plan confirmation, the showing of bad faith that must be made for dismissal should be greater than that necessary for denial of confirmation. n95 As with other grounds for dismissal, the moving party has the burden of proof on the issue of bad faith. n96

Failure to Pay Current Domestic Support Obligations. Section 1307(c)(11), added in 2005 as part of a package of amendments meant to promote the payment of support obligations, n97 renders the debtor's failure to pay domestic support obligations n98 that first become payable after the date of the petition grounds for dismissal or conversion of the case. It is important to note that this provision is limited to payments that first become due after the case is filed, and

does not look to payment of prepetition arrearages. Those arrearages are to be dealt with in the chapter 13 plan as priority debts, pursuant to other provisions of the Code. n99 Like other parts of section 1307(c), section 1307(c)(11) leaves the decision about whether to dismiss the case in the discretion of the court. The debtor may be allowed to cure the default in support payments and the court may decide that it will be more likely that the debtor can do this if the chapter 13 case remains pending. In some cases, the court may decide that making payments that have been assigned to a governmental unit is less urgent than ensuring that the debtor's family will not, as a result of a case dismissal, lose its home to foreclosure or lose a car necessary to continued production of income. However, payment of current support is also a standard for confirmation under section 1325(a)(8), and a requirement for a discharge under section 1328(a), as those sections were amended in 2005. n100

Failure to File Required Tax Returns. Section Section 1307(e), enacted by the 2005 amendments to the Bankruptcy Code, n101 provides that the court shall dismiss the case or convert it to chapter 7, whichever is in the best interests of creditors and the estate, if the debtor does not file a tax return under section 1308, which was enacted at the same time. n102 This dismissal provision can be invoked by a party in interest, presumably a taxing authority, or the United States trustee and the case can be dismissed only after notice and a hearing.

For a complete discussion of Code section 1307, see Collier on Bankruptcy, ch. 1307 (Matthew Bender).

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n1 1. *11 U.S.C. § 1307(c)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. The United States trustee program is not scheduled to become operational in judicial districts in Alabama and North Carolina. Pub. L. No. 99-554, § 302(d)(3) (1986), as amended by the Federal Courts Improvement Act of 2000, Pub. L. No. 106-518, effective November 13, 2000, which removed the October 1, 2002, deadline for Alabama and North Carolina to elect to participate in the United States trustee program. Most of the functions of the United States trustee are carried out in those districts by a bankruptcy administrator appointed by the court under Pub. L. No. 99-554, § 302(d)(3)(I).

n3

3. *11 U.S.C. § 1307(c)*.

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4. 11 U.S.C. § 1307(c).

n5

5. 11 U.S.C. § 1307(c); see H.R. Rep. No. 595, 95th Cong., 1st Sess. 428 (1977).

n6

6. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n7

7. 11 U.S.C. § 1307(c). But cf. 11 U.S.C. § 1330(b); see Revocation of Order of Confirmation for Fraud and Denial of Confirmation of a Modified Plan; § 1307(c)(7) *infra*.

n8

8. The United States trustee program is not scheduled to become operational in judicial districts in Alabama and North Carolina. Pub. L. No. 99-554, § 302(d)(3) (1986), as amended by the Federal Courts Improvement Act of 2000, Pub. L. No. 106-518, effective November 13, 2000, which removed the October 1, 2002, deadline for Alabama and North Carolina to elect to participate in the United States trustee program.

n9

9. See 11 U.S.C. § 102(1); see *Collier on Bankruptcy*, 1300.07[1][a] (Matthew Bender).

n10

10. See Power to Dismiss or Convert Case to Chapter 7; § 1307(c) & (e); *Fed. R. Bankr. P. 1017 infra*.

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11. *In re Kutner*, 2 C.B.C.2d 34, 3 B.R. 422 (Bankr. N.D. Tex. 1980), appeal dismissed, 656 F.2d 1107, 5 C.B.C.2d 58 (5th Cir. 1981), cert. denied, 455 U.S. 945, 102 S. Ct. 1443, 71 L. Ed. 2d 658 (1982).

n12

12. *In re Faaland*, 37 B.R. 407 (Bankr. D.N.D. 1984); *In re Kelsey*, 2 C.B.C.2d 1192, 6 B.R. 114 (Bankr. S.D. Tex. 1980).

n13

13. 11 U.S.C. §§ 1307(e), 1308, enacted by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see Failure to File Required Tax Returns; § 1307(e) *infra* and Collier on Bankruptcy, ch. 1308 (Matthew Bender).

n14

14. *In re Terry*, 630 F.2d 634, 636 n.5, 2 C.B.C.2d 1237, 1240 n.5 (8th Cir. 1980); *Griswold v. Banco Central (In re Lozano)*, 11 C.B.C.2d 1424, 42 B.R. 971 (D.P.R. 1984); see also *In re Moog*, 774 F.2d 1073, 13 C.B.C.2d 910 (11th Cir. 1985) (chapter 11).

n15

15. 11 U.S.C. § 105(a), as amended by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, and as further amended by Pub. L. No. 101-650 (Judicial Improvements Act of 1990); see *In re Minkes*, 237 B.R. 476 (B.A.P. 8th Cir. 1999) (after enactment of amendment to section 105, that motion by party in interest was not required, notice and a hearing were still required).

n16

16. See 11 U.S.C. § 101; Collier on Bankruptcy, 1300.12[13] and 1300.12[9] (Matthew Bender).

n17

17. 11 U.S.C. § 1307(f), formerly § 1307(e), as redesignated by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, 1307.06 (Matthew Bender).

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18. 11 U.S.C. § 1307(b); see *Collier on Bankruptcy*, 1307.03[1] (Matthew Bender).

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19. *Fed. R. Bankr. P. 1017(a)* and (b), as amended by the 1991 amendments to the Federal Rules of Bankruptcy Procedure. The rule was amended to add a reference to dismissal of chapter 12 cases, to make reference to cause for dismissal other than want of prosecution, and to clarify that all entities required to receive notice under Rule 2002 are entitled to notice of the hearing to dismiss the case. *In re Krueger*, 88 B.R. 238 (B.A.P. 9th Cir. 1988) (dismissal order was void because debtor did not have notice of hearing on dismissal); see also *In re Badalyan*, 236 B.R. 633 (B.A.P. 6th Cir. 1999) (reversing 180-day bar on refiling after dismissal because debtor had no notice of hearing at which bar was imposed).

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20. *Fed. R. Bankr. P. 1017(a)* and (b), as amended by the 1999 amendments to the Federal Rules of Bankruptcy Procedure.

n21

21. An additional exception, not relevant in chapter 13, is a dismissal motion under section 707(b). *Fed. R. Bankr. P. 1017*, as amended by the 2000 amendments to the Federal Rules of Bankruptcy Procedure.

n22

22. See *Collier on Bankruptcy*, 1017.02 (Matthew Bender).

n23

23. *Fed. R. Bankr. P. 1017(f)(1)*, formerly 1017(d), as amended and redesignated by the 1999 amendments to the Federal Rules of Bankruptcy Procedure.

n24

24. See *Collier on Bankruptcy*, ch. 9014 (Matthew Bender).

n25

25. *See In re Blaise*, 219 B.R. 946 (B.A.P. 2d Cir. 1998).

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26. 11 U.S.C. § 109(e). Pursuant to 11 U.S.C. § 104(b), these amounts are subject to adjustment every three years beginning April 1, 1998. For cases commenced on or after April 1, 2004, the limitations are \$307,675 for unsecured debts and \$922,975 for secured debts. For the three-year period beginning April 1, 2001, the amounts are \$290,525 and \$871,550, respectively. For the three-year period beginning April 1, 1998, the amounts are \$269,250 and \$807,750, respectively. For cases commenced before April 1, 1998, the amounts are \$250,000 and \$750,000, respectively. *See* Collier on Bankruptcy, 104.03, 109.05 and 1300.40 (Matthew Bender).

n27

27. *In re Pearson*, 773 F.2d 751, 13 C.B.C.2d 749 (6th Cir. 1985). The information formerly found in the Chapter 13 Statement, an abrogated Official Form, is now found in the schedules and statement of affairs filed by the debtor.

n28

28. *In re Pearson*, 773 F.2d 751, 13 C.B.C.2d 749 (6th Cir. 1985).

n29

29. *See, e.g., In re Sylvester*, 6 C.B.C.2d 586, 19 B.R. 671 (B.A.P. 9th Cir. 1982).

n30

30. *Rudd v. Laughlin*, 866 F.2d 1040 (8th Cir. 1989); *In re Toronto*, 165 B.R. 746 (Bankr. D. Conn. 1994) (conversion preserved the ability to recover preference).

n31

31. *United States v. Edmonston*, 99 B.R. 995 (E.D. Cal. 1989).

n32

32. See 11 U.S.C. § 1307(c)(1)(11). 11 U.S.C. § 1307(c)(11) was added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n33

33. Note the use of the term including; see 11 U.S.C. § 102(3); see *Collier on Bankruptcy*, 1300.07[1][c] (Matthew Bender).

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34. 11 U.S.C. § 109(a), (e) and (g).

n35

35. *Alt v. United States (In re Alt)*, 305 F.3d 413 (6th Cir. 2002); *In re Lilley*, 91 F.3d 491 (3d Cir. 1996); *In re Eisen*, 14 F.3d 469 (9th Cir. 1994); *In re Love*, 957 F.2d 1350 (7th Cir. 1992); see Other Cause, Including Lack of Good Faith *infra*.

n36

36. 11 U.S.C. § 1307(e), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see Failure to File Required Tax Returns; § 1307(e) and *Collier on Bankruptcy*, ch. 1308 (Matthew Bender).

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37. 11 U.S.C. § 1307(c)(1).

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38. 284 F.3d 320 (1st Cir. 2002).

n39

39. *Cf. Department of the Treasury v. Pagan*, 279 B.R. 43 (D.P.R. 2002) (affirming denial of motion to dismiss for failure to file tax returns when plan had already been confirmed and taxing authority had not objected to confirmation). Failure to file such returns is now grounds for dismissal under section 1307(e), enacted by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Failure to File Required Tax Returns*; § 1307(e) and *Collier on Bankruptcy*, ch. 1308 (Matthew Bender).

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40. See, e.g., *In re Blaise*, 219 B.R. 946 (B.A.P. 2d Cir. 1998) (debtor who had converted from chapter 11 did not deny that plan was fraught with problems and he had made no efforts to market property that was to be sold under plan).

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41. 28 U.S.C. § 1930(a)(1), as most recently amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, which was itself amended by Pub. L. No. 109-13 (2005).

n42

42. In addition to the filing fee of 28 U.S.C. § 1930(a)(1), a debtor or couple commencing a chapter 13 case must also pay a miscellaneous administrative noticing fee of \$39 imposed by the Judicial Conference of the United States under 28 U.S.C. § 1930(b). See *Collier on Bankruptcy*, 1325.03[1][a][ii] (Matthew Bender).

n43

43. 11 U.S.C. § 1307(c)(2).

n44

44. *Fed. R. Bankr. P. 1017(b)*, as amended by the 1999 amendments to the Federal Rules of Bankruptcy Procedure; see *Collier on Bankruptcy*, 1017.05[3] (Matthew Bender).

n45

45. *Fed. R. Bankr. P. 1017(b)*, as amended by the 1999 amendments to the Federal Rules of Bankruptcy Procedure. *Fed. R. Bankr. P. 2002* was amended by the 2001 amendments to the Federal Rules of Bankruptcy Procedure with respect to addresses to be used in notices, among other matters. *See Collier on Bankruptcy*, ch. 2002 (Matthew Bender).

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46. *11 U.S.C. § 1321*; *see Collier on Bankruptcy*, 1321.01 (Matthew Bender).

n47

47. *11 U.S.C. § 1307(c)(3)*. *Dudley v. Powers (In re Dudley)*, 273 B.R. 197 (B.A.P. 8th Cir.), *aff'd*, *Dudley v. Powers (In re Dudley)*, 49 Fed. Appx. 91, 2002 U.S. App. LEXIS 22420 (8th Cir. Oct. 17, 2002); *Simmons v. Cosby (In re Simmons)*, 256 B.R. 578 (D. Md.), *aff'd*, *Simmons v. Cosby (In re Simmons)*, 8 Fed. Appx. 228, 2001 U.S. App. LEXIS 8442 (4th Cir. May 4, 2001).

n48

48. *In re McConnell*, 60 B.R. 310 (Bankr. W.D. Va. 1986).

n49

49. *In re Martin-Trigona*, 9 C.B.C.2d 958, 35 B.R. 596 (Bankr. S.D.N.Y. 1983) (unexplained failure to submit plan or any other financial information for four months after petition filed).

n50

50. *11 U.S.C. § 1326(a)*. Section 1326(a) was amended in 2005 by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, to require the debtor to begin, within 30 days after filing the petition, not only plan payments but also, in some cases, adequate protection payments to secured creditors and payments to personal property lessors. *See Collier on Bankruptcy*, ch. 1326 (Matthew Bender).

n51

51. The date of the order for relief is ordinarily the date of the petition. *11 U.S.C. § 301(b)*, as amended by

Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. If a case is commenced and subsequently converted to chapter 13 more than 30 days after the order for relief, because section 348(a) provides that conversion does not effect a change in the date of the order for relief, it may be impossible to commence payments within 30 days after the order for relief, as appears to be required under section 1326(a)(1). *See Collier on Bankruptcy*, ch. 1326 (Matthew Bender).

n52

52. 11 U.S.C. § 1307(c)(4).

n53

53. The United States trustee program is not scheduled to become operational in judicial districts in Alabama and North Carolina. Pub. L. No. 99-554, § 302(d)(3) (1986), as amended by the Federal Courts Improvement Act of 2000, Pub. L. No. 106-518, effective November 13, 2000, which removed the October 1, 2002, deadline for Alabama and North Carolina to elect to participate in the United States trustee program.

n54

54. 11 U.S.C. § 102(1).

n55

55. *In re McDonald*, 118 F.3d 568 (7th Cir. 1997); *In re Smith*, 85 B.R. 729 (E.D. Va. 1988).

n56

56. 11 U.S.C. § 349(a). Code section 109(g), which forbids repetitive filings, would not apply in such a case, since there would be no willful failure to abide by orders of the court or to appear before the court in proper prosecution of the case. However, under amendments to section 362(c), enacted by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, such a debtor would not automatically receive the full protection of the section 362(a) automatic stay. *See Collier on Bankruptcy*, ch. 362 (Matthew Bender).

n57

57. *See, e.g., In re Blaise*, 219 B.R. 946 (B.A.P. 2d Cir. 1998) (debtor who had converted from chapter 11

had made no payments for 11 months and had otherwise delayed case).

n58

58. *See 11 U.S.C. § 329(b)* (court may examine debtor's transactions with attorneys).

n59

59. *11 U.S.C. § 1325*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. *See generally* Collier on Bankruptcy, ch. 1325 (Matthew Bender).

n60

60. *See 11 U.S.C. § 1329*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. *See generally* Collier on Bankruptcy, ch. 1329 (Matthew Bender).

n61

61. *In re Minkes*, 237 B.R. 476 (B.A.P. 8th Cir. 1999) (submission of one unconfirmable plan not sufficient cause for dismissal); *see also In re Wilson*, 117 B.R. 714 (Bankr. M.D. Fla. 1990) (debtor permitted to submit supplemental budgetary information to cure problems identified by the court).

n62

62. *11 U.S.C. § 1307(c)(5)*; *see, e.g., Howard v. Lexington Investments, Inc.*, 284 F.3d 320 (1st Cir. 2002); *In re Badalyan*, 236 B.R. 633 (B.A.P. 6th Cir. 1999).

n63

63. The United States trustee program is not scheduled to become operational in judicial districts in Alabama and North Carolina. Pub. L. No. 99-554, § 302(d)(3) (1986), as amended by the Federal Courts Improvement Act of 2000, Pub. L. No. 106-518, effective November 13, 2000, which removed the October 1, 2002, deadline for Alabama and North Carolina to elect to participate in the United States trustee program.

n64

64. 11 U.S.C. § 102(1); see *Collier on Bankruptcy*, 1300.07[1][a] (Matthew Bender).

n65

65. 11 U.S.C. § 1307(c)(6).

n66

66. *In re Midkiff*, 85 B.R. 467 (Bankr. S.D. Ohio 1988).

n67

67. *In re Durben*, 70 B.R. 14 (Bankr. S.D. Ohio 1986); *In re Jarvis*, 7 C.B.C.2d 759, 24 B.R. 46 (Bankr. D. Vt. 1982).

n68

68. *Roberts v. Boyajian (In re Roberts)*, 279 F.3d 91 (1st Cir. 2002) (no abuse of discretion in dismissing case when debtors failed to pay over sixty months all amounts that plan had provided that creditors would receive); *In re Green*, 64 B.R. 530 (B.A.P. 9th Cir. 1986).

n69

69. See 11 U.S.C. § 1330(a); *Collier on Bankruptcy*, 1330.01[2][b] (Matthew Bender).

n70

70. 11 U.S.C. § 1307(c)(7); *In re Scott*, 77 B.R. 636 (Bankr. N.D. Ohio 1987).

n71

71. 11 U.S.C. § 1330(b).

n72

72. 11 U.S.C. § 1330(b).

n73

73. 11 U.S.C. § 1322(b)(10). The words other than completion of payments under the plan were added to section 1307(c)(8) by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353 (1984). The legislative history describes this as a stylistic change. S. Rep. No. 65, 98th Cong., 1st Sess. 86 (1983).

n74

74. The United States Trustee Program is not scheduled to become operational in judicial districts in Alabama and North Carolina. Pub. L. No. 99-554, § 302(d)(3) (1986), as amended by the Federal Courts Improvement Act of 2000, Pub. L. No. 106-518, effective November 13, 2000, which removed the October 1, 2002, deadline for Alabama and North Carolina to elect to participate in the United States Trustee Program.

n75

75. 11 U.S.C. § 1307(c)(8).

n76

76. 11 U.S.C. § 1325(a)(1); see *Collier on Bankruptcy*, 1325.02[2] (Matthew Bender).

n77

77. Pub. L. No. 99-554.

n78

78. 11 U.S.C. § 521(1) concerns the debtor's duty to file a list of creditors, a schedule of assets and liabilities, a schedule of current income and current expenditures and a statement of financial affairs; see *Collier*

on Bankruptcy, ch. 521 (Matthew Bender). 11 U.S.C. § 521(1) was redesignated as section 521(a)(1) and amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, but section 1307(c)(9) was not amended to reflect these changes.

n79

79. See Failure to Make Timely Filing of Plan; § 1307(c)(3) *supra*.

n80

80. 11 U.S.C. § 521(2) concerns the duty of an individual debtor to file a statement of the debtor's intention to retain or surrender property being used to secure consumer debt. See *Collier on Bankruptcy*, 521.10 (Matthew Bender). 11 U.S.C. § 521(2) was redesignated as section 521(a)(2) and amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, but section 1307(c)(10) was not amended to reflect these changes.

n81

81. See also *Fed. R. Bankr. P. 1007(b)(2)*, as amended by the 1991 amendments to the Federal Rules of Bankruptcy Procedure (filing of a statement of intention required only in a chapter 7 case).

n82

82. See *Collier on Bankruptcy*, 1300.80[2] (Matthew Bender).

n83

83. 11 U.S.C. § 102(3); see *Collier on Bankruptcy*, 102.04 (Matthew Bender).

n84

84. *E.g.*, *Alt v. United States (In re Alt)*, 305 F.3d 413 (6th Cir. 2002); *In re Lilley*, 91 F.3d 491 (3d Cir. 1996); *In re Molitor*, 76 F.3d 218 (8th Cir. 1996); *In re Eisen*, 14 F.3d 469 (9th Cir. 1994).

n85

85. *In re Barrett*, 964 F.2d 588 (6th Cir. 1992); *In re Smith*, 848 F.2d 813 (7th Cir. 1988).

n86

86. *In re Dickerson*, 232 B.R. 894 (Bankr. E.D. Tex. 1999); *In re Estalella*, 101 B.R. 391 (Bankr. S.D. Fla. 1989).

n87

87. *In re Cox*, 247 B.R. 556 (Bankr. D. Mass. 2000).

n88

88. *In re Smith*, 848 F.2d 813 (7th Cir. 1988); see 11 U.S.C. § 1325(a)(3); *Collier on Bankruptcy*, 1325.04 (Matthew Bender).

n89

89. 171 F.3d 1219 (9th Cir. 1999).

n90

90. However, a court must consider all the circumstances in applying this standard; merely filing a case prior to some significant event in a state court suit is not bad faith. *Ho v. Dowell (In re Ho)*, 274 B.R. 867 (B.A.P. 9th Cir. 2002).

n91

91. 171 F.3d 1219, 1224.

n92

92. 957 F.2d 1350, 1357 (7th Cir. 1992); see also *In re Lilley*, 91 F.3d 491 (3d Cir. 1996) (quoting *Love*

factors).

n93

93. *See Alt v. United States (In re Alt)*, 305 F.3d 413 (6th Cir. 2002) (debtor failed to answer most basic questions at Rule 2004 examination and omitted from schedules tax debt that put her over chapter 13 eligibility limits).

n94

94. 11 U.S.C. § 1325(a)(7), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 1325 (Matthew Bender).

n95

95. *In re Love*, 957 F.2d 1350, 1356 (7th Cir. 1992).

n96

96. 957 F.2d 1350, 1355.

n97

97. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n98

98. Domestic support obligation is defined in 11 U.S.C. § 101, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n99

99. 11 U.S.C. §§ 507(a)(1); 1322(a), as both were amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 507 and ch. 1322 (Matthew Bender).

n100

100. 11 U.S.C. §§ 1325(a)(8); 1328(a), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 1325 and ch. 1328 (Matthew Bender).

n101

101. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n102

102. 11 U.S.C. § 1308, enacted by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 1308 (Matthew Bender).

ABOUT THE AUTHOR(S):

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150 of 197 DOCUMENTS

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Collier on Priority Status of Employee Benefit Plans

2008 Emerging Issues 1308

Collier on Priority Status of Employee Benefit Plans

By Collier

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SUMMARY: This Emerging Issues Analysis covers issues pertaining to employee benefit plan contributions under section 507, including issues such as the types of employee benefit plans eligible for priority, the applicable 180-day priority period, pension plans, and workers compensation programs.

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ARTICLE: The fifth priority of *section 507 of the Bankruptcy Code* consists of allowed unsecured claims for contribution to an employee benefit plan arising from services rendered within 180 days before the earlier of the date of the filing of the petition or the date of the cessation of the debtor's business. n1 The maximum dollar amount of priority claim for each employee benefit plan is equal to the number of employees covered by such plan multiplied by \$10,950, n2 less the sum of (i) the aggregate amount paid to such employees under section 507(a)(4) and (ii) the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan. Section 507(a)(4) contains a priority for wages, salaries and commissions, including vacation and severance pay, up to \$10,950 per individual.

Section 507(a)(5) was enacted in response to Supreme Court cases decided under the Bankruptcy Act holding that fringe benefits, unlike wages, were not entitled to priority status. n3 The legislative history indicates that Congress believed that fringe benefits were often taken by employees in lieu of higher wages and that Congress thought it appropriate to supplement the priority for wages with a priority for contributions to employee benefit plans. n4 Because the amount payable to employee benefit plans under the fifth priority is reduced dollar-for-dollar by the amount of payments to covered employees under the fourth priority for wages, the overall priority granted to employment related claims is not increased by the addition of section 507(a)(5). n5

Types of Employee Benefit Plans Eligible for Priority

The Code does not define the term employee benefit plan. The legislative history refers to pension plans, health insurance plans and life insurance plans as the type of employee benefit plan intended to be included within the scope of the priority. n6 Many courts defer to the definition used in the Employee Retirement Income Security Act of 1974, commonly known as ERISA. n7 The definition is used to determine the scope of the term employee benefit plan and does not mean that only employee benefit plans governed by ERISA are eligible for priority. Other courts reject use of the ERISA definition, believing that had Congress intended the ERISA definition to apply to section 507(a)(5), it would

have said so. n8 Those courts refer to the legislative history and common usage of the term.

In most instances, it will not matter whether the ERISA definition is used. The vast majority of employee benefit programs will qualify for priority regardless of the definition used.

Employee benefit plans eligible for priority generally fall into two categories. The first are self-insured plans where employees are reimbursed for expenses incurred by them that are covered by the employee benefit program. Claims for reimbursement of these expenses qualify for priority if they are customarily reimbursed by the employer whether or not there is a formal plan. n9 It is not necessary that the employer be obligated to establish the program through a collective bargaining agreement or other contractual arrangement. A voluntary or unilateral benefit program qualifies for priority to the same extent as one that the employer is legally obligated to provide. n10

The other common category of employee benefit plans is that in which the employer maintains insurance programs for the benefit of the employees. Employer contributions to such insurance programs are eligible for priority to the same extent as self-funded programs. n11

Applicable 180-Day Priority Period

A claim is entitled to priority under section 507(a)(5) only if the claim arises from services rendered within 180 days before the earlier of the filing of the petition or the cessation of the debtor's business. Cessation of the debtor's business is used as an alternative measuring date in order to protect the employee benefits priority if the debtor shuts down its business but delays the filing of a bankruptcy case. The 180-day priority period is the same as the 180-day priority period provided under the fourth priority for wages, salaries and commissions.

Cessation of the debtor's business is to be used as the measuring date only if the debtor ceases business altogether. It should not be used if the debtor merely scales back its business, closes a division or line of business or terminates the employee benefit plan or the portion of the debtor's business that established the employee benefit plan. n12 The standard for determining when to use cessation of the business as the measuring date is the same as under the fourth priority for wages, salaries and commissions. Cases under the fourth priority analyzing when cessation is considered to have occurred are relevant to the same issue under the fifth priority. n13

Scope of Claims Eligible for Fifth Priority

A claim will qualify for priority under section 507(a)(5) only if it is for contributions arising from services rendered during the 180-day period. The Code does not describe what kind of contributions qualify for priority. In self-insured programs, payments to be made directly to employees will qualify as contributions entitled to priority. In programs established through an insurance company or other third-party provider, the full range of payments owed under the debtor's contract with the third-party ought to be eligible for priority so long as they relate specifically to an eligible employee benefits plan. This would include claims for administrative costs as well as more direct reimbursements. n14

Time Within Which Services Are Rendered. The Code also provides no guidance on when services are rendered for the purposes of determining whether they are within the 180-day period. The paucity of case law on the issue suggests either that this has not been a difficult issue to resolve or that the dollar limits have been hit long before the 180-day limitation becomes an issue. It is clear, however, that the claim must be based upon services rendered during the applicable period. If the debtor fails to make a contribution for a period prior to the 180-day period, but that failure remains undiscovered until within the 180-day period, a claim based on the contribution will not be eligible for priority. n15 If a claim is based on services rendered both before and during the 180-day period, it will need to be apportioned with that part of the claim relating to services within the period being eligible for priority and the balance being a general unsecured claim. n16

Amount of Eligible Claim. The amount of an eligible claim that will be entitled to priority will be determined according to the statutory formula. The maximum claim for each plan will be \$10,950ⁿ¹⁷ multiplied by the number of employees covered by such plan minus (i) the aggregate amount paid to such employees under the fourth priorityⁿ¹⁸ and (ii) the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.ⁿ¹⁹ The effect of the last portion of the formula is that if there is more than one plan covering a group of employees, the priority will be apportioned pro rata among the various plans. In calculating the maximum amount of the priority, the calculation is to be done on the basis of the full number of employees covered by the plan, regardless of the particular amount of benefits allocatable to any individual.ⁿ²⁰

Pension Plans

Priority under section 507(a)(5) is often sought for claims seeking to recover unpaid contributions to pension plans. Such claims, whether relating to a single employer plan maintained by the debtor or a multi-employer plan, may be eligible for priority if the requirements of section 507(a)(5) are met. However, a number of issues may arise in determining whether such a claim is entitled to priority.

Defined Contribution Plans and Defined Benefit Plans. An analysis regarding the application of section 507(a)(5) to a pension plan will usually begin with a determination of whether the plan is a defined contribution or a defined benefit plan.ⁿ²¹ A defined contribution plan provides for an individual account for each employee eligible to participate in the plan. Benefits under a defined contribution plan are based solely on (1) the amount contributed to the participant's account and (2) any income, expenses, gains and losses, and forfeitures of accounts of other participants that may be allocated to the participant's account. In contrast, a defined benefit plan promises a specified benefit upon retirement, such as a percentage of compensation for each year of service, a percentage of average annual compensation or a fixed dollar amount per month. Employer contributions to a defined benefit plan must generally be actuarially determined. Some types of defined contribution plans, such as money purchase pension plans which mandate that specified levels of contributions be made with respect to each plan year, and all defined benefit plans, are subject to certain minimum funding standards under *section 412 of the Internal Revenue Code*ⁿ²² and section 302 of ERISA.ⁿ²³

Claims for contributions owed to defined contribution plans are relatively easy to categorize under section 507. Contributions on behalf of employee-participants under these plans with respect to any plan year are generally not based on services rendered for the employer in any prior year. For example, a defined contribution multi-employer plan may require a specified employer contribution for each hour worked by a covered employee. Even a defined contribution plan, however, may raise difficult issues under Code section 507. In *In re Pacific Far East Line*,ⁿ²⁴ the Court of Appeals for the Ninth Circuit addressed the priority of an employer contribution that was due on the 20th day of the month, based on covered hours worked the prior month. Even though the debtor filed in chapter 11 on January 31, the Ninth Circuit ruled that the contribution due on February 20 (which was based on hours worked in January, i.e., before the filing of the bankruptcy petition) was entitled to an administrative expense priority. The court ruled the hours of pre-filing labor were not the consideration for the payments under the plan. Rather, the pre-filing hours were merely the units of measure for the post-filing payments, which were necessary for continued performance under the collective bargaining agreement.ⁿ²⁵

Unlike a defined contribution plan, *section 412 of the Internal Revenue Code*ⁿ²⁶ and section 302 of ERISAⁿ²⁷ define the obligation to contribute to a defined benefit pension plan to include both (1) the normal cost of the plan for the plan year and (2) the amount necessary to amortize liabilities not directly arising from work performed during such plan year (for example, unfunded past service liabilities, experience losses or changes in actuarial assumptions).

Furthermore, payment of non-forfeitable benefits under terminated defined benefit pension plans are generally guaranteed by the Pension Benefit Guarantee Corporation (PBGC") under title IV of ERISA, n28 subject to certain limitations. n29 Thus, defined benefit pension plans are more heavily regulated than defined contribution plans.

Bankruptcy claims for contributions to defined benefit pension plans are often asserted by the PBGC. ERISA authorizes the PBGC to institute judicial proceedings to have it appointed as a successor trustee for the purpose of terminating pension plans that satisfy certain specified criteria indicating financial distress. n30 As a successor trustee under the plan, the PBGC has the authority to take such actions as it deems necessary to recover unpaid contributions and amounts sufficient to satisfy any accumulated funding deficiencies. n31

Claims for contributions to defined benefit pension plans thus present unique problems. Those that are based on the debtor's failure to pay the normal cost portion of debtor's minimum funding requirement for the 180-day period preceding the filing of the petition are clearly within the scope of section 507(a)(5). The normal cost component is determined with reference to the service of employees, and so fits within the statutory framework. However, minimum funding requirements, including the normal cost component, are determined on an annual basis. Therefore, unpaid contributions for the normal cost of the plan must be apportioned over the applicable 180-day period. The minimum required contribution under the Internal Revenue Code and ERISA, which is generally determined in advance based on projections of such data such as number of employees, must also be adjusted for actual experience during the 180-day period.

Non-Normal Costs. A more difficult question is posed by the other portions of the debtor's minimum funding requirement, the non-normal costs. Under a broader ERISA construction, the minimum funding obligation is a unitary concept and is entitled to a priority based on when the liability is due. In addition to the normal cost incurred postpetition and during the 180 day prepetition period, priority would also be claimed for the past service liability and other non-normal costs that are payable within those periods.

For example, in *Columbia Packing Co. v. PBGC*, n32 the court adopted an ERISA construction of funding priorities. The district court, relying largely on *In re Pacific Far East Lines*, n33 held that past service liability accrued when it became payable, even though it was calculated by reference to services performed before the priority period. n34 The court said that the fixed, amortized past service liability is more accurately viewed as a current cost of continuing the plan rather than as a form of compensation for past service. Therefore, the court granted priority to past service liability based on the portion of the plan year that fell within the subsection 507(a)(1) and (a)(5) periods.

Other courts have rejected the reasoning of *Columbia Packing*. In *In re Sunarhausen, Inc.*, n35 the court held the PBGC's claim for minimum funding contributions was entitled to priority only for the normal cost component of the unpaid contribution. With regard to section 507(a)(5), the court quoted the statute in stating the priority applied to plan contributions arising from services rendered within 180 days before the date of the filing of the petition. n36 The court said this language invites, if it does not compel, an effort to match the services rendered within the 180-day period prior to the filing with the pension costs attributable to those services. n37

The priority treatment of claims for the non-normal cost component of unpaid defined benefit pension plan contributions has not been definitely resolved. The PBGC continues to press Congress for legislative clarification of plan sponsors' funding obligations in bankruptcy.

Debtor's Statutory Withdrawal Liability. Similar issues exist with respect to a debtor's statutory withdrawal liability. Under section 4201 of ERISA, n38 an employer that withdraws from a multi-employer pension plan in a complete or partial withdrawal n39 is liable to the plan for a portion of the plan's unfunded vested benefits liabilities. Generally, a debtor's withdrawal liability is not, in its entirety, an expense of administration, even where the withdrawal arises after the filing of a bankruptcy petition. In the leading case, *Amalgamated Insurance Fund v. McFarlin, Inc.*, n40 the Second Circuit squarely rejected the administrative priority argument, reasoning that [t]he consideration supporting the withdrawal liability is the same as that supporting the pensions themselves, the past labor of the employees covered

by the Plan. Because this consideration was largely provided prepetition, the court declined to allow an administrative expense priority for the withdrawal liability. n41

In *In re Buf-Air Freight, Inc.*, n42 the court applied the reasoning of *McFarlin* in deciding whether withdrawal liability was entitled to any priority under Code section 507(a)(5). One issue that seemed to be left open by *McFarlin* was whether any part of a withdrawal liability could be allocated to services rendered either postpetition or during the 180-day prepetition period. Some courts recognized this possibility but provided no clear guidance regarding how an allocation should be made. n43 The *Buf-Air* court held that withdrawal liability is not of the nature contemplated by section 507 and that any claim for priority must be rejected. n44 The court reasoned that [w]ithdrawal liability represents *future* benefit contributions that will not be paid, and it is merely measured by the prior period. n45

Workers' Compensation Programs

For many years, there was controversy over the issue of whether workers' compensation insurance programs can be considered employee benefit plans within the scope of section 507(a)(5). This controversy was settled by the Supreme Court in *Howard Delivery Service, Inc. v. Zurich American Insurance Co.* n46 The Supreme Court, in a six-to-three decision, held that unpaid premiums on a policy purchased by the debtor to cover its workers' compensation liability do not fall within the scope of section 507(a)(5). The debtor in *Howard Delivery Service* purchased a workers' compensation insurance policy required under the laws of the states where the debtor did business. The insurance premiums were payable in installments. When the debtor filed for bankruptcy, the insurance carrier filed a claim for the unpaid premiums and alleged that the claim was entitled to section 507(a)(5) priority because the unpaid premiums constituted contributions to an employee benefit plan.

The Supreme Court held that a workers' compensation plan does not qualify as an employee benefit plan as that term is used in section 507(a)(5). The Court noted that workers' compensation plans are different than the employer-funded welfare and pension plans that are clearly within the scope of the statute. Welfare and pension plans are benefit plans because they constitute indirect compensation to employees and are part of the employees' overall remuneration from their employment. A workers' compensation program, in contrast, is designed to benefit the employer as much as the employees. The workers' compensation program shields the employer from being subject to lawsuits arising from job-related injuries. The Court held that a workers' compensation program was more akin to a liability insurance policy than an employee benefit plan. In reaching this decision, the Court declined to adopt an ERISA definition of employee benefit plans that arguably extends to workers' compensation plans. n47

For a complete discussion of Code section 507, see Collier on Bankruptcy, ch. 507 (Matthew Bender).

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n1 1. This section was renumbered from 507(a)(4) to 507(a)(5) by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 212 (2005), effective in cases commenced on or after October 17, 2005. Decisions in cases filed before the effective date will thus refer to what was then section 507(a)(4).

n2

2. This dollar amount is effective for cases commenced on or after April 1, 2007. Pursuant to 11 U.S.C. § 104(b), the amount is adjusted every three years to account for changes in the cost of living. See Collier on Bankruptcy, 104.03 (Matthew Bender). The 2005 Act had set the amount at \$10,000, effective April 20, 2005. For cases commenced between April 1, 2004, and April 19, 2005, the dollar amount was \$4,925. For cases commenced during the three-year period beginning April 1, 2001, the amount was \$4,650. The amount for the three-year period beginning April 1, 1998, was \$4,300. For cases commenced before April 1, 1998, the amount was \$4,000.

n3

3. *Joint Indus. Bd. v. United States*, 391 U.S. 224, 88 S. Ct. 1491, 20 L. Ed. 2d 546 (1968); *United States v. Embassy Restaurant, Inc.*, 359 U.S. 29, 79 S. Ct. 554, 3 L. Ed. 2d 601 (1958).

n4

4. H.R. Rep. No. 595, 95th Cong., 1st Sess. 357 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 69 (1978).

n5

5. *Crafts Precision Indus., Inc. v. U.S. Healthcare, Inc. (In re Crafts Precision Indus., Inc.)*, 43 C.B.C.2d 1194, 244 B.R. 178 (B.A.P. 1st Cir. 2000).

n6

6. H.R. Rep. No. 595, 95th Cong., 1st Sess. 357 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 69 (1978); Contributions to 401(k) plans have also been considered eligible employee benefits. See, e.g., *In re C & S Cartage & Leasing Co.*, 204 B.R. 565 (Bankr. D. Neb. 1996).

n7

7. *In re Plaid Pantries, Inc.*, 137 B.R. 405 (D. Or. 1991), *aff'd on other grounds*, 10 F.3d 605, 30 C.B.C.2d 159 (9th Cir. 1993) (ERISA definition of employee benefit plan applies to section 507(a)(4)); *Allegheny Int'l, Inc. v. Metropolitan Life Ins. Co. (In re Allegheny Int'l, Inc.)*, 138 B.R. 171 (Bankr. W.D. Pa. 1992), *aff'd*, 145 B.R. 820 (W.D. Pa. 1992); *Perlstein v. Rockwood Ins. Co. (In re AOV Indus., Inc.)*, 85 B.R. 183 (Bankr. D.C. 1988).

n8

8. *State Ins. Fund v. Southern Star Foods, Inc. (In re Southern Star Foods, Inc.)*, 144 F.3d 712 (10th Cir. 1998); *Employer Ins. of Wausau, Inc. v. Ramette (In re HLM Corp.)*, 62 F.3d 224 (8th Cir. 1995) (ERISA definition of employee benefit plan is not controlling for purposes of this section); *Official Labor Creditors Comm. v. Jet Fla. Sys., Inc. (In re Jet Fla. Sys., Inc.)*, 80 B.R. 544 (S.D. Fla. 1987).

n9

9. *Official Labor Creditors Comm. v. Jet Fla. Sys., Inc. (In re Jet Fla. Sys., Inc.)*, 80 B.R. 544 (S.D. Fla. 1987) (individuals seeking reimbursement for medical expenses entitled to priority where employer maintained self-insurance program); *Allegheny Int'l, Inc. v. Metropolitan Life Ins. Co. (In re Allegheny Int'l, Inc.)*, 145 B.R. 820 (W.D. Pa. 1992) (contributions to both outside insured and self-insured plan eligible for priority).

n10

10. *In re Saco Local Dev. Corp.*, 711 F.2d 441, 8 C.B.C.2d 1093 (5th Cir. 1983); *Official Labor Creditors Comm. v. Jet Fla. Sys., Inc. (In re Jet Fla. Sys., Inc.)*, 80 B.R. 544 (S.D. Fla. 1987); *Official Creditors Comm. v. Blue Cross (In re Lummus Indus., Inc.)*, 193 B.R. 615 (Bankr. M.D. Ga. 1996).

n11

11. *Employers Ins. of Wausau v. Plaid Pantries, Inc.*, 10 F.3d 605, 30 C.B.C.2d 159 (9th Cir. 1993); *In re Saco Local Dev. Corp.*, 711 F.2d 441, 449, 8 C.B.C.2d 1093 (5th Cir. 1983) (To allow the insurer to obtain the priority for premiums through the priority would seem the surest way to provide the employees with the policy benefits to which they are entitled.). *But see In re AER-Aerotron, Inc.*, 182 B.R. 725 (Bankr. E.D.N.C. 1995) (insurance company not entitled to benefits priority). *Accord Edward W. Minte Co. v. Franey & Parr (In re Edward W. Minte Co.)*, 286 B.R. 1 (Bankr. D.D.C. 2002).

n12

12. *In re Danborn Mfg. Co.*, 56 B.R. 8 (Bankr. N.D. Ohio 1985) (no cessation of business where debtor continued in main line of work); *In re Bodin Apparel, Inc.*, 46 B.R. 555 (Bankr. S.D.N.Y. 1985) (cessation of business occurs when debtor ceases its principal business activity and undertakes liquidation of its assets), *aff'd*, 56 B.R. 728 (S.D.N.Y. 1985); *In re Adcock Excavating, Inc.*, 42 B.R. 84 (Bankr. N.D. Ill. 1984) (dismissing substantially all employees not cessation of business).

n13

13. See *Collier on Bankruptcy*, 507.05[4] (Matthew Bender).

n14

14. *Official Creditors Comm. v. Blue Cross (In re Lummus Indus., Inc.)*, 193 B.R. 615 (Bankr. M.D. Ga. 1996) (fees for administering plan properly included in amount of priority claim); *Allegheny Int'l, Inc. v. Metropolitan Life Ins. Co. (In re Allegheny Int'l, Inc.)*, 145 B.R. 820 (W.D. Pa. 1992) (same).

n15

15. See *In re Pittston Stevedoring Corp.*, 40 B.R. 424 (Bankr. S.D.N.Y. 1984) (debtor's non-payment to fringe benefit fund uncovered by audit arose from services rendered prior to 180-day period and therefore not eligible for priority). But see *In re Braniff, Inc.*, 218 B.R. 628 (Bankr. M.D. Fla. 1998) (for an insurance company providing benefits, the services rendered under this section are the provision of insurance rather than the work performed by the employees covered by the insurance; because the insurance company provided benefit services during the 180-day period, it was entitled to priority); see also *In re A.B.C. Fabrics of Tampa, Inc.*, 259 B.R. 759 (Bankr. M.D. Fla. 2001) (applying same reasoning to self-funded plan; applicable point in time is when the debtor's obligations to make required plan payments arose).

n16

16. See *Principal Mut. Life Ins. Co. v. Joint Comm. of Unsecured Creditors (In re Cirruscorp)*, 196 B.R. 76 (S.D. Tex. 1996) (where amount payable to plan covers period both within and beyond the 180-day period, the amount entitled to priority can be determined by proration).

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17. This dollar amount is effective for cases commenced on or after April 1, 2007. Pursuant to 11 U.S.C. § 104(b), the amount is adjusted every three years to account for changes in the cost of living. See *Collier on Bankruptcy*, 104.03 (Matthew Bender). The 2005 Act had set the amount at \$10,000, effective April 20, 2005. For cases commenced between April 1, 2004, and April 19, 2005, the dollar amount was \$4,925. For cases commenced during the three-year period beginning April 1, 2001, the amount was \$4,650. The amount for the three-year period beginning April 1, 1998, was \$4,300. For cases commenced before April 1, 1998, the amount was \$4,000.

n18

18. See *In re Braniff, Inc.* 218 B.R. 628 (Bankr. M.D. Fla. 1998) (the deduction for employees under the third priority includes necessity payments of those wages done shortly after commencement of the case and is

not limited to payments under the plan).

n19

19. See *In re Cornell & Co., Inc.*, 219 B.R. 682 (Bankr. E.D. Pa. 1998) (the deduction only applies to postpetition payments to those other plans); *In re Braniff, Inc.*, 218 B.R. 628 (Bankr. M.D. Fla. 1998) (the reference to other benefit plans is not limited to those plans that qualify for priority under section 507(a)(4)).

n20

20. See *In re Edgar B., Inc.*, 200 B.R. 119 (M.D.N.C. 1996) (reversing bankruptcy court decision placing a \$4,000 limitation on benefits per individual where \$4,000 was the applicable cap on wage priority claims); *Crafts Precision Indus., Inc. v. U.S. Healthcare, Inc.* (*In re Crafts Precision Indus., Inc.*), 43 C.B.C.2d 1194, 244 B.R. 178 (B.A.P. 1st Cir. 2000) (retired employees not counted in determination of cap amount); *In re New England Cartage Corp.*, 220 B.R. 503, 504 (Bankr. D. Mass. 1998) (Section 507(a)(4)(B) [now section 507(a)(5)] is an aggregate limitation. It limits the total claims that can be paid under fourth [now fifth] priority, not the amount that can be paid to or on account of an individual employee.); *In re Braniff, Inc.*, 218 B.R. 628, 635 (Bankr. M.D. Fla. 1998) (same); *In re C & S Cartage & Leasing Co.*, 204 B.R. 565 (Bankr. D. Neb. 1996) (an employee is not precluded from receiving a priority claim under this priority because the employee also received the maximum claim under the wage priority); *In re P.C. White Truck Line*, 22 B.R. 540 (Bankr. M.D. Ala. 1982) (calculation is done on basis of gross numbers; there is no limitation based on individual benefits).

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21. Some pension plans have features of both defined contribution and defined benefit plans. These plans are sometimes commonly referred to as hybrid plans.

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22. 26 U.S.C. § 412.

n23

23. 29 U.S.C. § 1082(b).

n24

24. 713 F.2d 476 (9th Cir. 1983).

n25

25. 713 F.2d 476, 479. It should be noted, however, that *Pacific Far East Lines* was decided under the Bankruptcy Act, not the Bankruptcy Code. The outcome may have been affected by that difference.

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26. 26 U.S.C. § 412.

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27. 29 U.S.C. § 1082(b).

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28. The PBGC is a wholly owned United States government corporation established under section 4002 of ERISA, 29 U.S.C. § 1302, to administer the pension plan termination program created under title IV of ERISA, 29 U.S.C. §§ 1301-1461.

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29. See ERISA §§ 4021, 4022, 4022A, 4022B, 4061, 29 U.S.C. §§ 1321, 1322, 1322a, 1322b, 1361.

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30. See ERISA § 4042, 29 U.S.C. § 1342.

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31. ERISA §§ 4042, 4062, 29 U.S.C. §§ 1342, 1362.

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32. *81 B.R. 205 (D. Mass. 1988).*

n33

33. *713 F.2d 476 (9th Cir. 1983).*

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34. *81 B.R. 205, 208 (D. Mass. 1988).*

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35. *184 B.R. 273 (Bankr. N.D. Ohio 1995).*

n36

36. *184 B.R. 273, 279.*

n37

37. *Id.*

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38. *29 U.S.C. § 1301.*

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39. *See ERISA §§ 4203, 4205, 29 U.S.C. §§ 1383, 1385.*

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40. 789 F.2d 98 (2d Cir. 1986).

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41. 789 F.2d 98, 101-02.

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42. 174 B.R. 184 (Bankr. W.D.N.Y. 1994).

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43. See, e.g., *In re Great Northeastern Lumber & Millwork Corp.*, 64 B.R. 426 (Bankr. E.D. Pa. 1986); *In re Pulaski Highway Express, Inc.*, 57 B.R. 502 (Bankr. M.D. Tenn. 1986); *In re Cott Corp.*, 47 B.R. 487 (Bankr. D. Conn. 1984).

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44. 174 B.R. 184, 186.

n45

45. *Id.*

n46

46. 547 U.S. 651, 126 S. Ct. 2105, 165 L. Ed. 2d 110 (2006).

n47

47. Workers' compensation obligations owed to a state agency have been held to qualify for priority as an excise tax under section 507(a)(8)(E). See *Collier on Bankruptcy*, 507.10[6][a][i] (Matthew Bender).

ABOUT THE AUTHOR(S):

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151 of 197 DOCUMENTS

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Collier on Appointment of Ch 11 Trustee

2008 Emerging Issues 1312

Collier on Appointment of Ch 11 Trustee

By Collier

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SUMMARY: This Emerging Issues Analysis covers the standards for appointment of a chapter 11 trustee, including topics such as the discretionary standards of section 1104(a) of the Bankruptcy Code, appointment of a trustee for cause, the grounds for finding of cause for the appointment of a trustee, and the best interests standard.

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ARTICLE: Discretionary Standards of Section 1104(a)

Section 1104(a) of the Bankruptcy Code provides that a trustee shall be appointed for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management or if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate . To apply the imperative of the word shall, a court must first determine whether cause exists. Thus, the question of whether a trustee should be appointed in a reorganization case must be considered on a case-by-case basis. n1 To understand the underlying basis for the standards in section 1104(a), it is useful to remember the context, discussed in greater detail at the end of this chapter, n2 in which the provision was enacted. Section 1104(a), with its discretionary standard for the appointment of a trustee, represented a compromise between those who believed that, as under the prior Chapter X, a trustee should be appointed in all cases involving public security holders, and those who believed that a trustee would be unnecessary in most reorganization cases.

Section 1104(a) explicitly rejects the idea of mandatory appointment of trustees in public company cases. Instead, it states that cause for the appointment of a trustee under subsection (a)(1) does not include the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor. In addition, section 1104(a)(2) states that the court's decision to appoint a trustee under subsection (a)(2) must be made without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

The flexible standards embodied in section 1104(a) are intended to accommodate two goals: (1) facilitation of the debtor's reorganization; and (2) protection of the public interest and of creditors. According to the House Report, these goals could best be accomplished by flexible standards that envisioned the debtor remaining in possession unless some

strong reason existed to remove the debtor in favor of a trustee. The House Report suggested that, in most cases, the debtor will have entered bankruptcy as a result of honest business reverses, and appointment of a trustee, with the attendant disruption of business management, would not benefit, and indeed might harm, creditors. n3 A trustee unfamiliar with the business and its creditors will usually suffer delay and expense learning facts and circumstances that the trustee needs to know in order to facilitate the debtor's reorganization. n4 Nevertheless, the House Report recognized that in some cases fraud, gross mismanagement, or other circumstances might be present under which the benefit of a trustee would outweigh the detriment. n5 In view of this expressed purpose, it would seem that a court considering a motion to appoint a trustee should generally balance the benefit to be gained from such an appointment against the detriment to the reorganization effort and the rights of the debtor that may result from such an appointment.

Appointment of a Trustee for Cause

Section 1104(a)(1) permits the court, on request of a party in interest or the United States trustee, to order the appointment of a trustee for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

Appointment of Trustee as an Extraordinary Remedy in a Chapter 11 Case. The appointment of a trustee in a chapter 11 case is an extraordinary remedy. n6 The drafters of the Code recognized that, as a general rule, in the absence of fraud, dishonesty, incompetence, gross mismanagement, or similar grounds, the debtor's management should be given an opportunity to propose a plan of reorganization for the debtor. For this reason, there is a strong presumption that the debtor should be permitted to remain in possession absent a showing of need for the appointment of a trustee n7 or a significant postpetition change in the debtor's management. n8

Focus on Current Management. In authorizing appointment of a trustee for cause, section 1104(a)(1) focuses on the current management of the debtor rather than on any misdeeds of past management. Thus, the fact that the prior management of the debtor might have been guilty of fraud, dishonesty, incompetence, or gross mismanagement does not provide grounds for the appointment of a trustee under subsection (a)(1), as long as the court is satisfied that the current management of the debtor is free from the taint of prior management. n9

In some cases, however, even the presence of new managers may not be sufficient to avoid the appointment of a trustee when prior management committed substantial fraud or mismanagement. In order to be free of the taint of the prior management, the new managers may need to have had sufficient time to familiarize themselves with and stabilize the business in order to have sufficient credibility with creditors to gain their confidence.

Cause may be found when the debtor's management fails to take appropriate steps to begin to turn around the debtor's business and improve its financial condition. Particularly when management miscues led the debtor into bankruptcy, management's failure to change its operations after commencement of a case may provide evidence of its inability to guide the debtor through the bankruptcy process. n10

Similarly, the consistent failure of management to meet its own operating projections or to satisfy requirements for its own plan proposals may suggest the need for a trustee. For example, in one case a debtor first proposed a plan calling for a 100 percent payout to unsecured creditors, then proposed a plan calling for only a 50 percent payout, and finally proposed one calling for only a 25 percent payout, spread over years. In that case, the court found that appointment of a trustee was appropriate as a result of the debtor's continuing operating losses, inability to make operating projections

which have a longevity of more than several months" and lack of ability to proffer a business plan. n11

Extent to Which Court Can Exercise Discretion in the Appointment of Trustee When Cause Exists. Section 1104(a) provides that the court shall order the appointment of a trustee upon a finding of cause, suggesting that the court's discretion is circumscribed. Thus, the court must order the appointment of a trustee once it finds that cause exists. n12 However, the court retains considerable discretion to determine when evidence of fraud, dishonesty, incompetence, mismanagement or other factors are sufficiently serious to constitute cause requiring the appointment of a trustee and the extent to which any such allegations involve current (as opposed to former) management. The exercise of such discretion is likely to take on greater importance in light of the 2005 amendment to this section, which added section 1104(e), discussed below. n13 The amendment is likely to result in a motion for the appointment of a trustee in more cases than previously, so it will fall to the court to exercise sound discretion as to whether the grounds for appointment in section 1104(a) have been met in any particular case. Exercising this discretion, some courts have held that even after a court finds evidence of management's misbehavior, the court may determine that there is insufficient cause to warrant the appointment of a trustee. n14 This is, of course, a fact-sensitive determination. However, once such cause is found, the appointment is required and may not be denied based on the economics of the situation. n15

Grounds for Finding of Cause for Appointment of a Trustee

Four Bases Listed in Section 1104(a). Section 1104(a) lists four bases upon which cause may be found: fraud, dishonesty, incompetence and gross mismanagement. These are not the exclusive bases for finding cause for the appointment of a trustee. The provision states that appointment of a trustee shall be ordered for cause, *including* fraud, dishonesty, incompetence, or gross mismanagement of the debtor by current management. n16 Use of the word including suggests that the grounds listed are not exclusive, and that a finding of cause may be based on other factors as well. n17

Fraud, dishonesty and incompetence require fact-sensitive determinations concerning types of behavior that would suggest a need to oust the current management of the debtor. For example, in one case the court ordered the appointment of a trustee after discovering that the principal of the debtor in possession was looting the estate through a kickback scheme in connection with a company that was hired to provide management services to the debtor. n18 Other courts have ordered appointment where the debtor hid n19 or diverted funds, n20 or lied at the section 341 meeting of creditors. n21

In describing gross mismanagement of the debtor as one type of cause for the appointment of a trustee, section 1104(a)(1) is not intended to suggest that a court should order the appointment of a trustee whenever management has, to any degree, mismanaged the debtor's affairs. Instead, the reference to gross mismanagement represents tacit recognition that some degree of mismanagement exists in virtually every insolvency case, and that mere mismanagement does not, by itself, constitute cause. n22 The philosophy of chapter 11 is to give the debtor a second chance at business success. n23 Consistent with that philosophy, under normal circumstances current management should be permitted to identify and correct its past mistakes. However, if management's performance has been so deficient as to constitute gross mismanagement, creditors may reasonably lose all confidence in the ability of management to direct the reorganization effort. In such a case, a trustee may properly be appointed.

Additional Bases for Finding of Cause. In addition to the four enumerated bases for a finding of cause, other bases may be found. In one case, for example, the court affirmed the bankruptcy court's appointment of a trustee based on the debtor in possession's failure to keep adequate records and to file reports coupled with a history of questionable transactions between the debtor and affiliated companies. n24 In another case, the court ordered the appointment of a

trustee after finding that the debtor's principal had an irreconcilable conflict through his interest in another enterprise that was seeking to acquire technology owned by the debtor. The court found that the principal was more concerned about the other enterprise than about the debtor, and that an independent, disinterested person was necessary to manage the debtor and investigate various causes of action that might exist. The court found that the underlying conflicts and self dealing constituted cause for the appointment of a trustee. n25 In still another case, the court found that conflicts among members of a debtor cooperative, coupled with the debtor's failure to collect payments due from some members and other misdeeds, provided sufficient basis for the appointment of a trustee. n26 Similarly, intense, irreconcilable conflicts and acrimony between the debtor and creditors may rise to the level of cause. n27 One court also appointed a trustee based on an agreement between the debtor and a major creditor, approved by the court in settlement of a motion to convert to chapter 7 or appoint a trustee, that a trustee would be appointed if the debtor did not assume and assign its lease by a certain date. The debtor failed to do so and the court appointed a trustee without an evidentiary hearing, which the district court affirmed. n28

However, one factor that does not constitute cause is the existence of public securities holders or a particular amount of debt. Under the Bankruptcy Act, the bankruptcy court was required to appoint one or more trustees upon approval of a Chapter X petition if the liquidated, noncontingent debts in the case exceeded \$250,000. n29 In eliminating from cause the existence of public securities or of a certain amount of assets or liabilities, Congress sought to eliminate any automatic use of a trustee based on a perceived need to protect securities holders. n30 Instead, protections are contained in various provisions of chapter 11. The appointment of a trustee is not considered essential to effective protection.

Also, the court may not use the appointment of a trustee as a sanction for discovery misconduct, although such misconduct may itself provide cause under section 1104(a)(1) for the appointment. n31 When rehabilitation is unlikely, conversion to chapter 7 is preferred to appointment of a trustee in chapter 11. n32 This should remain true even after the addition of section 1104(a)(3), discussed below, which provides as an additional ground for the appointment of a trustee, satisfaction of the grounds for dismissal or conversion of the case to chapter 7. n33

Best Interests Standard; Appointment of Trustee

Section 1104(a)(2) provides that the court shall order the appointment of a trustee if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

Since earlier versions of section 1104 did not contain language comparable to subsection (a)(2), the House Report and Senate Report are not particularly helpful in interpreting this subsection. It should be noted that the remarks of the sponsors indicate that the court may appoint a trustee under subsection (a)(2) even though the party requesting such appointment is unable to establish the requisite cause required for an order of appointment of a trustee under subsection (a)(1). n34 To illustrate this point, the sponsors stated that if the current management of the debtor gambled away rental income before the filing of the petition, a trustee should be appointed after the petition, whether or not post-petition mismanagement can be shown. n35 This statement is the only illustration of the application of subsection (a)(2) contained in the legislative history. However, this example is not particularly helpful since the dissipation of a debtor's assets through gambling would appear to be cause under section 1104(a)(1).

Comparison of Interests' Standard with Cause' Standard. The interests standard may initially seem less stringent than the cause standard. After all, no showing of wrongful behavior on the part of management is required, as long as interested parties can show a meaningful benefit from the appointment of a trustee. However, it is important to remember that the interests standard requires a finding that appointment of a trustee would be in the interest of essentially all interested constituencies. Section 1104(a)(2) provides for the appointment of a trustee when such an appointment is in the interest of creditors, any equity security holders, *and* other interests of the estate. n36 Use of the

word and suggests that creditors cannot on their own obtain the appointment of a trustee under this provision in order to disenfranchise equity security holders or other interests. Instead, appointment of a trustee must be in the interest of the estate generally in order to satisfy the statutory interests standard. Thus, when equity security holders or other ownership interests properly and in good faith support the debtor's current management, it will be difficult to obtain an order for the appointment of a trustee under the interests" standard, as such an appointment will presumably not be in the interest of equity. n37

Balancing of Costs and Benefits. The interests standard suggests a balancing of costs and benefits in determining whether the appointment of a trustee is appropriate. Such an appointment would be in the interest of the estate if the benefits to all interests of the estate to be derived from a trustee outweigh the detriment to the estate. The benefits will, of course, depend on the nature of the particular case. When current management is competent and able to adjust to its new obligations under chapter 11, and when the creditors' committee is functioning properly, there may in fact be little or no benefit to the appointment of a trustee. On the other hand, when significant tensions are present among the parties or corporate governance issues arise that place management in a conflicted position, appointment of a trustee may diffuse tensions and relieve suspicions about the debtor's managers. This may be essential to successful completion of plan negotiations and ultimate reorganization of the debtor. n38

The costs involved in a trustee's appointment are readily apparent. First, there is the cost of the trustee itself. The trustee is also likely to retain counsel. However, these costs must be balanced against the costs incurred by the debtor's managers in running the chapter 11 case, costs that may be saved when a trustee takes over. There are also the intangible costs of delay and education of the trustee, who must learn about the business and the various constituencies in a case before the trustee can address adequately the underlying issues. In addition, there is the even more intangible cost of divesting the debtor's owners and managers of control and influence in the chapter 11 process. Upon the appointment of a trustee, the debtor's exclusive period to propose a plan terminates. Prior to termination of exclusivity, the debtor maintains considerable control over the plan process, because only the debtor can propose a plan. This control enables the debtor to protect, to at least some extent, any interest that equity may have in the plan process. Termination of exclusivity, coupled with termination of the debtor's management prerogatives, reduces the ability of the debtor to protect its principals in negotiating a reorganization plan. However, cost alone does not appear to be sufficient to overcome the statutory directive for appointment of a trustee where best interest is shown. n39

Instances in Which Grounds Exist for Appointment in the Best Interest But Not for Cause. Few situations come to mind in which grounds will exist for the appointment of a trustee under subsection (a)(2) when cause for such appointment does not exist under subsection (a)(1). It may be argued that the existence of a split among partners in a partnership case or directors in a corporate case which prevents the partnership or the board of directors, as the case may be, from managing the debtor's affairs would justify the appointment of a trustee under subsection (a)(2) even though elements of fraud, dishonesty, incompetence or gross mismanagement are not present. On the other hand, it would seem likely that, in the absence of subsection (a)(2), a bankruptcy court could properly determine that a stalemate among partners or board members constitutes sufficient cause to justify the court's order for the appointment of a trustee. n40

Another situation in which section 1104(a)(2) might apply is when current management that has been recently appointed is competent and honest but does not have the expertise that an exceptional trustee would have in reorganizing the debtor. While the availability of superior management is probably not cause to oust current management, the appointment of a trustee in such a case might be in the best interest of creditors, equity security

holders and other interests of the estate. The inability of the court to select the trustee and the possibility of the creditors' election of a trustee under section 1104(c) suggest, however, that it would be difficult to satisfy a superior management test, because of the difficulty of conclusively determining the identity of the trustee before the court orders the appointment.

Still another example might arise if creditors and equity security holders have entirely lost confidence in the current management of the debtor. Although generally such a drastic loss of confidence would result from management's fraud, incompetence or gross mismanagement and, therefore, would constitute cause, a loss of confidence may result from a simple inability to work with the current managers, which could interfere with the operation of the business and the negotiation of a reorganization plan. In such a case, the higher standard of fraud may not be met, but appointment of a trustee may be appropriate. n41 In light of the 2005 addition to the Code of section 1121(d)(2), which limits the permissible extension of the debtor's exclusive period to file a plan, courts should exercise caution not to vary the applicability and strictness of this standard based on how close to the expiration of the exclusivity period the motion is filed. Appointment of a trustee automatically terminates the exclusivity period. n42 Whether the moving party can meet the best interest standard should be independent of any considerations of exclusivity, because the court may shorten or terminate exclusivity independently of whether a trustee is appointed, and the court should keep the two issues appropriately separate. Courts should exercise caution, however, in relying on this ground in light of the 2005 addition to the Code of section 1121(d)(2), which limits the permissible extension of the debtor's exclusive period to file a plan, in case the creditors' ostensible dissatisfaction with management is merely a proxy for trying to let the exclusivity time limits run so that creditors can file their own plan without engaging in the hard bargaining with the debtor that is often necessary for a successful consensual resolution of a chapter 11 case.

As an Alternative to Dismissal or Conversion

Section 1112(b) of the Bankruptcy Code provides grounds for the dismissal or conversion of a chapter 11 case. If the grounds are met, dismissal or conversion is generally mandatory. However, section 1112(b) contains an exception, by reference to section 1104(a)(3), which provides that the court may order the appointment of a trustee if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate. n43

The best interests of creditors and the estate standard here does not appear to differ materially from the interests of creditors, any equity security holders, and other interests of the estate of section 1104(a)(2), unless one puts special weight on best, as though the interests to be considered under section 1104(a)(2) may be other than the best interests. Of course, the interests to which section 1104(a)(3) refers does not include the interests of equity security holders and therefore has a narrower focus. However, since section 1104(a)(3) applies only when the court has already determined that the case should be dismissed or converted, the interests of equity security holders should be decidedly secondary in any event. Section 1112(b) itself requires the court to consider the best interests of creditors and the estate in making the decision to dismiss or convert, so it appears that there will be two interests screens for the courts to consider in reaching a decision to order the appointment of a trustee under this paragraph. The first, in section 1112(b) seems to go to the interests of creditors and the estate in whether the court should act at all under that section; the second, in section 1104(a)(3) seems to go to the question of whether, once the court has decided to act, the best course of action is to dismiss, convert, or order the appointment of a trustee.

For a complete discussion of Code section 1104, see Collier on Bankruptcy, ch. 1104 (Matthew Bender).

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[Return to Text](#)

n1 1. *In re Sharon Steel Corp.*, 871 F.2d 1217, 1226 (3d Cir. 1989) (section 1104(a) decisions must be made on a case-by-case basis).

n2

2. *See Collier on Bankruptcy*, 1104.LH (Matthew Bender).

n3

3. H.R. Rep. No. 595, 95th Cong., 1st Sess. 232-33 (1977).

n4

4. *In re McCorhill Pub. Inc.*, 73 B.R. 1013 (Bankr. S.D.N.Y. 1987); *In re Fisher & Son, Inc.*, 70 B.R. 7 (Bankr. S.D. Ohio 1986); *In re L.S. Good & Co.*, 8 B.R. 312, 314 (Bankr. N.D. W. Va. 1980); *In re Hotel Assocs., Inc.*, 1 C.B.C.2d 733, 3 B.R. 343 (Bankr. E.D. Pa. 1980).

n5

5. H.R. Rep. No. 595, 95th Cong., 1st Sess. 232-33 (1977).

n6

6. *In re Sovereign Estates, Ltd.*, 104 B.R. 702 (Bankr. E.D. Pa. 1989); *In re William A. Smith Constr. Co., Inc.*, 77 B.R. 124 (Bankr. N.D. Ohio 1987); *In re Parker Grande Development, Inc.*, 64 B.R. 557 (Bankr. S.D. Ind. 1986); *Official Creditors' Comm. v. Liberal Market, Inc. (In re Liberal Market, Inc.)*, 13 B.R. 748, 751 (Bankr. S.D. Ohio 1981); *In re Anchorage Boat Sales, Inc.*, 2 C.B.C.2d 348, 4 B.R. 635 (Bankr. E.D.N.Y. 1980).

n7

7. *Committee of Dalkon Shield Claimants v. A.H. Robins Co., Inc.*, 828 F.2d 239, 17 C.B.C.2d 591 (4th Cir. 1987); *In re Parker Grande Development, Inc.*, 64 B.R. 557 (Bankr. S.D. Ind. 1986); *In re Evans*, 48 B.R. 46 (Bankr. W.D. Tex. 1985); *In re Eichorn*, 5 B.R. 755 (Bankr. D. Mass. 1980).

n8

8. *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 471 (3d Cir. 1998).

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9. See *In re Sharon Steel Corp.*, 871 F.2d 1217 (3d Cir. 1989) (citing *Treatise*).

n10

10. See, e.g., *In re Sharon Steel Corp.*, 871 F.2d 1217, 1228-29 (3d Cir. 1989).

n11

11. *In re Ionosphere Clubs, Inc.*, 22 C.B.C.2d 1583, 113 B.R. 164 (Bankr. S.D.N.Y. 1990) (Eastern Airlines case).

n12

12. *In re Oklahoma Refining Co.*, 838 F.2d 1133, 18 C.B.C.2d 278 (10th Cir. 1988).

n13

13. 11 U.S.C. § 1104(e), added by Pub. L. No. 109-8, § 1405 (2005), effective for cases filed on or after April 20, 2005; see *Collier on Bankruptcy*, 1104.02[4] (Matthew Bender).

n14

14. *Committee of Dalkon Shield Claimants v. A.H. Robins Co., Inc.*, 828 F.2d 239, 17 C.B.C.2d 591 (4th

Cir. 1987) (court affirmed the district court's denial of the motion for a trustee even though the debtor in possession had made improper postpetition payments to a degree that constituted civil contempt); *Schuster v. Dragone* (*In re Dragone*), 266 B.R. 268 (D. Conn. 2001).

n15

15. *Wilmington Trust Co. v. Aardvark, Inc.* (*In re Aardvark, Inc.*), 1997 U.S. Dist. LEXIS 3304 (D. Del. Mar. 4, 1997).

n16

16. Emphasis added.

n17

17. *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 472 (3d Cir. 1998). Section 1104(a)(1) does not define the term cause but merely notes that cause includes fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management. Section 102(3) provides that the terms includes and including are not limiting. The rule of construction contained in section 102(3) underscores the fact that cause for purposes of section 1104(a)(1) is not limited to fraud, dishonesty, incompetence or gross mismanagement.

n18

18. *In re Bibb, Inc.*, 76 F.3d 256 (9th Cir. 1996).

n19

19. *In re Brown, 2000 Bankr.* LEXIS 247 (Bankr. E.D.N.C. Feb. 24, 2000).

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20. *Koken v. Reliance Group Holdings, Inc.* (*In re Reliance Group Holdings, Inc.*), 273 B.R. 374 (Bankr. D. Del. 2001).

n21

21. *In re Sanders*, 2000 Bankr. LEXIS 263 (Bankr. N.D. Ill. Mar. 2, 2000).

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22. *In re Evans*, 48 B.R. 46 (Bankr. W.D. Tex. 1985); *Dardarian v. La Sherene, Inc. (In re La Sherene, Inc.)*, 1 C.B.C.2d 685, 3 B.R. 169 (Bankr. N.D. Ga. 1980).

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23. H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977).

n24

24. *In re Oklahoma Refining Co.*, 838 F.2d 1133, 18 C.B.C.2d 278 (10th Cir. 1988); see also *In re Cumberland Investment Corp.*, 23 C.B.C.2d 1433, 118 B.R. 3 (Bankr. D.R.I. 1990), *aff'd*, 133 B.R. 275 (D.R.I. 1991).

n25

25. *In re Embrace Sys. Corp.*, 178 B.R. 112 (Bankr. W.D. Mich. 1995).

n26

26. *In re Cajun Elec. Power Coop., Inc.*, 69 F.3d 746 (5th Cir. 1995), *reh'g granted and result reversed*, 74 F.3d 599 (5th Cir. 1996); see also *In re Colorado-Ute Elec. Ass'n, Inc.*, 120 B.R. 164 (Bankr. D. Colo. 1990).

n27

27. *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 472-74 (3d Cir. 1998).

n28

28. *In re Angelika Films 57th, Inc.*, 1997 U.S. Dist. LEXIS 7463 (S.D.N.Y. May 27, 1997).

n29

29. Chapter X Rule 10-202(a) provided as follows:

On approval of a petition, the court shall, if the indebtedness of a debtor, liquidated as to amount and not contingent as to liability, is \$250,000 or over, promptly and on its own initiative, appoint one or more trustees; if such indebtedness is less than \$250,000, the court may appoint one or more trustees or continue the debtor in possession.

n30

30. The Securities and Exchange Commission, in response to the Commission's Report, unsuccessfully sought to make the appointment of a trustee mandatory if the debtor had as few as 100 public security holders. *See Collier on Bankruptcy*, 1104.LH[1][d] (Matthew Bender).

n31

31. *Ngan Gung Restaurant, Inc. v. Official Comm.*, 195 B.R. 593 (S.D.N.Y. 1996).

n32

32. *In re Nelco Ltd.*, 210 B.R. 707 (Bankr. E.D. Va. 1997).

n33

33. 11 U.S.C. § 1104(a)(3), added by Pub. L. No. 109-8, § 442(b) (2005), effective in cases filed on or after October 17, 2005; see Standards for Appointment of Trustee As an Alternative to Dismissal or Conversion; § 1104(a)(3) *infra*.

n34

34. 124 Cong. Rec. H11,102 (daily ed. Sept. 28, 1978); S17,419 (daily ed. Oct. 6, 1978). One court suggested that section 1102(a)(2) creates a flexible standard and that a trustee may be appointed after a review of (1) trustworthiness of debtor, (2) past and present performance of debtor, (3) confidence of business community and creditors in management and (4) costs and benefits of appointing trustee. *In re Ionosphere Clubs, Inc.*, 22 C.B.C.2d 1583, 113 B.R. 164 (Bankr. S.D.N.Y. 1990).

n35

35. 124 Cong. Rec. H11,102 (daily ed. Sept. 28, 1978); S17,419 (daily ed. Oct. 6, 1978).

n36

36. Emphasis added.

n37

37. *But see In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 474-75 (3d Cir. 1998).

n38

38. *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 475 (3d Cir. 1998).

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39. *Wilmington Trust Co. v. Aardvark, Inc. (In re Aardvark, Inc.)*, 1997 U.S. Dist. LEXIS 3304 (D. Del. Mar. 4, 1997).

n40

40. *See Cajun Elec. Power Coop., Inc. v. Central La. Elec. Coop., Inc. (In re Cajun Power Coop., Inc.)*, 74 F.3d 599 (5th Cir. 1996) (conflicts among cooperative members constituted cause).

n41

41. *See In re Marvel Entertainment, Inc.* 140 F.3d 463 (3d Cir. 1998) (deep seated conflict and animosity among debtor and its creditors made appointment in the best interest).

n42

42. 11 U.S.C. § 1121(c)(1).

n43

43. 11 U.S.C. § 1104(a)(3), added by Pub. L. No. 109-8, § 442(b) (2005), effective in cases commenced on or after October 17, 2005.

ABOUT THE AUTHOR(S):

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152 of 197 DOCUMENTS

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Collier on Continued Payment of Retiree Benefits in a Chapter 11 Case

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Collier on Continued Payment of Retiree Benefits in a Chapter 11 Case

By Collier

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SUMMARY: This Emerging Issues Analysis covers continued payment of retiree benefits in chapter 11 cases, including topics such as the trustee's duty to comply with the provisions of the retiree benefit plan in effect at the time the case under the Bankruptcy Code was commenced, the limitation on prebankruptcy modification of retiree benefits, and remedies for non-payment of retiree benefits.

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ARTICLE: *Bankruptcy Code section 1114(e)(1)* sets forth the general rule that a trustee (which includes a debtor in possession) must continue to timely pay and not modify retiree benefits unless modification of such payments has been ordered by the court, upon motion and after notice and hearing, n1 or without a court order if the trustee and the authorized representative of the persons entitled to retiree benefits have agreed to such modification. n2 Delaying payments is a form of modification of retiree benefits for purposes of this section. n3 After modification, the trustee must continue to pay the modified amount. To prevent debtors from modifying retiree benefits prepetition to evade the requirements of section 1114(e), section 1114(l) permits a court to unwind any such modifications made within 180 days before the date of the filing of the petition. n4

Trustees Duty to Comply with Employee Benefit Plan in Existence on the Date of Commencement of Chapter 11 Case. The trustee or debtor in possession must comply with the provisions of the retiree benefit plan that was in effect at the time the case under the Bankruptcy Code was commenced. When an agreement provides that upon its expiration the responsibility shifts to another entity, the debtor in possession has no obligation to continue benefits under the expired agreement. n5

The majority of courts addressing the issue have found that a debtor in possession need not comply with the procedures and requirements of section 1114 if it has a right to unilaterally terminate retiree benefits under the retirement plan in question and applicable nonbankruptcy law. n6 These courts have reasoned that section 1114 does not expressly limit the debtor in possession's ability to exercise a reserved right under a contract to terminate retiree benefits and that the section does not preclude termination. Courts have found that retirees are protected by section 1114 from the termination of benefits due to the filing of a petition under the Bankruptcy Code but that they are not protected from the termination of rights due to the postpetition expiration of the agreement. n7 Furthermore, section 1114 generally does not require reinstatement of a plan terminated prepetition, even where another statute requires that an

employer maintain such a plan. n8 The section applies only to benefits that have been previously promised by the debtor; it does not create any new obligations on the trustee or debtor in possession. n9

In addition, some courts have reasoned that sections 1114 and 1129(a)(13) of the Code were enacted against the backdrop of the Employee Retirement Income Security Act, n10 which provides that a right to terminate a welfare benefit plan prevents the vesting of such benefits. Therefore, if section 1114 takes away the debtor in possessions right to modify or terminate a welfare benefit plan, in effect, the filing of a chapter 11 petition would cause the vesting of such benefits. Rather, section 1129(a)(13) is meant to result in the continued payment of retiree benefits only according to the prebankruptcy contract, as modified under section 1114. If sections 1114 and 1129(a)(13) prevent termination, chapter 11 would provide better protection for retiree welfare benefits than is pro-

vided under section 1113 for pensions under collective bargaining agreements. n11 It would also lead to disparate treatment of debtors, their creditors and retirees, depending on whether the debtor modified or terminated retiree benefits more than 180 days before, or within 180 days before, the date of the filing of the petition, or the trustee or debtor in possession attempted to terminate or modify the benefits after the date of the filing of the petition. Courts have reasoned that, absent explicit statutory language or other convincing evidence, they may not attribute to congressional intent such unusual results. n12 In one jurisdiction in which the court permitted a debtor in possession to terminate retiree benefits under a prebankruptcy contract that no longer obligated the debtor to make any such payments, the court permitted the debtor in possession to avoid payments made in respect to the benefits, both before and after the bankruptcy filing, under Code sections 548 and 549 on the ground that the debtor did not receive reasonably equivalent value, and to recover the value of such payments from the entity that was obligated to pay such benefits. n13

At least one court has held that even if section 1114 does not restrict modification of benefits because the debtor reserved the right to unilaterally terminate the retiree benefits in question, such termination was a transaction outside the ordinary course of business that required approval under *sections 363 and 554 of the Bankruptcy Code*, since the termination of the contract could be viewed as abandoning property of the estate. n14 On the other hand, a few courts, rejecting the prevailing view, have held that, regardless of a unilateral termination right in the contract, the plain language of section 1114 prohibits termination or modification of retiree benefits unless the court grants approval under subsections 1114(g) and (h). n15 This rationale assumes that the word modification in section 1114 includes termination insofar as termination would be a far more drastic measure than changes in benefits. n16 In the *Farmland Industries* case, the court cited as support for this position the legislative history of section 1114, n17 which indicates that the statute was intended to protect retirees regardless of whether a collective bargaining agreement was in effect, n18 as well as the pervasive nature of the statutory scheme which is meant to provide special protection to retirees. n19 Arguably lending some support to this view is the 2005 addition of new subsection (l) to section 1114 limiting a company's ability to modify retiree benefits during the 180-day period prior to the filing of the bankruptcy petition. n20

Limitation on Prebankruptcy Modification of Retiree Benefits. For cases commenced on or after April 20, 2005, section 1114(l) of the Code, added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, n21 limits a debtors ability to modify retiree benefits in anticipation of the bankruptcy filing. Section 1114(l) provides that if the debtor, while insolvent, modifies retiree benefits within 180 days prior to the filing of the petition, the bankruptcy court shall order reinstatement of the retiree benefits, unless the court finds that the balance of the equities clearly favors such modification. The section provides for the court to act upon the motion of a party in interest, and after notice and hearing. Unless the court finds that the balance of the equities clearly favors the modification, the court shall reinstate, as of the date the modification was made, the retiree benefits that were in effect immediately before the date of modification. Such retroactive payments will have the status of administrative expenses under *section 503 of the Bankruptcy Code*. n22

The intent of the section is to prevent debtors from unfairly modifying or terminating retiree benefits just prior to the bankruptcy filing so as to avoid section 1114s restraints on unilateral modification after the petition is filed. The House Report states:

Current bankruptcy law prevents a chapter 11 debtor from unilaterally modifying certain retiree benefits, such as health insurance, during the pendency of the bankruptcy case unless an authorized retiree representative is appointed and agrees to the modification, or the court authorizes the modification. Section 1403 amends *Bankruptcy Code section 1114* to prevent debtors from evading these requirements by terminating retiree benefit plans on the eve of bankruptcy. The amendment would require retroactive reinstatement of retiree benefits that were modified within 180 days before the debtor filed for bankruptcy protection, unless the court finds that the balance of the equities clearly favors the modification. n23

While section 1114(l) limits the debtors ability to modify retiree benefits prepetition, the test for allowing modification--that the balance of the equities clearly favors such modification--is an easier test to meet than that imposed after the petition is filed--that the modification is necessary to permit the debtors reorganization, the parties are treated fairly and equitably and modification is clearly favored by a balance of the equities. n24 The section does not authorize the bankruptcy court to act *sua sponte*, and no time frames are set regarding when a motion may be filed or a hearing held to determine whether the prepetition modification meets the balancing of the equities test of section 1114(l).

If, as discussed above, n25 modify includes terminate, then where the debtor had a legal right under a prebankruptcy retirement plan to terminate benefits unilaterally and did in fact terminate benefits within 180 days before bankruptcy, while insolvent, section 1114(l) appears to give the court the power to rescind the termination where the balance-of-the-equities test is met. Because, unlike section 1114(e)(1)(B), which applies postpetition, the language of section 1114(l) makes no exception for prepetition modification based upon an agreement between the debtor and the retirees authorized representative, it may also be read to restrict the debtors ability to modify retiree benefits even when a company and its union agree to do so within 180 days of the bankruptcy filing.

However, it remains to be seen whether courts will apply new subsection (l) in a manner that restores benefits that have been modified pursuant to a reserved right in a prebankruptcy contract. Even if a court were to find that subsection (l) applies to such amendable benefits, the fact that the debtor reserved a right to terminate such rights unilaterally might be considered by the court as a factor in balancing the equities under section 1114(l).

Effect of Sale or Reorganization of Debtor on Rights of Retirees to Continuation of Retiree Benefits. Whether a purchaser of the debtors operations is bound to assume obligations to pay retiree benefits under a collective bargaining agreement is governed by the terms of the sale agreement, and a third party will be obligated to assume making retiree payments only to the extent the plan, sale agreement, or applicable nonbankruptcy law provides for successor liability. n26 The debtor, therefore, may sell its operations free of such obligations unless the collective bargaining agreement or applicable nonbankruptcy law precludes it. Even in liquidating chapter 11 cases where the collective bargaining agreement or nonbankruptcy law does not preclude a sale free and clear of retiree obligations and the debtor does not seek, or is not granted, an order to modify such benefits, the debtor will retain all the obligations to pay its retiree benefits pursuant to section 1114. n27 Generally, when a debtor seeks to modify retiree benefits in the context of a sale of all of the debtors assets to a third party that will not be bound to make payments, it will not preclude a finding that the debtor is negotiating in good faith in attempting to reach mutually satisfactory modifications pursuant to section 1114(f)(2). n28

Remedy for Non-Payment of Retiree Benefits. The trustee must continue to timely make payments of retiree benefits as set forth under the benefit plan, and when there has been a modification of such plan, the trustee must continue to pay the modified amount. The required payment of benefits, however, depends upon the availability of unencumbered assets with which the debtor can make such payments. n29

There is no explicit remedy provided for when a debtor is unable to make payments as required by section 1114. It would appear, however, that traditional bankruptcy remedies for noncompliance with chapter 11--conversion to chapter 7, dismissal or the appointment of a trustee or examiner--would be available. Such remedies, however, may be counterproductive in the context of retiree benefits by lessening or eliminating the recovery. For example, section 1114

is not applicable so as to afford such benefits administrative claim status once a case has been converted to chapter 7.
n30

One court formulated a remedy that required the payment of the benefits as soon as there were unencumbered assets available to make such payments. In *In re GF Corp.*, n31 the bankruptcy court recognized that by requiring the debtor to pay retiree benefits as soon as it has the funds to do so it was, in effect, creating a superpriority without the authority of an explicit provision of the Bankruptcy Code. To do otherwise the court stated, would ignore the mandate of section 1114(e)(1) that the DIP [debtor in possession] shall timely pay these benefits. n32 In reaching this conclusion, the court faced a dilemma of reconciling the mandate of section 1114(e)(1) with the underlying policy of chapter 11 which is to encourage the debtor in possession to reorganize in such a manner that the greatest benefit derives to all creditors. The court stated:

There is no remedy provided by law to effect the congressional desire that retiree benefits shall always be paid. Based on the information before the Court, the path chosen today presents the greatest likelihood that those benefits will be paid. This Courts finding that retiree benefits will accrue as first priority administrative expenses might be of little comfort to the GF retiree making the uncertain trip to the hospital today. But if this Court forces GF into a Chapter 7 liquidation, the company would be unlikely to make any other payment toward retiree benefits. If GF completes a sale in Chapter 11, there is a better chance that there will be funds available to make first priority payments to secure these benefits into the future. n33

Payment of Retiree Benefits Granted Administrative Expense Priority; § 1114(e)(2). Section 1114(e)(2) n34 provides that any payment for retiree benefits required to be made before the effective date of a reorganization plan confirmed under section 1129 of this title n35 has the status of an allowed administrative expense as provided in section 503 of this title. n36 Thus section 1114(e)(2) gives payments of retiree benefits the status of an allowed administrative expense. This appears to be true regardless of when the right to receive such benefits vests or whether the obligation to make the payment arose prepetition or postpetition. n37 Thus, section 1114(e)(2) has the effect of giving retiree claims a higher priority than third-party wage claims.

The fact that such benefits are allowed as administrative expenses does not appear, however, to require the debtor to use secured collateral to make benefits payments. Section 1114 does not authorize the debtor to use cash collateral without obtaining the secured creditor's consent or obtaining court authorization after providing adequate protection.
n38

Section 1114 is applicable in chapter 11 liquidating cases. n39 However, when a debtor is completely liquidating its assets in contemplation of a final distribution to creditors, one court has suggested that the debtor should not be compelled to continue to pay full retiree benefits on a priority basis under section 1114. n40

Effect of the Coal Industry Retiree Health Benefit Act of 1992 on the Administrative Expense Priority Status of Payments of Retiree Benefits. The Coal Industry Retiree Health Benefit Act of 1992 n41 (the Coal Act), imposes costs on companies involved in the coal mining industry and their successors in order to provide health and life insurance benefits to retired coal workers. The legislations purpose was to remedy problems with the provision and funding of health care benefits with respect to the beneficiaries of multi-employer benefit plans that provide health care benefits to retirees in the coal industry. n42 The constitutionality of the Coal Act under the Due Process Clause and the Takings Clause has been upheld by several courts. n43

Courts addressing bankruptcy treatment of Coal Act claims have addressed the difficult issue of whether the claims arise pre- or postpetition. In *United Mine Workers of America 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, n44 the Fourth Circuit determined that a debtors liability for Coal Act premiums is not determined by the time when the premiums are assessed, but by the acts which created the obligations. The fact that premiums were assessed after the bankruptcy filing simply made the prepetition claim unmatured, unliquidated and contingent. Similarly, the Fourth Circuit distinguished *LTV Steel Co. v. Shalala (In re Chateaugay Corp.)*, n45 in which

the Second Circuit addressed the status of claims arising under the Coal Act in the context of a chapter 11 case. The LTV court concluded the critical issue was whether premiums due to the combined retirement benefit fund for mine workers, created by the Coal Act, were in the nature of claims preexisting the chapter 11 petition which would therefore have to be disallowed insofar as no proof of claim had been filed. n46 The court held that such premiums were not prepetition claims because the statute, and consequently the obligation to pay such premiums, was enacted after the bankruptcy petition was filed. Instead, the court found that such premiums were taxes incurred by the estate under *section 503(b)(1)(B) of the Bankruptcy Code*, n47 and that any such obligations imposed before confirmation were entitled to first priority as an administrative expense under section 507(a)(1). n48

Other courts have found it more appropriate to make a straightforward determination of whether the obligations at issue here were incurred by the estate pursuant to section 503(b)(1)(B). n49 In one such case, premium obligations due after the filing of the Chapter 11 petition were found to be postpetition taxes entitled to first priority treatment under section 507(a)(1). Contributions owed under any applicable National Bituminous Coal Wage Agreement which had not been rejected under *section 1113 of the Bankruptcy Code*--and was therefore deemed assumed by the debtor--were found to constitute postpetition administrative expenses insofar as the debtor had an obligation under section 365(b)(1) of the Code to cure any existing default. n50 Where all events giving rise to liability occur prepetition, no administrative expense priority arises. n51 Furthermore, it is unclear that bankruptcy courts may compel postpetition reinstatement of terminated individual employer plans required by the Coal Act where claims arising from such termination are prepetition claims since to do so would distort the Bankruptcy Codes priority scheme. n52

For a complete discussion of Code section 1114, see Collier on Bankruptcy, ch. 1114.

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Return to Text

n1 11 U.S.C. § 1114(e)(1)(A); see §§ 1114(g), (h); *Collier on Bankruptcy*, 1114.06 and *Collier on Bankruptcy*, 1114.08.

n2 2. 11 U.S.C. § 1114(e)(1)(B).

n3 3. See *Argeras v. GF Corp. (In re GF Corp.)*, 27 C.B.C.2d 42, 140 B.R. 884 (N.D. Ohio 1992), appeal dismissed, 996 F.2d 1215 (6th Cir. 1993).

n4 4. 11 U.S.C. § 1114(l), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1403(2) (2005). The limitation applies to cases commenced on or after April 20,

2005. Id. § 1406; see *Collier on Bankruptcy*, 1114.03[2].

n5 5. See *CF & I Fabricators of Utah Inc. v. Connors (In re CF & I Fabricators of Utah Inc.)*, 163 B.R. 858 (Bankr. D. Utah 1994), appeal dismissed sub nom. *United Mine Workers Combined Fund v. CF & I Fabricators (In re CF & I Fabricators)*, 169 B.R. 984 (D. Utah 1994); *LTV Steel Co. v. Connors (In re Chateaugay Corp.)*, 111 B.R. 399, 404-05 (Bankr. S.D.N.Y. 1990), *aff'd sub nom. LTV Steel Co. v. United Mine Workers (In re Chateaugay Corp.)*, 945 F.2d 1205, 25 C.B.C.2d 802 (2d Cir. 1991), cert. denied, 502 U.S. 1093, 112 S. Ct. 1167, 117 L. Ed. 2d 413 (1992) (section 1114 prevents unilateral termination of bargained-for benefits, not the operation of mutually agreed upon contract provisions).

n6 6. See, e.g., *LTV Steel Co. v. United Mine Workers (In re Chateaugay Corp.)*, 945 F.2d 1205, 120809, 25 C.B.C.2d 802 (2d Cir. 1991), cert. denied, 502 U.S. 1093, 112 S. Ct. 1167, 117 L. Ed. 2d 413 (1992); *In re North American Royalties, Inc.*, 276 B.R. 860 (Bankr. E.D. Tenn. 2002); *In re Doskocil Cos. Inc.*, 25 C.B.C.2d 699, 130 B.R. 870 (Bankr. D. Kan. 1991); see also *In re Lykes Bros. S.S. Co.*, 233 B.R. 497, 517 (Bankr. M.D. Fla. 1997) (section 1114 does not require appointment of retiree committee where benefits were terminable under applicable nonbankruptcy law and were in fact effectively terminated by the Debtor during the pendency of this case).

n7 7. See *LTV Steel Co., Inc. v. United Mine Workers (In re Chateaugay Corp.)*, 945 F.2d 1205, 25 C.B.C.2d 802 (2d Cir. 1991), cert. denied, 502 U.S. 1093, 112 S. Ct. 1167, 117 L. Ed. 2d 413 (1992); *In re Federated Dept Stores*, 132 B.R. 572 (Bankr. S.D. Ohio 1991).

n8 8. See *Buckner v. Westmoreland Coal Co. (In re Westmoreland Coal Co.)*, 213 B.R. 1 (Bankr. D. Colo. 1997) (section 1114 does not apply to statutorily imposed obligations or benefits paid by an insurer following prepetition termination of a debtors self-funded plan). But note the limit on modification of benefits during the 180-day period prior to the filing of a bankruptcy petition. 11 U.S.C. § 1114(l); see *Collier on Bankruptcy*, 1114.03[2].

n9 9. See *In re Doskocil Cos. Inc.*, 25 C.B.C.2d 699, 130 B.R. 870 (Bankr. D. Kan. 1991) (debtors preexisting contractual right to terminate retiree not lost by virtue of section 1114); see also *LTV Steel Co. v. United Mine Workers (In re Chateaugay Corp.)*, 945 F.2d 1205, 25 C.B.C.2d 802 (2d Cir. 1991), cert. denied, 502 U.S. 1093, 112 S. Ct. 1167, 117 L. Ed. 2d 413 (1992); *In re North America Royalties, Inc.*, 276 B.R. 860 (Bankr. E.D. Tenn. 2002) (section 1114 held to be inapplicable if agreement reserves right to amend benefits).

n10 10. 29 U.S.C. § 1001 et seq.

n11 11. See *In re North American Royalties, Inc.*, 276 B.R. 860 (Bankr. E.D. Tenn. 2002); *In re Federated Dep't Stores*, 132 B.R. 572 (Bankr. S.D. Ohio 1991); see also *In re Doskocil Cos. Inc.*, 25 C.B.C.2d 699, 130 B.R. 870 (Bankr. D. Kan. 1991).

n12 12. See note 11 *supra*.

n13 13. *CF & I Fabricators of Utah Inc. v. Conners (In re CF & I Fabricators of Utah Inc.)*, 163 B.R. 858 (Bankr. D. Utah 1994), appeal dismissed sub nom. *United Mine Workers Combined Fund v. CF & I Fabricators (In re CF & I Fabricators)*, 169 B.R. 984 (D. Utah 1994). Subsections 548(a)(2)(A) and (B) provide that the trustee may avoid any transfer of an interest of the debtor in property that was made or incurred on or within two years before the date before the filing of the petition if the debtor received less than a reasonably equivalent value in exchange for such transfer, and the debtor was insolvent on the date that such transfer was made. (The 2005 Act increased the look-back period to two years from one year, Pub. L. No. 109-8, § 1402(1) (2005), but only for cases commenced after April 20, 2006, id. § 1406(b)(2).) Section 549 permits avoidance of postpetition transactions made after the commencement of the case that are not authorized under title 11 or by the court. Where a plan is required to make payments for retiree benefits, the plan qualifies as an entity for whose benefit the transfers were made as set forth in 11 U.S.C. § 550(a)(1). That section allows for the recovery of property, or the value thereof, of a fraudulent conveyance under section 548, or a postpetition transfer under section 549, from the entity for whose benefit such transfer was made.

n14 14. *In re North American Royalties, Inc.*, 276 B.R. 860, 866 (Bankr. E.D. Tenn. 2002).

n15 15. *In re Farmland Indus., Inc.*, 294 B.R. 903, 917 (Bankr. W.D. Mo. 2003); see also *In re Ames Dept Stores, Inc.*, 1992 U.S. Dist. LEXIS 18275 (S.D.N.Y. Nov. 30 1992), vacated and remanded on other grounds, 76 F.3d 66 (2d Cir. 1996). The Second Circuit in *Ames*, ruling only on the appropriateness of attorneys fees incurred in appealing a decision on this issue, declined to rule on the issue of whether section 1114 applies when the debtor has a contractual right to terminate benefits because that issue was not before the court. However, it indicated that there was substantial room for disagreement on that issue.

n16 16. See *In re Farmland Indus., Inc.*, 294 B.R. 903, 917 (Bankr. W.D. Mo. 2003).

n17 17. *Id.*

n18 18. 133 Cong. Rec. 21,099 (1987) (statement of Sen. Heflin); see Retirement Benefits Security Act of 1987: Hearings on S. 548 Before the Subcomm. on Courts and Administrative Practice of the Senate Comm. on the Judiciary, 100th Cong., 1st Sess. 14 (1987) (statement of Sen. Metzenbaum).

n19 19. See 11 U.S.C. §§ 503, 1114(e)(2) (granting administrative expense priority to retiree benefits), § 1114(c)(2) (requiring appointment by debtor of an authorized representative with whom to negotiate if it seeks not to pay benefits), § 1114(j) (exempting retiree benefits from limitations on damages under section 502(b)(7)), § 1129(a)(13) (adding continuation of retiree benefits to plan confirmation standards). See generally Susan J. Stabile, *Protecting Retiree Medical Benefits in Bankruptcy: The Scope of Section 1114 of the Bankruptcy Code*, 14 Cardozo L. Rev. 1911 (1993).

n20 20. Pub. L. No. 109-8, § 1403(2) (2005); see *Collier on Bankruptcy*, 1114.03[2]. The contrary argument is that had Congress intended to change prevailing judicial interpretation of section 1114 (that section 1114 is not applicable if a unilateral termination right exists), it could have done so explicitly as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

n21 21. Pub. L. No. 109-8, § 1403(2) (2005). New subsection (l) applies to cases commenced on or after the Acts date of enactment, April 20, 2005. Id. § 1406.

n22 22. See 11 U.S.C. § 1114(e)(2).

n23 23. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 154 (2005).

n24 24. 11 U.S.C. § 1114(g); see *Collier on Bankruptcy*, 1114.06.

n25 25. See *Collier on Bankruptcy*, 1114.03[1].

n26 26. See *CF & I Fabricators of Utah Inc. v. Conners (In re CF & I Fabricators of Utah Inc.)*, 163 B.R.

858 (Bankr. D. Utah 1994), appeal dismissed sub nom. *United Mine Workers Combined Fund v. CF & I Fabricators* (In re CF & I Fabricators), 169 B.R. 984 (D. Utah 1994); see also *In re After Six, Inc.*, 141 L.R.R.M. (BNA) 2709, 1992 U.S. Dist. LEXIS 12154 (Bankr. E.D. Pa. 1993), citing *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27, 40-41, 107 S. Ct. 2225, 2234, 96 L. Ed. 2d 22, 36 (1987) and *NLRB v. Burns Intl Sec. Serv., Inc.*, 406 U.S. 272, 281-82, 92 S. Ct. 1571, 1579, 32 L. Ed. 2d 61, 69-70, 80 L.R.R.M. (BNA) 2225 (1972).

n27 27. *In re GF Corp.*, 23 C.B.C.2d 267, 115 B.R. 579 (Bankr. N.D. Ohio 1990) (in the context of a debtor seeking to sell its business as a going concern, the court found that the debtor was still obligated to promptly pay retiree benefits from any unencumbered funds in its possession or which it may obtain during the pendency of the chapter 11 case); *In re Ionosphere Clubs*, 26 C.B.C.2d 798, 134 B.R. 515 (Bankr. S.D.N.Y. 1991) (court found that even though the case was a liquidating chapter 11 case, section 1114 would still apply to grant administrative expense status to the payment of retiree benefit claims) (citing *In re Garfinckels, Inc.*, 24 C.B.C. 2d 1135, 124 B.R. 3 (Bankr. D.D.C. 1991)).

n28 28. See *In re Maxwell Newspapers, Inc.*, 981 F.2d 85, 28 C.B.C.2d 352 (2d Cir. 1992), *rev'd in part In re Maxwell Newspapers, Inc.*, 149 B.R. 334 (Bankr. S.D.N.Y. 1992) (authorizing rejection of collective bargaining agreement and finding that a distinction between the reorganization of a debtor and the sale of a going concern asset to a third party is irrelevant to considerations of good faith negotiations under section 1113, based on chapter 11's goal of continuing the enterprise, regardless of ownership); *United Food & Com. Workers Union, Local 770 v. Official Unsecured Creditors Comm. (In re Hoffman Bros. Packing Co.)*, 32 C.B.C.2d 293, 173 B.R. 177 (B.A.P. 9th Cir. 1994) (section 1113's requirement to bargain in good faith does not preclude rejection of agreement where the purpose or plan of the debtor is to liquidate by selling a going concern).

n29 29. See *United Steelworkers of Am. v. Jones & Lamson Mach. Co. (In re Jones & Lamson Mach. Co.)*, 21 C.B.C.2d 259 (D. Conn. 1989); *In re Garfinckels, Inc.*, 24 C.B.C.2d 1135 (Bankr. D.D.C. 1991) (an interim order terminating retirement benefits under section 1114(h)(1) will not be granted when the debtor is not conducting any business and is incapable of making benefit payments because it has no unencumbered funds).

n30 30. See *In re Ionosphere Clubs, Inc.*, 26 C.B.C.2d 798 (Bankr. S.D.N.Y. 1991).

n31 31. 23 C.B.C.2d 267 (Bankr. N.D. Ohio), *vacated in part on reconsideration*, 120 B.R. 421 (Bankr. N.D. Ohio 1990). The court recognized that there is nothing in the legislative history of section 1114 to suggest that it was intended to discourage postpetition lending or to discourage chapter 11 reorganization in general.

n32 32. 23 C.B.C.2d 267, 276.

n33 33. 23 C.B.C.2d 267, 276.

n34 34. 11 U.S.C. § 1114(e)(2).

n35 35. 11 U.S.C. § 1129.

n36 36. 11 U.S.C. § 503.

n37 37. See *Buckner v. Westmoreland Coal Co. (In re Westmoreland Coal Co.)*, 213 B.R. 1, 18 (Bankr. D. Colo. 1997) (although the court found that section 1114 did not apply as the debtor had terminated its plan prepetition, it did note that, if section 1114 were applicable, the prepetition claims of a trustee of a union benefit plan for annual prefunding premiums for future health benefits for orphaned retirees and their families would be accorded an administrative expense priority).

n38 38. See discussion relating to remedies for nonpayment of retiree benefits in *Collier on Bankruptcy*, 1114.03[4].

n39 39. See *In re Garfinckels, Inc.*, 24 C.B.C.2d 1135 (Bankr. D.D.C. 1991); see also *In re Moline Corp.*, 27 C.B.C.2d 1423 (Bankr. N.D. Ill. 1992), appeal denied, 1992 U.S. Dist. LEXIS 14,202 (N.D. Ill. 1992) (section 1114 applies in chapter 11 liquidating cases). But cf. *In re Ionosphere Clubs, Inc.*, 26 C.B.C.2d 797 (Bankr. S.D.N.Y. 1991) (although *Bankruptcy Code* section 1114 applies to chapter 11 liquidations, it does not apply to chapter 7 liquidations).

n40 40. See *In re Ionosphere Clubs, Inc.*, 26 C.B.C.2d 798 (Bankr. S.D.N.Y. 1991).

n41 41. Pub. L. No. 102-486, Subtitle C (1992) (codified at 26 U.S.C. §§ 1, 9701 et seq.).

n42 42. The Coal Act combined the 1950 and 1974 Benefit Trusts into a trust entitled the United Mine Workers of America Combined Benefit Fund (the Combined Fund), and requires all signatories to any Wage Agreement (or their successors) to make contributions to the Combined Fund, which in turn is responsible for providing benefits to retirees. Each signatory's contribution, which is calculated annually and payable in monthly/ installments, is based on the number of retirees who worked for the signatory and the current cost of health care, with an additional contribution required for orphan beneficiaries who are not allocated to a signatory or would be allocated to a signatory which has gone out of business. For an in-depth discussion of the Coal Act, see *Carbon Fuel Co. v. USX Corp.*, 891 F. Supp. 1186 (S.D. W.Va. 1995).

n43 43. *Blue Diamond Co. v. Secretary of Health & Human Servs. (In re Blue Diamond Co.)*, 79 F.3d 516 (6th Cir. 1996); *Barrick Gold Exploration, Inc. v. Hudson*, 47 F.3d 832 (6th Cir.), cert. denied, 516 U.S. 813, 116 S. Ct. 64, 133 L. Ed. 2d 26 (1995); *Davon, Inc. v. Shalala*, 75 F.3d 1114 (7th Cir. 1996); *LTV Steel Co., Inc. v. Shalala (In re Chateaugay Corp.)*, 53 F.3d 478 (2d Cir.), cert. denied, 516 U.S. 913, 116 S. Ct. 298, 133 L. Ed. 2d 204 (1995); *Lindsey Coal Mining Co. v. Shalala*, 901 F. Supp. 959 (W.D. Pa. 1995); see also *Holland v. High-Tech Collieries, Inc.*, 911 F. Supp. 1021 (N.D. W.Va. 1996). But see *Unity Real Estate Co. v. Hudson*, 889 F. Supp. 818 (W.D. Pa. 1995) (Coal Act, as applied to a corporate successor to signatory operators, did not violate substantive due process but did effect an uncompensated taking).

n44 44. 99 F.3d 573, 580-81, 36 C.B.C.2d 1693, (4th Cir. 1996), cert. denied, 520 U.S. 1118, 117 S. Ct. 1251, 137 L. Ed. 2d 332 (1997); see *Adventure Resources, Inc. v. Holland*, 137 F.3d 786, 797-98, 39 C.B.C.2d 847 (4th Cir.), cert. denied, 525 U.S. 962, 119 S. Ct. 404, 142 L. Ed. 2d 328 (1998); *Buckner v. Westmoreland Coal Co. (In re Westmoreland Coal Co.)*, 213 B.R. 1 (Bankr. D. Colo. 1997).

n45 45. 53 F.3d 478, 486 (2d Cir. 1995).

n46 46. 53 F.3d 478, 496-97. A claim, for purposes of the Bankruptcy Code, is defined in 11 U.S.C. § 101 as a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. 53 F.3d 478, 496.

n47 47. 11 U.S.C. § 503(b)(1)(B).

n48 48. The court held such payments to be involuntary pecuniary burdens imposed by Congress for the public purpose of stabilizing the coal industry; these obligations were probably imposed under Congress taxing

powers. 53 F.3d 478, 496. *Accord UMW 1992 Benefit Plan ex rel. Holland v. Rushton (In re Sunnyside Coal Co.)*, 146 F.3d 1273, 40 C.B.C.2d 732 (10th Cir. 1998); *Adventure Resources, Inc. v. Holland*, 137 F.3d 786, 793, 39 C.B.C.2d 847 (4th Cir.), cert. denied, 525 U.S. 962, 119 S. Ct. 404, 142 L. Ed. 2d 328 (1998); see also *The Pittston Co. v. United States*, 199 F.3d 694, 24 Employees Benefits Cas. 1576 (4th Cir. 1999); *United Mine Workers of Am. 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573, 583, 36 C.B.C. 2d 1693 (4th Cir. 1996), cert. denied, 520 U.S. 1118, 117 S. Ct. 1251, 137 L. Ed. 2d 332 (1997); see also 11 U.S.C. §§ 503(b)(1)(B), 507507(a)(1).

n49 49. *Adventure Resources, Inc. v. Holland*, 193 B.R. 787 (Bankr. S.D. W.Va. 1996), rev'd in part on other grounds, 137 F.3d 786, 39 C.B.C.2d 847 (4th Cir.), cert. denied, 525 U.S. 962, 119 S. Ct. 404, 142 L. Ed. 2d 328 (1998); see *UMW 1992 Benefit Plan ex rel. Holland v. Rushton (In re Sunnyside Coal Co.)*, 146 F.3d 1273, 40 C.B.C.2d 732 (10th Cir. 1998). But see *In re Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506 (1996) (ERISA exaction on accumulated funding deficiency was not a tax subject to priority under the Bankruptcy Code); *Pension Benefit Guaranty Corp. v. CF & I Fabricators of Utah (In re CF & I Fabricators of Utah, Inc.)*, 150 F.3d 1293 (10th Cir. 1998), cert. denied, 526 U.S. 1145, 119 S. Ct. 2020, 143 L. Ed. 2d 1032 (1999) (chapter 11 debtors minimum contributions to employee pension plan are not taxes entitled to administrative priority in bankruptcy); see also *In re Olga Coal Co.*, 194 B.R. 741 (Bankr. S.D.N.Y. 1996).

n50 50. *Adventure Resources, Inc. v. Holland*, 137 F.3d 786, 79798, 39 C.B.C.2d 847 (4th Cir.), cert. denied, 525 U.S. 962, 119 S. Ct. 404, 142 L. Ed. 2d 328 (1998); see *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531-32, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482 (1984); *In re Stewart Foods, inc.*, 64 F.3d 141, 145 (4th Cir. 1995). But see *United Food & Comm. Workers Union v. Family Snacks, Inc. (In re Family Snacks, Inc.)*, 257 B.R. 884, 905 (B.A.P. 8th Cir. 2001) (debtor must affirmatively assume collective bargaining agreement to fall subject to requirement to cure existing defaults in executory contract).

n51 51. See *Buckner v. Westmoreland Coal Co. (In re Westmoreland Coal Co.)*, 213 B.R. 1 (Bankr. D. Colo. 1997).

n52 52. 213 B.R. 1, 41-45.

ABOUT THE AUTHOR(S):

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153 of 197 DOCUMENTS

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Property of the Estate in a Chapter 11 Case in Which the Debtor Is an Individual

2008 Emerging Issues 1314

Collier on Property of the Estate in a Chapter 11 Case in Which the Debtor Is an Individual

By Collier

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SUMMARY: Bankruptcy Code section 1115, added to the Bankruptcy Code in 2005, defines property of the estate for a chapter 11 case in which the debtor is an individual. Its text is based upon and almost identical to section 1306, which is applicable only in chapter 13 cases. This Emerging Issues Analysis covers property of the estate in a chapter 11 case in which the debtor is an individual.

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ARTICLE: Overview. Bankruptcy Code Section 1115, added to the Bankruptcy Code in 2005, n1 defines property of the estate for a chapter 11 case in which the debtor is an individual. Its text is based upon and almost identical to section 1306, which is applicable only in chapter 13 cases. n2 Both sections supplement the estate with property that is excluded from the estate in an individuals chapter 7 case--namely, postpetition earnings from services as well as other property acquired postpetition.

This expansion of property of the estate includes property acquired postpetition and ensures that the additional property, which usually is necessary to fund or otherwise implement a plan of reorganization, n3 is protected by the automatic stay. n4 This is even the case with respect to entities which could pursue such property in a chapter 7 case, such as those holding postpetition claims. n5

This inclusion, however, does not change other provisions in chapter 11 that look to property of the estate as defined in section 541, such as the best interests of creditors test. n6 There is also no requirement that property coming into the estate due only to the operation of section 1115(a) be listed in the schedules. Obviously, such a requirement would be unworkable, since the debtors schedules would have to amended to reflect each paycheck or acquisition of property, as well as every expenditure.

While section 1115(a) adds additional property into the estate, section 1115(b) confirms the debtors presumptive right to remain in possession of that property as well as all other property of the estate. n7 The right to remain in possession of this property of the estate is a major advantage for individual chapter 11 debtors, who in a chapter 7 case would be required to turn over nonexempt property to the trustee. n8

Property of the Chapter 11 Estate Compared with Property of the Chapter 7 Estate; 11 U.S.C. §§ 541(a) and 1115(a)

Property Described in Section 541. A case under chapter 11 may be commenced by the filing of a petition under section 301 or section 302. The commencement of a chapter 11 case, in turn, creates an estate, the property of which, as set forth in the introductory language of section 1115(a), is defined initially by section 541(a). The broadly inclusive language of section 541(a) includes all legal and equitable interests of the debtor in property at the date of the commencement of the case, n9 as well as many (if not most) property interests acquired by the debtor after the commencement of the case, n10 exclusive of postpetition earnings. n11

Chapter 11s Inclusion of Postpetition Earnings; 11 U.S.C. § 1115(a)(2). Section 1115 expands the broad definition contained in section 541. For individuals who are debtors under chapter 11, section 1115 provides that property of the estate includes earnings from services of the debtor performed while the chapter 11 case is pending. In this regard, section 1115(a)(2) effectively nullifies section 541(a)(6) as it applies to postpetition income from services. n12 As a consequence, earnings from postpetition services are property of the chapter 11 estate for every chapter 11 debtor who is an individual.

Chapter 11s Inclusion of Postpetition Property Acquired by the Debtor; 11 U.S.C. § 1115(a)(1). Under chapter 11, as in other cases, property of the estate includes not only all of the kinds of property identified in section 541 as property of the estate, but also all proceeds, product, rents and profits of such property. This includes the standard concept of postpetition rent paid with respect to prepetition property, and postpetition interest paid on prepetition investments. n13 However, in chapter 11 it also includes permutations of postpetition income from services earned during the pendency of the chapter 11 case. Thus, at least one court has construed section 1306, an analogous provision affecting chapter 13 cases, to mean that a tax refund arising from earnings of a debtor during the pendency of a chapter 13 case was property of the estate when received prior to closing of the case, where the debtor's plan had committed tax refunds to payment of creditors. n14

Effect of Plan Confirmation on Estate Property. Section 1141(b) provides that, except as otherwise provided in the plan or the order confirming the plan, confirmation of a chapter 11 plan of reorganization vests all of the property of the estate in the debtor. Under the analogous provision in chapter 13, section 1327(b), courts have differed regarding whether this vesting of estate property terminates the estates rights in property, and whether new property acquired by the debtor after confirmation of a plan becomes property of the estate if the confirmed plan does not specifically so provide. n15 In any event, it is clear that if the plan, or order confirming the plan, provides that some or all property of the estate does not vest until the closing of the case or some other later date, all such property remains property of the estate until that date. n16

Possession of Property of the Chapter 11 Estate; 11 U.S.C. § 1115(b). Chapter 11 allows the debtor to remain in possession of all property of the estate as a debtor in possession. n17 Section 1115(b) confirms this status, and thus effectively nullifies section 521(a)(4), requiring the surrender by the debtor of nonexempt property of the estate.

Section 1115(b) also confirms that the ability to remain in possession of property of the estate is subject to section 1104, regarding the appointment of a trustee or examiner, and the provisions of a confirmed plan or an order confirming the plan.

The portion of section 1115(b) regarding the inability of the debtor to continue to hold estate property after a trustee is appointed could lead to confusing results. If a chapter 11 trustee is appropriate for a case of an individual chapter 11 debtor, and is appointed, section 1115(a) requires all postpetition earnings from the debtor's services to be property of

the estate. Section 521(a)(4) then requires turnover of such property to the trustee. The prospect thus exists that a debtor would have to turn over all wages and earnings to the trustee, and the trustee would have to determine how much of the funds the debtor could retain for the maintenance and support of the debtor, and presumably, his or her dependents, and the authority for such retention. Resort to chapter 13 cases is of little help here, since chapter 13 does not imbue the trustee with the same wide-ranging powers as are held by the chapter 11 trustee, and section 1306 does not have any carve out for the chapter 13 trustee.

Property of the Estate in Cases Converted to Chapter 7 or Dismissed

Cases Converted to Cases Under Chapter 7; 11 U.S.C. §348. Section 348(a) governs the fate of estate property in a case converted from chapter 11 to chapter 7. n18 That section essentially provides that a conversion does not change the date of the commencement of the case; it only changes the applicable chapter. In chapter 11 cases involving individual debtors, this means that, upon conversion, the composition of property of the estate changes; property included solely under section 1115 no longer retains its status as property of the estate. As a consequence, the debtor will be entitled to regain all postpetition service income that is still identifiable that would have been excluded had the case been initially filed as one under chapter 7.

This result, although logical, is not clear. Before 1994, courts were split regarding the effect of section 348(a) in chapter 13 cases. During that year, however, Congress added section 348(f) to the Code. That section explicitly provides that if property comes into a chapter 13 estate solely because of section 1306(a), it is not included in the estate in the converted case. n19 Therefore, property the debtor acquired during a chapter 13 case that is attributable to earnings from postpetition services loses its status as property of the estate in the chapter 7 case after conversion.

When Congress added section 1115 to the Code in 2005, it did not amend section 348(f) to refer to conversions from chapter 11 to chapter 7. There is thus less clarity as to the correct result. The legislative history of the 1994 changes to section 548(f)(2), however, indicates that Congress simply clarified what it already believed to be the law. n20 If a court were to adopt this explanation, then the same result should obtain in conversions to chapter 7 from chapter 11 as from chapter 13 to chapter 7: the debtor should receive back all funds held by the estate that are attributable to income from postpetition services.

Uncertainty might still exist, however, with respect to conversions made in bad faith. Section 348(f)(2) expressly addresses such bad faith conversions, and provides that postpetition service income remains property of the estate--a remedy that might not necessarily be reached by a court seeking to remedy the bad faith conversion in the absence of section 348(f).

Dismissed Cases; 11 U.S.C. § 349. When a chapter 11 case is dismissed, any property acquired by the debtor thereafter never becomes estate property, because section 1115(a)(2) limits the property coming into the estate to property and earnings acquired before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title, whichever occurs first. n21 In addition, all property of the estate reverts in the entity in which such property was vested immediately before the commencement of the case under this title under section 349(b)(3). n22 The purpose of reversion, according to the legislative history is to undo the bankruptcy case, as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case. n23

For these reasons, the Court of Appeals for the Ninth Circuit, in *In re Nash*, n24 held that upon dismissal of a chapter 13 case, a chapter 13 trustee must return all funds in the trustee's hands to the debtor. The court held that funds

received by the trustee after the case was dismissed never became property of the estate and that ownership of the other funds held by the trustee had reverted in the debtor upon dismissal.

For further discussion of Code section 1115, see Collier on Bankruptcy, ch. 1115.

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[Return to Text](#)

n1 1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 321(a)(1) (2005), effective in cases commenced on or after October 17, 2005.

n2

2. See Collier on Bankruptcy, ch. 1306.

n3

3. 11 U.S.C. § 1123(a)(8) (requiring an individual chapter 11 debtor to include all or a portion of income from postpetition services necessary to fund the plan).

n4

4. The chapter 13 cases construing cognate language in section 1306 establish this principle. See, e.g., *Security Bank of Marshalltown, Iowa v. Neiman*, 1 F.3d 687 (10th Cir. 1993) (chapter 13 estate continues to exist after confirmation of plan, so expenses to protect estate property were administrative expenses); *Carver v. Carver*, 954 F.2d 1573 (11th Cir. 1992) (debtors wages were property of estate and therefore action to collect alimony from those wages was not a section 362(b)(2) exception to automatic stay); *Annese v. Kolenda (In re Kolenda)*, 38 C.B.C.2d 1640, 212 B.R. 851 (W.D. Mich. 1997) (property acquired postpetition remains in estate after confirmation and is protected by automatic stay); *Clark v. United States (In re Clark)*, 207 B.R. 559 (Bankr. S.D. Ohio 1997) (all property of debtor was property of estate protected by automatic stay after confirmation of plan when order confirming the plan so provided).

n5

5. See 11 U.S.C. § 362(a)(3)(4), (b)(2) (protecting property of the estate); *Carver v. Carver*, 954 F.2d 1573, 1577 (11th Cir. 1992) (postpetition income protected from support enforcement); *Collier on Bankruptcy*, 362.03[5]362.03[6] and *Collier on Bankruptcy*, 362.05[2].

n6

6. See 11 U.S.C. § 1129(a)(7).

n7

7. See also 11 U.S.C. § 1107.

n8

8. 11 U.S.C. § 521(a)(4); see *Collier on Bankruptcy*, 521.12.

n9

9. 11 U.S.C. § 541(a)(1); see *Collier on Bankruptcy*, 541.04*Collier on Bankruptcy*, 541.09.

n10

10. These interests include interests recovered in an avoidance action, 11 U.S.C. § 541(a)(3), (4), as well as some interests acquired within the first 180 days after filing, 11 U.S.C. § 541(a)(5), and all proceeds, product, offspring, rents or profits from any estate property, 11 U.S.C. § 541(a)(6). In some cases, property of the estate also includes community property interests of the debtor and the debtors spouse. 11 U.S.C. § 541(a)(2).

n11

11. To foster a fresh start for individuals, property of the estate as defined in section 541 does not include earnings from services performed by an individual debtor after the commencement of the case. 11 U.S.C. § 541(a)(6).

n12

12. Ordinarily, the earnings of a nondebtor spouse of the debtor are not included in this definition, although special issues may arise in community property states. For an example in the analogous chapter 13 context, see *In re Nahat*, 278 B.R. 108 (Bankr. N.D. Tex. 2002) (nondebtor spouses earnings were special community property under Texas law and not available to satisfy debts of her spouse).

n13

13. See Collier on Bankruptcy, ch. 541.

n14

14. *Midkiff v. Dunivent (In re Midkiff)*, 271 B.R. 383 (B.A.P. 10th Cir. 2002), *aff'd*, 342 F.3d 1194 (10th Cir. 2003); see also *U.S. Postal Serv. v. Hudson*, 230 B.R. 542 (W.D. Tenn. 1999) (chapter 13 case; imposition by employer of administrative fee complying with chapter 13 payroll deduction order constituted violation of automatic stay with respect to earnings which were part of the estate).

n15

15. The cases espousing the various viewpoints on these issues are discussed elsewhere in the Treatise. See *Collier on Bankruptcy* 1327.03.

n16

16. But see *In re Richardson*, 283 B.R. 783 (Bankr. D. Kan. 2002) (chapter 13 case; language deferring the vesting of property that was inserted by trustee in form order submitted to court without notice to debtor was not binding because it was imposed through denial of due process to debtor).

n17

17. 11 U.S.C. § 1107.

n18

18. See *Collier on Bankruptcy*, 348.02.

n19

19. See *Collier on Bankruptcy*, 348.07.

n20

20. See 140 Cong. Rec. H10,770-71 (1994). This legislative history indicates that Congress agreed with the reasoning of the Court of Appeals for the Third Circuit in *In re Bobroff*, 766 F.2d 797, 12 C.B.C.2d 1491 (3d Cir. 1985), and disagreed with decisions such as that of the Court of Appeals for the Seventh Circuit in *In re Lybrook*, 951 F.2d 136 (7th Cir. 1991).

n21

21. 11 U.S.C. § 1115(a)(1).

n22

22. See *Collier on Bankruptcy*, 349.03[1].

n23

23. S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978).

n24

24. 765 F.2d 1410, 13 C.B.C.2d 209 (9th Cir. 1985).

ABOUT THE AUTHOR(S):

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154 of 197 DOCUMENTS

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Duties of a Trustee or a Debtor in Possession in Small Business Chapter 11 Cases

2008 Emerging Issues 1316

Collier on Duties of a Trustee or a Debtor in Possession in Small Business Chapter 11 Cases

By Collier

December 4, 2007

SUMMARY: This Emerging Issues Analysis covers the duties of a trustee or a debtor in possession under section 1116, including topics such as compliance by the trustee or debtor in possession, the documents to be provided, required attendance at meetings scheduled by the court or United States trustee, and the required filing of schedules and statements.

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ARTICLE: Overview. Added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, n1 section 1116 imposes duties on trustees and small business debtors in possession for the purpose of providing "greater administrative oversight and controls" in small business chapter11 cases. n2 These duties, which apply in cases commenced on or after October 17, 2005, n3 are in addition to those required by the Bankruptcy Code, and they complement the newly added duty of small business debtors to provide periodic reports pursuant to section 308, n4 as well as the United States trustees' new obligations with respect to small business cases pursuant to 28 U.S.C. § 586(a)(3)(H) and (a)(7). n5

A trustee or small business debtor in possession in a small business case is required to "append" to the voluntary petition the debtor's most recent financial documents, including a balance sheet, statement of operations, cash-flow statement and federal income tax return. The same documents must be provided in an involuntary case within seven days of the order for relief.

Senior management and counsel are required to attend meetings scheduled by the court or the United States trustee, including initial debtor interviews, scheduling conferences and meetings of creditors. The court may waive the requirement that senior management and counsel attend the meetings, but only after notice and a hearing and a finding of "extraordinary and compelling circumstances."

The trustee and the small business debtor in possession must timely file all schedules and statements of financial affairs, and the date for filing those documents may not be extended beyond 30 days after the order for relief "absent extraordinary and compelling circumstances." The trustee and the small business debtor in possession must file all

postpetition reports required by the Federal Rules of Bankruptcy Procedure or by local rules, and must also maintain insurance that is "customary and appropriate to the industry." Tax returns and "other required government filings" must be timely filed, and all taxes entitled to administrative expense priority must be timely paid, with the exception of those being contested and diligently prosecuted by appropriate proceedings.

The United States trustee, or a designated representative of the United States trustee, shall be allowed to inspect the debtor's business premises, books and records at reasonable times, after reasonable written notice, unless notice is waived.

Compliance by Trustee or Debtor in Possession. Section 1116 provides that a trustee or the debtor in possession in a small business case shall have the duties described in paragraphs (1) through (7) of that section. A small business debtor in possession may be able to perform those duties, but in a small business case some of the duties are inapplicable to a trustee. For example, the trustee would not be able to append the required documents to the petition or to attend scheduled meetings through "senior management personnel."

A chapter 11 debtor's status as a "small business debtor," as defined in section 101, n6 depends in part on whether a creditors' committee is appointed, and also on whether an appointed committee is sufficiently active and representative to provide oversight of the debtor. That uncertainty may in some circumstances make it difficult for chapter 11 debtors to know whether they must perform the duties required by section 1116. Creditors' committees are, pursuant to section 1102(a)(1), supposed to be appointed in every chapter 11 case, but in smaller cases the committees are only rarely established. Creditors' committees typically are not appointed before the first meeting of creditors. If there is no creditors' committee when the case is filed and if the requirements of section 101 are otherwise met, the debtor would be designated a small business debtor.

Duties Otherwise Required by Title 11. The duties specified in section 1116 are required in addition to other duties imposed by the Bankruptcy Code. *Section 1107 of the Bankruptcy Code* describes the duties of all debtors in possession in chapter 11 cases, and section 521 imposes duties that are applicable to debtors in all chapters. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added Code section 308, n7 which requires small business debtors to file periodic reports. n8

Documents to Be Provided

Voluntary Petition. Section 1116(1) requires a small business debtor in possession to "append" n9 to its voluntary petition the debtor's most recent balance sheet, statement of operations, cash-flow statement and federal income tax return. The debtor is not required to create these documents if they do not already exist; it must, however, append a sworn statement certifying that the documents have not been created or filed.

Presumably the balance sheet that is required is a statement of assets, liabilities and equity, and the required cash-flow statement is a statement of the sources and uses of funds. It is not clear, however, what is meant by a "statement of operations." The term "operating statement" frequently refers to a profit and loss statement; that is most likely what is meant by the term "statement of operations." However, in section 308, where a report relating to profitability is required, the term "profitability" is used and defined. "Statement of operations" as used in section 1116 may refer to something else, such as a narrative description of the debtor's business operations. Whether a particular type of "statement of operations" will satisfy the requirements of section 1116(1) is likely to depend on whether the United States trustee believes it is satisfactory or, if a dispute arises, how the courts construe that statutory language.

Involuntary Petition. In an involuntary small business case, the trustee or small business debtor in possession must file the debtor's most recent balance sheet, statement of operations, cash-flow statement and federal income tax return within seven days of the order for relief.

Statement That Documents Are Not Prepared or Filed. In lieu of filing a required document, section 1116(1)(B) provides that a statement may be filed "under penalty of perjury" certifying that no balance sheet, statement

of operations, or cash-flow statement has been prepared and that no Federal tax return has been filed. (The requirement that the statement be filed under penalty of perjury is redundant as all statements must be verified pursuant to *Rule 1008 of the Federal Rules of Bankruptcy Procedure*.)

Section 1116(1)(B) does not address the situation where a balance sheet, statement of operations or cash-flow statement was in fact prepared but is no longer in the debtor's possession.

To avoid disputes regarding whether the most recent documents have been appended to the petition, a debtor may prepare a balance sheet, cash-flow statement and statement of operations immediately before filing the petition and file those documents with the court together with the petition.

Privacy and Redaction. The documents filed pursuant to section 1116(1)(A) become part of the public record and are open to examination. An entity may be protected, however, at the discretion of the court with respect to trade secrets or confidential research, development or commercial information. A debtor, when filing any documents, must observe the privacy requirements imposed by the BankruptcyCode. n10

Required Attendance at Meetings Scheduled by Court or United States Trustee

Who Must Attend. A trustee or debtor in possession in a small business case must attend, "through its senior management personnel and counsel," all meetings scheduled by the court or the United States trustee. These meetings include initial debtor interviews, scheduling conferences and meetings of creditors convened under section 341. The statute refers to meetings scheduled by the court and the United States trustee, but it does not refer to meetings scheduled by bankruptcy administrators in districts in Alabama and North Carolina. The statute also does not refer to hearings or trials held by the court.

Rule 9001(5) of the Federal Rules of Bankruptcy Procedure provides that when it is necessary to compel attendance of a debtor for examination and the debtor is not a natural person, the debtor includes, if designated by the court, any or all of the debtor's officers, members of its board of directors or trustees or of a similar controlling body, controlling stockholders or members, or any other person in control. n11 If the debtor is a partnership, the debtor shall include all general partners or, if designated by the court, any other person in control of the partnership. The authority of the court pursuant to Rule 9001(5) to designate persons other than "senior management" to attend meetings called by the court or the United States trustee supplements the requirements of section 1116(2).

In most small business chapter 11 cases, identifying "senior management" should not be difficult. If there is any doubt, the debtor should confer and reach an understanding with the United States trustee before the identification of senior management becomes an issue.

Waiver of Required Attendance upon a Finding of "Extraordinary and Compelling Circumstances." The court may waive the requirement that the senior management and counsel of the small business debtor in possession attend meetings scheduled by the court or the United States trustee upon a finding of "extraordinary and compelling circumstances." "Extraordinary and compelling circumstances" is a new standard that was introduced to the Bankruptcy Code for the first time by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The standard, which is not found in any other federal statute, is presumably a higher standard than "special circumstances," n12 "unusual circumstances" n13 or even "exigent circumstances," n14 as those terms are used in other sections of the Bankruptcy Code.

Required Filing of Schedules and Statements

Schedules and Statements to Be Timely Filed. Section 1116(3) requires the trustee or small business debtor in possession to timely file all schedules and statements of financial affairs. All debtors, unless otherwise ordered by the court, are required by section 521(a)(1)(B) n15 to file a schedule of assets and liabilities, a schedule of current income and current expenditures, and a statement of the debtor's financial affairs. It is not clear whether the requirements of

section 1116(3) would preclude the court from ordering, pursuant to section 521(a)(1)(B), that such statements not be filed. *Rule 1007(c) of the Federal Rules of Bankruptcy Procedure* provides that schedules and statements shall be filed with the petition in a voluntary case, or within 15 days thereafter if the petition is accompanied by a list of all the debtor's creditors and their addresses. n16

Extension of Time in Which to File. The time for filing schedules and statements may be extended pursuant to Rule 1007(c) only on motion "for cause." n17 Rule 1007(c) does not limit the length of the extension, but section 1116(3) imposes a limit of 30 days after the order for relief in small business cases. The 30-day limit may be extended only if there is a showing of "extraordinary and compelling circumstances." n18

Required Filing of Postpetition Reports. Trustees and debtors in possession in small business cases are required to file all postpetition financial and other reports required by the Federal Rules of Bankruptcy Procedure or by local rules. n19 The postpetition reports would include the reports required by section 308, n20 but not the reports required by rules issued by the Attorney General pursuant to 28 U.S.C. § 589b. n21

Trustee or Debtor in Possession Must Maintain Insurance. Section 1116(3) requires the trustee or debtor in possession in a small business case, subject to the prohibition in section 363(c)(2) against using cash collateral, to maintain insurance "customary and appropriate" to the industry. Presumably the industry referred to is the debtor's industry, not the insurance industry. There are many types of insurance, n22 and for several reasons small businesses chapter 11 debtors may have difficulty complying with this requirement. It is not uncommon for small businesses in financial difficulty to relinquish insurance coverage to save the costs of insurance premiums. Debtors often will not be able to afford new insurance that is "customary and appropriate" to the industry. Even if they can afford the premiums, debtors in a bankruptcy case may find it difficult or impossible to obtain insurance coverage. The specific circumstances of a debtor, especially one that has made large insurance claims in the past, may make insurance either impossible to obtain or prohibitively expensive.

Questions will surely arise concerning the type of coverage that is required. Does the "customary and appropriate" insurance refer to insurance necessary to protect the assets of the estate, or is the requirement much broader? Must small business debtors provide health insurance benefits for employees if that is the industry standard? Must a small business debtor obtain insurance coverage equivalent to that of a large profitable corporation in the same industry?

Unfortunately, section 1116(5) provides no exception to the insurance requirement even if "extraordinary and compelling circumstances" are demonstrated.

Required Timely Filing of Tax Returns and Other Government Filings. Trustees and debtors in possession in small business cases must timely file tax returns and "other government filings." n23 "Other government filings" is not defined. However, given the subsection's accompanying references to the filing of tax returns and the payment of taxes entitled to administrative expense priority, the "other government filings" should include at least other tax-related schedules and documentation. n24 The language differs from the reference to "required government filings" in the debtor reporting requirements of 11 U.S.C. § 308, which like section 1116 was added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. n25 It is not clear whether "timely" filing tax returns and other government filings means that the filings must be made within the prescribed time limits, or whether trustees and small business debtors in possession may seek extensions of those limits.

Required Payment of Taxes Entitled to Administrative Expense Priority. Trustees and debtors in possession in small business cases must, subject to the prohibition in section 363(c)(2) against using cash collateral, timely pay all taxes entitled to administrative expense priority. n26 Excepted from the requirement to timely pay all taxes entitled to administrative priority are those being contested by "appropriate proceedings" being diligently prosecuted. Presumably, one of several forms of "appropriate proceeding" to contest the amount or legality of a tax is a proceeding brought pursuant to section 505(a). n27

Trustee or Debtor in Possession Must Allow Inspection of Premises, Books and Records by United States Trustee. Section 1116(7) requires the trustee or debtor in possession in a small business case to allow the United States trustee, or a designated representative of the United States trustee, to inspect the debtor's business premises, books and records. The inspections must take place "at reasonable times, after reasonable prior written notice, unless notice is waived by the debtor." The timing of visits and the inspection of books may be the subject of scheduling orders arising from status conferences pursuant to section 105(d).

The United States trustee and bankruptcy administrators already routinely visit the debtor's business location in small business chapter 11 cases. The requirement of section 1116(7) complements the United States trustee's duty, under 28 U.S.C. § 586(a)(7)(B), to visit the appropriate business premises of the debtor, ascertain the state of the debtor's books and records, and verify that the debtor has filed its tax returns, if determined to be "appropriate and advisable." Although section 1116(7) requires cooperation with inspections by the United States trustee or the United States trustee's designated representative, section 1116 does not address the situation of districts in Alabama and North Carolina which have bankruptcy administrators instead of a United States trustee.

For a complete discussion of Code section 1116, see Collier on Bankruptcy, ch. 1116.

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n1 Pub. L. No. 109-8, § 436(a) (2005).

n2 H.R. Rep. 109-31, 109th Cong., 1st Sess. 101 (2005).

n3 Pub. L. No. 109-8, § 1501 (2005).

n4 11 U.S.C. § 308, added by Pub. L. No. 109-8, § 434(a)(1) (2005), does not become effective until 60 days after Federal Rules of Bankruptcy Procedure and official forms are prescribed to be used to comply with section 308. Id. § 434(b).

n5 These provisions were added by Pub. L. No. 109-8, § 439(1)(C), (4) (2005), effective in cases commenced on or after October 17, 2005.

n6 11 U.S.C. § 101(51D), added by Pub. L. No. 109-8, § 532(a) (2005); see *Collier on Bankruptcy*, 101.51D

n7 Pub. L. No. 109-8, § 434(a)(1) (2005). Section 308 does not become effective until 60 days after Federal Rules of Bankruptcy Procedure and official forms are prescribed to be used to comply with section 308. Id. § 434(b).

n8 See Collier on Bankruptcy, ch. 308.

n9 The term "append" suggests that the documents will be physically attached to the petition. Most of the small business petitions will be filed electronically, and the documents will be attached electronically.

n10 See 11 U.S.C. §§ 112, 332, 351, added by Pub. L. No. 109-8, §§ 233(a), 232(a), 1102(a), effective in cases commenced on or after October 17, 2005. The Federal Rules of Bankruptcy Procedure also address privacy concerns, and additional rules will be implemented in connection with the new sections and with the E-Government Act of 2002, Pub. L. No. 107-347 (2002).

n11 See Collier on Bankruptcy, ch. 9001.

n12 11 U.S.C. § 707(b)(2)(B)(i); 11 U.S.C. § 523(d).

n13 11 U.S.C. § 1112(b)(1).

n14 11 U.S.C. § 109(h)(3)(A)(i).

n15 As redesignated and amended by Pub. L. No. 109-8, §§ 106(d)(1), 315(b)(1) (2005), effective in cases commenced on or after October 17, 2005.

n16 See Collier on Bankruptcy, ch. 1007.

n17 *Fed. R. Bankr. P. 1007*.

n18 See the discussion of "extraordinary and compelling circumstances" at *Collier on Bankruptcy*, 1116.05[2].

n19 11 U.S.C. § 1116(4).

n20 11 U.S.C. § 308, added by Pub. L. No. 109-8, § 434(a)(1) (2005), does not become effective until 60 days after Federal Rules of Bankruptcy Procedure and official forms are prescribed to be used to comply with section 308. Id. § 434(b).

n21 Section 589b was added to title 28 by Pub. L. No. 109-8, § 602(a) (2005).

n22 Typical types of insurance include workers' compensation, property, vehicle and general liability, as well as "key man" coverage.

n23 11 U.S.C. § 1116(6)(A).

n24 11 U.S.C. § 1116(6)(A)-(B).

n25 But see *Collier on Bankruptcy*, 1116.LH notes 7 & 8 and accompanying text.

n26 11 USCS § 1116(6)(B).

n27 See Collier on Bankruptcy, ch. TX5 (discussing section 505(a)).

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155 of 197 DOCUMENTS

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Collier on Chapter 13 Cramdown

2008 Emerging Issues 1253

Collier on Chapter 13 Cramdown

By Collier

December 3, 2007

SUMMARY: This Emerging Issues Analysis discusses issues pertaining to Chapter 13 cramdown, including retention of the lien securing the allowed secured claim and the requirement that the Chapter 13 plan propose to distribute property having a value, as of the effective date of the plan, at least equal to the amount of the allowed secured claim.

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ARTICLE: Under chapter 13 of the Bankruptcy Code, unless the debtor surrenders the property securing the lien to the holder of an allowed secured claim provided for by the plan n1 or such holder accepts the plan, n2 a chapter 13 plan that provides for a secured claim n3 may not be assured of confirmation without a cramdown provision comporting with section 1325(a)(5)(B). n4 Chapter 13 cramdown is comprised of two essential elements, lien retention n5 and equivalent value, distributed in accordance with certain rules n6 each of which must be provided for under the chapter 13 plan itself. n7

Retention of Lien Securing Allowed Secured Claim

The first essential element in chapter 13 cramdown is that the plan provide for the retention of the lien n8 securing the allowed secured claim. n9 Provision for retention of the lien securing the allowed secured claim is to be made in the plan itself. n10 The practical effect of requiring a lien retention provision in the plan is to protect the holder of an allowed secured claim from loss occasioned by a later failure on the part of the debtor to complete the proposed plan. Absent such a provision, the lien may be eliminated upon confirmation by the vesting of all property of the estate in the debtor. n11

Cases Filed Prior to Effective Date of 2005 Amendments. In light of its purpose, it seems clear under the law in effect for cases filed before the effective date of the 2005 amendments, n12 that to meet this confirmation standard the plan need only provide that the lien will be retained until all payments attributable to the allowed secured claim have been received by the holder of that claim. Indeed, the legislative history accompanying the addition of the original 1978 lien retention language to section 1325(a)(5) states specifically:

Of course, the secured creditors' lien only secures the value of the collateral and to the extent property is distributed of a present value equal to the allowed amount of the creditor's secured claim the creditor's lien will have been satisfied

in full. Thus the lien created under section 1325(a)(5)(B)(i) is effective only to secure payments to the extent of the amount of the allowed secured claim. To the extent the deferred payments exceed the value of the allowed amount of the secured claim and the debtor subsequently defaults, the lien will not secure unaccrued interest represented in such deferred payments. n13

In other words, once the holder of an allowed secured claim has received all payments attributable to that claim under the plan, the lien must be satisfied and the secured creditor has no further right to special treatment. n14 If, due to claim bifurcation under section 506(a), n15 the same creditor also holds an allowed unsecured claim, that creditor, like other holders of allowed unsecured claims, has no right to a lien securing its right to payment of the unsecured portion of its claim.

Moreover, as the legislative history above also states, if the debtor defaults on plan payments the secured creditor's lien cannot increase to include other amounts, such as present value interest, which should have been paid during the plan. If the debtor has reduced the lien by partial payment, or the value of the property appreciates during the plan, the equity created thereby cannot be encumbered by additions to the lien based upon charges such as unpaid interest. Thus, if the case is subsequently converted to chapter 7 or the debtor receives a hardship discharge before completing payments on the allowed secured claim, the remaining lien should not exceed the unpaid principal amount of the allowed secured claim. n16 With respect to conversion to chapter 7, this result was codified in section 348(f), enacted by the Bankruptcy Reform Act of 1994. n17 For cases filed prior to the effective date of the 2005 amendments, that section provides that upon conversion, valuations of property and of allowed secured claims in the chapter 13 case apply in the converted case and allowed secured claims are reduced to the extent they have been paid in accordance with a chapter 13 plan. n18

Cases Filed after Effective Date of 2005 Amendments. The 2005 amendments to the Bankruptcy Code added new language to section 1325(a)(5)(B)(i)(I), providing that to meet the lien retention standard the plan must permit the holder of an allowed secured claim to retain its lien until the earlier of the payment of the underlying debt determined under nonbankruptcy law or a discharge under section 1328. The new language also states that the plan must provide that if the case is dismissed or converted without completion of the plan, the lien will be retained to the extent recognized by applicable nonbankruptcy law. n19

This amendment is apparently an attempt to overrule the results of cases under the prior language that, as discussed above, n20 required elimination of the creditor's lien when the allowed secured claim had been paid. For debtors who cannot complete a plan but who have completely paid an allowed secured claim, it makes more attractive the options of a hardship discharge or a modification that allows plan completion, so that a discharge is entered and the lien can be eliminated. It is important to note that the fact that a lien is retained to the extent recognized by applicable nonbankruptcy law if the case is converted does not affect the amount that may be necessary to redeem the property in a chapter 7 case. That amount is determined by section 722. n21

A lien on substitute or replacement collateral for that securing the claim at the outset will not meet this confirmation test n22 without the consent of the holder of the claim. n23 Thus, a plan proposing to transfer the lien securing the allowed secured claim to other collateral is not entitled to confirmation without the acceptance of the holder of the claim. n24 Nor may a plan provide for the sale of part of the property securing a claim to obtain funds to pay other creditors without the claim holder's acceptance. n25 However, a chapter 13 plan may provide for the distribution of property in payment of an allowed claim secured by the lien retained by the holder n26 if the lien itself is not replaced; in that case, the claim is merely reduced to the extent of the property distributed. A chapter 13 debtor may also elect not to provide for an allowed secured claim under the plan n27 so that substitute or replacement collateral may be provided as adequate protection n28 outside the plan for collateral that the debtor will use, sell or lease. n29

Section 1325(a)(5)(B)(i) assures the holder of an allowed secured claim that its lien cannot be directly affected by a chapter 13 plan without its consent, although various indirect deleterious effects, resulting from depreciation,

deterioration, damage, or loss may nonetheless occur during the extension period. But section 1325(a)(5)(B)(i) does not require that a chapter 13 plan guarantee protection to the holder of an allowed secured claim against whatever diminution in value may result to the property securing the allowed secured claim in which the lien is retained; it merely requires a provision in the plan for the *retention* of the lien. n30 Furthermore, the plan may provide that the lien shall be eliminated upon entry of a discharge. n31

Equivalent Value

In addition to providing for retention of the lien securing an allowed secured claim, n32 chapter 13 cramdown requires that the chapter 13 plan propose to distribute property having a value, as of the effective date of the plan, at least equal to the amount of the allowed secured claim. n33 However, there is no prohibition under chapter 13 against a proposal to pay the holder of an allowed secured claim more than the amount of the allowed secured claim, provided the holders of allowed unsecured claims are not thereby deprived of any portion of the liquidation value of their claims as required under subsection 1325(a)(4). n34

In the language of the Code, it must be established that the value, as of the effective date of the plan, of property to be distributed under the plan on account of such [allowed secured] claim is not less than the allowed amount of such claim. n35 In *Rake v. Wade*, n36 the Supreme Court held that present value also had to be provided when a default on a claim is cured through a plan pursuant to section 1322(b)(5). In such cases, however, the Court held that the arrearage being cured is a distinct claim, and that the present value of the arrears is the amount made payable under section 1325(a)(5). n37 The result in *Rake* was overruled by a new section 1322(e), enacted by the Bankruptcy Reform Act of 1994, n38 at least with respect to agreements entered into after the enactment of that Act. n39 Section 1322(e) provides that in a cure situation, a creditor shall receive only the interest and fees provided for in the agreement and permitted by applicable nonbankruptcy law. n40

Effective Date of Plan as Valuation Date. The effective date of the plan will ordinarily be provided for by the plan, and may be the date as of which the order confirming the chapter 13 plan becomes final. n41 However, the court will normally determine present value as of the date of the hearing on confirmation held under section 1324, because, as a practical matter, confirmation will almost always follow within a brief time after the issues raised under section 1325(a)(5)(B)(ii) are resolved.

Property to Be Distributed under the Plan. The phrase property to be distributed under the plan plainly and significantly indicates that cramdown may be accomplished in a chapter 13 plan merely by proposing to distribute property during the course of the extension period. The property may be property of the estate in existence at the date of confirmation, either exempt property n42 or other property of the estate, n43 or deferred cash payments representing future earnings or income of the chapter 13 debtor, provided the *present dollar value* at confirmation n44 of the property to be distributed in the future equals the amount of the allowed secured claim. n45

Property is not a defined term, but it is altogether unrestricted in scope and unquestionably encompasses any and all kinds of property of the estate n46 and property of the debtor n47 to be distributed under the plan. n48 The phrase is not limited in its application to property in existence at the date of confirmation, n49 but may and usually will include deferred payments from future earnings or income of the debtor. n50 The crucial import of the phrase property to be distributed under the plan lies in its connotation of permission to satisfy allowed secured claims through future distributions of property of equivalent present value.

Property to Be Distributed in Equal Monthly Payments. Section 1325(a)(5)(B)(iii)(I), enacted in 2005, n51 provides that if property to be distributed to the holder of an allowed secured claim is to be in the form of periodic payments, such payments shall be in equal monthly amounts. It is important to note that this provision refers to the distributions to the holder of the allowed secured claim and not to the debtor's plan payments. As long as the plan provides that the trustee's distributions to the holder of the allowed secured claim be in equal monthly amounts, the debtor's plan payments need not be. There also does not seem to be any requirement that the equal monthly amounts

extend throughout the plan. Indeed, because the debtor's payments must also be sufficient to provide adequate protection, and therefore greater than the amount necessary for equal payments throughout the plan, it may be mathematically impossible both to provide adequate protection and to make equal payments throughout the plan. n52 A debtor may, for example, provide for equal monthly amounts to be distributed to a particular secured creditor for the first 24 months of a 36-month plan or, if the requirement of providing adequate protection is met, n53 the last 24 months of a 36-month plan. Because section 1325(a)(5)(B)(iii)(I) only applies if the plan provides for periodic payments, it also does not preclude a plan providing for a single lump sum payment to a creditor. The requirement also does not apply to payments made to cure a default on a long term debt pursuant to section 1322(b)(5). n54

Payments Must Be Sufficient to Provide Adequate Protection. Section 1325(a)(5)(B)(iii)(II), also enacted in 2005, n55 simply codifies once more the right of the holder of an allowed secured claim to receive payments during the plan that are sufficient to provide adequate protection to the creditor's interest in the property, as was already provided by section 362 and section 363. n56 For the period prior to plan confirmation, section 1326(a)(1)(C), enacted at the same time, similarly provides for payments sufficient to provide adequate protection, to be made directly to the creditor unless the court orders otherwise. n57

The fact that provision of adequate protection has now been explicitly included in the standards for plan confirmation further buttresses those cases which have held that a creditor may not, after confirmation, seek relief from the stay based on a lack of adequate protection because the issue of adequate protection should have been raised before confirmation and confirmation of the plan is *res judicata* on the issue of adequate protection. n58

Valuation of Property to Be Distributed under the Plan. The valuation conducted by the court under section 1325(a)(5)(B)(ii) is meant to determine whether the property to be distributed under the plan n59 is at least equal in value to the amount of the allowed secured claim. n60 In most chapter 13 cases the property to be distributed under the plan will consist of deferred cash payments derived from the earnings or other future income of the chapter 13 debtor during the course of the extension period.

Section 1325(a)(5)(B)(ii) is phrased in language virtually identical with section 1325(a)(4), the best interests test applicable in respect to allowed unsecured claims. n61 Both require that the court ascertain the value, as of the effective date of the plan, of property to be distributed under the plan on account of [the] claim. n62 Consequently, although the referent differs, the valuation of property proposed to be distributed under the plan for cramdown purposes is essentially the same as that required in the application of the best interests test in relation to unsecured claims under section 1325(a)(4). n63

Timing of Valuation. The value of property to be distributed under the plan is to be ascertained as of the effective date of the plan. n64 As a practical matter, the court will in fact ascertain present value n65 as of the date of the hearing on confirmation held under section 1324. n66 However, if no party objects to the plan and the plan is confirmed, the payment of interest is governed by the terms of the confirmed plan and cannot later be challenged. n67

Present Value Determination. Section 1325(a)(5)(B)(ii) requires the court to determine the value of property to be distributed under the plan, as of the effective date of the plan. n68 In other words, the court must ascertain the then *present value* of the property *to be distributed*. In order to implement section 1325(a)(5)(B)(ii) the court must capitalize deferred payments by converting the deferred payments proposed to be distributed under the chapter 13 plan into an equivalent capital sum as of the effective date of the plan. Section 1325(a)(5)(B)(ii), cannot be faithfully implemented simply by comparing the sum total of all deferred payments proposed by the plan with the amount of the allowed secured claim. The court must arrive at an appropriate discount factor so as to fairly discount value proposed to be given in the future on account of the allowed secured claim. n69

The simplest method of equating the present value of deferred future payments with the amount of the allowed secured claim is to propose interest payments over and above the face amount of the allowed secured claim at whatever interest rate is equivalent to the discount rate selected by the court or agreed upon by the parties. Accordingly, in

addition to deferred principal payments aggregating the face amount of the allowed secured claim, n70 a chapter 13 plan need only propose to pay interest on the face amount of the allowed secured claim at the appropriate discount rate over the course of the payment extension period.

The purpose of the present value requirement is to place the holder of an allowed secured claim in the same position economically as if the debtor exercised the option n71 of surrendering the collateral. Through the payment of interest, the creditor is compensated for the delay in receiving the amount of the allowed secured claim, which would be received in full immediately upon confirmation if the collateral were liquidated.

For many years the courts debated the appropriate discount or interest rate to accomplish this purpose, with some courts adopting a formula approach based on treasury bills or some other market index n72 and others holding that the pre-bankruptcy contract rate should be used absent evidence that it was not appropriate. n73 The Supreme Court resolved the issue in *Till v. SCS Credit Corp.*, n74 holding that a formula approach based upon the prime rate of interest best carried out the intentions of Congress. n75

The Court reversed a decision of the Court of Appeals for the Seventh Circuit that had held that the pre-bankruptcy contract rate should be the presumptive rate based on the theory that chapter 13 imposed a coerced loan on the secured creditor. The Supreme Court found that approaches based on such theories imposed significant evidentiary costs, requiring a bankruptcy court to consider evidence about credit markets, creditors' costs, creditors' financial circumstances and creditors' lending practices. n76 The Court also found that this approach overcompensated creditors to the extent it would yield a rate that included lenders' transaction costs and profits. The Court pointed out that such approaches could yield different rates for different lenders to the same debtors who were similarly situated in all relevant respects. n77

In contrast, the Court found that the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings. n78 The use of a formula, in which a small risk factor is added to the prevailing prime rate of interest depends only on the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor. n79 The evidentiary burden of showing the appropriate risk factor that should be added is placed squarely on the creditors, who are likely to have readier access to any information absent from the debtor's filing (such as evidence about the liquidity of the collateral market.) n80

The Court did not decide the proper scale for the risk adjustment factor to be added to the prime rate, though it did note that other courts had approved adjustments of 1 percent to 3 percent, n81 and seemed to suggest that large adjustments would not be appropriate because a plan cannot be confirmed unless the bankruptcy court finds it is feasible. If the court determines that the likelihood of default is so high as to necessitate an eye-popping interest rate, the plan probably should not be confirmed. n82 The Court identified four relevant factors to be considered: (1) the probability of plan failure; (2) the rate of collateral depreciation; (3) the liquidity of the collateral market; and (4) the administrative expenses of enforcement. n83

The risk factor in such a calculation need not be large for several other reasons as well. First, the creditor's main protection against risk comes from its right to retain its lien, n84 and from its right to seek dismissal of the case in the event of a material default in payments, n85 which would restore the creditor's pre-bankruptcy remedies. Other protections include the requirement the trustee's monitoring of the case and the availability of wage deduction orders. n86 Indeed, the Court noted in *Till* that high contract rates cannot be assumed to reflect the true risk of a transaction. n87

The net effect of section 1325(a)(5)(B)(ii) is to accord allowed secured claims under a chapter 13 plan the identical treatment given to recourse creditors under section 1111(b)(1), except that the chapter 13 plan may propose distribution of other property as well as deferred cash payments. n88 But the lien retained by virtue of section 1325(a)(5)(B)(i)(I) only secures deferred payments under the plan to the extent of the allowed secured claim. n89 Therefore, interest

payments over and above deferred payments aggregating the full amount of the allowed secured claim are not secured by the lien retained by the holder under section 1325(a)(5)(B)(i)(I). n90

Amount of Allowed Secured Claim. Section 1325(a)(5)(B)(ii) requires that the value of property to be distributed under the plan be not less than the amount of the *allowed secured claim*. n91 The amount of the allowed secured claim is determined in accordance with the provisions of subsections 506(a) and (b). n92 Section 506(a) imposes a valuation procedure for the determination of the status of allowed secured claims which reflects the extent to which an allowed claim is either undersecured or oversecured, based on a determination by the court as to whether the property encumbered by the lien has a dollar value that is greater or smaller than the dollar amount of the allowed claim. Absent a specific provision in a confirmed plan providing otherwise, this valuation procedure may take place either before or after confirmation of the plan. n93 Courts have differed regarding whether a proceeding separate from the confirmation hearing on a plan that assigns a value to an allowed secured claim is required for a secured claim to be bifurcated. n94

The allowed claim is deemed an allowed secured claim to the extent of the value of the estate's interest in the collateral and an allowed unsecured claim to the extent that the amount of the allowed claim exceeds the value of that interest. n95 In determining value of assets subject to a lien of the Internal Revenue Service, it is not clear whether the value of assets exempt from levy under the Internal Revenue Code should be included. n96

The Supreme Court addressed the issue of determining valuation for purposes of section 1325(a)(5) in *Associates Commercial Corp. v. Rash*. n97 Looking to the language of section 506(a), which states that value shall be determined in light of the purpose of the valuation and of the proposed disposition and use of such property, the Court held that the allowed secured claim to be paid pursuant to section 1325(a)(5)(B) must be based upon the cost the debtor would incur to obtain a like asset for the same proposed use. n98

The Court made clear that it was not holding that this replacement value was the retail value of the property. It left the determination of replacement value to the bankruptcy courts, based on the evidence presented, but pointed out that, in retaining a vehicle, the debtor was not receiving the value of items such as warranties, inventory storage, and reconditioning which are normally part of a retail price. n99 Even when a vehicle is sold by a dealer as is, some of these items are included. Instead, the Court stated that the value must be based upon the price a willing buyer would pay a willing seller for the property, n100 suggesting that the more relevant market to consult would be the market of private sales between individuals, in which items such as warranties, inventory storage, and reconditioning are not factors. n101 Alternatively, auto auctions may indicate a market price for vehicles sold without those items. In light of the high costs of presenting proof on these issues, many courts have continued to use standard formulas such as the average of the retail and wholesale values of a vehicle, as a presumptive starting point in the valuation process. n102 With respect to other types of personal property, the most relevant market might be that of yard sales or garage sales populated by willing buyers and sellers.

The 2005 amendments to section 506(a) n103 codify this approach, clarifying that, as the Supreme Court held, the value of personal property under section 506(a) is the replacement value of the property, without deduction of costs of sale or marketing. n104 Section 506(a)(2), as amended, provides that with respect to property acquired for personal, family, or household purposes, replacement value shall mean the price a retail merchant would charge for property of that kind, considering the age and condition of the property, which like the *Rash* decision would have to take into account what the debtor is not receiving, such as reconditioning and warranties.

Although not all courts are in agreement on this point, the collateral should probably be valued as of the effective date of the plan. n105 The 2005 amendments clarify this issue as well. Section 506(a)(2) provides that the valuation of property acquired for personal, family, or household purposes should consider the age and condition of the property at the time value is determined, n106 which would normally be the date of the confirmation hearing.

When the value of the property securing the lien exceeds the amount of the allowed claim, the allowed secured claim may include interest and other reasonable fees, charges, and expenses provided for in the contract between the

parties or a state statute, to the extent permitted by applicable nonbankruptcy law. n107 Interest, but not other fees, charges and expenses, may be included in an oversecured claim even if the lien securing the claim is nonconsensual. n108 In either case, section 506(b) permits such interest to run only to the date the plan is confirmed, and does not require that interest be calculated at the contract rate. n109

In *Rake v. Wade*, n110 the United States Supreme Court held that section 1325(a)(5) of the Code entitles holders of oversecured claims to postconfirmation interest on arrearages and other charges paid under a chapter 13 plan, even if the terms of the underlying promissory note did not provide for such interest. The Court found that while section 1322(b)(2) prohibits debtors from modifying the rights of home mortgage holders, the arrearages constituted a distinct claim which was provided for by the plan and, therefore, were subject to interest payments under the plain language of section 1325(a)(5)(B)(ii). The result in *Rake* was overruled by Congress through a new section 1322(e) enacted under the Bankruptcy Reform Act of 1994. n111 Section 1322(e) provides that in a cure situation, a creditor will receive only the interest and fees provided for in the agreement and permitted by applicable nonbankruptcy law. n112

However, if the claim is a claim secured solely by a security interest in the debtor's principal residence, the debtor's plan may not in some cases modify the rights of the holder of the claim. If a mortgage is not excepted from the operation of section 1322(b)(2) by section 1322(c)(2), n113 the debtor may not provide for the mortgage by paying the present value of the allowed secured claim and treating the allowed unsecured claim as unsecured. n114 In such a case, even if the value of the collateral is less than the amount of the claim, the plan may not modify the claim to provide for less than full payment of the claim according to its terms, at least if some portion of the claim is secured. n115 However, if the claim is wholly unsecured, the rationale of *Nobelman* dictates that it may be modified, because the creditor is not the holder of an allowed secured claim. n116

In addition, such a claim may be modified to the extent it is cured pursuant to section 1322(b)(5). n117 In such a case, the Supreme Court held in *Rake v. Wade*, n118 the arrearages are a distinct claim, and it is to that claim which the present value test of section 1325(a)(5) pertains. n119

For a complete discussion of Code section 1325, see Collier on Bankruptcy, ch. 1325 (Matthew Bender).

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n1 11 U.S.C. § 1325(a)(5)(C); see *Collier on Bankruptcy*, 1325.06[4] (Matthew Bender).

n2 11 U.S.C. § 1325(a)(5)(A); see *Collier on Bankruptcy*, 1325.06[2] (Matthew Bender).

n3 Section 1325(a)(5) applies only to secured claims provided for in plan. See *Collier on Bankruptcy*, 1325.06[1][b] (Matthew Bender); see also *Collier on Bankruptcy*, 1322.09[4] (Matthew Bender).

n4 11 U.S.C. § 1325(a)(5)(B), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n5 See 11 U.S.C. § 1325(a)(5)(B)(i); see Retention of Lien Securing Allowed Secured Claim *infra*.

n6 See 11 U.S.C. § 1325(a)(5)(B)(ii), (iii), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see Equivalent Value *infra*.

n7 11 U.S.C. § 1325(a)(5)(B), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n8 See 11 U.S.C. § 101; *Collier on Bankruptcy*, 1300.12[15] (Matthew Bender).

n9 11 U.S.C. § 1325(a)(5)(B)(i), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n10 *Id.*

n11 11 U.S.C. § 1327(b); see *Collier on Bankruptcy*, 1327.03 (Matthew Bender).

n12 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n13 124 Cong. Rec. H11,107 (Sept. 28, 1978) (remarks of Rep. Edwards); 124 Cong. Rec. S17,424 (remarks of Sen. DeConcini) (October 6, 1978).

n14 *IRS v. Campbell*, 180 B.R. 686, 33 C.B.C.2d 931 (M.D. Fla. 1993) (debtors were entitled to release of

IRS lien upon payment of allowed secured claim through plan, notwithstanding fact that unsecured priority claim had not yet been paid); *Ford Motor Credit Co. v. Lee (In re Lee)*, 162 B.R. 217, 30 C.B.C.2d 863 (D. Minn. 1993) (plan could provide that property would vest in debtors upon full payment of allowed secured claim); *Homeowners Funding Co. v. Skinner*, 129 B.R. 60 (E.D.N.C. 1991); *In re Rheame*, 50 C.B.C.2d 1085, 296 B.R. 313 (Bankr. D. Vt. 2003) (citing *First Branson Nat'l Bank v. Kerwin (In re Kerwin)*, 996 F.2d 552 (2d Cir. 1993)).

n15 11 U.S.C. § 506(a); see Amount of Allowed Secured Claim *infra*.

n16 See *In re Stoddard*, 167 B.R. 98 (Bankr. S.D. Ohio 1994) (upon conversion to chapter 7 after full payment of allowed secured claim in chapter 13, debtor could redeem property from lien pursuant to section 722 without further payment to creditor); *In re Hargis*, 103 B.R. 912 (Bankr. E.D. Tenn. 1989) (when case was converted to chapter 7 after allowed secured claim had been paid in full through plan, lien did not spring back into existence).

n17 Pub. L. No. 103-394.

n18 11 U.S.C. § 348(f) was amended in this regard by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 348.07[4] (Matthew Bender).

n19 11 U.S.C. § 1325(a)(5)(B)(i)(II), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n20 See Cases Filed Prior to Effective Date of 2005 Amendments *supra*.

n21 11 U.S.C. § 722, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 722 (Matthew Bender).

n22 11 U.S.C. § 1325(a)(5)(B)(i), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n23 11 U.S.C. § 1325(a)(5)(A); see *Collier on Bankruptcy*, 1325.06[2] (Matthew Bender).

n24 11 U.S.C. §§ 1325(a)(5)(A), (B)(i); cf. *In re Pence*, 905 F.2d 1107 (7th Cir. 1990) (if no objection to plan providing replacement lien is filed, plan may be confirmed).

n25 *In re Hink*, 81 B.R. 489 (Bankr. W.D. Ark. 1987).

n26 11 U.S.C. § 1325(a)(5)(B)(ii); see Property to be Distributed under the Plan *infra*.

n27 11 U.S.C. § 1322(b)(2); see *Collier on Bankruptcy*, 1322.06[1] (Matthew Bender).

n28 See 11 U.S.C. § 361(2). See generally *Collier on Bankruptcy*, ch. 361 (Matthew Bender).

n29 See 11 U.S.C. §§ 363, 1303; *Collier on Bankruptcy*, 1303.03 (Matthew Bender). 11 U.S.C. § 363 was amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see generally *Collier on Bankruptcy*, ch. 363 (Matthew Bender).

n30 11 U.S.C. § 1325(a)(5)(B)(i), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n31 11 U.S.C. § 1325(a)(5)(B)(i)(I)(bb).

n32 See 11 U.S.C. § 1325(a)(5)(B)(i); see Retention of Lien Securing Allowed Secured Claim *supra*.

n33 *11 U.S.C. § 1325(a)(5)(B)(ii).*

n34 *See Collier on Bankruptcy, 1325.05 (Matthew Bender). Compare Bankruptcy Act §§ 646(1), 656(a)(2), with former Bankruptcy Code §§ 1322(a)(3), (b)(1), 1325(a)(4).*

n35 *11 U.S.C. § 1325(a)(5)(B)(ii).*

n36 *508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424, 28 C.B.C.2d 983 (1993).*

n37 *508 U.S. 464, 474, 113 S. Ct. 2187, 2193, 124 L. Ed. 2d 424, 434, 28 C.B.C.2d 983, 990.*

n38 Pub. L. No. 103-394 (effective, as regards section 1322(e), with respect to agreements entered into after October 22, 1994).

n39 *See Pub. L. No. 103-394, § 702(b)(2)(D) (1994).*

n40 *11 U.S.C. § 1322(e); see Collier on Bankruptcy, 1322.18 (Matthew Bender).*

n41 *See Klee, All You Ever Wanted to Know About Cram Down under the New Bankruptcy Code, 53 Am. Bankr. L.J. 133, 137 n.24 (1979).*

n42 *See 11 U.S.C. §§ 522, 541; 1300.81, 1300.90 and 1306.02[1] (Matthew Bender); see also H.R. Rep. No. 595, 95th Cong., 1st Sess. 368 (1977).*

n43 *See 11 U.S.C. § 1306(a); see also Collier on Bankruptcy, 1306.02 (Matthew Bender).*

n44 See 11 U.S.C. § 1325(a)(5)(B)(ii); see Present Value Determination *infra*.

n45 11 U.S.C. § 1325(a)(5)(B)(ii).

n46 11 U.S.C. §§ 522, 541, 1306, 1322(a)(1), (b)(8); *In re Donahue*, 231 B.R. 865 (Bankr. D. Vt. 1998); see also *First Brandon Nat'l Bank v. Kerwin* (*In re Kerwin*), 996 F.2d 552, 29 C.B.C.2d 82 (2d Cir. 1993) (chapter 12 debtor could meet identical requirement under section 1225(b)(1)(A) by transferring to creditor portion of property securing claim if that portion had value equal to creditor's claim); Collier on Bankruptcy, 1300.81, 1300.90, 1306.02[1], 1322.02, 1322.12 (Matthew Bender). But see *Williams v. Tower Loan of Miss., Inc.* (*In re Williams*), 168 F.3d 845 (5th Cir. 1999) (transfer of a portion of property securing debt to pay allowed secured claim not permitted when creditor was undersecured and transfer of property would not pay debt in full).

n47 See 11 U.S.C. §§ 522, 541, 1306, 1322(a)(1), (b)(8); *First Brandon Nat'l Bank v. Kerwin* (*In re Kerwin*), 996 F.2d 552, 29 C.B.C.2d 82 (2d Cir. 1993) (chapter 12 debtor could meet identical requirement under section 1225(b)(1)(A) by transferring to creditor portion of property securing claim if that portion had value equal to creditor's claim); see also Collier on Bankruptcy, 1300.81, 1300.90, 1306.02[1], 1322.02 and 1322.12 (Matthew Bender).

n48 11 U.S.C. § 1325(a)(5)(B)(ii).

n49 11 U.S.C. § 1325(a)(5)(B)(ii).

n50 See 11 U.S.C. § 1322(a)(1); Collier on Bankruptcy, 1322.02 (Matthew Bender); cf. 11 U.S.C. § 1129(b)(2)(A)(i)(II).

n51 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n52 *In re DeSardi*, 340 B.R. 790 (Bankr. S.D. Tex. 2006).

n53 *11 U.S.C. § 1325(a)(5)(B)(iii)(II)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see* Equivalent Value; § 1325(a)(5)(B)(i) *infra*.

n54 *In re Davis*, 56 C.B.C.2d 322, 343 B.R. 326 (*Bankr. M.D. Fla. 2006*) (relying upon enactment of *11 U.S.C. § 1322(e)* to make section 1325(a)(5) inapplicable to cure of long-term debt).

n55 *11 U.S.C. § 1325(a)(5)(B)(iii)(II)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see* Equivalent Value; § 1325(a)(5)(B)(ii) *infra*.

n56 *11 U.S.C. §§ 362, 363*, as both were amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see* Collier on Bankruptcy, ch. 362 and ch. 363 (Matthew Bender).

n57 *11 U.S.C. § 1326(a)(1)(C)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see* Collier on Bankruptcy, ch. 1326 (Matthew Bender).

n58 *See Collier on Bankruptcy*, 1327.02[1][c] (Matthew Bender).

n59 *See* Property to Be Distributed under the Plan *supra*.

n60 *See 11 U.S.C. § 506(a)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; Collier on Bankruptcy, 1300.73[1][i] (Matthew Bender).

n61 *See Collier on Bankruptcy*, 1325.05 (Matthew Bender).

n62 *See 11 U.S.C. § 1325(a)(4), (5)(B)(ii)*.

n63 *See Collier on Bankruptcy*, 1325.05[2] (Matthew Bender).

n64 11 U.S.C. § 1325(a)(5)(B)(ii); *see* Effective Date of Plan as Valuation Date *supra*.

n65 11 U.S.C. § 1325(a)(5)(B)(ii); *see* Effective Date of Plan as Valuation Date *supra*.

n66 11 U.S.C. § 1325(a)(5)(B)(ii); *see* Effective Date of Plan as Valuation Date *supra*; *see also Collier on Bankruptcy*, 1324.02 (Matthew Bender).

n67 *In re Szostek*, 886 F.2d 1405 (3d Cir. 1989); *In re Vincent*, 252 B.R. 91 (Bankr. E.D. Va. 2000) (stating requested amount of interest in proof of claim does not constitute objection sufficient to contest interest rate at confirmation).

n68 11 U.S.C. § 1325(a)(5)(B)(ii); *see* Effective Date of Plan as Valuation Date *supra*.

n69 *But see Baxter v. Watson (In re Watson)*, 292 B.R. 441 (Bankr. S.D. Ga. 2003) (interest may be reduced under Soldiers and Sailors Civil Relief Act § 206, now § 207 of the Servicemembers Civil Relief Act, 50 U.S.C. App. § 527).

n70 H.R. Rep. No. 595, 95th Cong., 1st Sess. 414 (1977).

n71 11 U.S.C. § 1325(a)(5)(C); *see Collier on Bankruptcy*, 1325.06[4] (Matthew Bender).

n72 *E.g., GMAC v. Valenti (In re Valenti)*, 105 F.3d 55 (2d Cir. 1997).

n73 *E.g., Green Tree Fin. Servicing Corp. v. Smithwick (In re Smithwick)*, 121 F.3d 211, 38 C.B.C.2d 1005 (5th Cir. 1997).

n74 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787, 51 C.B.C.2d 643 (2004).

n75 Although no opinion commanded a majority of five justices, the plurality opinion of Justice Stevens, speaking for four justices entered a judgment that reversed the decision below and ordered further proceedings consistent with that plurality opinion. Justice Thomas, concurred in that judgment but, based upon the language of the statute, expressed the view that the appropriate rate should be lower, including no amount to compensate the creditor for risk. *See Bank of Montreal v. Official Comm. of Unsecured Creditors (In re American Homepatient, Inc.)*, 420 F.3d 559, 566 (6th Cir. 2005) (Till treated as decision of the Court).

n76 541 U.S. 465, 477, 124 S. Ct. 1951, 1960, 158 L. Ed. 2d 787, 799.

n77 *Id.*

n78 541 U.S. 465, 479, 124 S. Ct. 1951, 1961, 158 L. Ed. 2d 787, 800.

n79 *Id.*

n80 541 U.S. 465, 479, 124 S. Ct. 1951, 1961, 158 L. Ed. 2d 787, 800 (citation omitted).

n81 541 U.S. 465, 480, 124 S. Ct. 1951, 1962, 158 L. Ed. 2d 787, 801.

n82 *Id.*

n83 541 U.S. 465, 480-81, 124 S. Ct. 1951, 1964, 158 L. Ed. 2d 787, 803.

n84 11 U.S.C. § 1325(a)(5)(B)(i); see Retention of Lien Securing Allowed Secured Claim *infra*.

n85 11 U.S.C. § 1307(c)(6); see *Collier on Bankruptcy*, 1307.04[6] (Matthew Bender).

n86 *In re Knight*, 254 B.R. 227 (Bankr. C.D. Ill. 2000).

n87 See 541 U.S. 465, 475, 124 S. Ct. 1951, 1959 note 12, 158 L. Ed. 2d 787, 798 note 12 (noting reduction of risk due to fact that obligor becomes court-supervised estate).

n88 See 124 Cong. Rec. H11,107 (daily ed. Sept. 28, 1978).

n89 See *Ford Motor Credit Co. v. Stevens (In re Stevens)*, 130 F.3d 1027 (11th Cir. 1997) (creditor was entitled to receive insurance compensating for the destruction of collateral only to the extent of the balance of its allowed secured claim); *In re Arkell*, 165 B.R. 432 (Bankr. M.D. Tenn. 1994); *In re McDade*, 148 B.R. 42 (Bankr. S.D. Ill. 1992).

n90 See 124 Cong. Rec. H11,107 (daily ed. Sept. 28, 1978).

n91 11 U.S.C. § 1325(a)(5)(B)(ii).

n92 11 U.S.C. § 506(a)(b), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 1300.73 (Matthew Bender).. See generally ch. 506 *supra*.

n93 *In re Lewis*, 875 F.2d 53 (3d Cir. 1989).

n94 See *Collier on Bankruptcy*, 1327.02[2] (Matthew Bender).

n95 11 U.S.C. § 506(a); see *Collier on Bankruptcy*, 1300.73[1] (Matthew Bender). When community property that is property of the estate pursuant to section 541(a)(2) is encumbered by a lien, the determination of whether there is equity in the property is not affected by the fact that the nondebtor may hold a community property interest in the property. Because the entirety of the community property passes to the estate, see *Collier on Bankruptcy*, 541.13 (Matthew Bender), the elimination of a completely unsecured lien, or the reduction of the amount of a partially secured lien, affects the entire property, including the nondebtor spouse's community property interest therein. *Highland Federal Bank v. Maynard (In re Maynard)*, 264 B.R. 209 (B.A.P. 9th Cir. 2001). In valuing real estate, the value of rental income should not be added because it is already taken into account in the fair market value of the property. *Chase Manhattan Mortgage Corp. v. Thompson (In re Thompson)*, 352 F.3d 519 (2d Cir. 2003).

n96 See *United States v. Barbier*, 896 F.2d 377 (9th Cir. 1990), rev'g 84 B.R. 190 (D. Nev. 1988).

n97 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 37 C.B.C.2d 744 (1997).

n98 See also *Ardmor Vending Co. v. Kim (In re Kim)*, 130 F.3d 863 (9th Cir. 1997) (value of equipment must be determined based on intended continued use of property in debtor's business); *Taffi v. United States (In re Taffi)*, 96 F.3d 1190 (9th Cir. 1996) (en banc), cert denied, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997) (hypothetical costs of sale not deducted if debtor plans to retain property).

n99 520 U.S. 953, 965 n.6, 117 S. Ct. 1879, 1886 n.6, 138 L. Ed. 2d 148, 160 n.6, 37 C.B.C.2d 744, 751 n.6 (1997).

n100 520 U.S. 953, 959 n.2, 117 S. Ct. 1879, 1884 n.2, 138 L. Ed. 2d 148, 156 n.6, 37 C.B.C.2d 744, 747 n.2 (1997).

n101 See *In re McElroy*, 210 B.R. 833 (Bankr. D. Or. 1997) (discussing proof of value after *Rash*).

n102 *E.g., First Merit N.A. v. Getz (In re Getz)*, 242 B.R. 916 (B.A.P. 6th Cir. 2000) (in absence of other evidence, finding that value was average of bluebook wholesale and retail values was not clearly erroneous); *In re Lyles*, 226 B.R. 854 (Bankr. W.D. Tenn. 1998); *In re Younger*, 216 B.R. 649 (Bankr. W.D. Okla. 1998).

n103 11 U.S.C. § 506(a), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n104 H.R. Rep. No. 31, 109th Cong. 1st Sess., 17 (2005).

n105 *See Collier on Bankruptcy*, 506.02 (Matthew Bender). *But see In re Hall*, 24 C.B.C.2d 718, 118 B.R. 671 (Bankr. S.D. Ind. 1990) (valuation to occur as of commencement of the case); *GMAC v. Chapman (In re Chapman)*, 135 B.R. 11 (Bankr. M.D. Pa. 1990) (date of filing of chapter 13 plan should be valuation date).

n106 11 U.S.C. § 506(a)(2), as enacted by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n107 11 U.S.C. § 506(b), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 1300.73[2] (Matthew Bender); *see also In re Wilder*, 22 B.R. 294 (Bankr. M.D. Ga. 1982); *In re Roberts*, 6 C.B.C.2d 892, 20 B.R. 914 (Bankr. E.D.N.Y. 1982).

n108 *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 20 C.B.C.2d 267 (1989).

n109 *Key Bank N.A. v. Milham (In re Milham)*, 141 F.3d 420 (2d Cir.), *cert denied*, 525 U.S. 872, 119 S. Ct. 169, 142 L. Ed. 2d 138 (1998).

n110 508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424, 28 C.B.C.2d 983 (1993).

n111 Pub. L. No. 103-394 (effective with respect to agreements entered into after October 22, 1994).

n112 *See Collier on Bankruptcy*, 1322.18 (Matthew Bender).

n113 11 U.S.C. § 1322(c)(2); *see Collier on Bankruptcy*, 1322.16 (Matthew Bender).

n114 11 U.S.C. § 1322(b)(2); *Nobelman v. American Sav. Bank*, 508 U.S. 324, 113 S. Ct. 2106, 124 L. Ed. 2d 228, 28 C.B.C.2d 977 (1993); *see Collier on Bankruptcy*, 1322.06[1][a] (Matthew Bender).

n115 11 U.S.C. § 1322(b)(2); *Nobelman v. American Sav. Bank*, 508 U.S. 324, 113 S. Ct. 2106, 124 L. Ed. 2d 228, 28 C.B.C.2d 977 (1993); *see Collier on Bankruptcy*, 1322.06[1][a] (Matthew Bender).

n116 *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220 (9th Cir. 2002); *Lane v. Western Interstate Bancorp (In re Lane)*, 280 F.3d 663, 47 C.B.C.2d 1320 (6th Cir. 2002); *Pond v. Farm Specialist Realty (In re Pond)*, 252 F.3d 122 (2d Cir. 2001); *Tanner v. FirstPlus Fin., Inc. (In re Tanner)*, 217 F.3d 1357 (11th Cir. 2000); *Bartee v. Tara Colony Homeowners Ass'n (In re Bartee)*, 212 F.3d 277 (5th Cir. 2000); *McDonald v. Master Fin., Inc. (In re McDonald)*, 205 F.3d 606 (3d Cir.), *cert. denied*, 531 U.S. 822, 121 S. Ct. 66, 148 L. Ed. 2d 31 (2000); *see Collier on Bankruptcy*, 1322.06[1][a] (Matthew Bender).

n117 11 U.S.C. § 1322(b)(5); *see Collier on Bankruptcy*, 1322.09 (Matthew Bender).

n118 508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424, 28 C.B.C.2d 983 (1993).

n119 The result in *Rake* was overruled by Congress through a new section 1322(e) enacted under the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to agreements entered into after October 22, 1994). Section 1322(e) provides that in a cure situation, a creditor will receive only the interest and fees provided for in the agreement and permitted by applicable nonbankruptcy law. *See Collier on Bankruptcy*, 1322.18 (Matthew Bender).

ABOUT THE AUTHOR(S):

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156 of 197 DOCUMENTS

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Collier on Commencement of Ch 13 Plan Payments

2008 Emerging Issues 1254

Collier on Commencement of Ch 13 Plan Payments

By Collier

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SUMMARY: Before the passage of the Bankruptcy Amendments and Federal Judgeship Act of 1984, there was a good deal of variation among bankruptcy courts as to when chapter 13 plan payments by debtors were to begin. Congress added to section 1326 of the Code subsection (a), which generally requires plan payments to begin within 30 days of the filing of the plan. As discussed in this Emerging Issues Analysis, provisions were significantly amended in 2005.

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ARTICLE: Before the passage of the Bankruptcy Amendments and Federal Judgeship Act of 1984, n1 there was a good deal of variation among bankruptcy courts as to when chapter 13 plan payments by debtors were to begin. Many courts, by standing order or local rule, required commencement of payments immediately after the filing of a case. n2 Others held that no payments could be required until the plan was confirmed. n3 In those latter jurisdictions, this sometimes led to considerable delay in distributions to creditors. When confirmation was contested or delayed, the debtor did not begin making payments to the trustee for months or even years.

Congress also feared that some chapter 13 plans were being jeopardized by debtors becoming accustomed to higher living expenses when they were relieved of prior debt payments and not yet responsible for plan payments. n4 Trustees reported that when plan payments began promptly they had a greater chance of success. n5

Therefore, Congress added to section 1326 of the Code subsection (a), n6 which generally requires plan payments to begin within 30 days of the filing of the plan. n7 As discussed immediately below, this provision was significantly amended in 2005.

Deadline for Commencement of Payments

Section 1326(a)(1) was amended by the 2005 amendments to the Bankruptcy Code n8 to provide that payments to the trustee must begin not later than 30 days after the filing of the plan or the order for relief, whichever is earlier. Because it is hard to imagine a circumstance in which a plan would be filed before the order for relief, which is normally the petition, n9 but could also be the conversion of a case from another chapter, n10 this amendment effectively requires payments to commence within 30 days after the petition or conversion to chapter 13. Section 1326(a)(1) was also amended at the same time to require payments, governed by the same deadline, to lessors of

personal property and certain secured creditors, as discussed below. n11

Payments to the Trustee. Under subsection 1326(a)(1)(A), as amended and redesignated in 2005, n12 unless the court orders otherwise, the debtor must commence making payments to the chapter 13 trustee proposed by a plan within 30 days after the order for relief. This general rule will result in most plan payments beginning 30 days after the filing of a chapter 13 case, or the conversion of a case to chapter 13.

The court may extend the deadline for the commencement of plan payments in a particular case. Such an order is appropriate when the debtor is suffering a temporary drop in income or unusual expenses that are not likely to continue, although almost the same result could be achieved by the debtor's filing of a plan that simply provided for minimal payments at the beginning of the plan. An order would also be necessary when plan payments were to come from the liquidation of property, n13 which might take longer than 30 days or might have to await confirmation of the plan.

The failure to commence plan payments when required can be cause for dismissal or conversion of the chapter 13 case under section 1307(c)(4). n14 However, as in other situations in which the court may dismiss or convert the case under section 1307(c), the court has the discretion to excuse the failure to commence plan payments on time in appropriate circumstances. n15

Payments to Personal Property Lessors. Section 1326(a)(1)(B), added in 2005, n16 requires a chapter 13 debtor to make payment scheduled in a personal property lease directly to the lessor for that portion of the obligation that becomes due after the order for relief. These payments are to commence within the same 30 days after the filing of the plan or the order for relief, whichever is earlier. n17 Plan payments are to be reduced by the amount of such payments and the trustee is to be provided evidence of the payments, including the amounts and dates of the payments. n18

For leases that a debtor intends to assume, it has long been the practice to make current payments to the lessor after a chapter 13 petition is filed and to cure any default, as provided in section 365, through plan payments. n19 Therefore, for such leases, the practice will not be substantially changed. For leases the debtor intends to reject, the debtor may wish to continue lease payments to keep open the option of assumption, or the debtor may fail to comply with section 1326(a)(1)(B). If the lease is not assumed in the confirmed plan, it is deemed rejected as of the conclusion of the confirmation hearing and the stays under section 362 and section 1301 are automatically terminated. n20

The remedy for failure to make current lease payments required by section 1326(a)(1)(B) is likely to be relief from the automatic stay, the same remedy as exists under current law for failure to make current lease payments. However, a lessor will still have to file a motion for relief from the stay if payments have not been made, and the court may well allow a debtor to cure such a default in payments. Rather than filing such a motion, the lessor may decide to await plan confirmation if the plan does not propose to assume the lease, because the automatic termination of the stay upon confirmation will usually take place in about the same amount of time as it would take to file a motion for relief from the stay and obtain a hearing on the motion. A failure to make payments required by section 1326 is grounds for dismissal, n21 but the lessor will usually prefer stay relief and the trustee has no reason to seek dismissal of an otherwise viable plan.

Adequate Protection Payments. Section 1326(a)(1)(C), enacted in 2005, n22 requires a chapter 13 debtor to make adequate protection payments directly to a creditor holding an allowed claim secured by personal property to the extent it is attributable to the purchase of such property by the debtor for that portion of the obligation that becomes due after the order for relief. These payments are to commence within 30 days after the filing of the plan or the order for relief, whichever is earlier. n23 Plan payments are to be reduced by the amount of such payments and the trustee is to be provided evidence of the payments, including the amounts and dates of the payments. n24

Adequate protection payments under section 1326(a)(1)(C) need only be provided for the portion of claim that

becomes due after the order for relief. Does this mean that no adequate protection needs to be provided for any arrears portion of claim? Adequate protection payments also need be made only to the extent the obligation is purchase-money and the property was purchased by the debtor. If property was originally titled in the name of another, such as a nondebtor spouse, it probably was not purchased by the debtor. And adequate protection payments must be provided only to a creditor that holds an allowed claim, which suggests they are not necessary until the creditor files a proof of claim. n25 If these provisions are deemed the extent to which some creditors are entitled to adequate protection, they may in some cases override stronger protections that creditors had under prior law.

The adequate protection provision was obviously designed primarily for car lenders. As a practical matter, although it technically applies to appliance and furniture creditors, it is unlikely they will do much to enforce these provisions because the adequate protection amounts would be minimal and these creditors typically do not desire return of the collateral if they can collect anything at all on their claims.

The amount of adequate protection payments presumably will initially be set by the debtor and be based on the rate of the collateral's depreciation. n26 This can be calculated for a vehicle by looking at the change in industry guide values over the previous few months. However, if a claim is substantially oversecured, and will remain oversecured, there should be no need for adequate protection payments, or they should be nominal. The amount of payments can be modified by order of the court pending confirmation of a plan, n27 which suggests that the plan will govern thereafter.

There is no requirement that the payments be made at any particular time intervals. For ease of administration, a debtor may wish to make one payment, directly through the attorney's office to facilitate bookkeeping and providing evidence to the trustee. When such a payment for the preconfirmation period is less than a full plan payment, as will usually be the case, the amount paid will be deducted from the first plan payment due.

The statute does not specifically state whether adequate protection payments end as of plan confirmation. There is nothing in the provision that sets an ending date. However, the plan is required by language added to section 1325(a)(5) to provide that payments on allowed secured claims under the plan be sufficient to provide adequate protection, n28 and the plan can certainly provide that adequate protection shall be provided by such payments.

The remedy for failure to make required adequate protection payments is likely to be relief from the automatic stay, the same remedy as under prior law for failure to provide adequate protection. The main difference is that prior law in effect placed the burden on the creditor to demand adequate protection, usually by filing a motion. However, a creditor will still have to file a motion for relief from the stay if adequate protection payments have not been provided, and the court may well allow a debtor to cure such a default in payments. Theoretically, a failure to make payments required by section 1326 could also be grounds for dismissal, n29 but the creditor will usually prefer stay relief and the trustee has no reason to seek dismissal of an otherwise viable plan.

Disposition by Trustee of Payments Made Before Confirmation Decision

Subsection 1326(a)(2) sets forth the trustee's duties, both before and after the confirmation decision, regarding payments made to the trustee before the confirmation decision.

Trustee Retains Payments until Confirmation Decision. Section 1326(a)(2) provides that until a decision on plan confirmation is rendered, the payments made by the debtor are required to be retained by the chapter 13 trustee so that after confirmation they may be distributed to creditors under the plan.

The debtor's ability to make regular payments during this period may be an important factor in whether the plan is confirmed, because it will demonstrate whether it is feasible for the debtor to make the payments proposed. n30 Ordinarily, if a debtor has been able to comply substantially with the proposed plan during the preconfirmation period, he or she should be given the benefit of the doubt in application of the feasibility test and allowed to attempt the plan as proposed, especially when no modification to lower payments is possible within the parameters of chapter 13.

Disposition of Payments When Plan Is Confirmed. Section 1326(a)(2) further provides that if a plan is confirmed, the trustee must distribute any payment he or she retained in accordance with the plan as soon as is practicable. The words directing the trustee to make distributions as soon as practicable after confirmation were added to subsection 1326(a)(2) by the Bankruptcy Reform Act of 1994, n31 apparently in the belief that some chapter 13 trustees were unduly delaying distributions. The legislative history indicates that this new language may have been intended to encourage trustees to make distributions before the claims bar date, in districts where confirmation occurs before that date, as trustees in some districts have done. n32 Because of the 2005 amendment adding section 1324(b), n33 it is likely that almost all confirmation hearings will be concluded before the claims bar date.

However, other language in the legislative history states that trustees should make distributions before the claims bar date only if they can ensure adequate protection against any prejudice to later filing claimants caused by distributions before the bar date. n34 Unless a plan clearly directs a trustee to pay particular creditors who have already filed claims before all others, or a trustee obtains creditors' guarantees that they will disgorge payments if they have been paid in error, it is hard to see how a trustee can ensure such protection when distributions are made before the bar date. As long as there is a possibility that a timely filed secured or priority claim-- which should be paid by the initial distributions under the plan-- will be filed after distributions are made, the trustee will risk paying money to the wrong creditors. Indeed, this quandary is exacerbated by the 1994 Act's extension of the bar date for governmental creditors, who are often priority or secured creditors, n35 and by the 2005 amendment even further extending the deadline set for certain tax claims. n36

Hence, it is doubtful that the language in section 1326(a)(2) will cause any trustees to make distributions sooner than they had been doing previously. Few trustees, if any, would admit that they had not been making distributions as soon as practicable. Moreover, due to the extended bar dates for governmental claims, many of them will wait even longer before making distributions, until the government bar dates have passed.

Disposition of Payments When Plan Is Not Confirmed. Section 1326(a)(2) further provides that if a plan is not confirmed under chapter 13, the trustee must return all payments n37 to the debtor, deducting any unpaid claim for administrative expenses allowed under section 503(b). n38 Under language added in 2005, n39 the trustee is also to deduct any unpaid adequate protection payments that are due and owing to creditors under section 1326(a)(3). Because section 1326(a)(3) provides for possible court orders requiring particular payments pending confirmation of the plan, n40 the trustee is obligated to make payments to creditors, and withhold those payments from the debtor's refund, only if a specific order for payments to those creditors has previously been entered by the court and the trustee has not made the payments ordered when they were due.

The trustee's obligations under section 1326(a)(2) can arise if, before confirmation, the case is dismissed n41 or converted to another chapter. n42 They may also arise if confirmation is denied, although the trustee should normally first ascertain whether the debtor seeks to modify the plan n43 and again seek confirmation.

Ordinarily, if the case is converted to chapter 7, the payments returned to the debtor are not property of the chapter 7 estate. Those payments typically are derived from the debtor's postpetition income and section 348(f)(1)(a) provides that such property, which was not property of the estate as of the date the petition was filed, is not property of the

chapter 7 estate after conversion. n44 The only exception to this rule is if the court finds, under section 348(f)(2), that the case was converted in bad faith. n45

In *Beam v. IRS (In re Beam)*, n46 the Court of Appeals for the Ninth Circuit held that the funds in the trustee's hands after a case is dismissed that are due to be returned to the debtor could be levied upon by the Internal Revenue Service and that if such a levy occurred, the funds must be turned over to the Internal Revenue Service rather than the debtor. The court held that once the debtors had the right to receive the funds from the trustee, the Internal Revenue Service could levy under *section 6331 of title 26, United States Code*, just as it could levy on any other entity which owed the debtors money. However, other courts have held that a creditor's levy does not overcome the trustee's duty under this section to return funds to the debtor, and that the funds are simply to be returned subject to the levy. n47 This situation should not arise often, since the trustee should normally disburse funds to the debtors forthwith upon the case being dismissed and therefore will rarely be holding funds long enough for a levy to take place. A levy prior to the dismissal would normally violate section 362(a)(4), n48 as an act to create a lien against property of the estate. And, in any event, the amount that would be available to satisfy a levy would be only the amount due to the debtor after deduction of administrative expenses and any unpaid payments under section 1326(a)(3). n49

Payment of Administrative Expenses When Plan Not Confirmed. Before payments in the trustee's hands are returned to the debtor, section 1326(a)(2) requires deduction of any administrative expenses allowed under section 503(b). It is not clear that a standing trustee's percentage fee, intended to cover the trustee's costs and compensation, n50 may be paid under this provision. At least two courts have held that because the trustee's percentage fee is not governed by section 326 or section 330, it is not an administrative expense under section 503(b). n51

The \$5-per-month minimum compensation of section 330(c) n52 is not applicable to the payments returned to the debtor, because that section applies to distributions under the plan during the administration of the plan. n53

If the court has approved attorney's fees for the debtor's counsel, such fees would also be claims under section 503(b), n54 and must be paid by the trustee before the balance of the funds are returned to the debtor. n55 Any other claims of administrative expenses must be approved by the court and come within the ambit of section 503 n56 before they can be paid by the trustee.

Modification of Required Payments

Section 1326(a)(3), added by the 2005 amendments to the Bankruptcy Code, n57 permits the court, after notice and a hearing, to modify, increase, or reduce the payments required under section 1326(a), which would include payments to the trustee, payments to personal property lessors, or adequate protection payments to holders of allowed claims secured by personal property. Because the amount of payments will usually be set by the debtor in the first instance, this provision may be used more often by creditors and lessors seeking to increase payment amounts. However, because the payments do not commence until 30 days after the petition, and because it may well take another 30 days to obtain a hearing on a motion to increase payments, there may be little incentive for them to utilize section 1326(a)(3). By the time a hearing is scheduled, the court may have confirmed a plan or be about to confirm a plan and confirmation may moot any issue of preconfirmation payments.

Some courts or trustees may wish to use this section to modify the payment requirement so that adequate protection payments can be routed through the trustee in order to ease the bookkeeping difficulties that would otherwise occur. A local rule or practice could provide a default procedure giving notice and a hearing in every case regarding such a modification, i.e., an opportunity for a creditor to object, with the absence of such an objection resulting in all payments being routed through the trustee.

Proof of Required Insurance

Section 1326(a)(4), added in 2005, n58 provides that a debtor who retains possession of personal property subject to a lease or securing a claim attributable in whole or in part to the purchase price of the property must provide the lessor or secured creditor reasonable evidence of the maintenance of any required insurance coverage on the property and continue to do so for so long as the debtor retains possession of the property.

The maintenance of required insurance on vehicles is often considered a form of adequate protection and this provision seeks to shift the burden a creditor or lessor previously had of demanding proof of such adequate protection. In most cases, such proof is not necessary, because a creditor or lessor is named as a loss payee on the insurance policy and is notified if coverage lapses. However, if coverage has lapsed, the creditor or lessor has an obvious interest in being notified that it is reinstated. Indeed, the fact that such evidence need not be provided for 60 days leaves a significant period of time during which the property may be uninsured.

The remedy for failure to provide proof of insurance is likely to be a motion for relief from the stay. Presumably, a creditor who knows that the property, in fact, is insured would not file such a motion. Indeed, even when it is not clear whether insurance exists, it would seem that an inquiry to the debtor's counsel would be a logical step before the costs of such a motion are incurred.

The language at the end of section 1326(a)(4), that the debtor shall continue to do so for so long as the debtor retains possession of the property is somewhat peculiar. It does not state how often the debtor shall do so--presumably, provide proof of insurance. Certainly, the language cannot be read literally to require the debtor to continually provide such proof. Again, as a practical matter, assuming the debtor has insurance naming the creditor or lessor as loss payee, there would be notice from the insurer to the creditor or lessor if the coverage lapsed, so this language is not likely to be frequently invoked.

For a complete discussion of Code section 1326, see Collier on Bankruptcy, ch. 1326 (Matthew Bender).

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[Return to Text](#)

n1 1. Pub. L. No. 98-353 (1984).

n2

2. S. Rep. No. 65, 98th Cong., 1st Sess. 16 (1983).

n3

3. S. Rep. No. 65, 98th Cong., 1st Sess. 16 (1983).

n4

4. S. Rep. No. 65, 98th Cong., 1st Sess. 15-16 (1983).

n5

5. S. Rep. No. 65, 98th Cong., 1st Sess. 16 (1983).

n6

6. Former 11 U.S.C. § 1326(a) and (b) were redesignated as subsections (b) and (c).

n7

7. See Deadline for Commencement of Payments; § 1326(a)(1) *infra*.

n8

8. Pub. L. No. 109-8, 309(c)(2) (2005), effective in cases commenced on or after October 17, 2005.

n9

9. 11 U.S.C. § 301(b).

n10

10. 11 U.S.C. § 348(a). The language added to section 1326(a)(1) is ambiguous in that it could be read to require payments within 30 days after the order for relief in a converted case. However, such a reading would lead to a nonsensical result because conversion does not change the date of the order for relief, 11 U.S.C. § 348(a), and it would usually be impossible to begin payments within 30 days after the date of the order for relief under the chapter originally chosen, a date usually more than 30 days before the conversion.

n11

11. 11 U.S.C. § 1326(a)(1)(B), (C), added by Pub. L. No. 109-8, § 309(c)(2) (2005), effective in cases

commenced on or after October 17, 2005; see Payments to Personal Property Lessors; § 1326(a)(1)(B) and Adequate Protection Payments; § 1326(a)(1)(C) *infra*.

n12

12. Pub. L. No. 109-8, § 309(c)(2) (2005), effective in cases commenced on or after October 17, 2005.

n13

13. See 11 U.S.C. § 1322(b)(8); see also *Collier on Bankruptcy*, 1322.12 (Matthew Bender).

n14

14. 11 U.S.C. § 1307(c)(4); see *Collier on Bankruptcy*, 1307.04[4] (Matthew Bender).

n15

15. *In re Smith*, 85 B.R. 729 (E.D. Va. 1988); see *Collier on Bankruptcy*, 1307.04[4] (Matthew Bender).

n16

16. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 309(c)(2) (2005), effective in cases commenced on or after October 17, 2005.

n17

17. 11 U.S.C. § 1326(a)(1); see Deadline for Commencement of Payments; § 1326(a)(1) *supra*.

n18

18. 11 U.S.C. § 1326(a)(1)(B).

n19

19. See *Collier on Bankruptcy*, 1322.11 (Matthew Bender).

n20

20. 11 U.S.C. § 365(p)(3), added by Pub. L. No. 109-8, § 309(b) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 365 (Matthew Bender).

n21

21. 11 U.S.C. § 1307(c)(4).

n22

22. Pub. L. No. 109-8, § 309(c)(2) (2005), effective in cases commenced on or after October 17, 2005.

n23

23. 11 U.S.C. § 1326(a)(1); see Deadline for Commencement of Payments; §1325(a)(1) *supra*.

n24

24. 11 U.S.C. § 1326(a)(1)(C).

n25

25. 11 U.S.C. § 502(a); see *Collier on Bankruptcy*, 502.02[1][a] (Matthew Bender).

n26

26. However, if there are significant arrears in the creditor's claim, the language giving adequate protection to only the portions becoming due after the order for relief may permit lower payments.

n27

27. 11 U.S.C. § 1326(a)(3), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n28

28. 11 U.S.C. § 1325(a)(5)(B)(iii)(II), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n29

29. 11 U.S.C. § 1307(c)(4).

n30

30. 11 U.S.C. § 1325(a)(6); see *Collier on Bankruptcy*, 1325.07 (Matthew Bender); see also S. Rep. No. 65, 98th Cong., 1st Sess. 16 (1983).

n31

31. Pub. L. No. 103-394. A technical amendment adding is before practicable was made by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n32

32. See 140 Cong. Rec. H10,770 (daily ed. Oct. 4, 1994) (remarks of Rep. Jack Brooks).

n33

33. 11 U.S.C. § 1324(b), added by Pub. L. No. 109-8, § 317(b) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 1324.02[2] (Matthew Bender).

n34

34. See 140 Cong. Rec. H10,770 (daily ed. Oct. 4, 1994) (remarks of Rep. Jack Brooks).

n35

35. See 11 U.S.C. § 502(b)(9), providing that governmental unit's proof of claim is timely filed if filed before 180 days after date of order for relief or such later date as Bankruptcy Rules provide. See, e.g., *In re Wilson*, 274 B.R. 4 (Bankr. D.D.C. 2001) (trustee required to seek disgorgement of payments made to unsecured creditors in light of later-filed government claims which rendered those payments excessive under confirmed plan).

n36

36. 11 U.S.C. § 502(b)(9), as amended by Pub. L. No. 109-8, § 716(d) (2005), effective in cases commenced on or after October 17, 2005, to permit filing of tax claims in chapter 13 within 60 days of a tax return filed under section 1308.

n37

37. For purposes of this provision, funds received from the preconfirmation sale of a debtor's property and designated by the sale order for the payment of liens on the property were not payments under the plan to be returned to the debtor. *In re Witte*, 279 B.R. 585 (Bankr. E.D. Cal. 2002).

n38

38. See Payment of Administrative Expenses When Plan Not Confirmed. *infra*. The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, had previously made a minor technical amendment to section 1326(a)(2).

n39

39. Pub. L. No. 109-8, § 309(c)(2) (2005), effective in cases commenced on or after October 17, 2005.

n40

40. 11 U.S.C. § 1326(a)(3), added by Pub. L. No. 109-8, § 309(c)(2) (2005), effective in cases commenced on or after October 17, 2005; see Modification of Required Payments; § 1326(a)(3) *infra*.

n41

41. 11 U.S.C. § 1307(b), (c); see *Collier on Bankruptcy*, 1307.03 (Matthew Bender).

n42

42. 11 U.S.C. § 1307(a), (c), (d); see *Collier on Bankruptcy*, 1307.04 and 1307.05 (Matthew Bender).

n43

43. 11 U.S.C. § 1323; see *Collier on Bankruptcy*, ch. 1323 (Matthew Bender).

n44

44. 11 U.S.C. § 348(f)(1)(a); see *Collier on Bankruptcy*, 348.07[1] (Matthew Bender).

n45

45. 11 U.S.C. § 348(f)(2); see *Collier on Bankruptcy*, 348.07[2] (Matthew Bender).

n46

46. 192 F.3d 941 (9th Cir. 1999).

n47

47. *In re Oliver*, 40 C.B.C.2d 725, 222 B.R. 272 (Bankr. E.D. Va. 1998); *In re Clifford*, 33 C.B.C.2d 1006, 182 B.R. 229 (Bankr. N.D. Ill. 1995).

n48

48. See *Collier on Bankruptcy*, 362.03[6] (Matthew Bender).

n49

49. See *In re Doherty*, 229 B.R. 461 (Bankr. E.D. Wash. 1999) (claims of state taxing authority to funds in trustee's hands could be paid only after deduction of administrative expenses).

n50

50. 28 U.S.C. § 586(e).

n51

51. *In re Rivera*, 268 B.R. 292 (Bankr. D.N.M. 2001), aff'd, 2001 Bankr. LEXIS 1549 (B.A.P. 10th Cir. Dec. 4, 2001); *In re Ward*, 132 B.R. 417 (Bankr. D. Neb. 1991).

n52

52. 11 U.S.C. § 330(c); see *Collier on Bankruptcy*, 1302.05[1] (Matthew Bender).

n53

53. 11 U.S.C. § 330(c); see *Collier on Bankruptcy*, 1302.05[1] (Matthew Bender).

n54

54. 11 U.S.C. § 503(b)(2); see *In re Harris*, 258 B.R. 8 (Bankr. D. Idaho 2000) (attorney's fees could be paid from funds held by trustee only if allowed as administrative expenses); *Collier on Bankruptcy*, 503.09 (Matthew Bender).

n55

55. *In re Oliver*, 40 C.B.C.2d 725, 222 B.R. 272 (Bankr. E.D. Va. 1998).

n56

56. See *Williams v. IMC Mortg. Co. (In re Williams)*, 246 B.R. 591 (B.A.P. 8th Cir. 1999) (denying request that mortgage payments not made during plan be allowed as administrative expenses).

n57

57. Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n58

58. Pub. L. No. 109-8, § 309(c)(2) (2005), effective in cases commenced on or after October 17, 2005.

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157 of 197 DOCUMENTS

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Collier on Creditors Committees

2008 Emerging Issues 1255

Collier on Creditors Committees

By Collier

December 3, 2007

SUMMARY: This Emerging Issues Analysis discusses section 1102(a)(2) of the Bankruptcy Code, which provides that the court may, upon the request of a party in interest, order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders.

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ARTICLE: Committee Membership

Court's Authority to Appoint Additional Committees. *Section 1102(a)(2) of the Bankruptcy Code* provides that the court may, upon the request of a party in interest, order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation n1 of creditors or of equity security holders. n2 However, as section 1102(a)(1) also gives permission to the United States trustee to appoint such additional committees, a party seeking the appointment of an additional committee should first request appointment from the United States trustee before seeking an order from the court. If a party has failed to do so, the court ought to refrain from ruling on any request until the United States trustee has considered the request and determined not to appoint the additional committee. n3

Section 1102(a)(2) directs the court to order the appointment of additional committees only if necessary to assure adequate representation of creditors or of equity security holders. In most cases, a single committee of creditors and a single committee of equity security holders will be sufficient. Thus, the court should order the appointment of additional committees sparingly. The court should also keep in mind that the matter comes before the court only if the United States trustee determines that additional committees are not warranted. While the court is empowered to overrule the decision of the United States trustee not to appoint an additional committee, the court should afford some deference to that decision. n4

Court's Ability to Order Change in Membership of Committee. Section 1102(a)(4), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2004 (the 2005 Act), n5 provides that the court may, on request of a party in interest and after notice and a hearing, order the United States trustee to change the membership of a committee appointed under section 1102 if the court determines that the change is necessary to ensure adequate representation of

creditors or equity security holders.

Section 1102(a)(4) was enacted by Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Before the 2005 Act, the Code did not contain explicit authority for the court to overrule committee appointments made by the United States trustee. The lack of authority led to a large number of judicial decisions over whether such authority was within the scope of the court's general equitable powers.

The court's authority to adjust committee membership is not unfettered. With the one exception noted below, the court may order a change in the composition of a committee only if the court determines that doing so is necessary to ensure adequate representation of creditors or equity security holders. It should also be noted that the court will not appoint any replacement committee members. The court will order the United States trustee to change membership on the committee but appointment of replacement members is still a decision that will be made by the United States trustee.

Section 1102(a)(4) also permits the court to order the United States trustee to increase the number of members of a committee to include a creditor that is a small business concern as defined in the Small Business Act. n6 The court may only do so, however, if it determines that the creditor holds claims the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large. The effect of this section is to allow a smaller creditor to serve on a committee if the amount owed to that creditor will have a significant impact on the creditor's business, even if the creditor is not the holder of a large claim. The matter is discretionary and a court may decline to order the expansion of a committee to include such a creditor, even if the case will have a severe impact on the creditor's business.

Procedure for Challenging Appointment Decisions. *Rule 2020 of the Federal Rules of Bankruptcy Procedure* provides that a proceeding to contest any act or any failure to act by the United States trustee is governed by Bankruptcy Rule 9014. The effect of this rule is to establish that challenges to decisions by the United States trustee are to be determined by motion. Nothing in Bankruptcy Rule 2020 has an impact on whether particular actions are subject to judicial review or who may seek review of such actions.

Standing to Challenge Appointment Decisions. Before the enactment of section 1102(a)(4) by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, most courts allowing challenges to committee appointments have permitted the debtor, as well as any affected creditor, to contest committee appointments. n7 The 2005 Act should end any doubt by giving standing to challenge decisions to any party in interest.

There is nothing in the Federal Rules of Bankruptcy Procedure that requires an aggrieved party, whether an affected creditor or the debtor, to exhaust remedies with the United States trustee before seeking judicial review. n8 Nevertheless, doing so would be prudent for a party and a court should refrain from reviewing a decision until the United States trustee has had a chance to consider any request by a party to modify a decision. It would also be prudent for a party concerned about a committee appointment to act quickly. The courts have sometimes dismissed requests for review of decisions by the United States trustee for lack of timeliness. One court held that a motion to add a creditor to the committee which was filed two months after United States trustee denied request was untimely; another court held that a motion challenging composition of creditors' committee filed seven weeks after appointment of committee was void on timeliness grounds. n9

Appeal of Appointment Decisions. Appeals of judicial decisions reviewing committee appointments have been held to be interlocutory. n10 Consequently, there are relatively few appellate decisions on this issue. Those appellate courts considering the issue have applied a clearly erroneous standard in such appeals. n11

Special Duties of Creditors' Committees

Section 1102(b)(3), added by the 2005 Act, n12 specifies certain duties to be performed by creditors' committees. While the language of the section does not exclude equity committees, the operative portions of the subsection refer specifically and only to creditors. This subsection needs to be read in conjunction with section 1103, which sets forth the general duties of creditors' committees. Its inclusion in section 1102, rather than section 1103, is probably just the result of inartful drafting.

The Committee's Duty to Provide Access to Information. The first clause of section 1102(b)(3) requires that the committee provide access to information to creditors who hold claims of the kind represented by the committee and that are not appointed to the committee. n13 Note that the committee is not required to provide information. It is merely required to provide access to information. What this means will vary from case to case. In a small case, access to information may consist of no more than returning phone calls and responding to correspondence. In larger cases, it might be appropriate to establish a Web site or to ensure that the debtor's Web site contains information that would be of use to creditors.

One of the first published decisions to address this clause contains a good discussion of the factors that a committee needs to consider in determining how to fulfill its obligations under section 1102(b)(3)(A). In *In re Refco, Inc.*, n14 the creditors' committee filed a motion seeking clarification of its obligations under this section. In response to the motion, the court issued an order, a copy of which is attached to the decision, describing the scope of that committee's obligations under the section. The duties of the committee set forth in that order are extensive, as befits a high-profile case involving claims for billions of dollars where it is not practical for the committee to communicate directly with its constituents. In a smaller case, the committee's obligation to provide access will necessarily be more modest. In determining how to fulfill its duties, the committee will need to balance the cost of undertaking formal procedures against the benefit to creditors from so doing.

The court in *Refco* also considered the extent to which a committee could withhold information from creditors. The court determined that the committee would not need to provide access to information that was confidential, nonpublic or proprietary, that could reasonably be determined to result in a general waiver of the attorney-client privilege or other applicable privilege, or that could reasonably be determined to violate an agreement, order or law if disclosed. The court also noted that the committee's duty to provide access to information was similar to the duty of a chapter 7 trustee under section 704(7) and that cases construing that section would be relevant under section 1102(b)(3)(A).

The Committee's Other Duties under Section 1102(b)(3). The second clause of section 1102(b)(3) requires committees to solicit and receive comments from holders of claims of the kind represented by the committee. n15 The language of section 1102(b)(3) makes this duty mandatory, and so it is incumbent on a committee to find a way to solicit and receive comments from creditors. Perhaps the simplest way would be for a committee to send a letter to creditors notifying them that they welcome to provide comments to the committee or its professionals. If this were included as part of a general distribution by the debtor to creditors, this duty could be fulfilled at nominal additional cost.

The third clause of section 1102(b)(3) requires that a creditors' committee be subject to a court order that compels any additional report or disclosure to be made to creditors represented by such committee. n16 This clause dispels any doubt, should there have been any, that a creditors' committee must comply with a court order to provide reports of disclosures to creditors.

For a complete discussion of Code section 1102, see Collier on Bankruptcy, ch. 1102 (Matthew Bender).

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n1 1. The issue of whether appointment of additional committees of creditors and of equity security holders is necessary to assure adequate representation is discussed, respectively, at *Collier on Bankruptcy*, 1102.02[4] and 1102.03[4] (Matthew Bender).

n2

2. Section 1102(a)(2) also provides that the United States trustee shall appoint the members of any additional committee ordered by the court. This is consistent with the philosophy of section 1102 which is intended to remove the court from the process of appointing members to committees.

n3

3. See *In re McLean Indus., Inc.*, 16 C.B.C.2d 645, 70 B.R. 852 (Bankr. S.D.N.Y. 1987) (court's review of decision by United States trustee not to appoint additional committee subject to *de novo* review).

n4

4. In *In re Texaco*, 79 B.R. 560 (Bankr. S.D.N.Y. 1987), the court held that the underlying rationale for establishing two committees was no longer applicable and ordered that the two be combined into a single committee.

n5

5. Pub. L. No. 109-8, § 405(a), effective in cases commenced on or after October 17, 2005.

n6

6. A small business concern is defined in section 3(a)(1) of the Small Business Act, 15 U.S.C. § 631 *et seq.* The authority granted by the court to order the expansion of a committee to include a small business concern is not modified by the reference at the beginning of section 1102(a)(4) to the request of a party in interest after

notice and a hearing.

n7

7. See *In re Penn-Dixie Indus., Inc.*, 3 C.B.C.2d 710, 9 B.R. 936 (S.D.N.Y. 1981) (debtor has standing to object to composition of equity security holders committee); *In re Laclede Cab Co.*, 145 B.R. 308 (Bankr. E.D. Mo. 1992) (debtor permitted to object to appointment of creditor to creditors' committee). *In accord* are *In re Microboard Processing, Inc.*, 95 B.R. 283 (Bankr. D. Conn. 1989); *In re Richmond Tank Car Co.*, 93 B.R. 504 (Bankr. S.D. Tex. 1988); *In re Plant Specialties*, 59 B.R. 1 (Bankr. W.D. La. 1986); *In re M.H. Corp.*, 30 B.R. 266 (Bankr. S.D. Ohio 1983). See also *In re Lykes Bros. Steamship Co., Inc.*, 200 B.R. 933 (M.D. Fla. 1996) (creditor denied membership on committee has standing to appeal); *In re Victory Markets, Inc.*, 195 B.R. 9 (N.D.N.Y. 1996) (appeal from bankruptcy court order denying creditor's motion to be added to creditors' committee dismissed for lack of standing; but declining to decide whether creditor has standing to bring motion seeking to be added to creditors' committee).

n8

8. Decisions of the United States trustee with respect to committee appointments are not subject to the Administrative Procedures Act. *In re Sharon Steel Corp.*, 100 B.R. 767 (Bankr. W.D. Pa. 1989).

n9

9. See *Van Arsdale v. Clemo*, 825 F.2d 794 (4th Cir. 1987); *In re Hills Stores*, 137 B.R. 4 (Bankr. S.D.N.Y. 1992) (noting that granting request to form additional committee that could have been made six months earlier would result in delay of reorganization process); *In re Drexel Burnham Lambert Group, Inc.*, 118 B.R. 209 (Bankr. S.D.N.Y. 1990).

n10

10. See *In re Victory Markets, Inc.*, 195 B.R. 9 (N.D.N.Y. 1996) (appeal from bankruptcy court order denying creditor's motion to be added to creditors' committee is interlocutory; leave to appeal granted); *In re Lykes Bros. Steamship Co., Inc.*, 200 B.R. 933 (M.D. Fla. 1996) (same).

n11

11. See *Van Arsdale v. Clemo*, 825 F.2d 794 (4th Cir. 1987) (applying clearly erroneous standard to appeal of decision upholding committee appointed by United States trustee); *In re Value Merchants, Inc.*, 202 B.R. 280 (E.D. Wis. 1996) (same); *In re Penn-Dixie Indus., Inc.*, 3 C.B.C.2d 710, 9 B.R. 936 (S.D.N.Y. 1981) (bankruptcy court's determination under former section 1102(c) that committee was adequately representative was finding of

fact subject to review under clearly erroneous standard).

n12

12. Pub. L. No. 109-8, § 405(b) (2005), effective in cases commenced on or after October 17, 2005.

n13

13. 11 U.S.C. § 1102(b)(3)(A).

n14

14. 336 B.R. 187 (Bankr. S.D.N.Y. 2006).

n15

15. 11 U.S.C. § 1102(b)(3)(B).

n16

16. 11 U.S.C. § 1102(b)(3)(C).

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158 of 197 DOCUMENTS

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Collier on a Ch. 11 Plans Cure of Default to Reverse Acceleration

2008 Emerging Issues 1256

Collier on a Ch. 11 Plans Cure of Default to Reverse Acceleration

By Collier

December 3, 2007

SUMMARY: This Emerging Issues Analysis discusses topics such as the advantages of 1124(2), the defaults specified in 365(b)(2), the meaning of cure under 1124(2)(A), reinstatement under 1124(2), the rationale behind 1124(2), the deacceleration of foreclosure judgment, and compensation for damages under 1124(C) and (D).

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ARTICLE: *Section 1124(2) of the Bankruptcy Code* permits the plan to reverse a contractual or legal acceleration. In order for a class of claims or interests to be unimpaired for purposes of section 1124(2), the plan must cure any default, other than an *ipso facto* default of a kind specified in section 365(b)(2), or of a kind that section 365(b)(2) expressly does not require to be cured, n1 irrespective of whether such default occurred before or after commencement of the case. In addition, the plan must provide for the payment of compensation to the holder of the claim or interest for any damages incurred as a result of any reasonable reliance by the holder on the contractual provisions or applicable law that permitted acceleration.

Paragraph (D) of section 1124(2), n2 requires that the plan also provide for the compensation of actual pecuniary loss to the holder of a claim or interest arising from any failure to perform a nonmonetary obligation, other than a default arising from a failure to operate a nonresidential real property lease subject to section 365(b)(1)(A). Section 365(b)(1)(A) provides the types of nonmonetary obligations that need not be cured in order for a debtor to assume an executory contract or unexpired lease and expressly excludes from this cure requirement a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption. n3 However, section 365(b)(1)(A) also provides that if a default arises from the failure to operate in accordance with a nonresidential real property lease, then, in order for such a lease to be assumed, such default must be cured at the time of assumption, and subsequent to such time, in accordance with such lease, and pecuniary losses resulting from such default must be compensated. n4

Provided that the plan does not otherwise alter the legal, equitable or contractual rights to which the holder of the

claim or interest is entitled, section 1124(2) permits the plan to reinstate the original maturity of the claim or interest as it existed before the default without impairing the claim or interest. n5

Advantages of Section 1124(2)

The advantages of section 1124(2) to the debtor are easily illustrated. If the debtor has defaulted with respect to a long-term debt obligation that has an interest rate substantially lower than the current market rate, the plan can reinstate the original maturity of the obligation and the original, lower interest rate, if the plan provides for (i) the curing of any payment or performance defaults (other than *ipso facto* default), (ii) compensation for any damages caused by the claimant's reasonable reliance on the right of acceleration and (iii) affirmation of the agreement according to its original terms.

In the case of a partnership, the proponent of a plan may use section 1124(2) to undo the effect of a clause in a partnership agreement that grants one or more general or limited partners the right to receive specified distributions with respect to their partnership interests upon occurrence of an event of default specified in the partnership agreement. Under section 1124(2), the plan may provide for the curing of the event of default, compensation to the partners for any damages incurred as a result of reliance upon their right to accelerate distributions with respect to their partnership interests, and affirmation of the partnership agreement according to its original terms. As explained above, section 1124(2)(D) also requires compensation to the partners for actual pecuniary loss arising from any failure to perform a nonmonetary obligation. n6 If each of the conditions of section 1124(2) is met and the rights of the partners are not otherwise affected under the terms of the plan, their interests will not be impaired, and thus the consent of the affected partners will not be required unless their rights are otherwise impaired under the terms of the plan.

Section 365(b)(2) Defaults; Relationship to Feasibility Requirement

Section 1124(2) permits deacceleration even though a default of the kind specified in section 365(b)(2) or of the kind that section 365(b)(2) expressly does not require to be cured, n7 is not cured. The defaults specified in section 365(b)(2) are breaches of provisions relating to (1) the insolvency or financial condition of the debtor at any time before the closing of the case; (2) the commencement of a case under title 11; (3) the appointment of, or taking possession by, a trustee in a case under title 11 or a custodian n8 before the commencement; or (4) the satisfaction of any penalty rate or penalty provision n9 relating to a default arising from any failure by the debtor to perform nonmonetary obligations under an executory contract or unexpired lease.

It has been suggested that section 1124(2)(a) permits the plan to reinstitute the maturity of a claim or interest without curing defaults with respect to the financial condition of the debtor that are included in the section 365(b)(2)(A) *ipso facto* clauses. This interpretation of section 1124(2) is correct. It has also been suggested that the fact that a plan does not have to cure a default relating to financial condition effectively modifies the agreement by nullifying covenants relating to financial conditions, such as net worth clauses, tangible asset restrictions and the like. This interpretation of section 1124 is incorrect except that the filing of a case under title 11 never need be cured. If the reinstated agreement was in default by reason of breach of financial covenants, the plan may provide for the reinstatement of the maturity of the obligation even though the debtor remains in default with respect to the financial covenants; however, the debtor will have to be in compliance with such covenants on the date the plan becomes effective or else, as of such date, the obligation whose maturity has been reinstated will again be in default and the holders of the obligation will have the right to accelerate. If the obligation is of a material amount, the debtor's inability to cure the financial covenants and the fact that the obligation will be in default on the date the plan becomes effective will raise a question as to whether the plan satisfies the confirmation standard contained in section 1129. Section 1129(a)(11) provides that the plan shall be confirmed if [c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless the liquidation or reorganization is proposed in the plan.

Thus, a class is unimpaired even though defaults relating to the insolvency or financial condition of the debtor after the plan becomes effective may give rise to a continuing default permitting the nondebtor party to accelerate the contract, lease or obligation. While the court may retain jurisdiction under section 1123(b)(5) and refrain from closing the case in order to permit the plan to be effectuated, the court cannot confirm the plan unless satisfied that the plan is not likely to be followed by further financial reorganization. Unless it is clear at the time of confirmation that the debtor will be in compliance with financial covenants within a reasonable time period after confirmation, the plan will not satisfy section 1129(a)(11) and cannot be confirmed. n10

Meaning of Cure

Under section 1124(2)(A), in order to deaccelerate or otherwise place the creditor in its original position and leave it unimpaired, it is necessary to cure any defaults, whether prepetition or postpetition, that may have occurred, except those relating to insolvency and the like and those defaults of a kind that section 365(b)(2) expressly does not require to be cured. n11 Although the Bankruptcy Code does not define cure, the Court of Appeals for the Second Circuit has held that:

A default is an event in the debtor-creditor relationship which triggers certain consequences. Curing a default commonly means taking care of the triggering event and returning to pre-default conditions. The consequences are thus nullified. This is the concept of cure used throughout the Bankruptcy Code. n12

Section 1124(2) prefaces the provision that allows a debtor to cure defaults with a clause that provides notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default. The Court of Appeals for the Ninth Circuit, however, has rejected an argument that this clause indicates that cure is applicable only to obligations that have been accelerated due to default. Instead, the natural reading of references to default in section 1123 and section 1124 indicates that, subject to section 1124(2)(A)'s exception for defaults under section 365(b)(2), plans may cure all defaults without impairing the creditor's claim, and that such defaults include, but are not limited to, those defaults resulting in acceleration. n13 The court has held that a plan under which the debtor would pay arrearages on the debt, including interest at pre-default rate, and not a higher post-maturity default interest rate, would cure the default. n14 However, where the creditor is oversecured and the rights of unsecured creditors are not implicated, some courts have allowed the creditor to receive the default interest rate as part of the cure under section 1124(2). n15

Reinstatement under Section 1124(2) after Rights Are Altered by Operation of the Code

A creditor's rights may be altered by operation of the Code, n16 which raises the question whether reinstatement under section 1124(2) requires the restoration of the creditor's rights to its pre-bankruptcy position. n17 In *In re Blackwelder Furniture Co. of Statesville, Inc.*, n18 the question involved the operation of section 552(a) of the Code. Pursuant to section 552(a), an after-acquired property clause in a security agreement is not effective to cause a security interest to attach to property acquired by the estate postpetition. n19 The court turned to the Senate Committee Report, which stated that the intervention of bankruptcy was a temporary change but if the plan provided for a return of the claim to its original position postconfirmation, the claim would be unimpaired. Thus, if the plan provided that the after-acquired property clause resumed effectiveness after confirmation, the secured creditor's claim is unimpaired.

There is authority, however, for the position that a debtor may unimpaired a claim by curing a default and reinstating the maturity of a creditor's claim without restoring certain state law rights. In *In re Centre Court Apartments, Ltd.*, n20 the issue involved the application of a state statute that imposed attorney's fees with respect to a claim that was

classified as unimpaired pursuant to section 1124(2). The court held that, as the debtor cured and reinstated the debt pursuant to the plan, the claim was deaccelerated and the parties were returned to a point in time prior to the debtor's default. Therefore, the court found that any claim for attorney's fees on the formerly accelerated debt was no longer applicable.

Rationale Behind Section 1124(2)

If the holder of a claim or interest, upon the occurrence of a default, has a contractual or legal right to receive accelerated payment with respect to the claim or interest, the holder of the claim or interest has, as a matter of nonbankruptcy law, the right to receive payment of the full amount to which the claim or interest entitles the holder. Upon acceleration of the debtor's obligation, the terms of the original agreement relating to the claim or interest cease to apply. Thus, a plan of reorganization that proposes to pay the amount due in respect of the claim or interest according to the original terms of the agreement alters the legal, equitable and contractual rights of the holder of the claim or interest. Congress, however, quite appropriately concluded that a party that receives the benefits of its original bargain is not impaired even if the plan modifies the party's rights by preventing the party from using a contractual or legal right of acceleration to terminate a valuable contract of the debtor in circumstances where the debtor is willing to cure past defaults and perform under the original terms of the agreement. n21

Deacceleration of Foreclosure Judgment

In the context of deacceleration of a secured claim that has been the subject of a foreclosure judgment, the courts have had to consider the relationship between section 1124 and section 1123(a)(5)(G), which states: (a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall (5) provide adequate means for the plan's implementation such as (G) curing or waiving of any default. n22 In several cases, mortgagees who had obtained foreclosure judgments argued that, by reason of such judgments, they would be impaired if they received less than payment in full of the amount of the judgment on the effective date of the plan. n23 The essence of the argument has been that the mortgage obligation merged into the foreclosure judgment and therefore there was no mortgage to revive through deacceleration.

The issue of deacceleration in section 1124(2) was addressed by the Court of Appeals for the Seventh Circuit in *In re Madison Hotel Associates*. n24 The court held that a creditor holding a final judgment of foreclosure is not impaired under section 1124(2) if the debtor's plan of reorganization cures the default of an accelerated loan and reinstates the original terms of the loan. n25 The court distinguished earlier decisions where a judgment of foreclosure merged the mortgage and the judgment and transferred title to the mortgagee on the basis that, under the law of Wisconsin, a judgment of foreclosure was a judicial determination of what is due under an accelerated mortgage loan, but did not merge the mortgage and the judgment and, therefore, did not effectively transfer title to the mortgagee. n26

Notwithstanding the significance which the court attached to the fact that the judgment of foreclosure did not merge the mortgage and judgment, other cases suggest that the doctrine of merger under state law is irrelevant in sections 1124(2) and 1123(a)(5)(G) because these provisions evidence a clear intent by Congress to permit deacceleration and state law should not be relevant in defining the availability of such power. n27

In *In re Hewitt*, n28 the court held that section 1124 allows reversal of an acceleration even where the claim has been reduced to a judgment prior to the filing date. n29 The court supported its holding not only by reference to the legislative history of section 1124, but also by reference to the fact that section 1124(2) refers to class of claims and section 101 broadly defines the term claim to include a right to payment whether or not such right is reduced to

judgment. n30

Compensation for Damages; § 1124(2)(C) & (D)

Damages incurred as a result of any reasonable reliance by the holder of a claim or interest that has been reinstated pursuant to section 1124(2) must be paid as a condition of reinstating the claim or interest. In addition, if a claim or interest arises from a failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), the holder of such claim or interest must be compensated for any actual pecuniary loss. n31 Although section 1124(2) provides that defaults must be cured on the effective date of the plan, it does not specifically state when compensation for damages must be paid. The courts that have addressed the issue have held that damages must be paid as of the effective date of the plan. n32 Thus, curing defaults and paying damages as of the time of the sale of the mortgaged property as opposed to as of the effective date of the plan, would impair the right of the mortgagees. n33

Interest. Generally, when a default has been cured and a mortgage reinstated, there is no liability for interest on the accelerated debt, because the parties are seen as having been returned to the period of time before the default occurred. n34 Nor is the creditor in this situation entitled to compensatory damages for the deprivation of the immediate use of its money. n35 When the creditor is oversecured, the court will allow simple interest to be awarded for the installments of principal that remain unpaid during the pendency of the reorganization proceedings, calculated, under section 506(b), at the rate provided for under the agreement under which such claim arose. n36 In that situation, claims for prepetition interest on the defaulted installments will be determined in accordance with state law. n37

Contract Interest; Late Charges; Attorney's Fees. Contract interest and late charges allowable under section 502(b) and section 506, as well as attorney's fees, fall within the category of damages included within section 1124(2)(C). n38 The argument that damages should include the difference between the market rate of interest and the contractual rate has been rejected because allowing these damages would undercut the purpose of section 1124. n39

For a complete discussion of Code section 1124, see Collier on Bankruptcy, ch. 1124 (Matthew Bender).

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n1 1. This clarification was added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act), Pub. L. No. 109-8, § 328(b)(1) (2005), effective in cases commenced on or after October 17, 2005.

n2

2. New paragraph (D) of section 1124(2) was added by the 2005 Act; former paragraph (D) was

redesignated as paragraph (E). Pub. L. No. 109-8, § 328(b)(3)(4) (2005).

n3

3. Section 365(b)(1)(A) was amended by the 2005 Act to clarify a previous ambiguity as to what types of non-monetary obligations need not be cured in order for a debtor to assume an executory contract or unexpired lease. Pub. L. No. 109-8, § 328(a)(1) (2005).

n4

4. See *Collier on Bankruptcy*, 365.05 (Matthew Bender), discussing the effect of the 2005 Act on section 365(b) in more detail.

n5

5. See, e.g., *DiPierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 28-29 (2d Cir. 1982) (a chapter 13 case in which the court, referring to section 1124(2), wrote that curing a default, even though it inevitably changes a contractual acceleration clause, does not thereby impair a creditor's claim).

n6

6. In 2005, a new paragraph (D) of section 1124(2) was added; former paragraph (D) was redesignated as paragraph (E). Pub. L. No. 109-8, § 328(b)(3)(4) (2005).

n7

7. This clarification was added by the 2005 Act, Pub. L. No. 109-8, § 328(b)(1) (2005), effective in cases commenced on or after October 17, 2005.

n8

8. See 11 U.S.C. § 101 defining custodian; *Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n9

9. The 2005 Act clarified this provision of section 365(b)(2)(D) by changing the phrase satisfaction of any penalty rate or provision to satisfaction of any penalty rate or penalty provision. Pub. L. No. 109-8, § 328(a)(1)(B) (2005).

n10

10. See *Collier on Bankruptcy*, 1129.03[11] (Matthew Bender) discussing feasibility of a plan.

n11

11. See note 1 *supra*.

n12

12. *DiPierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 26-27 (2d Cir. 1982); see also *Great W. Bank & Trust v. Entz-White Lumber & Supply (In re Entz-White Lumber & Supply)*, 850 F.2d 1338, 1340 (9th Cir. 1988).

n13

13. *Great W. Bank & Trust v. Entz-White Lumber & Supply (In re Entz-White Lumber & Supply)*, 850 F.2d 1338, 1341 (9th Cir. 1988) (also finding that language of Senate Report on bill that became section 1124 did not support creditor's claim, but merely showed that the drafters in the Senate were concerned primarily [but not exclusively] with defaults resulting in acceleration); see also *In re Jones*, 9 C.B.C.2d 451, 32 B.R. 951 (Bankr. D. Utah 1983) (plan provided for installment payment of amounts necessary to cure defaults; proponent of plan took position that this treatment left class unimpaired for purposes of section 1124(2), and that class did not need protections afforded by section 1129(b) because plan provided for market interest rate on deferred payments and thus, under formulation of *In re Barrington Oaks General P'ship*, 5 C.B.C.2d 969, 15 B.R. 952 (Bankr. D. Utah 1981), class was not impaired since protections afforded by section 1129(b) were not necessary; court held that installment payments did not leave the class unimpaired; installment payments constitute impermissible alternative beyond express terms of section 1124(2); court also found that class was impaired in terms of the protection afforded by section 1129(b) since section 1129(b) provides a structure in which the sufficiency of deferred cash payments may be tested); see also *In re Onco Investment Co.*, 316 B.R. 163, 165168 (Bankr. D. Del. 2004) (where the debtor reinstated senior notes under section 1124(2) by paying interest at the nondefault rate and paying the senior notes in full, senior noteholders sought to recover the default interest and other penalty from distributions under the debtor's plan to subordinated noteholders pursuant to the terms of a subordination agreement between the senior noteholders and the junior, subordinated noteholders; the court held that allowing the senior noteholders to recover the default interest rate amounts from the subordinated noteholders would undermine the intended effect of reinstatement under section 1124(2)), *appealed and dismissed as moot on appeal, In re Onco Investment Co.*, 2005 U.S. Dist. LEXIS 21709 (D. Del. Sept. 29, 2005). But see *In re Barrington Oaks General P'ship*, 5 C.B.C.2d 969, 15 B.R. 952 (Bankr. D. Utah 1981) (where original mortgagor transferred property to general partnership and both entities filed chapter 11 petitions and

subsequently filed consolidation plan that purportedly left claims of secured creditors unimpaired on the basis of curing defaults under the mortgages on plan's effective date, court held that sale of property breached due on sale clauses in mortgages, and that such breach, unlike a default for nonpayment, was incurable under section 1124(2); [b]y changing obligors, debtors may have altered the complexion of risk and hence of present value, and bank is therefore impaired because it needs the protection of Section 1129(b)'.

n14

14. *Great W. Bank & Trust v. Entz-White Lumber & Supply (In re Entz-White Lumber & Supply)*, 850 F.2d 1338, 1340 (9th Cir. 1988) (debtor could cure debt that naturally matured prepetition by paying arrearages at predefault rate of interest).

n15

15. *In re 139-141 Owners Corp.*, 313 B.R. 364 (S.D.N.Y. 2004) (section 1124(2) is limited to authorizing the debtor to deaccelerate previously accelerated debt but does not allow the debtor to avoid all consequences of its prepetition default, including, where its contract with creditor so provides, its liability for interest at default rate); see also *Hepner v. PWP Golden Eagle Tree, LLC (In re K & J Properties, Inc.)*, 2005 Bankr. LEXIS 1993, at *29-31 (Bankr. D. Colo. May 13, 2005) (oversecured creditor is entitled to collect postpetition default interest on its claim)). For further explanation of the calculation of interest rates as part of creditor's claim, see 11 U.S.C. § 506; *Collier on Bankruptcy*, 506.04 (Matthew Bender).

n16

16. See *Collier on Bankruptcy*, 1124.02[9] (Matthew Bender), discussing impairment by operation of the Code pursuant to section 1124(1).

n17

17. See, e.g., *In re Centre Court Apartments, Ltd.*, 18 C.B.C.2d 1064, 85 B.R. 651 (Bankr. N.D. Ga. 1988) (debtor may cure and reinstate debt pursuant to sections 506(b) and 1124(2)(C); creditors seeking payment for attorney's fees under prepetition note and state law were not impaired because section 506(b) trumps state law regarding attorney's fees and creditors were free to seek cure for attorney's fees consistent with sections 506(b) and 1124(2)(C)); see also *Florida Partners Corp. v. Southeast Co. (In re Southeast Co.)*, 868 F.2d 335, 20 C.B.C.2d 1348 (9th Cir. 1989) (payment of post-default rate of interest, even if no acceleration, is not required in order to leave claim unimpaired); *United States Trust Co. of N.Y. v. LTV Steel Co. (In re Chateaugay)*, 150 B.R. 529, 542 (Bankr. S.D.N.Y. 1993) (allowance of bondholders' claims in full, including postpetition interest at pre-default contract rate to original bond maturity date, and post-maturity rate from the original bond maturity date permissible to unimpaired claims).

n18

18. 8 C.B.C.2d 1379, 31 B.R. 878 (Bankr. W.D.N.C. 1983).

n19

19. See Collier on Bankruptcy, ch. 552 (Matthew Bender).

n20

20. 18 C.B.C.2d 1064, 85 B.R. 651 (Bankr. N.D. Ga. 1988).

n21

21. *In re Southeast Co.*, 18 C.B.C.2d 359, 81 B.R. 587 (B.A.P. 9th Cir. 1987), *aff'd*, *Florida Partners Corp. v. Southeast Co. (In re Southeast Co.)*, 868 F.2d 335, 20 C.B.C.2d 1348 (9th Cir. 1989) (cure, reinstatement and reasonable reliance damages permit unimpairment even if there is some slight alteration; *e.g.*, penalty interest need not be paid after default); *Young v. Farmers Home Admin. (In re Young)*, 12 C.B.C.2d 983, 48 B.R. 678 (Bankr. E.D. Mich. 1985) (purchaser at prepetition foreclosure sale is not creditor of debtor with whom it did not contract; accordingly, there is no claim to be modified in plan and debtor's only remedy is via redemption pursuant to state law by paying redemption price within redemption period).

n22

22. See discussion in *Collier on Bankruptcy*, 1123.01[5] (Matthew Bender).

n23

23. See, *e.g.*, *In re Madison Hotel Assocs.*, 749 F.2d 410, 11 C.B.C.2d 771 (7th Cir. 1984) (order of foreclosure); *In re Clark*, 738 F.2d 869, 10 C.B.C.2d 1280 (7th Cir. 1984) (chapter 13); *Grubbs v. Houston First Am. Sav. Ass'n*, 730 F.2d 236, 246, 10 C.B.C.2d 549, 560 (5th Cir. 1984) (*en banc*) (chapter 13).

n24

24. 749 F.2d 410, 11 C.B.C.2d 771 (7th Cir. 1984).

n25

25. 749 F.2d 410, 422, 11 C.B.C.2d 771, 784.

n26

26. 749 F.2d 410, 422-23, 11 C.B.C.2d 771, 785, referring to *In re Monroe Park*, 18 B.R. 790 (Bankr. D. Del. 1982); *In re St. Peter's School*, 16 B.R. 404 (Bankr. S.D.N.Y. 1982).

n27

27. See *Di Pierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 29, 6 C.B.C.2d 1201, 1207 (2d Cir. 1982); see also *Valente v. Savings Bank of Rockville*, 9 C.B.C.2d 1004, 34 B.R. 362 (D. Conn. 1983).

n28

28. 5 C.B.C.2d 1626, 16 B.R. 973 (Bankr. D. Alaska 1982).

n29

29. *In re Hewitt*, 5 C.B.C.2d 1626, 1633, 16 B.R. 973, 977 (Bankr. D. Alaska 1982).

n30

30. See Collier on Bankruptcy, ch. 101 (Matthew Bender).

n31

31. The 2005 Act added paragraph (D) to section 1124(2) and redesignated existing paragraph (D) as paragraph (E). Pub. L. No. 109-8, § 328(b)(3)(4) (2005), effective in cases commenced on or after October 17, 2005.

n32

32. See, e.g., *In re Bernard*, 70 B.R. 181, 184 (Bankr. E.D. Ark. 1986); *In re Holthoff*, 58 B.R. 216, 219

(Bankr. E.D. Ark. 1985).

n33

33. *In re Otero Mills, Inc.*, 8 C.B.C.2d 1340, 31 B.R. 185 (Bankr. D.N.M. 1983).

n34

34. *In re Forest Hills Assocs.*, 40 B.R. 410, 414 (Bankr. S.D.N.Y. 1984) (citing *DiPierro v. Taddeo* (*In re Taddeo*), 685 F.2d 24, 6 C.B.C.2d 1201 (2d Cir. 1982); *In re Masnorth Corp.*, 36 B.R. 335, 337 (Bankr. N.D. Ga. 1984).

n35

35. *In re Forest Hills Assocs.*, 40 B.R. 410, 414 (Bankr. S.D.N.Y. 1984) (citing *DiPierro v. Taddeo* (*In re Taddeo*), 685 F.2d 24, 6 C.B.C.2d 1201 (2d Cir. 1982); *In re Masnorth Corp.*, 36 B.R. 335 (Bankr. N.D. Ga. 1984); *In re Masnorth Corp.*, 28 B.R. 892, 896 (Bankr. N.D. Ga. 1983)); see also *In re Rainbow Forest Apartments*, 33 B.R. 576, 578 (Bankr. N.D. Ga. 1983) (The difference between the value of the loan amount reloaned at current market rate and value of the loan at the contract rate is not the type of compensatory damages contemplated by § 1124(2)(C). To award such damages would be counterproductive to Congress' scheme to allow for the reorganization and rehabilitation of debtors in distress.); *In re Rolling Green Country Club*, 26 B.R. 729, 733 (Bankr. D. Minn. 1982) (creditor's economic loss of expectation in such circumstances has a speculative basis assuming no decline in the cost of funds over time, and is not damage of the type contemplated by this section and need not be compensated).

n36

36. *In re Forest Hills Assocs.*, 40 B.R. 410, 415-16 (Bankr. S.D.N.Y. 1984).

n37

37. *In re Forest Hills Assocs.*, 40 B.R. 410, 416 (Bankr. S.D.N.Y. 1984); see also *In re Arlington Village Partners, Ltd.*, 66 B.R. 308, 317 (Bankr. S.D. Ohio 1986) (compensation under section 1124(2)(C) must be in connection with reasonable reliance on contractual right to accelerate, which ends once bankruptcy petition is filed; compensation can consist of interest on prepetition arrearages; where creditor's claim is oversecured, interest may be granted on entire claim (i.e., whether prepetition or postpetition) under section 506(b); with oversecured claim, creditor may also receive reasonable fees, costs, or charges provided for under agreement under which such claim arose; in case of oversecured creditor, 11 U.S.C. § 506(b) provides independent basis for awarding interest in addition to other forms of compensation; if, however, parties' contract did not provide for

fees, costs or charges and those fees, costs or charges related to reasonable reliance on lost right to accelerate, then damages may be obtained under section 1124(2)(C)).

n38

38. *In re Orlando Tennis World Dev. Co.*, 9 C.B.C.2d 816, 819, 34 B.R. 558, 560 (Bankr. M.D. Fla. 1983); ; see *In re Southeast Co.*, 18 C.B.C.2d 359, 81 B.R. 587 (B.A.P. 9th Cir. 1987) *aff'd*, *Florida Partners Corp. v. Southeast Co. (In re Southeast Co.)*, 868 F.2d 335, 20 C.B.C.2d 1348 (9th Cir. 1989) (although not being required to pay post-default penalty interest is modification, nevertheless debt may be deaccelerated, reinstated and any damages paid so as to leave the debt unimpaired; only interest on overdue installments at contract nondefault rate is payable).

n39

39. *In re Orlando Tennis World Dev. Co.*, 9 C.B.C.2d 816, 819-20, 34 B.R. 558, 560-61 (Bankr. M.D. Fla. 1983); see also *General Elec. Mortgage Corp. v. South Village, Inc. (In re South Village, Inc.)*, 8 C.B.C.2d 42, 55, 25 B.R. 987, 998 (Bankr. D. Utah 1982) (given option to reinstate the contract on its original terms when a plan is proposed, it may be anomalous to require the payment of interest at a market rate while a case is pending [i]f this occurred, and if the market rate were greater than the contract rate, a refund of interest from the creditor to the estate would be necessary upon confirmation of the plan. Congress never contemplated opportunity cost as adequate protection in light of Section 1124(2).).

ABOUT THE AUTHOR(S):

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159 of 197 DOCUMENTS

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Collier on Disposable Income

2008 Emerging Issues 1259

Collier on Disposable Income

By Collier

December 3, 2007

SUMMARY: Section 1325(b) of the Bankruptcy Code was amended in a number of significant respects by the 2005 amendments to the Bankruptcy Code. This Emerging Issues Analysis discusses the 2005 amendments to section 1325(b), including the use of current monthly income to determine income, exclusions from income, determination of expenses, and the applicable commitment period.

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ARTICLE: *Section 1325(b) of the Bankruptcy Code* was amended in a number of significant respects by the 2005 amendments to the Bankruptcy Code. n1 These amendments altered the method of determining the debtor's income and the method for determining the debtor's expenses. They also increased the required plan length for some debtors from three to five years.

Use of Current Monthly Income" to Determine Income

The first major change in the disposable income test of section 1325(b) is the use of current monthly income as the basis for determining disposable income. Current monthly income is defined in section 101 as the debtor's average income over the last six months, but does not include benefits under the Social Security Act and certain other payments. n2 This use of prior income numbers directly contradicts language in section 1325(b)(1)(B), which refers to projected disposable income, creating immediate interpretive difficulties because the plan is subject to denial of confirmation only if all of the debtor's projected disposable income is not committed to the plan for the applicable time period. A projection for the future would seem to be something that could be quite different than an average of monthly income in the past. To the extent that courts give any meaning to the word projected, and courts are supposed to give meaning to every word in a statute, they may have to disregard the debtor's prior income if circumstances have changed. A number of courts have interpreted the word projected to allow them to look at changes in the debtor's income from the prior six months average, while recognizing that the sources of income considered must be the same as those defined to make up current monthly income by section 101. n3

If courts disregard the word projected,' the use of current monthly income to determine disposable income will help

some debtors, whose income has increased, and could harm those whose income has decreased, since there is no explicit provision for adjusting income for such changes. If a debtor's income has increased, the trustee or unsecured creditors may not be able to tap all of it for plan payments. Even for plan modification, if section 1325(b) is applicable, the disposable income standard remains based on current monthly income, which never changes because it is based on the six months before the petition. To the extent current monthly income is determinative of required plan payments under section 1325(b), it will lead debtors to carefully time their bankruptcy petitions, when possible, to minimize current monthly income.

If a debtor's income has decreased, and is unlikely to change, a trustee should not file an objection under section 1325(b) based on the current monthly income figure if the debtor is paying all disposable income as defined by current law. Trustees have no legitimate interest in objecting to plans where debtors are paying all that they can truly afford. Unsecured creditors also would rarely have an interest in forcing debtors into chapter 7, which would be the likely result of such an objection, especially if the debtor is below median income and therefore not subject to the means test. Thus, absent an objection, a reasonable plan based on the debtor's true income may be confirmed, because section 1325(b), by its own terms, comes into play only if an objection is filed.

Exclusions from Income

The amended language of section 1325(b)(2) also creates new exclusions from disposable income. First, of course, are the exclusions in the section 101 definition of current monthly income of benefits under the Social Security Act and certain other payments. n4 The definition also makes clear that the income of other household members, including a non-debtor spouse, can be considered only to the extent that it is regularly contributed to household expenses. n5

Other exclusions from income in section 1325(b)(2) are child support payments, foster care payments, or disability payments received by the debtor for a dependent child to the extent reasonably necessary to be expended for the child. It is not clear what effect these exclusions will have. If courts exclude such payments, which may well go to expenses for the debtor's dependents, the debtor's income is reduced. But courts might exclude expenses for the child, to the extent covered by the payments. If so, the provision could be rendered almost meaningless. Its main effect would probably occur when the payments exceeded the child's pro-rata share of family expenses; it would prevent payments meant for the child from being diverted to pay debts or imputed to the expenses of other household members. In addition, courts could not necessarily exclude the expenses of the child if the debtor's current monthly income is over median income, because expenses would be determined under the rigid means test formula, based on household size, as discussed below. n6

Another important exclusion from disposable income consists of funds used for repayments of pension loans. New section 1322(f) provides that amounts required to repay loans described in section 362(b)(19) (basically loans from qualified plans) shall not constitute disposable income under section 1325(b). n7 This provision reverses the holdings of many courts under the law in effect prior to the 2005 amendments. n8 It is consistent with the increased protections given by the bill to retirement savings n9 and the fact that continued collection of such loans, usually through wage withholding, is permitted by section 362(b)(19). It also may be a recognition that debtors have often incurred such loans in attempts to pay other debts, so that repayment of the loans is really repaying an obligation incurred to pay other creditors. In addition, section 541(b)(7) specifically provides that neither amounts withheld from wages or received by employers as contributions to employee benefit plans, deferred compensation plans, or *IRC section 403(b)* plans shall be considered disposable income under section 1325(b)(2). n10 This exclusion covers most pension contributions, both involuntary and voluntary, and is a further step by Congress to give protection to retirement savings.

Determination of Expenses

Equally significant changes were made by the 2005 amendments in determining the debtor's expenses. For all

debtors, payments on domestic support obligations first payable after the petition is filed are, under new language in section 1325(b)(2)(A)(i), specifically deducted from income in determining disposable income. This language simply gives effective priority to current support payments, which were ordinarily deducted from debtor's budget under the law in effect prior to the amendments as well.

Debtors with Current Monthly Income Above Applicable State Family Income. Perhaps the most dramatic changes in the disposable income test are the use of the section 707(b) means test expense calculations, coupled with the requirement of a five-year plan, for some debtors. New section 1325(b)(3) provides that for debtors with current monthly income ⁿ¹¹ above the applicable state median income for their household size, ⁿ¹² reasonably necessary expenses are to be calculated using the means test formula in section 707(b)(2)(A) and (B) in order to determine payments to unsecured creditors. ⁿ¹³

The applicable median income is the same as that used for the section 707(b)(7) means test safe harbor, based on the household size of the debtor, with a one person household using the state median income for one earner, households of two to four using the highest median income for a family of equal or lesser size, and household of over four using the highest median income for families of four or less, augmented by \$525 per month for each member over four. ⁿ¹⁴ Because this provision is based on current monthly income rather than actual income, this may apply to debtors whose actual income has decreased to well below state median at the time they file the bankruptcy petition and throughout the plan. Again, the trustee is not compelled to object to a plan in these circumstances, and a trustee should not object to a plan, or later modification of a plan, if the debtor proposes to pay all the debtor can truly afford.

At the same time, this provision permits debtors to deduct amounts allowed by the chapter 7 means test, ⁿ¹⁵ even if they seem excessive to a trustee or creditor. ⁿ¹⁶ Secured debt payments are deductible, no matter how high. Moreover, secured debt payments due are deductible even if the debtor will have to pay less in a chapter 13 plan because the debt can be crammed down under section 1325(a)(5). ⁿ¹⁷ This differential provides the debtor a cushion equal to the difference between the amount of the scheduled payments on secured debts plus arrears (or IRS national standard if higher) and the amount payable on the debt in chapter 13. It may also provide some leeway from the strictures of the IRS standards for other expenses. Other expenses that are sometimes not allowed under prior law, such as a limited amount for private school education, are also permitted. ⁿ¹⁸

As originally enacted, section 1325(b)(3) probably did not permit debtors to deduct expenses for charitable contributions, because such expenses are not specified in section 707(b)(2). ⁿ¹⁹ To correct this flaw, Congress enacted the Religious Liberty and Charitable Donation Clarification Act of 2006, ⁿ²⁰ which amended section 1325(b)(3) to provide that expenses for religious and charitable contributions, those described in section 1325(b)(2)(A)(ii), are not to be determined under section 707(b)(2). Such expenses, therefore, continue to be determined under section 1325(b)(2)(A)(ii), which permits a chapter 13 debtor to make such contributions to the extent they do not exceed 15 percent of the debtor's annual gross income.

The provisions permitting the court to adjust expenses for special circumstances ⁿ²¹ are among those incorporated, so that if there are other expenses for which there is no reasonable alternative, the court can take those facts into account. Ultimately, the special circumstances test is not terribly different than the reasonably necessary test used today. However, it is not clear that adjustments to income based on special circumstances are possible. Although section 707(b)(2)(B), referenced in section 1325(b)(3), allows for adjustment of income, section 1325(b)(3) speaks only of amounts reasonably necessary to be expended.

Unfortunately, poor drafting does not make crystal clear how administrative expenses are to be paid. There has been some concern that the incorporated provisions from section 707(b) would limit the debtor's administrative expenses to the 10 percent cap in those provisions. ⁿ²² This would make almost every chapter 13 case impossible, because the expenses necessary to administer almost always exceed 10 percent. However, that cap applies only to

hypothetical administrative expenses added for determining abuse in chapter 7. In chapter 13, the administrative expenses are actual priority claims under section 507(a)(2) n23 and therefore may be deducted as part of the means test deduction of priority claims. n24 Even if this were not the case, a debtor could argue that the administrative expenses are necessary legal expenses that may be deducted as Other Necessary Expenses allowed by the Internal Revenue Service collection expense standards. n25

In any event, if trustees were to regularly file such objections, the likely result would be that very few chapter 13 cases would be filed because there would be no way to pay all necessary administrative expenses through the plan. Indeed, if the administrative expenses were limited to 10 percent, the trustee would share those funds pro-rata with other administrative claimants and could not recover his or her full percentage payment. n26

Alternatively, if an objection is filed, courts will hopefully recognize that an administrative expense is an unsecured claim and that section 1325(b) requires funds remaining after the means test deductions to be paid to unsecured creditors generally, not just nonpriority creditors. n27 Creditor is defined as an entity holding a prepetition claim. Normally, the debtor's attorney seeking payment of fees is seeking payment primarily of prepetition fees. Moreover, the provision merely states that unsecured creditors are the entities to be paid from disposable income. It does not limit the payments to payments on prepetition claims. In addition, interpreting section 1325(b) to preclude payment of administrative expenses would place it in direct conflict with section 1326(b), which requires payment of any unpaid claim under section 507(a)(2), which provides for administrative claim priority. In light of all these factors, it seems very unlikely courts will adopt a reading of the statute that precludes payment of the expenses necessary to administer the case.

Debtors with Current Monthly Income Below Applicable State Median Family Income. The calculation of expenses for debtors with current monthly income below the applicable state median family income is much more similar to the expense calculation under prior law. Indeed, other than the specific deduction for postpetition payments on a domestic support obligation, the language is largely unchanged. However, as discussed above, these expenses are now deducted from current monthly income as defined in section 101 and adjusted by other provisions of the Code. n28

Poor drafting creates some confusion about how secured creditors can be paid by debtors below median income. The amended section 1325(b) uses language similar to the language now used by the statute to describe how much is paid *into the plan for all creditors*, but states that this amount is to be paid *to unsecured creditors*, creating a possible interpretation that debtors below median income cannot pay any money to secured creditors. However, in light of the fact that section 1325(b)(3), through its incorporation of the section 707(b)(2) means test, now considers payments to secured creditors a part of the amounts reasonably necessary to be expended for support of the debtor and the debtor's dependents with respect to debtors over median income, n29 it would be consistent to read the requirements for debtors below median income the same way, allowing necessary secured debt payments to be considered as reasonably necessary expenses. Some courts have implicitly done so even under prior law, when they have disallowed large secured debt payments made by debtors on items such as luxury automobiles as expenses that are not reasonably necessary. And again, trustees are not likely to raise such an objection to debtors paying secured claims; such objections, if made regularly, would eliminate most chapter 13 cases.

With respect to administrative expenses, the same reasoning should apply for debtors below median income as to debtors above median income, so that payments to unsecured creditors can include payments on priority administrative claims. n30 Alternatively, for debtors both above and below median income, one could argue that administrative expenses are allowed as other necessary expenses for a debtor in chapter 13.

Applicable Commitment Period

Another very significant change in the disposable income test made by the 2005 amendments n31 is the commitment period that must be proposed if the debtor is not proposing to pay 100 percent of allowed unsecured claims n32 and an objection is raised. Section 1325(b)(4) sets an applicable commitment period for section 1325(b) objections. The applicable commitment period remains three years if the current monthly income of the debtor and the debtor's spouse combined is below the applicable state median income, but is five years if it that current monthly income is above the applicable state median income. n33

One immediate issue with this provision is that a non-debtor spouse does not have any current monthly income, because current monthly income is defined by section 101 as income received *by the debtor (or in a joint case the debtor and the debtor's spouse)*. n34 Thus, by definition, income of a non-debtor spouse not paid to the debtor's household expenses is not current monthly income. Congress must be assumed to know that its definitions will be used and the definition itself tells us when a spouse's income is current monthly income.

If this were not the case, the language including income of a debtor's spouse would not exclude income of a non-debtor separated spouse, even if that spouse contributes nothing to household. The debtor may not even know a separated spouse's income, so it may be difficult to base an objection on it. Moreover, including a separated spouse's total income makes no policy sense. It is hoped that trustees will not invoke section 1325(b) to demand a five-year plan based on income that in reality is unavailable to the debtor.

Because current monthly income does not change during the case--it remains, by definition in section 101, the average income for the six months before the petition--the debtor cannot be forced to change the commitment period if the debtor's income later changes from below median income to above median income.

On the other hand, the required applicable commitment period of five years if current monthly income is above the state median income will discourage some debtors who might otherwise file chapter 13 cases. It will also make plans more likely to fail. There will be two additional years, 67 percent more time, in which an unexpected drop in income or emergency expense could occur.

Another issue is whether the applicable commitment period has any relevance when the debtor's disposable income under section 1325(b) is zero or a negative number. Most courts have held that in such cases the debtor may propose a 36-month plan, since the amount required to be paid to unsecured creditors remains zero, whether the plan is 36 months or longer. n35

In any event, a chapter 13 trustee is not compelled to demand a five-year plan from a debtor whose current monthly income is above the state median income, and probably should not do so in cases where the debtor is not barred from chapter 7 by the means test. The five-year requirement is not applicable unless an objection to confirmation is filed, and it is hard to see how forcing such a debtor into chapter 7 is a desirable result for anyone.

The five-year-plan requirement does not appear to apply to modification of plans. Section 1329 is amended only to say that a modified plan cannot be *longer* than the applicable commitment period unless the court approves, with a five-year maximum, which implies that the plan may be shorter than the applicable commitment period. n36 Although there had been some dispute under prior law as to whether section 1325(b) applies to modifications, n37 this specific reference seems to make clear that this part of section 1325(b), at least, does not apply. Without the availability of modification, the only solutions for a debtor's inability to complete a plan, even after three years, would be conversion, dismissal or, if possible, a hardship discharge.

For a complete discussion of Code section 1325, see Collier on Bankruptcy, ch. 1325 (Matthew Bender).

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n1 1. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. 11 U.S.C. § 101, as amended by Pub. L. No. 109-8, § 102(b) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 101.10A; Exclusions from Income; §§ 1325(b)(2), 541(b)(7) and 1322(f) *infra*.

n3

3. *E.g.*, *In re Jass*, 55 C.B.C.2d 1461, 340 B.R. 411 (Bankr. D. Utah 2006).

n4

4. 11 U.S.C. § 101, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 101 (Matthew Bender); see also *In re Rotunda*, 349 B.R. 324 (Bankr. N.D.N.Y. 2006) (Congress intended to exclude Social Security benefits from income available to creditors).

n5

5. 11 U.S.C. § 101(10A); *In re Quarterman*, 342 B.R. 647 (Bankr. M.D. Fla. 2006) (income of debtor's spouse could be considered only to extent contributed to household expenses).

n6

6. 11 U.S.C. § 1325(b)(3); see Determination of Expenses; § 1325(b)(2) & (3) *infra*.

n7

7. See *Baxter v. Johnson (In re Johnson)*, 346 B.R. 256 (Bankr. S.D. Ga. 2006); *In re Haley*, 354 B.R. 340 (Bankr. D.N.H., 2006).

n8

8. See *Collier on Bankruptcy*, 1325.08[4][b][iv] (Matthew Bender).

n9

9. See, e.g., 11 U.S.C. § 522(a)(3)(C), (d)(12), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *Collier on Bankruptcy*, ch. 522 (Matthew Bender).

n10

10. *Baxter v. Johnson (In re Johnson)*, 346 B.R. 256 (Bankr. S.D. Ga. 2006).

n11

11. Current monthly income is defined in § 101, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n12

12. Median family income is defined in 11 U.S.C. § 101, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. The applicable median income is the same as that used for the section 707(b)(7) means test safe harbor, based on the household size of the debtor, with a one person household using the state median income for one earner, households of two to four using the highest median income for a family of equal or lesser size, and household of over four using the highest median income for families of four or less, augmented by \$525 per month for each member over four.

n13

13. New provisions in chapter 11 make certain chapter 13 concepts, including the disposable income test, applicable to individual chapter 11 cases. However, because new section 1129(a)(15) incorporates only section 1325(b)(2) and not section 1325(b)(3), it does not appear that section 1325(b)(3) would be applicable in chapter 11 cases, even though most chapter 11 individual debtors will have incomes above the applicable state median income.

n14

14. *See Collier on Bankruptcy*, 707.05[2][b] (Matthew Bender).

n15

15. 11 U.S.C. § 707(b)(2), enacted by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 707.05[2][c] (Matthew Bender).

n16

16. *In re Barr*, 55 C.B.C.2d 1763, 341 B.R.181 (Bankr. M.D.N.C. 2006) (debtor entitled to Internal Revenue expense deductions, even if actual expenses are less); *In re Guzman*, 56 C.B.C.2d 636, 345 B.R. 640 (Bankr. E.D. Wis. 2006) (same).

n17

17. *See Collier on Bankruptcy*, 1325.06[3] (Matthew Bender).

n18

18. 11 U.S.C. § 707(b)(2)(A)(ii)(IV).

n19

19. *In re Diagostino*, 347 B.R. 116 (Bankr. N.D.N.Y. 2006). Chapter 7 debtors may deduct such expenses in the chapter 7 means test by virtue of 11 U.S.C. § 707(b)(1).

n20

20. Pub. L. No. 109-439 (2006).

n21

21. 11 U.S.C. § 707(b)(2)(B); *see Collier on Bankruptcy*, 707.05[2][d] (Matthew Bender).

n22

22. 11 U.S.C. § 707(b)(2)(A)(ii)(III).

n23

23. 11 U.S.C. § 507(a)(2), formerly § 507(a)(1), as redesignated by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n24

24. 11 U.S.C. § 707(b)(2)(A)(iv).

n25

25. See *Collier on Bankruptcy*, 707.05[2][c][i] (Matthew Bender).

n26

26. See 11 U.S.C. § 1326(b), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n27

27. The Advisory Committee on Bankruptcy Rules adopted this position in drafting the Official Forms. See Advisory Committee Note to Official Form 22C (debtor's attorney's fees can be paid from disposable income determined available for unsecured creditors). The confusion is compounded because section 707(b)(2)(A)(iv) allows the deduction of priority claims in the means test calculation, in addition to the chapter 13 administrative expenses up to 10% allowed by section 707(b)(2)(A)(ii)(III). Then, section 1325(b) requires the disposable income remaining after the calculation to be paid to unsecured creditors generally, presumably including priority claims. It is doubtful that any court would allow the double-counting, or even triple-counting of administrative expenses that this language suggests.

n28

28. *See* Use of Current Monthly Income to Determine Income; § 1325(b)(2) *supra*.

n29

29. 11 U.S.C. § 707(b)(2)(A)(iii); *see Collier on Bankruptcy*, 707.05 [c][ii] (Matthew Bender).

n30

30. *See* Debtors with Current Monthly Income Above Applicable State Median Family Income; § 1325(b)(2) & (3) *infra*.

n31

31. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n32

32. 11 U.S.C. § 1325(b)(4)(B), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n33

33. 11 U.S.C. § 1325(b)(4)(A), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n34

34. *See Collier on Bankruptcy*, ch. 101 (Matthew Bender). Official Form 22C, which is intended to be neutral on this issue, incorporates this interpretation, as well as the interpretation that the income of both spouses must be counted, by permitting the debtor to take the position in line 13 that the nondebtor spouse's income that is not regularly contributed to household expenses of the debtor and the debtor's dependents is not counted to determine the applicable commitment period.

n35

35. *In re Brady*, 2007 Bankr. LEXIS 501 (Bankr. D.N.J. Feb. 13, 2007); *In re Fuger*, 56 C.B.C.2d 475, 347 B.R. 94 (Bankr. D. Utah 2006); *In re Alexander*, 56 C.B.C.2d 427, 344 B.R. 742 (Bankr. E.D.N.C. 2006).

n36

36. 11 U.S.C. § 1329(c), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n37

37. See *Collier on Bankruptcy*, 1329.05[3] (Matthew Bender).

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160 of 197 DOCUMENTS

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Collier on Ch. 13 Trustees Duty to Give Notices re Domestic Support Obligations

2008 Emerging Issues 1260

Collier on Ch. 13 Trustees Duty to Give Notices re Domestic Support Obligations

By Collier

December 3, 2007

SUMMARY: Section 1302(b)(6) of the Bankruptcy Code, added by the 2005 amendments, requires the trustee to provide certain notices in cases in which there is a claim with respect to the debtor for a domestic support obligation. This Emerging Issues Analysis discusses issues pertaining to notice requirements under section 1302.

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ARTICLE: *Section 1302(b)(6) of the Bankruptcy Code*, n1 added by the 2005 amendments, requires the trustee to provide certain notices in cases in which there is a claim with respect to the debtor for a domestic support obligation. n2 Although the language of this provision is not entirely clear, it appears from section 1302(d) and the legislative history that the requirement only applies when the debtor is the obligor on such an obligation, and not when the debtor is the obligee. Section 524(c) speaks of the holder of a claim and the legislative history speaks of a domestic support claimant, n3 both of which suggest application to a person who has a claim against the debtor. Virtually identical provisions were also added in 2005 to chapters 7, 11 and 12. n4

The obvious purpose of these provisions is to enhance the ability of child support claimants and state child support enforcement agencies to assert their claims in the bankruptcy process and after bankruptcy, in order to compete with the enhanced rights of other creditors under the 2005 amendments.

Notice of Child Support Enforcement Agency Services and Bankruptcy Rights; § 1302(d)(1)(A). The trustee is required by section 1302(d)(1)(A) to provide to the holder of a domestic support obligation claim written notice that the claimant is entitled to use the services of the state child support enforcement agency established under sections 464 and 466 of the Social Security Act to obtain assistance in collecting support in bankruptcy and afterwards. n5 Such agencies exist in every state, as part of the federal government's effort to facilitate the collection of child support. However, because the definition of domestic support obligation goes beyond child support, n6 such agencies could not assist in the collection of every domestic support obligation. The notice is to include the address and telephone number of the child support enforcement agency. n7

Notice to State Child Support Agency; § 1302(d)(1)(B). The trustee must also provide written notice to the state child support enforcement agency of the existence of the claim against the debtor, and include in the notice the name,

address and telephone number of the holder of the claim. n8 The statute does not say how the trustee is to obtain the telephone number of the claim holder, which is not listed in any papers filed in the case. Although the schedules could perhaps be changed to include this information, many holders of domestic support obligations would probably not appreciate their phone numbers being made available in public records. The trustee could also inquire about the telephone number at the meeting of creditors, although the debtor may not know the number. Presumably, this information is to be sent in case the child support agency wants to become involved in the case, perhaps because the claim has been assigned to it or because it has assisted the claimant in the past.

Notice at Time of Discharge; § 1302(d)(1)(C). The trustee is required to send another notice at the time the debtor is granted a discharge. This notice is to be sent to the domestic support obligee and to the state child support enforcement agency. n9

This notice is to inform its recipients of the granting of the discharge, the last recent known address of the debtor, the last recent known address of the debtor's employer, and the name of each creditor that holds a claim that is not discharged under section 523(a)(2) or (4), or that was reaffirmed. n10 Again, the purpose of this notice is presumably to facilitate child support collection, especially in cases in which there exist nondischarged or reaffirmed debts held by creditors that will be competing with the support claimant for the debtor's limited assets and income.

Request for Address of Debtor; § 1302(d)(2). Section 1302(d)(2)(A), also added in 2005, n11 permits the holder of a domestic support obligation claim or a state child support obligation agency to request the debtor's last known address from a creditor holding a claim that is not discharged under section 523(a)(2) or (4), or that was reaffirmed. This provision was likely added in recognition that large national creditors often have more sophisticated collection facilities that may give them an advantage in competing with child support creditors. Unfortunately, the provision does not oblige the creditor to respond to the request, so it simply confers a right that already existed--the right to make a request.

In the unlikely event that the creditor does respond to the request, the creditor is protected from liability for disclosing the debtor's address, notwithstanding any other provision of law, by section 1302(d)(2)(B). Such liability could otherwise be substantial, at least in occasional cases. It is possible, for example, that a child support creditor may have been the abuser in a domestic violence case, and that the debtor may have been a victim who had fled from the abuser. Although the debtor might have been able to protect her identifying information under section 107(c), n12 the debtor may not have known to seek such protection. The possibility of becoming involved in such situations is likely to discourage creditors from responding to requests for address information.

For a complete discussion of Code section 1302, see Collier on Bankruptcy, ch. 1302 (Matthew Bender).

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n1 1. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. Domestic support obligation is defined in *11 U.S.C. § 101*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch.101 (Matthew Bender).

n3

3. H.R. Rep. No.31, 109th Cong. 1st Sess., 62 (2005).

n4

4. *11 U.S.C. §§ 704(a)(10)*, (c); *1106(a)(8)*, (c); *1202(b)(6)*, (c); *1302(b)(6)*, (d), all added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. *See Collier on Bankruptcy*, 704.14, ch. 1106 and ch. 1202 (Matthew Bender).

n5

5. *11 U.S.C. § 1302(d)(1)(A)(i)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n6

6. *See Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n7

7. *11 U.S.C. § 1302(d)(1)(A)(ii)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n8

8. *11 U.S.C. § 1302(d)(1)(B)*, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n9

9. 11 U.S.C. § 1302(d)(1)(C), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n10

10. 11 U.S.C. § 1302(d)(1)(C)(i)-(iv), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n11

11. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n12

12. 11 U.S.C. § 107(c), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 107.04 (Matthew Bender).

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161 of 197 DOCUMENTS

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Effect of Existing Defaults on the Assumption or Rejection of Executory Contract

2008 Emerging Issues 1261

Collier on Effect of Existing Defaults on the Assumption or Rejection of Executory Contracts

By Collier

December 3, 2007

SUMMARY: Section 365(b) of the Bankruptcy Code provides that the trustee may not assume an executory contract or lease on which there has been a default unless the trustee complies with three requirements. This Emerging Issues Analysis discusses issues pertaining to section 365(b).

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ARTICLE: Section 365(b) provides that the trustee may not assume an executory contract or lease on which there has been a default unless the trustee complies with three requirements. n1 The trustee must: (1) cure the default or provide adequate assurance that the default will be promptly cured; (2) compensate or provide adequate assurance that the trustee will promptly compensate the other party for any pecuniary loss to the party resulting from the default; and (3) provide adequate assurance of future performance under the contract or lease. n2

As will be discussed more extensively below, n3 these requirements do not apply to a default that is a breach of a provision relating to insolvency or the financial condition of the debtor, the commencement of the case, or the appointment of a trustee or custodian. In addition, they do not apply to a cross-default clause unless the contract or lease at issue is part of a single, integrated transaction with the other contract or lease, such that, as a matter of state law, the breach of one contract would, independent of the cross-default provision, excuse performance under the other. n4 Where a single lessor leases multiple locations to a single debtor under separate leases, the cross-default provision will not be enforced. n5

Requirements Inapplicable Unless There Has Been Default

By its terms, section 365(b) applies only when there has been a default other than a default relating to bankruptcy or financial condition. If there has been no default, the trustee need not comply with the cure, compensation and adequate assurance requirements of section 365(b). Instead, the trustee, subject to court approval, may simply assume a contract or lease, unless such assumption is barred by other provisions of subsection 365, such as section 365(c) n6 or (e). n7

Default May Have Occurred Pre- or Postpetition

Section 365(b) applies to contracts for which default has occurred either before or after the commencement of the case. The other party to the contract or lease that the trustee proposes to assume is entitled to insist that any defaults, whenever they may have occurred, be cured, that appropriate compensation be provided, and that, a past default having occurred, adequate assurance of future performance is available. A chapter 11 debtor's discharge does not affect the obligation to cure defaults under a contract assumed under a plan. n8

However, the trustee or debtor in possession may cure, and thereafter assume, a contract or lease only if the agreement is still in existence. If the contract or lease was terminated prepetition or expired postpetition according to its terms, and if the termination process was actually completed and not subject to reversal, there is no contract or lease for the trustee to cure or to assume. n9

Terms of Cure

One important question under section 365(b) concerns the terms of the cure. The Code answers some but not all of the questions that may arise. First, there must be a cure. This means that the contract or lease must be brought back into compliance with its terms. Second, there must be compensation for pecuniary loss to the other party. n10 Finally, there must be assurance that the contract or lease will be performed in the future.

Adequate Assurance Suffices. In each instance, adequate assurance that the action will be taken is a substitute for the immediate taking of the action. There is no general definition of the term adequate assurance. n11 Its meaning is left to be developed based upon the facts and circumstances of each case. The term, however, has some flexibility. In particular, because in an appropriate case it is possible for the cure or compensation for loss to be something other than immediate cash payment, adequate assurance may be of something other than the availability of cash to cure or compensate.

Strict Compliance with Contract Terms Not Necessarily Required. The trustee takes executory contracts and leases as they are, subject to all of their provisions except those rendered unenforceable by applicable nonbankruptcy law or section 365. n12 This might suggest that the trustee is required to cure defaults according to the terms of the agreement. In many instances, however, a cure according to the terms of the lease or contract will not be possible, even with the assistance of the minimum 60-day grace period afforded the trustee by section 108(b), n13 because a cure cannot be effected within the first 60 days of the case. A contract or lease may be subject to a noncurable default but may not have terminated under state law. n14

This raises important questions concerning the cure under section 365(b). Must the cure of a default be upon the terms, and within the time, set forth in the contract or lease? Alternatively, is a cure of a default possible if there is no cure provision in the agreement?

The answer seems to be that the Code provides a broad right to cure, regardless of whether the agreement itself would permit cure. n15 The idea of cure in the Code is to provide the other party to the contract with the benefit of its economic bargain. n16 This suggests that if the trustee is able to provide a remedy that offers the other party to the contract the substantial equivalent to its economic rights under the contract, the trustee will have provided an adequate cure and, if the trustee complies with the other provisions of section 365(b), will be able to assume the contract or lease. n17

Incurable Nonmonetary Defaults. By their nature, certain nonmonetary defaults are not curable. For example, the prepetition breach of a continuous operation clause in a real property leases cannot literally be cured, because the trustee

cannot go back in time and cause the debtor to operate in the past during the time that it did not operate. It was generally understood that a 1994 amendment to the Code, which added section 365(b)(2)(D), was intended to relieve the trustee of the obligation to cure such a default. However, the provision was poorly and ungrammatically drafted and so led to confusion. n18 In *Claremont Acquisition Corp.*, the Court of Appeals for the Ninth Circuit read the provision to require cure of such a default, thereby preventing the trustee from assuming a real property lease under which the debtor had violated a continuous operation clause. n19

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 n20 amended section 365(b)(1)(A) to overrule the result, although not the statutory reading, in *Claremont Acquisition*. n21 Section 365(b)(1)(A) specifically exempts from the cure requirement the cure of a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption. The provision retains much of the awkward and indecipherable flavor of section 365(b)(2)(D): a default that is a breach of a provision relating to the satisfaction of any provision relating to a default arising from any failure to perform . leaves the reader somewhat breathless, as well as perplexed as to what was intended. It is suggested, however, that the reference to nonmonetary obligations and the impossibility of cure by subsequent performance means that the provision relates to continuous operation provisions and other provisions that are similar in that they involve nonmonetary obligations and cannot be retroactively cured. Certainly, all of the bankruptcy and financial condition defaults described in section 365(b)(2) would fall within that group were they not covered separately.

Although this provision was intended to overturn the result in *Claremont Acquisition*, it does so narrowly. It applies only to real property leases. Personal property leases and nonlease executory contracts are expressly excluded. In addition, a companion amendment to section 365(b)(2)(D) resolves the prior ambiguity in that section consistent with the Ninth Circuit's decision in *Claremont Acquisition*, preventing a more charitable reading of the provision for personal property leases and executory contracts. n22 Moreover, it does not apply to the breach of a provision relating to the satisfaction of a penalty rate or penalty provision. Thus, a penalty rate or penalty provision must be cured. Cure of a penalty rate should be a straight-forward matter, which is accomplished by the payment of money. It is unclear how to cure a penalty provision that is not a rate, especially if the penalty provides, for example, for forfeiture of a right under the lease.

The new provision also adds the requirement that if such default arises from the failure to operate in accordance with a nonresidential real property lease, it must be cured by performance at and after the time of assumption in accordance with such lease, and the lessor is entitled to compensation for any pecuniary losses resulting from the default. This provision also suffers from an ambiguity, in that the antecedent to such default is unclear. It could be the default referenced in the beginning language of section 365(b)(1)(A)--the default that must be cured as a condition to assumption. Or it could be the default that need not be cured--the breach of a nonmonetary obligation that is impossible to cure. The latter makes more sense in context, because it would provide a substitute for cure of an incurable obligation. Monetary compensation for the former kind of default is already required under section 365(b)(1)(B).

Effect of Other Code Provisions. Three other provisions of the Code affect the treatment of breaches under executory contracts and unexpired leases in section 365(b). First, under section 108(b) some courts have held the trustee to a period of 60 days after the order for relief to cure any existing defaults. n23 Other courts have declined to apply section 108(b) literally in this context, holding that the trustee must be permitted a reasonable amount of flexibility, consistent with other provisions of the Code, in determining whether to assume or to reject an unexpired lease or executory contract. Under this approach, section 108(b) is not tacked on to the express requirements for curing defaults under section 365(b). n24 Second, section 362(a)(3) stays an act or action to obtain possession or control over a debtor's leasehold estate, including any act to obtain possession of the leased property. n25 Consequently, a lessor must obtain stay relief prior to terminating or modifying a lease. Similarly, the automatic stay prohibits any nondebtor party to a contract or lease from unilaterally terminating the agreement. n26 Third, just as a postpetition cure of a default

under an assumed contract or lease is not only permitted but required, a cure of a default under an assumed contract or lease, which the debtor effected prepetition, is not subject to recovery as a preference under section 547. n27 Similarly, any prepetition payment under a contract that is later assumed is not avoidable as a preference, because assumption and cure would defeat the greater percentage test for preference. n28

Terminated Contracts. An even more difficult problem arises when the contract has already been terminated according to its terms under applicable nonbankruptcy law, which leaves the trustee with nothing to assume or reject. n29 If the termination process has not been completed or, if completed, can be reversed by application of a nonbankruptcy anti-forfeiture statute or waiver doctrine, the trustee may still assume. n30 It has often been said that bankruptcy courts generally are not inclined to support forfeitures. n31 However, if the contract has been completely and irrevocably terminated before the commencement of the case, the trustee's ability to cure under section 365(b) is inapplicable, as the contract no longer exists.

Insolvency-Related Defaults; § 365(b)(2)

The requirements of section 365(b)(1) do not apply to defaults that concern provisions that relate to the insolvency or financial condition of the debtor, the commencement of the case or the appointment of a trustee, receiver or custodian before the case. n32 This exception to the general rule requiring cure of defaults furthers the bankruptcy policy of preventing the enforcement of *ipso facto* or optional bankruptcy termination clauses. In the context of the cure requirement, the exception is particularly important because the trustee cannot possibly cure a default flowing, for example, from the debtor's commencement of a case. If a provision stating that the contract was in default upon the filing of a bankruptcy petition could be enforced, parties could write contracts that could never be assumed by a trustee or debtor in possession. The bars to the enforcement of *ipso facto* clauses in subsections 365(b)(2) and (e) are intended to prevent a party to a contract from opting out of bankruptcy through the use of such clauses. Section 365(e) also preempts nonbankruptcy laws that effect *ipso facto* terminations upon bankruptcy filings. n33

The scope of section 365(b)(2) is broad. It applies not only to defaults triggered by a bankruptcy filing, but also to defaults triggered by events or conditions that are likely to occur or exist around the time that a case is commenced. For example, a default measured by the debtor's financial condition need not be cured, whether the default is related directly to the bankruptcy filing or merely occurred on the road to bankruptcy.

This paragraph is a significant departure from Section 70b of the prior Act, which had permitted enforcement of *ipso facto* clauses and the like. Such clauses had been reluctantly enforced in rehabilitation cases under the Act, n34 although a significant trend away from enforceability had begun, at least in cases in which a public interest might be said to have been present or where termination might have frustrated confirmation of an otherwise feasible plan. n35

The Bankruptcy Reform Act of 1994 n36 amended section 365(b)(2) by adding subparagraph (D) to make it clear that, in curing a default under an executory contract or unexpired lease, it is not necessary to satisfy any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations. In a very close, but questionable, textual reading of subparagraph (D), however, the Court of Appeals for the Ninth Circuit held that the provision does not excuse the trustee from curing the debtor's prepetition violation of a continuous operation clause. n37 The court concluded that the adjective penalty in the phrase satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations modified provision as well as rate. Because the debtor's failure to operate was not a default of a provision relating to satisfaction of a penalty rate or the payment of a penalty, n38 subparagraph (D) did not apply to excuse cure of the default. Whether or not the court was correct in its grammatical parsing of the phrase, it seems that Congress's intent in enacting the subparagraph was to address just such a situation, that is, where the trustee cannot go back in time to undo an act or omission of the debtor but could compensate for any actual pecuniary loss that the other contracting party suffered as a result of the default. The Court of Appeals for the First Circuit came to the opposite conclusion, absolving the trustee of curing a

nonmonetary historical default. n39 Whether the reference to any penalty rate will include late charges on lease payments will be determined by case law.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 n40 resolved the differences in readings between the Ninth and the First Circuits. It amended subparagraph (D) by inserting penalty immediately before provision, so that the phrase now refers to the satisfaction of any penalty rate or penalty provision. This adopts the Ninth Circuit's view of the interpretation of subparagraph (B). At the same time, Congress amended section 365(b)(1)(A) in an effort to overturn the result in cases such as the one in which the Ninth Circuit ruled, that is, in the case of the prior breach of a continuous operation clause. n41

Leases of Real Property in a Shopping Center; § 365(b)(3)

The right to assume an unexpired lease under which there is an existing default is further limited by section 365(b)(3) if the lease is one of real property in a shopping center. The term shopping center is not defined in the Code, but should be strictly construed. n42 It is likely that the most important characteristic will be a combination of leases held by a single landlord, leased to commercial retail distributors of goods, with the presence of a common parking area. n43

Adequate Assurance of Future Performance of Shopping Center Leases. Section 365(b)(3) provides that when there has been a default in a shopping center lease, adequate assurance of future performance includes adequate assurance

- . of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;

- . that any percentage rent due under such lease will not decline substantially;

- . that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; n44 and

- . that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

It is worth noting that, pursuant to section 102(3), the word includes, which is used in section 365(b)(3), is not limiting. Thus, other aspects of adequate assurance may be required in addition to those listed in section 365(b)(3).

Adequate Assurance in Absence of Default. In general, paragraph (3) applies only when there is a default. As with other executory contracts and leases, the assumption of a shopping center lease is not limited when the lease is not in default. Assignment of a shopping center lease, like other contracts or leases, requires adequate assurance of future performance whether or not the lease is in default. n45 Here, however, the standard of adequate assurance differs for shopping center leases even if they are not in default. This is because in 1984 Congress added the phrase and paragraph (2)(B) of subsection (f) to section 365(b)(3), confirming that the description of adequate assurance in section 365(b)(3) is applicable both to adequate assurance of future performance provided in order to assume a defaulted shopping center lease and also to the adequate assurance necessary when such a lease is assigned. n46 Thus, whether or not a default exists, the added language requires reference to section 365(b)(3) for the definition of the term adequate assurance in

section 365(f)(2)(B) whenever a lease in a shopping center is to be assigned.

Furnishing of Services or Supplies; § 365(b)(4)

The remaining exception in section 365(b) involves any lease under which the lessor is required to provide services or supplies incidental to the lease. Subsection (b)(4) relieves the lessor of any requirement to provide services or supplies under the lease prior to assumption if there has been a default under the lease and the trustee fails to furnish compensation under the terms of the lease for the services or supplies provided. The lessor would be required in any event to provide such services or supplies if there were no default, in accordance with the terms of the lease. This paragraph indicates that a debtor-lessee's default under the lease does not necessarily relieve the lessor of its obligations to provide services or supplies, as long as the lessor receives compensation for the services or supplies provided.

Subsection (b)(4) has the effect of requiring that compensation for postpetition services or supplies be under the terms of the lease rather than upon terms approved by the court. Thus if the lease provides for payment on 30-day terms, the lessor cannot demand cash payment as a condition to providing services or supplies.

As with the assumption provision, the defaults that trigger the trustee's obligation to compensate the lessor do not include defaults related to *ipso facto* and similar clauses.

For a complete discussion of Code section 365, see *Collier on Bankruptcy*, ch. 365 (Matthew Bender).

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n1 1. See *Collier on Bankruptcy*, 365.03 (Matthew Bender), text accompanying notes 1 and 2 (debtor in possession in a chapter 11 case and debtor in a chapter 12 or 13 case may assume or reject).

n2

2. *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1309-10, 12 C.B.C.2d 1202, 1207-08 (5th Cir. 1985); *Pieco, Inc. v. Atlantic Computer Sys., Inc. (In re Atlantic Computer Sys., Inc.)*, 173 B.R. 844 (S.D.N.Y. 1994).

n3

3. See *Collier on Bankruptcy*, 365.07 (Matthew Bender).

n4

4. See *In re Sanshoe Worldwide, Corp.*, 139 B.R. 585 (S.D.N.Y. 1992) (leases of different floors in separate transactions); *In re Easthampton Sand & Gravel Co.*, 7 C.B.C.2d 903, 25 B.R. 193 (E.D.N.Y. 1982) (single transaction); see also *In re Karfakis*, 162 B.R. 719 (Bankr. E.D. Pa. 1993) (certain agreements are indivisible and may therefore only be assumed together or not at all).

n5

5. *In re Sanshoe Worldwide, Corp.*, 139 B.R. 585 (S.D.N.Y. 1992) (leases of different floors in separate transactions); *In re Sambo's Restaurants, Inc.*, 24 B.R. 755 (Bankr. C.D. Cal. 1982) (leases of different locations).

n6

6. See *Collier on Bankruptcy*, 365.06 (Matthew Bender).

n7

7. See *Collier on Bankruptcy*, 365.07 (Matthew Bender).

n8

8. *Century Indem. Co. v. National Gypsum Co. Settlement Trust (In re National Gypsum Co.)*, 208 F.3d 498 (5th Cir. 2000).

n9

9. See *Collier on Bankruptcy*, 365.02[2] (Matthew Bender).

n10

10. Attorney's fees are included as pecuniary loss only if the contract or lease provides for payment of attorney's fees by the defaulting party and only as to fees not relating to litigation arising under the Bankruptcy Code. *In re Shangri-La, Inc.*, 213 B.R. 303 (Bankr. E.D.N.C. 1997).

n11

11. See, e.g., *In re Martin Paint Stores*, 199 B.R. 258, 263 (Bankr. S.D.N.Y. 1996) (courts give phrase adequate assurances a pragmatic construction and [a]t a minimum, the primary focus of adequate assurance concerns the assignee's [or debtor's] ability to fulfill the financial obligations under the lease); *In re Carlisle Homes, Inc.*, 103 B.R. 524 (Bankr. D.N.J. 1988) (phrase adopted from UCC; should be given practical, pragmatic construction based upon the facts and circumstances of each case).

n12

12. See 11 U.S.C. § 365(e)(f).

n13

13. See Collier on Bankruptcy, ch. 108 (Matthew Bender).

n14

14. See *In re Waterkist Corp.*, 775 F.2d 1089 (9th Cir. 1985); *In re Fontainebleau Hotel Corp.*, 515 F.2d 913, 914 (5th Cir. 1975) (court observed that under Louisiana law cancellation for nonpayment of rent is not effective until the court has ordered termination and granted possession).

n15

15. See *Post v. Sigel & Co., Ltd. (In re Sigel & Co., Ltd.)*, 923 F.2d 142, 24 C.B.C.2d 869 (9th Cir. 1991) (contract that is silent as to right to cure may nevertheless be assumed provided the other requirements for assumption are met) (citing *Seacoast Prods., Inc. v. Spring Valley Farms*, 34 B.R. 379, 382 (Bankr. M.D.N.C. 1983) (section 365(b) gives the debtor the power to void the non-debtor's right under state law to terminate the contract, provided the contract is executory)).

n16

16. See S. Rep. No. 989, 95th Cong., 2d Sess., 59; H.R. Rep. No. 595, 95th Cong., 2d Sess.

n17

17. *Coleman Oil Co. v. Circle K Corp. (In re Circle K Corp.)*, 190 B.R. 370 (B.A.P. 9th Cir. 1996), *aff'd*,

127 F.3d 904 (9th Cir. 1997), cert. denied, 522 U.S. 1148 (1998); *In re Masterworks, Inc.*, 100 B.R. 149 (Bankr. D. Conn. 1989).

n18

18. More important than the ambiguity that the 2005 amendment to section 365(b)(2)(D) resolved, see Insolvency-Related Defaults; § 365(b)(2) *infra*, the language of subparagraph (D) does not parse as part of the grammatical sentence that is paragraph (2) of section 365(b).

n19

19. *Worthington v. Gen. Mot. Corp. (In re Claremont Acquisition Corp.)*, 113 F.3d 1029 (9th Cir. 1997).

n20

20. Pub. L. No. 109-8, § 328(a)(1)(A) (2005), the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

n21

21. The amendments to section 365 are effective in cases commenced on or after October 17, 2005. Pub. L. No. 109-8, § 1501 (2005).

n22

22. See *Collier on Bankruptcy*, 365.04 (Matthew Bender). The Court of Appeals for the First Circuit had interpreted section 365(b)(2)(D) in a manner that would have permitted substitution of a monetary cure of such nonmonetary defaults. *Eagle Ins. Co. v. Bankvest Capital Corp. (In re Bankvest Capital Corp.)*, 360 F.3d 291 (1st Cir. 2004) (prepetition failure to deliver equipment to the debtor's lessee need not be cured, but the reorganized debtor remained liable for damages for the breach).

n23

23. See *Counties Contracting & Constr. Co. v. Constitution Life Ins. Co.*, 855 F.2d 1054, 1058-60 (3d Cir. 1988) (effectively holding debtor in possession to 60 days to assume or reject executory contract); *In re Players Pub., Inc.*, 45 B.R. 387 (Bankr. D. Mass. 1985) (section 108(b) prevails over section 362 or 365 and requires debtor in possession to act within the parameters of section 108(b)).

n24

24. *Coleman Oil Co. v. The Circle K Corp. (In re The Circle K Corp.)*, 127 F.3d 904, 38 C.B.C.2d 1445 (9th Cir. 1997), cert. denied, 522 U.S. 1148, 118 S. Ct. 1166, 140 L. Ed. 2d 176 (1998) (a time-sensitive renewal option that may be exercised only if the debtor is not in default may be exercised before assumption and cure so as not to effectively shorten the time for assumption); *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1216, 11 C.B.C.2d 1, 17 (7th Cir. 1984) (Applying section 108(b) here would force debtors to decide whether to cure long before they must decide whether to assume or reject the contract and long before they know whether any reorganization plan will be confirmed.); *Coleman Oil Co. v. Circle K Corp. (In re Circle K Corp.)*, 190 B.R. 370 (B.A.P. 9th Cir. 1996); *In re Tudor Motor Lodge Assocs., Ltd. P'ship*, 102 B.R. 936, 951 & n. 8 (Bankr. D.N.J. 1989); *In re Masterworks, Inc.*, 100 B.R. 149 (Bankr. D. Conn. 1989) (section 365 gives the debtor a right to cure any time before confirmation); *In re Memphis-Friday's Assocs.*, 88 B.R. 830 (Bankr. W.D. Tenn. 1988) (section 365(c)(3) is more specific and limiting than section 108(b)).

n25

25. *In re Convenient Food Mart No. 144, Inc.*, 968 F.2d 592, 27 C.B.C.2d 272 (6th Cir. 1992); *In re Atlantic Business & Community Corp.*, 901 F.2d 325, 22 C.B.C.2d 1176 (3d Cir. 1990) (mere possessory interest in property triggers stay).

n26

26. *Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.)*, 824 F.2d 725, 17 C.B.C.2d 556 (9th Cir. 1987).

n27

27. *In re Superior Toy Mfg. Co., Inc.*, 78 F.3d 1169, 35 C.B.C.2d 637 (7th Cir. 1996).

n28

28. *Philip Servs. Corp. v. Luntz (In re Philip Servs. (Del.), Inc.)*, 284 B.R. 541 (Bankr. D. Del. 2002).

n29

29. *See Robinson v. Chicago Hous. Auth.*, 54 F.3d 316, 33 C.B.C.2d 603 (7th Cir. 1995); *Erickson v. Polk*,

921 F.2d 200 (8th Cir. 1990); *Vanderpark Props., Inc. v. Buchbinder (In re Windmill Farms, Inc.)*, 841 F.2d 1467 (9th Cir. 1988).

n30

30. *In re Waterkist Corp.*, 775 F.2d 1089 (9th Cir. 1985); *Elkton Assocs. v. Shelco Inc. (In re Shelco Inc.)*, 107 B.R. 483 (Bankr. D. Del. 1989); *Gallatin Hous. Auth. v. Talley (In re Talley)*, 69 B.R. 219 (Bankr. M.D. Tenn. 1986); see also *In re Burke*, 76 F. Supp. 5 (S.D. Cal. 1948) (court invoked Cal. Code Civ. P. § 1179 to relieve the debtor from a prepetition forfeiture based upon defaults arising from nonpayment of rent and failure to report gross income).

n31

31. See *Finn v. Meighan*, 325 U.S. 300, 301, 65 S. Ct. 1147, 1149, 89 L. Ed. 1624, 1626 (1945), in which the Court, per Justice Douglas, stated: The bankruptcy court does not look with favor upon forfeiture clauses in leases. They are liberally construed in favor of the bankrupt lessee so as not to deprive the estate of property which may turn out to be a valuable asset.

n32

32. See 11 U.S.C. § 365(b)(2), (e); *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 34 C.B.C.2d 1351 (1st Cir. 1995) (section 365(e) invalidates contractual *ipso facto* provisions and preempts state partnership laws to the same effect).

n33

33. See, e.g., *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 34 C.B.C.2d 1351 (1st Cir. 1995).

n34

34. See *Finn v. Meighan*, 325 U.S. 300, 301, 65 S. Ct. 1147, 1149, 89 L. Ed. 1624, 1626 (1945).

n35

35. *Queens Blvd. Wine & Liquor Corp. v. Blum*, 503 F.2d 202 (2d Cir. 1979); *In re D. H. Overmyer Co., Inc.*, 510 F.2d 329 (2d Cir. 1975).

n36

36. Pub. L. No. 103-394, § 219 (1994).

n37

37. *Worthington v. General Motors Corp. (In re Claremont Acquisition Corp., Inc.)*, 113 F.3d 1029 (9th Cir. 1997). The court also reviewed the legislative history to support its conclusion. *Id.* at 1034.

n38

38. 113 F.3d 1029, 1033-34.

n39

39. *Eagle Ins. Co. v. Bankvest Capital Corp. (In re Bankvest Capital Corp.)*, 360 F.3d 291 (1st Cir. 2004); *accord Ramco-Gershenson Props., L.P. v. Service Merch. Co., Inc.*, 293 B.R. 169 (M.D. Tenn. 2003) (going dark clause).

n40

40. Pub. L. No. 109-8, § 328(a)(1)(B) (2005), effective in cases commenced on or after October 17, 2005.

n41

41. Pub. L. No. 109-8, § 328(a)(1)(A) (2005); *see Incurable Nonmonetary Defaults supra*.

n42

42. *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1087, 24 C.B.C.2d 581, 587 (3d Cir. 1990) (factors considered in determining status of property under section 365(b)(3) include a combination of lease with other leases; all leases held by a single landlord; all tenants engaged in the commercial retail distribution of goods; the presence of a common parking area; the purposeful development of the premises as a shopping center; the existence of a master lease; the existence of fixed hours during which all stores are open; the existence of joint

advertising; contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases; the existence of percentage rent provisions in the leases; joint participation by tenants in trash removal and other maintenance; existence of a tenant mix; and contiguity of the stores).

n43

43. The characteristics of a shopping center and of pedestrian malls have been examined to some extent in picketing cases, such as *Amalgamated Food Employees Union Local 590 v. Logan Valley Plaza, Inc.*, 391 U.S. 308, 88 S. Ct. 1601, 20 L. Ed. 2d 603 (1968), which have been cited approvingly in the bankruptcy context, see *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 24 C.B.C.2d 581 (3d Cir. 1990); *In re Goldblatt Bros., Inc.*, 766 F.2d 1136, 13 C.B.C.2d 115 (7th Cir. 1985); *In re Ames Dept. Stores, Inc.*, 24 C.B.C.2d 1076, 121 B.R. 160 (Bankr. S.D.N.Y. 1990).

n44

44. In a very aggressive reading of this provision, the Court of Appeals for the Fourth Circuit rejected an assignment of a lease to a discount retail clothier, based on a lease provision that required that the premises be used only for an auto parts store. The lease required that the store be operated only under the debtor's trade name, but court left open the question of whether that provision could be enforced, because the landlord waived it in this case. *Congress Fin. Corp. v. West Town Ctr. LLC (In re Trak Auto Corp.)*, 367 F.3d 237 (4th Cir. 2004).

n45

45. 11 U.S.C. § 365(f)(2).

n46

46. Added by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353; see also *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1090, 24 C.B.C.2d 581, 591-92 (3d Cir. 1990) (court observes that court's authority to waive the strict enforcement of lease provisions in the context of shopping center cases is limited further than nonshopping center leases. However, literal compliance with all lease provisions is not required as insubstantial disruptions in, among other things, the tenant mix, are not fatal and may be allowed.).

ABOUT THE AUTHOR(S):

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162 of 197 DOCUMENTS

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Collier on Dismissal of a Ch. 7 Case for Abuse

2008 Emerging Issues 1257

Collier on Dismissal of a Ch. 7 Case for Abuse

By Collier

December 3, 2007

SUMMARY: This Emerging Issues Analysis discusses section 707(b), including the 2005 amendments, the bright line test to determine whether a debtor's chapter 7 case is to be presumed abusive, safe harbor from means testing, the expenses allowed in a means test, adjustments for special circumstances, the exception for certain disabled veterans, and motions to dismiss based upon forms of abuse other than the presumption of abuse.

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ARTICLE: Modification of Former Substantial Abuse Standard

The 2005 amendments to the Bankruptcy Code very substantially amended section 707(b) to establish new and detailed provisions relating to dismissal of chapter 7 cases. n1 The former language permitting motions under section 707(b) to be filed only by the court or the United States trustee was deleted, as was the language prohibiting motions filed at the request or suggestion of a party in interest. However, a new section 707(b)(6) forbids motions under section 707(b) against debtors below the applicable state median income standard from being filed by anyone other than the court or the United States trustee, or Bankruptcy Administrator, n2 if any. n3 In addition, a new section 707(b)(7) forbids any party from filing a means test motion, based on the debtor's ability to pay debts, against a debtor below the applicable median income standard. n4

The 2005 amendments also changed the standard for dismissal from "substantial abuse" to "abuse." It is unclear how much impact this will have; few, if any, courts permitted a chapter 7 case to proceed because they found it to be an abuse, but not a substantial abuse, under prior law. If courts found cases to be abusive under the totality of the circumstances, those cases were dismissed. n5

Similarly, the amendments eliminated the sentence that created a presumption in favor of granting chapter 7 relief to the debtor. Again, it is not clear whether this will make much difference in motions under section 707(b). Few courts relied upon this presumption to alter the disposition they would otherwise have ordered. n6 However, the amendments also created a presumption against granting relief to the debtor, a presumption of abuse, in certain cases. n7

Finally, the former language of section 707(b), which is now incorporated in section 707(b)(1) was amended to provide that as an alternative to dismissal, the court could convert a case to chapter 11 or chapter 13 with the debtor's consent. This, too, is not a marked change from the pre-existing practice, as debtors facing dismissal under former section 707(b) had normally been given the opportunity to voluntarily convert their cases to chapter 11 or chapter 13.

Presumption of Abuse

General Principles. The provisions of section 707(b)(2) create a bright line test to determine whether a debtor's chapter 7 case is to be presumed abusive for purposes of section 707(b). The test is applied only if the debtor's current monthly income, as defined in section 101, n8 is above the safe harbor amount set forth in section 707(b)(7). n9 Such debtors are required to perform a complicated set of calculations, in which various monthly expenses allowed by the statute, including certain expenses specified in the collection standards of the Internal Revenue Service, are deducted from current monthly income. If, after deduction of those expenses, the monthly amount deemed to be remaining, multiplied by 60, is either (1) greater than or equal to \$6,575 n10 or 25 percent of the debtor's nonpriority unsecured debts, whichever is greater or (2) greater than or equal to \$10,950, n11 then the case is presumed to be an abuse. If the case is presumed to be an abuse, the court may dismiss it under section 707(b) or, with the debtor's consent, convert the case to chapter 13. n12

Safe Harbor from Means Testing. Section 707(b)(7) provides a safe harbor that prohibits use of the means test if the current monthly income n13 of the debtor and the debtor's spouse combined, multiplied by 12, is equal to or less than the median family income n14 for a family the size of the debtor's household as set forth in the statute. n15 For a debtor in a household of one, the median family income is that for a family of one earner in the applicable state. For a debtor in a household of more than four members, the median family income is the highest median family income for a family of four or fewer members plus \$575 n16 per month for each individual in excess of four. This language, and similar language applicable to households of two to four members, recognizes that in many states the median income for a smaller family may be higher than for a larger family, and allows the debtor to utilize the highest number.

The language concerning the debtor's spouse is problematic if the case is not a joint case. The definition of "current monthly income" includes only income that the debtor receives or, in a joint case, the debtor and the debtor's spouse. n17 By definition, then, a nondebtor spouse has no current monthly income. This fact might raise a question about why Congress found it necessary to add section 707(b)(7)(B), which excludes the income of a separated spouse in a case that is not a joint case, for purposes of the means test threshold if the debtor certifies that the spouses are separated for purposes other than evading the means test and specifies any cash or money payments from the nondebtor spouse to the debtor's household. However, this provision serves the purpose of preventing two spouses from evading the means test by living apart and filing separate chapter 7 cases; in that situation each spouse would be a debtor with current monthly income.

Official Form 22A, promulgated to implement the means test, appears to take the position that the nondebtor's spouse should be added to the debtor's income for purposes of section 707(b)(7), in that line 12 directs the debtor to state the total of both spouses' incomes. n18 Although the nondebtor spouse's income not devoted to the household expenses of the debtor or dependents of the debtor is subtracted in line 17 for other means tests purposes, the inclusion of the income will require some debtors whose current monthly income is below the applicable median income threshold to complete the entire means test form nonetheless, unless they affirmatively assert that the form is contrary to the language of the statute.

It does seem clear that the "bright line test" of section 707(b)(7) means that no chapter 7 case should be dismissed based on the debtor's ability to pay if the debtor has an income below the safe harbor threshold. As the House Report stated:

The Act's second safe harbor only pertains to a motion under section 707(b)(2), that is, a motion to dismiss based on a debtor's ability to repay. It does not allow a judge, United States trustee, bankruptcy administrator or party in

interest to file such motion if the income of the debtor (including a veteran, as that term is defined in 38 U.S.C. § 101) and the debtor's spouse is less than certain monetary thresholds. n19

The median income threshold adopted by Congress for means testing recognizes that families with incomes below that threshold do not have the ability to pay significant amounts to their creditors while maintaining a reasonable living standard. Courts should not attempt to evade this congressional intent by using some alternative means test to find "abuse" on the part of debtors whose incomes are below the applicable median income threshold.

Expenses Allowed in Means Test

Internal Revenue Expense Standards. The first set of deductions allowed for debtors subject to the means test consists of the "applicable monthly expense amounts specified under the National Standards and Local Standards, and the debtor's actual expenses for the categories specified as Other Necessary Expenses" issued by the Internal Revenue Service. The National and Local Standards include amounts for housing and utilities, n20 transportation, n21 food, clothing, and other expenses. n22 The "Other Necessary Expenses" consist of a nonexclusive n23 list of other expenses necessary for family health and welfare or production of income. n24

Some of the IRS standards depend on the size of the debtor's household. Presumably, the household size at the time of the petition will be used for this purpose. The amounts allowed under the National Standards for food, clothing and other items depend on the debtor's income. Since there is no reference to current monthly income in the provisions incorporating the standards, unlike in many other provisions, but rather a reference to the "applicable" amounts, the income amounts used should be based on the way the IRS computes income. For example, benefits received under the Social Security Act should not be excluded for this purpose. The amounts allowed for food and clothing may be adjusted upward by up to 5 percent if the debtor demonstrates such adjustment is reasonable and necessary. n25

The statute is not crystal clear about how transportation expenses are computed. n26 The better view is that, because the language refers to deducting the "amounts specified" in the standards, and not actual expenses, the ownership allowance specified in the standards is the minimum amount to be deducted for the expense of car ownership, rather than the remaining car payments on a vehicle, if any, divided by 60 permitted by a later subparagraph. n27 This is the position taken by the Advisory Committee on Bankruptcy Rules in drafting Official Form 22A. n28 In fact, the literal language of the provisions could lead to a conclusion that both the "amounts specified" and the secured debt payments should be deducted, which would allow double counting of some of those payments. n29

The argument that only the remaining secured debt payments, and not the full ownership allowance, may be deducted does not withstand textual or policy scrutiny. This argument is based on language in the same paragraph stating "the monthly expenses of the debtor shall not include any payments for debts." This language means simply what it says: Although the IRS Other Necessary Expense standards permit debtors to make payments on other secured and unsecured debts, such payments are not allowed as part of the means test use of the IRS standards. The amounts deducted under the transportation ownership allowance are not payments for debts. They are the "amounts specified" by the allowance. It is more logical to conclude that the language prevents secured debt payments, which are allowed under a separate provision of the means test, from being double counted as part of the application of the IRS standards. Moreover, the argument that the language means the transportation ownership allowance cannot be allowed for a debtor with a car loan because it is a debt payment also proves too much. Under the Code's definition of "debt," n30 if no payment for any item that constitutes a debt were permitted under the local standards, debtors could not deduct any expenses for housing or transportation if they had a housing lease or an automobile lease, since an obligation on a prepetition lease is indisputably a debt. In addition, on policy grounds, allowing debtors to deduct only the remaining portion of their secured debt would leave them with no funds to replace an old car needed to continue employment, a result that would certainly not enhance either repayment of creditors or a fresh start. n31

For these reasons, the better reasoned decisions considering this issue have permitted debtors to deduct the amounts specified for the transportation ownership expense allowance even if they do not have an obligation to make

car loan payments or are intending to surrender the vehicle. n32 These courts have rejected the arguments of the United States trustee that the allowance should not be allowed in such cases because the Internal Revenue Service would not allow it in its financial analysis. As one court pointed out, the legislative history undercut this argument.

A prior version of the BAPCPA that was never passed defined "projected monthly net income" for the means test to require a calculation of expenses as follows:

"(A) the expense allowances under the applicable National Standards, Local Standards, and Other Necessary Expenses allowance (excluding payments for debts) for the debtor .. in the area in which the debtor resides as determined under the Internal Revenue Service financial analysis for expenses in effect as of the date of the order for relief."

H.R. 3150, 105th Congress (1998) (emphasis added).

The fact that Congress omitted this language, as well as the fact that Congress specified in other parts of the means test that "actual expenses" were to be used, supported the argument that the Internal Revenue Service analysis was not intended to be used and the ownership allowance could be deducted for each car the debtor owned. n33

An additional issue that may arise with the IRS transportation allowance, especially in metropolitan areas, is that it seems to assume that debtor families who have cars do not use public transportation. For cases in which this is not true and family members commute to work or school by rail or bus, the allowance of "Other Necessary Expenses" required for production of income or the "special circumstances" adjustment to expenses, n34 appears to be the remedy. Similarly, the IRS transportation allowance does not take into account large disparities in car insurance costs that exist within some metropolitan areas.

The IRS housing expense allowances, determined by county and family size, present different issues. Again, there is the interrelationship with the allowed payments of secured debt, although home mortgage payments are much less likely to be concluded before the end of the plan. As with the transportation allowance, a literal reading of the provisions might well allow both the housing allowance and the secured debt payment. However, this would permit double-counting. To avoid such double-counting, it appears that in trying to combine the two provisions the homeowner debtor should first deduct the "amount specified" for the IRS housing allowance, which covers utilities, home maintenance, and other similar expenses, and then deduct the mortgage payment, after subtracting from the mortgage payment the amount which would be double counted because it was included in the housing allowance. n35 Using some other method that deducted the full mortgage payment from the housing allowance could quite possibly leave debtors no money to maintain their homes or even pay for telephone service, a result at odds with the obvious intent that homeowners should be able to continue mortgage payments and retain their homes. n36

For renters, as well as homeowners, the IRS housing allowance is also enhanced, with a special allowance for reasonable and necessary home energy costs to the extent they would take total housing and utility expenses over the IRS allowance. n37 However, if a renter's rent, by itself, exceeds the IRS allowance, there may be no way to include an expense for other utilities, such as basic telephone service, other than through the "Other Necessary Expense" category n38 or the special circumstances adjustment.

The Other Necessary Expense category presents still other issues. As discussed above, it is a nonexclusive list and includes such expenses as child care, court ordered payments, including alimony, support and other court-ordered payments (such as restitution), expenses for care of the elderly, invalid or handicapped, education for special needs children if suitable education is not available from public schools, n39 medical and dental expenses, n40 taxes, involuntary deductions from wages, including union dues, uniforms, etc., term life insurance premiums, mandatory pension loan repayments or contributions, and withholding taxes, optional telephone service, and Internet service. n41

Debtors may have a variety of other expenses that are necessary to family health and welfare or production of income, such as business expenses, required homeowner association or other assessments, household help for an elderly

debtor who cannot feed or bathe herself, unreimbursed employee business expenses such as travel expenses or uniforms, and burglar alarm expenses in high crime neighborhoods. n42 The rigidity of the means test can be softened somewhat by sensible exercise of judicial discretion with respect to such expenses.

Other Expenses Allowed by Section 707(b). The means test specifies additional deductions that may overlap or exceed those allowed by the IRS standards. The debtor is clearly permitted to deduct reasonably necessary health insurance, disability insurance, and health savings account expenses, including for a spouse who may not be a codebtor or a dependent and may not be living with the debtor. n43 These provisions, evidencing a clear policy that families should have such insurance, may dictate purchasing insurance prior to bankruptcy if a debtor does not already have it, an important step toward financial stability, in order to assure that the substantial funds necessary for such insurance will be available to the debtor.

The debtor may deduct reasonably necessary expenses to maintain safety of the debtor and the family of the debtor from domestic violence, n44 which must be kept confidential by the court. n45 It is unclear how the confidentiality provision will work. If the court is to keep expenses confidential, is the trustee or United States trustee permitted to review them?

The allowed expenses may include "continuation of" actual reasonable and necessary expenses for the care and support of elderly, chronically ill, or disabled household members or immediate family members (parent, grandparent, sibling, child, grandchild, other dependent or spouse in a joint case if not a dependent). n46 This allowance may be broader than the IRS Other Necessary Expense category listed above, since it is not limited to dependents. It also may be broader, since the IRS category may not include support in addition to care.

Debtors are allowed to deduct, as under current law, charitable contributions to qualified religious or charitable entities or organizations. n47 However, the language of section 707(b)(1) referring to contributions the debtor "continues to make" suggests that the charitable impulse must have been evidenced by at least some contributions prior to the filing of the bankruptcy case, and debtors may need to provide some evidence of such gifts.

Debtors may also deduct actual public or private school educational expenses of up to \$1,650 per year per child under 18. n48 To take this deduction, the debtor must supply detailed documentation of such expenses and of why they are reasonable and necessary and why they are not already accounted for under IRS standards. However, there is no explicit provision for a determination of whether the expenses are reasonable and necessary after the debtor supplies documentation stating they are. In any event, the allowance is insufficient for virtually all parochial or private schools, and also does not cover high school students over 18.

But the debtor may be able to argue that an adjustment for special circumstances should be allowed because pulling children out of school in the middle of a school year would be very disruptive to their lives and education. At a minimum, this allowance can provide funds for school supplies, school trips, uniforms and the like, which are not insignificant family expenses.

Beyond the listed expenses, the means test allows deduction of amounts payable on secured and priority debts, presumably on the theory that such debts would be paid before unsecured claims in a chapter 13 case. n49 But the deduction for secured claims is not in the amount that would be paid in chapter 13. Instead it is in the total amount "scheduled as contractually due" to any secured creditors in the 60 months after the petition, plus any arrears necessary to maintain possession of a principal residence, motor vehicle, or other necessary property, divided by 60. Determining this amount is relatively straightforward in the case of most mortgage or car loans (putting aside the interrelationship with the transportation and housing allowances discussed above.) However, on secured claims such as tax liens, mechanics' liens or other liens with respect to which the entire amount is immediately due, will the debtor be allowed to add the interest that would accrue over a 60 month repayment period? And the payments that may be deducted under this provision, which makes no distinction among secured debts on necessary property, include payments on debts secured by appliances and payments on credit union loans where credit cards are cross-collateralized by the debtor's car

loan. Although it is not necessarily clear what is "scheduled as contractually due" on a credit card with a minimum payment, that may not matter much because with the high default interest rates charged to delinquents on most such cards the debtor would pay at least the entire balance on the card over a five year period.

The calculation for priority debts is somewhat less complicated, but there may be issues about which debts have priority. Debtors must divide the total amount due on priority claims by sixty to obtain a monthly amount. n50 Debtors will have an incentive to classify debts as priority rather than nonpriority. Most nonpriority tax debts formerly dischargeable in chapter 13 are now nondischargeable, n51 so debtors may arrange their financial affairs to maximize the nondischargeable debt that will be priority debt. Similarly, divorce property settlements are no longer dischargeable in chapter 7 cases, n52 so debtors may wish to argue that such debts are intended for support and therefore priority domestic support obligations, rather than property settlement debts, n53 so that they may be deducted in the means test.

Finally, if the debtor is eligible to file a chapter 13 case, the debtor's attorney must construct a hypothetical chapter 13 plan and determine the projected administrative expenses, but limited to ten percent. n54 This involves determining not only what would be paid to secured and priority creditors in a plan, but also the approximate amount that would be paid to unsecured creditors over five years, an amount that can only be precisely calculated under the same means test the debtor is in the process of completing.

Adjustments for Special Circumstances. Once all of the allowed expense deductions are taken, even if the income that is deemed to remain available is above the amount that creates a presumption of abuse, the debtor may rebut the presumption by showing special circumstances that justify additional expenses or a reduction in the income figure used. n55 Such special circumstances could be simply a reduction in the debtor's income below the current monthly income figure, or additional expenses, such as the moving expenses, security deposit, and other costs that would be incurred if the debtor moved to a lower rent apartment. There are many other possibilities, such as high commuting costs, n56 the increased price of gas, n57 security costs in dangerous neighborhoods or the cost of infant formula and diapers. Indeed, any legitimate expense that is out of the ordinary for an average family, or that may have increased since the IRS guidelines were calculated, could be considered.

The debtor must itemize each adjustment to income or expenses and provide supporting documentation. n58 The debtor must also provide a "detailed explanation" of why the adjustment is necessary and reasonable. n59 The debtor must certify "under oath" that both the itemization and explanation are accurate. n60 Presumably, a certification under penalty of perjury will meet this requirement. n61

The test for special circumstances in section 707(b)(2)(B) is that there must be "no reasonable alternative" to the adjustment, which might be viewed as a reasonableness test of sorts, and which gives the court a good deal of discretion to temper the arbitrariness of the means test numbers. Although the debtor has the burden of overcoming the presumption, as a practical matter the party seeking dismissal will have to show that there is a reasonable alternative to the debtor's additional expenses.

In any event, the presumption is only rebutted if the reduction in income or additional expenses bring the debtor's deemed available income below the amount that would trigger the presumption. n62 The statute speaks of special circumstances being shown only in the context of a dismissal proceeding, but a debtor may make such circumstances known to the United States trustee before such a proceeding is brought, in hopes that a decision will be made that no dismissal motion should be filed.

Exception for Certain Disabled Veterans. A complete exemption from the means test is carved out by section 707(b)(2)(D) for a disabled veteran, as defined in *section 3741(1) of title 38 U.S. Code*, n63 but only if the indebtedness occurred primarily during a period during which the veteran was on active duty, as defined by *section 101(d)(1) of title 10, United States Code*, n64 or performing a homeland defense activity, as defined by *32 USC 901(1)*. n65

This exception, in the cases where it applies, may raise issues of when a debt was primarily incurred. Are finance

charges and other charges incurred when they are assessed, even if the original debt was incurred before the debtor was on active duty? It would seem that the exception should be construed broadly to include the situation of a debtor who was paying most debts until active duty or disability rendered that more difficult and led to increased finance charges and other fees.

There may also be an issue when the debtor files a joint case with a spouse who does not qualify for the exception. The purpose of the exception would be undermined if the veteran's spouse were to be subjected to means testing, because that would almost invariably involve consideration of the disabled veteran's situation as well and impact on the relief available to the veteran.

Abuse Other Than under Means Test Presumption

In addition to the presumption of abuse that is used for determining the debtor's ability to pay debts, section 707(b) permits a motion to dismiss based on other types of abuse. The 2005 amendmentsⁿ⁶⁶ in some ways expand and in other ways limit the ability of parties other than the court and United States trustee to bring motions to dismiss based on abuse. Creditors and trustees are permitted to bring motions under section 707(b) alleging abuse against debtors not protected by the safe harbor of section 707(b)(6).ⁿ⁶⁷ However, the amendments define abuse under section 707(b) to include bad faith, which some courts had held, under prior law, to be grounds for dismissal under section 707(a) that could be raised by any party.ⁿ⁶⁸

Safe Harbor. Section 707(b)(6) provides a safe harbor from abuse motions brought by creditors, trustees, and other entities other than the court or United States trustee if the current monthly incomeⁿ⁶⁹ of the debtor, or, in a joint case, the debtor and the debtor's spouse, is equal to or less than the state median family incomeⁿ⁷⁰ for a family size equal to or less than the size of the debtor's household. In the case of a debtor in a household of one person, the median family income for one earner is used. In the case of a household of more than four, the highest state median income for a family of four or less is used, augmented by \$525 per month for each household member in excess of four.

This safe harbor preserves to some extent the protections against motions brought by creditors under section 707(b) to coerce or harass debtors who cannot afford to defend them.ⁿ⁷¹ It limits the use of section 707(b) by creditors and trustees to debtors whose income is above the applicable state median income level. To the extent that the language of section 707(b)(6) is more restrictive than section 707(b)(7),ⁿ⁷² it also prevents a creditor or trustee from bringing a means test motion against a debtor whose income is below the levels set forth in section 707(b)(6).

Other Types of Abuse. Section 707(b)(3), added in 2005,ⁿ⁷³ specifies the two issues that the court must consider in determining whether a case is an abuse under section 707(b)(2) when the presumption of abuse does not arise or has been rebutted. In view of the language of this provision, it is not clear whether these factors are to be considered in cases in which the presumption of abuse does arise. The better view is that they can be considered in such cases as well, even though that view renders some of the language to be surplusage, because there is no language limiting the consideration of the section 707(b)(3) factors only to cases in which the presumption of abuse is not operative.

The court must first consider whether the case was filed in bad faith.ⁿ⁷⁴ As discussed above, under the law in effect prior to the 2005 amendments, courts had disagreed about whether bad faith was grounds for dismissal under section 707(a).ⁿ⁷⁵ The specific inclusion of bad faith as grounds for dismissal under section 707(b) should resolve this dispute, making clear that Congress intended bad faith to be raised only by parties who are permitted to file section 707(b) motions against the debtor.

The second consideration of the court must be the totality of the circumstances, and whether those circumstances demonstrate abuse.ⁿ⁷⁶ This consideration had been adopted almost universally as the primary standard for determining whether substantial abuse exists under section 707(b) prior to the 2005 amendments.ⁿ⁷⁷ It is doubtful that courts will create any bright line rules under this standard, by which its very nature is an open-ended and discretionary

inquiry. It is also doubtful that the grounds for dismissal will change much, despite the change in the standard from "substantial abuse" to "abuse." Few, if any courts, permitted a case to go forward under prior law if they found it abusive. The general view appeared to be that any abuse was substantial and grounds for dismissal.

However, section 707(b)(3) does not permit a court to devise its own means test to determine ability to pay whenever the results of the congressionally devised means test in section 707(b)(2) are not satisfactory to the Court. n78 Section 707(b)(2) was designed to provide an objective methodology to limit courts' widely varying results with respect to ability to pay. n79 To determine that a case is an abuse solely on the basis of the debtor's ability to pay even though the means test concludes otherwise would be to invent a new means test, different than the uniform standard enacted by Congress after great deliberation and compromise to ensure that it appropriately balanced all of the interests involved.

Thus, for example, it would be contrary to congressional intent to use the \$167 figure for available income to determine abuse without using all of the other parts of the means test of which that figure is a component. The section 707(b)(2) means test reflects policy choices made by Congress as to factors that should be considered in determining a debtor's ability to pay. For example, Congress specifically excluded Social Security benefits from current monthly income, a choice that is consistent with other amendments that protect retirement benefits at the expense of creditors. Similarly, by permitting debtors to deduct the amounts specified in the IRS guidelines rather than limiting debtors to actual expenses, Congress has chosen not to penalize debtors for their frugality in spending less than the IRS allowances. By comparing the *total* of allowed expenses to the debtor's current monthly income, Congress clearly intended that a debtor might spend more than the allowance for one category (e.g., rent) and less for another (e.g., food), as long as the end result did not leave \$167 per month in disposable income. Courts should not undermine this policy by considering additional income available when the debtor's expenses for a particular item are less than the means test allows.

A special mention is made in section 707(b)(3)(B) of whether the debtor seeks to reject a personal services contract and the financial need for such a rejection. This language was a compromise on an earlier provision of the bill that would have more strictly limited the ability of debtors, such as highly paid recording artists, to reject personal services contracts they found to be disadvantageous. n80

Attorney's Fees in Abuse Motions

Subsections 707(b)(4) and (5), added by the 2005 amendments, n81 provide that in certain circumstances the prevailing party in a 707(b) motion may be awarded attorney's fees. The standards for awarding such fees vary depending upon which party prevailed and who brought the motion.

Abuse Motion Is Sustained. Under section 707(b)(4)(A), costs and attorney's fees incurred in a successful section 707(b) motion *may* be assessed against debtor's attorney, but only in those circumstances that would permit fees to be awarded under current law. Fees and costs may be awarded on motion of a party in interest or on the court's own initiative, but only if the case was dismissed under section 707(b) and the debtor's attorney violated *Federal Rule of Bankruptcy Procedure 9011* in filing the bankruptcy case itself. n82 Moreover, the procedures of Rule 9011 for awarding costs and fees must be followed. n83

The only real change in this provision is that costs and attorney's fees may be awarded to the trustee even if the court makes the award on its own initiative. n84 However, this provision only applies if the motion to dismiss under section 707(b) is brought by the trustee, not the United States trustee. n85 The original purpose of the provision apparently was to give trustees an incentive to file section 707(b) motions, but since the provision was originally introduced, the standard was changed to a Rule 9011 standard n86 that is unlikely to entice trustees to expend great efforts in litigating under that section.

The court may also assess a civil penalty against a debtor's attorney who violates Rule 9011, either on motion of a

party or on the court's own initiative. n87 Again, this is nothing new. Courts have long been able to assess civil penalties under Rule 9011. The only difference is that the penalty, unlike those assessed *sua sponte* under Rule 9011, may be payable to a trustee, United States trustee, or Bankruptcy Administrator.

Abuse Motion Is Denied. Section 707(b)(5) contains provisions that largely parallel those of section 707(b)(4), but provides for awarding to the debtor reasonable costs and fees, including attorney's fees, when a section 707(b) motion filed by a party in interest is denied. Like section 707(b)(4), it permits fees to be awarded by the court on motion of a party in interest or on its own motion, using the procedures of *Federal Rule of Bankruptcy Procedure 9011*. n88 However, it is not applicable to section 707(b) motions filed by a trustee, United States trustee or Bankruptcy Administrator. n89

Costs and fees may be awarded under this section if the position of the party that brought the section 707(b) motion violated Rule 9011. n90 They also may be awarded if the attorney, if any, who filed the motion did not comply with section 707(b)(4)(C)(1) and (ii) and the motion was made solely to coerce the debtor into waiving a right guaranteed by title 11. n91 These provisions also largely repeat standards that were already in place under Rule 9011.

Section 707(b)(5)(B), however, carves out an exception to the general rule of section 707(b)(5)(A)(ii)(I) allowing the award of costs and statutory fees against a party that violates Rule 9011 in filing a section 707(b) motion. A small business with an aggregate claim of under \$1000 is not subject to that provision. "Small business" is defined in section 707(b)(5)(C), for purposes of this paragraph only, as an unincorporated business, partnership, corporation, association, or organization that has fewer than 25 full time employees when the motion is filed and is engaged in commercial or business activity. This exception is unlikely to be invoked often, because few small creditors with such a small claim would litigate a section 707(b) motion. Because the provision requires the small business to be the holder of a claim in order to be exempted, the protection would not extend to the attorney for the small business, even if the attorney is a small business.

In any event, all attorneys and parties in section 707(b) motions, including trustees, United States trustees, and Bankruptcy Administrators, continue to be subject to *Federal Rule of Bankruptcy Procedure 9011*. There is no indication that Congress intended to give any attorney or party *carte blanche* to violate the fundamental rules governing conduct in bankruptcy cases.

For a complete discussion of Code section 707, see Collier on Bankruptcy, ch. 707 (Matthew Bender).

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n1 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 102(a) (2005), effective in cases commenced on or after October 17, 2005.

n2 The Bankruptcy Administrator performs most of the duties of the United States trustee in judicial districts in North Carolina and Alabama, where the United States trustee program is not operational.

n3 11 U.S.C. § 707(b)(6); see "Dismissal for Abuse under the 2005 Act; § 707(b)" *infra*.

n4 11 U.S.C. § 707(b)(7); see "Dismissal for Abuse under the 2005 Act; § 707(b)" *infra*.

n5 See *Collier on Bankruptcy*, 707.04[4] (Matthew Bender).

n6 See *Collier on Bankruptcy*, 707.04[5][a] (Matthew Bender).

n7 11 U.S.C. § 707(b)(2); see "Presumption of Abuse; § 707(b)(2)" *infra*.

n8 See *Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n9 11 U.S.C. § 707(b)(7); see "Dismissal for Abuse under the 2005 Act; § 707(b)" *infra*.

n10 Pursuant to 11 U.S.C. § 104(b), this amount is adjusted every three years to account for changes in the cost of living. See *Collier on Bankruptcy*, 104.03 (Matthew Bender). This dollar amount is effective for cases filed on or after April 1, 2007. For cases commenced between October 17, 2005, and March 31, 2007, the amount is \$6,000.

n11 Pursuant to 11 U.S.C. § 104(b), this amount is adjusted every three years to account for changes in the cost of living. See *Collier on Bankruptcy*, 104.03 (Matthew Bender). This dollar amount is effective for cases filed on or after April 1, 2007. For cases commenced between October 17, 2005, and March 31, 2007, the amount is \$10,000.

n12 11 U.S.C. § 707(b)(2)(A)(i).

n13 "Current monthly income" is defined in *11 U.S.C. § 101*, as amended by Pub. L. No. 109-8, § 102(b) (2005), effective in cases commenced on or after October 17, 2005.

n14 "Median family income" is defined in *11 U.S.C. § 101*, as amended by Pub. L. No. 109-8, § 102(k) (2005), effective in cases commenced on or after October 17, 2005.

n15 *11 U.S.C. § 707(b)(7)*.

n16 Pursuant to *11 U.S.C. § 104(b)*, this amount is adjusted every three years to account for changes in the cost of living. *See Collier on Bankruptcy*, 104.03 (Matthew Bender). This dollar amount is effective for cases filed on or after April 1, 2007. For cases commenced between October 17, 2005, and March 31, 2007, the amount is \$525.

n17 *11 U.S.C. § 101*; *see Collier on Bankruptcy*, 101.10A (Matthew Bender).

n18 Official Form 22A.

n19 H.R. Rep. No. 109-31, 109 Cong., 1st Sess. 51 (2005); *see also* the statement of the bill's Senate floor managers: "If you are below the State median income, you are not subject to the means test. It is as simple as that." 151 Cong. Rec. S2311 (Mar. 9, 2005) (statement of Sen. Hatch); "This bill clearly provides that people of limited income can still file under chapter 7 and get that fresh start. .. There is a specific safe harbor built in for these individuals, so their debts can be wiped away, as is done right now." 151 Cong. Rec. S1856 (Mar. 1, 2005) (statement of Sen. Grassley).

n20 *See* www.irs.gov/businesses/small/article/0,,id=104696,00.html.

n21 *See* www.irs.gov/businesses/small/article/0,,id=104623,00.html.

n22 See www.irs.gov/businesses/small/article/0,,id=104627,00.html.

n23 H.R. Rep. 109-31, 109th Cong., 1st Sess. 114 n.66 (2005). The Other Necessary Expense standards themselves also state that the list is nonexclusive.

n24 See <http://www.irs.gov/irm/part5/ch15s01.html#d0e182546>.

n25 11 U.S.C. § 707(b)(2)(ii)(I).

n26 See Culhane & White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, 7 Am. Bankr. Inst. L. Rev. 27, 44-46 (1999).

n27 11 U.S.C. § 707(b)(2)(A)(iii); see "Presumption of Abuse; § 707(b)(2)" *infra*.

n28 Official Form 22A, line 24.

n29 This conclusion gains support from the language of section 707(b)(2)(A)(ii)(IV), which, unlike section 707(b)(2)(A)(iii), requires the debtor to show that educational expenses have not already been accounted for in the IRS allowances.

n30 11 U.S.C. § 101(12).

n31 See Culhane & White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, 7 Am. Bankr. Inst. L. Rev. 27, 44-46 (1999).

n32 *In re Haley*, 2006 Bankr. LEXIS 2857 (Bankr. D.N.H. Oct. 18, 2006) (ownership expense allowed for

vehicle with no loan or lease payment); *In re Fowler*, 349 B.R. 414 (Bankr. D. Del. 2006)(same); *In re Farrar-Johnson*, 2006 Bankr. LEXIS 2214 (Bankr. N.D. Ill. Sept. 15, 2006) (debtor could deduct ownership allowance in case where debtor intended to surrender vehicle).

n33 *In re Fowler*, 349 B.R. 414, 419 (Bankr. D. Del. 2006).

n34 11 U.S.C. § 707(b)(2)(B); see "Abuse Other Than under Means Test Presumption" *infra*.

n35 A similar method was used by a creditor-funded study of the means test. See Culhane & White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, 7 Am. Bankr. Inst. L. Rev. 27, 47 (1999). In this respect, the creditor-funded Ernst and Young study was inconsistent in how it treated secured debt payments.

n36 The Executive Office of United States Trustees has published on its Web site tables that break out the ownership and non-ownership components of the housing allowance, similar to the separation of those components for the transportation allowance. Because this breakdown has not been adopted as a local standard by the Internal Revenue Service there is a significant issue as to whether it complies with the statutory requirement that the IRS local standards be used. Nonetheless, Official Form 22A directs the debtor to use the breakdown in the means test computation.

n37 11 U.S.C. § 707(b)(2)(A)(ii)(V); see "Presumption of Abuse; § 707(b)(2)" *infra*.

n38 This category includes "optional telephone services" and also more generally includes any expense necessary for the welfare of a family.

n39 There is a separate education deduction, discussed below, for other students.

n40 There is also a separate deduction allowed, discussed below, for health and disability insurance.

n41 Because the statutory language allows "actual monthly expenses for the categories specified" as Other Necessary Expenses it is unclear whether the court can scrutinize these expenses, as the IRS would, to determine whether they are necessary to family health and welfare or the production of income.

n42 However, Official Form 22 does not permit such expenses to be deducted, simply permitting the debtor to list them at the end of the form for informational purposes only, and therefore appears to be inconsistent with the Code. In any event, Official Form 22 does not preclude the debtor from asserting that such expenses must be deducted when a motion to dismiss is filed under section 707(b) and the court applies the means test to determine whether a presumption of abuse exists.

n43 *11 U.S.C. § 707(b)(2)(ii)(I).*

n44 Such expenses are those which are reasonably necessary to maintain safety of the debtor and the family of the debtor from family violence as identified under federal law including section 309 of the Family Violence Prevention and Services Act, which provides for: shelter, safe homes, meals, and related assistance to victims of family violence and their dependents. Related assistance includes direct assistance to victims of family violence and their dependents for the purpose of preventing further violence, helping such victims to gain access to civil and criminal courts and other community services, facilitating the efforts of such victims to make decisions concerning their lives in the interest of safety, and assisting such victims in healing from the effects of the violence; outreach and prevention services for victims and their children, employment training, parenting and other educational services for victims and their children, preventive health services within domestic violence programs (including nutrition, disease prevention, exercise, and prevention of substance abuse), domestic violence prevention programs for school age children, counseling with respect to family violence; transportation, technical assistance with respect to obtaining financial assistance under Federal and State programs, and referrals for appropriate health-care services (including alcohol and drug abuse treatment), but not reimbursement for any health-care services; legal advocacy to provide victims with information and assistance through the civil and criminal courts, and legal assistance; and children's counseling and support services, and child care services for children who are victims of family violence or the dependents of such victims. *42 U.S.C. § 10408.*

n45 *11 U.S.C. § 707(b)(2)(ii)(I).*

n46 *11 U.S.C. § 707(b)(2)(A)(ii)(II).*

n47 *11 U.S.C. § 707(b)(1); see Collier on Bankruptcy, 707.04[4][a] (Matthew Bender).*

n48 *11 U.S.C. § 707(b)(2)(A)(ii)(IV)*. This dollar amount is effective for cases filed on or after April 1, 2007. Pursuant to *11 U.S.C. § 104(b)*, the amount is adjusted every three years to account for changes in the cost of living. See *Collier on Bankruptcy*, 104.03 (Matthew Bender).. For cases commenced between October 17, 2005, and March 31, 2007, the amount is \$1,500.

n49 *11 U.S.C. § 707(b)(2)(A)(iii)*.

n50 *11 U.S.C. § 707(b)(2)(iv)*.

n51 *11 U.S.C. § 1328(a)*, as amended.

n52 See *11 U.S.C. § 523(a)(15)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 523 (Matthew Bender).

n53 See *Collier on Bankruptcy*, 523.11 (Matthew Bender).

n54 *11 U.S.C. § 707(b)(2)(A)(ii)(III)*. The United States trustee is required to publish schedules of administrative expenses in particular districts, but since chapter 13 trustees will have more work to do under the new provisions, and since administrative expenses include attorney's fees, it is hard to imagine how they could be less than ten percent in any district. Nonetheless, the United States Trustee Program has inexplicably published percentage figures that appear to include only the trustee's percentage fee and not administrative expenses for attorney's fees.

n55 *11 U.S.C. § 707(b)(2)(B)*.

n56 *In re Batzkiel*, 56 C.B.C.2d 1205, 349 B.R. 581 (Bankr. N.D. Iowa 2006).

n57 *In re Batzkiel*, 56 C.B.C.2d 1205, 349 B.R. 581 (Bankr. N.D. Iowa 2006); see also 147 Cong. Rec. S2363 (daily ed. Mar. 15, 2001) (remarks of Sen. Grassley on predecessor bill with identical special circumstances language, stating that significant increase in gas prices could constitute special circumstances).

n58 11 U.S.C. § 707(b)(2)(B)(ii)(I).

n59 11 U.S.C. § 707(b)(2)(B)(ii)(II).

n60 11 U.S.C. § 707(b)(2)(B)(iii).

n61 See 28 U.S.C. § 1746; *Fed. R. Bankr. P.* 1008.

n62 11 U.S.C. § 707(b)(2)(B)(iv).

n63 Under 38 U.S.C. § 3741(1), the term "disabled veteran" means (A) a veteran who is entitled to compensation under laws administered by the Secretary for a disability rated at 30 percent or more, or (B) a veteran whose discharge or release from active duty was for a disability incurred or aggravated in line of duty.

n64 Under 10 U.S.C. § 101(d)(1), the term "active duty" means full-time duty in the active military service of the United States. Such term includes full-time training duty, annual training duty, and attendance, while in the active military service, at a school designated as a service school by law or by the Secretary of the military department concerned. Such term does not include full-time National Guard duty.

n65 Under 32 U.S.C. § 901(1), the term "homeland defense activity" means an activity undertaken for the military protection of the territory or domestic population of the United States, or of infrastructure or other assets of the United States determined by the Secretary of Defense as being critical to national security, from a threat or aggression against the United States.

n66 Pub. L. No. 109-8, 102(a) (2005), effective in cases commenced on or after October 17, 2005.

n67 See "Safe Harbor" *infra*.

n68 See "Other Types of Abuse; § 707(b)(1)" *infra*.

n69 "Current monthly income" is defined in 11 U.S.C. § 101, as amended by Pub. L. No. 109-8, § 102(a) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 101.10A (Matthew Bender). 101.39A (Matthew Bender).

n70 "Median family income" is defined in 11 U.S.C. § 101, as amended by Pub. L. No. 109-8, § 102(k) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 101.39A (Matthew Bender).

n71 See *Collier on Bankruptcy*, 707.04[1] (Matthew Bender).

n72 See "Presumption of Abuse; § 707(b)(2)" *supra*.

n73 Pub. L. No. 109-8, § 102(a) (2005), effective in cases commenced on or after October 17, 2005, specifies two issues that the court must consider in determining whether a case is an abuse under section 707(b)(2) when the presumption of abuse does not arise or has been rebutted.

n74 11 U.S.C. § 707(b)(3)(A).

n75 See *Collier on Bankruptcy*, 707.03[2] (Matthew Bender).

n76 *11 U.S.C. § 707(b)(3)(B)*.

n77 *See Collier on Bankruptcy, 707.04[4]* (Matthew Bender).

n78 *In re Nockerts, 357 B.R. 497 (Bankr. E.D. Wis. 2006)*.

n79 "The Means Test contained in the bill will provide a uniform standard to bankruptcy judges to evaluate the ability of bankruptcy filers to repay debts." 151 Cong. Rec. S1842-S1843 (Mar. 1, 2005) (statement of Sen. Hatch) (emphasis added).

n80 H.R. Rep. 105-794, 105th Cong. 2d Sess., 123 (1998).

n81 Pub. L. No. 109-8, § 102(a) (2005), effective in cases commenced on or after October 17, 2005.

n82 *11 U.S.C. § 707(b)(4)(A)*.

n83 *Id.*

n84 Under Bankruptcy Rule 9011(c)(2), if the court initiates the proceeding, any monetary sanction must be payable to the court.

n85 For this reason, it can apply only in cases of debtors above the median income safe harbor of section 707(b)(6), since a trustee cannot bring a section 707(b) motion against a debtor protected by that safe harbor.

n86 *Cf. S.625 § 102* (as reported from Judiciary Committee in the 106th Congress).

n87 11 U.S.C. § 707(b)(4)(B).

n88 11 U.S.C. § 707(b)(5)(A).

n89 *Id.*

n90 See *Collier on Bankruptcy*, 707.06 (Matthew Bender).

n91 11 U.S.C. § 707(b)(5)(ii).

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163 of 197 DOCUMENTS

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Collier on Disclosure of Compensation for Debtors Attorney

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Collier on Disclosure of Compensation for Debtors Attorney

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SUMMARY: This Emerging Issues Analysis discusses issues pertaining to disclosure of compensation for the debtors attorney, including the disclosure provisions of Bankruptcy Rule 2016(b), which should be read in conjunction with Section 329, and the consequences of an attorneys nondisclosure.

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ARTICLE: *Section 329(a) of the Bankruptcy Code* requires an attorney for the debtor to file with the court a statement indicating any compensation paid or agreed to be paid to such attorney for services rendered or to be rendered in contemplation of or in connection with a case under the Code. The debtor's Statement of Financial Affairs (which must be filed pursuant to section 521) similarly requires the disclosure of all payments or agreements to pay the attorney or any other person rendering services to the debtor in connection with the case during the year preceding or since the filing of the petition. n1

Disclosure Provisions of Rule 2016(b)

Section 329 should be read in conjunction with Rule 2016. Rule 2016 implements and further specifies the disclosure requirements of section 329(a) of the Code. n2 Under section 329 and Bankruptcy Rule 2016(b), the statement also must disclose the source of such compensation, even if the source is not the debtor but a third party entity. The statement must be filed whether or not the attorney intends to apply for compensation under the Code, specifically under section 330 (*e.g.*, a flat fee payment in full before the petition date). If, however, the payment or agreement was made more than one year before the date of the filing of the petition, then no such statement is required. n3 This temporal limitation represents a departure from prior law. Apparently a presumption exists that any compensation paid or promised prior to such time would not be for services rendered in contemplation of or in connection with a liquidation or reorganization case.

Disclosure of Fee Sharing Agreements. Bankruptcy Rule 2016(b) also incorporates specifically the requirement that the statement filed indicate whether the attorney has shared or has agreed to share in respect of any such compensation with any other person. With limited exceptions, the sharing of compensation is expressly prohibited by

section 504 of the Bankruptcy Code. n4 Section 504(a) applies the general prohibition against attorney fee splitting to virtually all professional persons who seek compensation in bankruptcy cases except with certain public service attorney referral programs. n5 Since virtually all of the cases which address section 504 discuss the attorneys' role in the context of their professional ethics, rather than merely addressing the scope of the rule, the importance of disclosure of any agreements to share fees is exceedingly important. Only entities that perform real services are to be compensated and referral fees and forwarding fees are not permitted. n6 In addition, 18 U.S.C. § 155 imposes criminal sanctions for improper fee splitting or fixing by attorneys as well as non-attorney professionals.

The statement must include the details of any such sharing or sharing agreement, except that disclosure of the details of any sharing agreement with a member or regular associate of the attorney's law firm is not required. Regular associate of a law firm is defined in Bankruptcy Rule 9001(9) to include any attorney regularly employed by, associated with or counsel to that law firm. n7

Debtor Not Required to Be Insolvent. Section 329(a) is applicable when services are rendered in contemplation of or in connection with the case by such attorney. n8 Moreover, Bankruptcy Rule 2017, n9 also incorporates the in contemplation of language. Whether the services rendered were in contemplation of bankruptcy does not turn on whether the debtor was actually insolvent at the time. n10 Section 329 does not incorporate an insolvency test unlike other sections of the Bankruptcy Code. n11

Compensation Paid after the Case Is Filed. Only compensation for services rendered or to be rendered in contemplation of or in connection with the case by the debtor's attorney is the subject of section 329. Bankruptcy Rule 2017(b), however, subjects to court review all payments, or any agreements to pay, by the debtor to an attorney, made after entry of the order for relief, for services in any way related to the case. Services that are in any way related to the case encompass all services rendered in contemplation of the filing of a petition, as well as services rendered or to be rendered after the commencement of the case. Thus, the Code's addition of the phrase or in connection with to section 329, together with the language of Bankruptcy Rule 2017(b), effectively subjects to court examination compensation which is paid or promised to the debtor's attorney at some point after entry of the order for relief in, and in relation to, the liquidation or reorganization case. Section 329 also gives the bankruptcy court the authority to review fees which the debtor may have paid prepetition to a state court receiver. n12

Test Applied to Determine If Payment Was in Contemplation of Bankruptcy. Courts will apply a subjective, rather than an objective, test in determining whether the debtor's payments were made in contemplation of bankruptcy, and the debtor's financial condition at the time carries little relevancy. n13 The thought of impending liquidation or reorganization must be the impelling cause of the transaction. The controlling question is the state of mind of the debtor, i.e., whether, in making the transfer, the debtor is influenced by the possibility or imminence of a bankruptcy proceeding. n14 Thus, the payment of fees on the eve of bankruptcy, related to the attorneys' actions to obtain a moratorium from the state on certain obligations of the debtor to make refunds to investors, has been held to have been made in contemplation of bankruptcy and reviewable by the court. n15

Applicability of Section 329 to Services Rendered to Avoid Bankruptcy. Attorneys frequently represent debtors trying to avoid the commencement of a bankruptcy case by, for example, meeting with the borrower's creditors in an effort to restructure the borrower's debt. Services devoted to the prevention of bankruptcy, such as to effect a settlement or to determine the continued viability of a company, may also be subject to the provisions of section 329 once a bankruptcy case is commenced. n16 For example, in *Arens v. Boughton (In re Prudhomme)*, n17 the Court of Appeals for the Fifth Circuit determined that payments to attorneys were made in contemplation of or in connection with the case when the evidence suggested that the debtors were in desperate financial straits when they first consulted counsel, that they sought representation in resolving their disputes with their largest creditor, and that they had been unsuccessful in restructuring their debt in contemplation of bankruptcy and were, therefore, subject to reexamination. Thus, when a payment or promise of payment is made to a debtor's attorney in contemplation of a case under the Code, the reasonableness of such compensation may be reexamined, whatever the nature of the specific services rendered. n18

Limits of Section 329 Authority. There are limits to the scope of section 329. For example, in *In re Swartout*,ⁿ¹⁹ an attorney's fee for representing a debtor in divorce proceedings was subject to section 329 because the debtor's personal and business affairs so closely overlapped that the financial aspects of the divorce were intertwined with the bankruptcy. However, the portion of the compensation directly allocable to the divorce case was ruled to be unconnected to the bankruptcy, and thus not subject to section 329, which requires that the services bear more than a casual relationship to the bankruptcy proceedings.ⁿ²⁰

Time Period for Services Subject to Section 329. The time period during which these legal services are actually provided may also impact whether section 329(a) applies.

Courts have held that although the debtor's attorney was not required to obtain court approval during the gap period between the filing of an involuntary petition against the debtor and the entry of an order for relief, fees received during this period will be subject to judicial review for reasonableness' under section 329.ⁿ²¹

Courts have held that an attorney performing postconfirmation services for the reorganized debtor must still meet the requirements of section 329(a).ⁿ²² The mere fact that the attorney is representing a debtor in a case under the Bankruptcy Code required that the attorney file a statement of compensation paid or agreed to be paid under section 329(a) and Bankruptcy Rule 2016(b).

Claims for Compensation Where Services Were Not in Contemplation of Bankruptcy. When compensation is sought for legal services rendered prior to the filing of the bankruptcy petition that were not in contemplation of or in connection with a case under the Code, the claim of the attorney is treated like that of any other creditor,ⁿ²³ and the claim does not fall within the purview of section 329. However, section 502, which provides for the allowance of claims, permits the court under section 502(b)(4) to examine the claim for services of a debtor's attorney and to disallow it to the extent that it exceeds the reasonable value of the attorney's services.

Compensation Paid or Agreed to Be Paid More Than One Year Before Petition Filed. Despite the language of section 329(a) which requires counsel to report compensation paid or agreed to be paid if such payment or agreement was made after one year before the date of the filing of the petition, the Court of Appeals for the Fifth Circuit has held that a court has the power to order the disgorgement of a fee paid or agreed to be paid *more than* one year before the debtor's bankruptcy petition was filed.ⁿ²⁴ The court held that section 329(a) does not provide a limitations period beyond which the court cannot reach.ⁿ²⁵ The court reasoned that neither the reporting requirement of section 329(a) nor section 329(b) specifies any limitations period, nor that Rule 2017(a) also contains no one year limitations period. Focusing on the presumptive nature of the one year period, the court concluded that the one-year period mentioned in § 329(a) is based on the apparent presumption that any compensation paid before the year prepetition was not for services rendered in contemplation of bankruptcy. To recognize that the one-year period is based on a presumption is to suggest that the presumption can be rebutted, as the bankruptcy court reasoned. The court's treatment of the one-year period in § 329(a) as a presumption rebutted by fraud or concealment is consonant with the principle that, in a court of equity, a statute of limitations may be tolled by the inequitable conduct of the parties.ⁿ²⁶

Thus, a pattern of nondisclosure and concealment may constitute misconduct justifying disgorgement of fees paid more than one year before the petition date. The court may order disgorgement even if section 329(a) would otherwise preclude recovery of fees paid earlier than one year prepetition.ⁿ²⁷

Consequences of Attorney's Nondisclosure; Sanctions

An attorney's nondisclosure (which rises to the level of concealment) may expand the authority of the court under section 329. Failure to strictly follow the requirements of section 329(a) may result in other severe consequences, as demonstrated by the decision of the Court of Appeals for the Ninth Circuit in *Neben & Starrett Inc. v. Chartwell Financial Corp.* (*In re Park-Helena Corp.*).ⁿ²⁸ In *Park-Helena*, the court denied all fees and costs requested by the

debtor's law firm in part because the firm violated section 329 by stating that its \$150,000 retainer was paid by the debtor, when in fact the retainer was paid by the debtor's president. The attorneys attempted to justify their misstatement by arguing that the president's payment was, in effect, a payment from the debtor because the president had previously received a \$1.35 million loan from the debtor, and the \$150,000 payment to the attorneys was credited toward this debt. The court rejected this argument, finding that a fee applicant must disclose the precise nature of the fee arrangement, and not simply identify the ultimate owner of the funds. n29 The court reasoned that [t]he disclosure rules are applied literally, even if the results are sometimes harsh. Negligent or inadvertent omissions do not vitiate the failure to disclose. Similarly, a disclosure violation may result in sanctions regardless of actual harm to the estate. n30

Because the attorneys failed to disclose all of the facts of the transaction, as those facts were known to the law firm, n31 the firm violated section 329 and was not allowed to receive any fees. n32 Several other courts have required disgorgement when the attorney failed to disclose that it had entered into a prepetition fee arrangement with certain of the debtor's creditors. n33

Just as the failure to strictly comply with the disclosure requirements of section 329 may result in harsh consequences, an attorney may also be sanctioned for failing to comply with the requirements contained in Rule 2016(b). A court may disallow fees requested by an attorney who receives, but does not file, a supplemental affidavit under Rule 2016 disclosing an additional retainer paid by a debtor's principal. n34 Notably, disclosure of any supplemental retainer in a fee application in lieu of a supplemental affidavit has been held to be insufficient disclosure. n35 Several other courts have held that a law firm may not rely on other documents filed in a case--such as a fee application--to excuse noncompliance with Rule 2016(b). n36

Return to Text

n1 Official Form 7, the Statement of Financial Affairs, is a separate document required to be filed with the petition or within 15 days thereafter. *Fed. R. Bankr. P. 1007(b)(1)*, (c). See Collier on Bankruptcy, ch. 1007 (Matthew Bender). Only a debtor that is or has been in business, as defined in the form, should answer the questions concerning such debts.

n2 Rule 2016 provides that:

Every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 15 days after the order for relief, or at another time as the court may direct, the statement required by § 329 of the Code including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney, but the details of any agreement for the sharing of compensation with a member or regular associate of the attorney's law firm shall not be required. A supplemental statement shall be filed and transmitted to the United States trustee within 15 days after any payment or agreement not previously disclosed.

n3 *But see Arnes v. Boughton (In re Prudhomme)*, 43 F.3d 1000 (5th Cir. 1995) (payments were made in contemplation of or in connection with the case when the evidence suggested that the debtors were in desperate financial straits when they first consulted counsel).

n4 See Collier on Bankruptcy, ch. 504 (Matthew Bender); (one-year time period under section 329 is not a limitation of the court's powers).

n5 11 U.S.C. § 504, as amended by Pub. L. 109-8, § 326 (2005), effective in cases commenced on or after October 17, 2005.

n6 See *In re Matis*, 73 B.R. 228 (Bankr. N.D.N.Y. 1987).

n7 See also *In re Palladino*, 267 B.R. 825, 833 (Bankr. N.D. Ill. 2001) (phrase associates does not bring other attorneys not in the firm within the exception).

n8 This language is derived from former Rule 220.

n9 Bankruptcy Rule 2017 permits the court, on motion or *sua sponte*, to examine payments to the debtor's attorney to determine whether the payments are excessive. This rule is derived from former Rule 220.

n10 *In re J.J. Bradley & Co., Inc.*, 2 C.B.C.2d 1245, 6 B.R. 529 (Bankr. E.D.N.Y. 1980).

n11 See, e.g., 11 U.S.C. §§ 547, 553.

n12 *Yellow Cab Coop. Ass'n v. Mathis (In re Yellow Cab Coop. Ass'n)*, 185 B.R. 844 (Bankr. D. Colo. 1995).

n13 *In re Zepecki*, 258 B.R. 719, 724 (B.A.P. 8th Cir. 2001) (reviewing attorney's services in connection with prepetition sale of debtor's property). *Wootton v. Ravkind (In re Dixon)*, 143 B.R. 671, 67576 n.3 (Bankr. N.D. Tex. 1992); *In re GIC Gov't Sec., Inc.*, 92 B.R. 525 (Bankr. M.D. Fla. 1988).

n14 *Wootton v. Ravkind (In re Dixon)*, 143 B.R. 671, 67576 n.3 (Bankr. N.D. Tex. 1992) (relying on *Conrad, Rubin & Lesser v. Pender*, 289 U.S. 472, 53 S. Ct. 703, 77 L. Ed. 1327 (1933)).

n15 *In re GIC Gov't Sec., Inc.*, 92 B.R. 525 (Bankr. M.D. Fla. 1988); *see also In re Newton*, 292 B.R. 563 (Bankr. E.D. Tex. 2003) (services rendered were not in contemplation of bankruptcy).

n16 *See generally Conrad, Rubin & Lesser v. Pender*, 289 U.S. 472, 53 S. Ct. 703, 77 L. Ed. 1327 (1933).

n17 43 F.3d 1000, 1004 (5th Cir. 1995); *see also In re Mayeaux*, 269 B.R. 614, 62324 (Bankr. E.D. Tex. 2001).

n18 *See In re Wood & Henderson*, 210 U.S. 246, 28 S. Ct. 621, 52 L. Ed. 1046 (1908); *In re Ostas*, 158 B.R. 312 (N.D.N.Y. 1993) (attorney was required to disclose \$1600 in fees charged to obtain a stay of foreclosure because services were in connection with bankruptcy case; fees ordered disgorged due to nondisclosure).

n19 20 B.R. 102 (Bankr. S.D. Ohio 1982); *see also In re Zepecki*, 258 B.R. 719, 724 (B.A.P. 8th Cir. 2001).

n20 20 B.R. 102, 106.

n21 *In re McNar, Inc.*, 116 B.R. 746 (Bankr. S.D. Cal. 1990).

n22 *In re John G. Berg Assocs., Inc.*, 138 B.R. 782 (Bankr. E.D. Pa. 1992).

n23 *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1127 (7th Cir. 2003), *cert. denied*, 541 U.S. 1043, 124 S. Ct. 2176, 158 L. Ed. 2d 733 (2004); *see also In re Griffin*, 313 B.R. 757 (Bankr. N.D. Ill. 2004) (reviewing all cases); *In re Symes*, 174 B.R. 114 (Bankr. D. Ariz. 1994) (examining retainer agreement requiring

post-dated checks to be cashed postpetition and finding they constituted dischargeable claims) ; *In re Swartout*, 20 B.R. 102 (Bankr. S.D. Ohio 1982); *Tripp v. Mitschrich*, 211 F. 424 (8th Cir. 1914); see also *Magee v. Fox*, 229 F. 395 (2d Cir. 1916).

n24 See *Arnes v. Boughton (In re Prudhomme)*, 43 F.3d 1000 (5th Cir. 1995).

n25 43 F.3d 1000, 1003.

n26 43 F.3d 1000, 1002.

n27 43 F.3d 1000, 1002. In *Prudhomme*, the court required disgorgement of a \$75,000 retainer after determining that the fee was excessive and that the professional consciously breached its duty to disclose the retainer fee as well as a contingency interest in a lender liability action the debtor was pursuing against the debtor's major creditor. See also *In re Zepecki*, 258 B.R. 719, 725 (B.A.P. 8th Cir. 2001) (bankruptcy court may order disgorgement *sua sponte*).

n28 63 F.3d 877 (9th Cir. 1995), cert. denied, 516 U.S. 1049, 116 S. Ct. 712, 133 L. Ed. 2d 667 (1996).

n29 63 F.3d 877, 881 (citations omitted).

n30 63 F.3d 877, 881.

n31 63 F.3d 877, 881; see also *In re Lewis*, 113 F.3d 1040 (9th Cir. 1997).

n32 *In re Chestnut Hill Mortg. Corp.*, 158 B.R. 547 (D. Mass. 1993); accord *In re Whitman*, 51 B.R. 502 (Bankr. D. Mass. 1985).

n33 See also *In re Hargis*, 887 F.2d 77 (5th Cir. 1989), modified, 895 F.2d 1025 (5th Cir. 1990); *In re W.T. Mayfield Sons Trucking Co., Inc.*, 225 B.R. 818, 828 (Bankr. N.D. Ga. 1998). *In re Century Plaza Assocs.*, 154 B.R. 349, 352 (Bankr. S.D. Fla. 1992).

n34 See *In re TJN, Inc.*, 194 B.R. 400 (Bankr. D.S.C. 1996).

n35 *In re TJN, Inc.*, 194 B.R. 400, 40203.

n36 See *In re Quality Respiratory Care, Inc.*, 157 B.R. 180 (Bankr. D. Me. 1993); *In re Brandenburger*, 145 B.R. 624 (Bankr. D.S.D. 1992); see also *In re Redding*, 247 B.R. 474 (B.A.P. 8th Cir. 2000).

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164 of 197 DOCUMENTS

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Collier on Matters to Be Handled at Creditors Meeting

2008 Emerging Issues 1049

Collier on Matters to Be Handled at Creditors Meeting

By Collier

November 19, 2007

SUMMARY: Although section 341 of the Bankruptcy Code does not set forth specific provisions concerning the conduct of the meeting of creditors, Rule 2003(b)(1) states that the business of the meeting shall include the examination of the debtor and, if appropriate, the election of a trustee or of a creditors' committee. This Emerging Issues Analysis discusses these issues pertaining to matters at the creditors meeting.

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ARTICLE: Agenda for Meeting

Although *section 341 of the Bankruptcy Code* does not set forth specific provisions concerning the conduct of the meeting of creditors, Rule 2003(b)(1) states that the business of the meeting shall include the examination of the debtor and, if appropriate, the election of a trustee or of a creditors' committee. n1 When a trustee is elected, the creditors may recommend the amount of the trustee's bond to be fixed by the court. n2

The following order of business might be followed at the meeting: n3

- . call for noting of appearance in person or by power of attorney;
- . election of trustee in a chapter 7 case, if any creditors seek election of a trustee; n4
- . election of creditors' committee in a chapter 7 case, if any creditors wish to elect a creditors' committee. n5 (But this is a rare event.)
- . examination of debtor; n6
- . miscellaneous business; and
- . continuance to a place, day and hour certain or final adjournment.

Creditors' Appearances at Creditors' Meetings. Creditors may appear at the meeting of creditors to participate in the examination of the debtor or in the other aspects of the meeting. In most consumer bankruptcy cases, few creditors attend the meeting because the expenditure of time and money necessary is rarely justified by significant benefits derived from attending. The meeting in such a case then consists simply of an examination of the debtor conducted by the trustee.

In some business cases, creditors may have reason to attend the meeting. The section 341 meeting represents a unique opportunity for a creditor, particularly one with a significant claim, to conduct a wide-ranging examination that may help determine whether a debtor has a realistic prospect for reorganizing and what a reorganized debtor might look like.

An individual creditor may represent himself or herself at a creditors' meeting. n7 Rejecting the minority view that appearing for a corporate creditor is the practice of law n8 and expanding on the majority view that a corporate creditor may be represented by a nonattorney, n9 the 2005 amendments to section 341 permit a nonattorney to appear and participate in a creditors' meeting on behalf of any creditor holding a consumer debt in a chapter 7 or chapter 13 case. n10 The nonattorney representative may appear alone or in conjunction with an attorney for the creditor, and may represent more than one creditor. n11 Amended section 341(c) provides that the representative may be an entity or an employee of an entity, enabling corporations, partnerships, and governmental units, as well as individuals, to represent creditors. n12 The amendments could create a negative implication concerning representatives of creditors that do not hold consumer claims and creditors in cases under other chapters. However, the amended provision does state that [n]othing in this subsection shall be construed to require any creditor to be represented by an attorney at any meeting of creditors. Therefore the law with respect to meetings of creditors in those situations will remain somewhat uncertain.

Rule 9010(a) requires that when a creditor appears by an attorney, the attorney shall be authorized to practice in the court. The attorney must have written authority to conduct any business other than the execution and filing of a proof of claim. But a creditor may employ an agent or attorney to vote its claim at creditors' meetings, provided such representative has the proper written authority. n13 Such written authority for voting at creditors' meetings should be presented by a creditor's attorney who is representing the creditor generally in the proceedings. n14 Authority of an attorney to act may be revoked, of course, in accord with ordinary principles of agency law. n15

Election of Trustee. Section 702 of the Code provides that, in a chapter 7 case, if creditors representing 20 percent in amount of the claims held by creditors qualified to vote request the election of a trustee, n16 the election is to take place at the meeting of creditors required under section 341. n17 A candidate for trustee can be elected by a majority of qualified voting creditors as long as qualified voting creditors representing at least 20 percent in amount of claims do in fact vote. n18 If a trustee is not elected, as is almost always the case, the interim trustee will serve as trustee for the duration of the chapter 7 case. n19

If the court has ordered the appointment of a trustee in a chapter 11 case, creditors have the option of electing a trustee. If such an order is entered prior to the creditors' meeting and the appropriate request required by section 1104(b) is made to the United States trustee, an election could be held at the creditors' meeting. n20

Eligibility and qualification of the trustee is provided for under section 321 and section 322 and, pursuant to section 324, the court may remove a trustee for cause. n21

Creditors' Committees. In a chapter 7 case at the meeting of creditors, a creditors' committee may be elected by creditors qualified to vote for the trustee. n22 However, this almost never occurs, because even in the small percentage of cases in which there are assets, the presence of a trustee is normally considered to provide sufficient oversight, especially since creditors may elect a trustee of their choosing. If a committee is elected, it must consist of no fewer than three and no more than 11 creditors, each holding an allowable unsecured claim entitled to distribution under section 726(a)(2) of the Code. The committee may consult with the trustee regarding the administration of the estate, make recommendations to the trustee and submit to the court any questions affecting the administration of the estate.

n23

Examination of Debtor. The debtor is required to appear at the meeting of creditors and submit to examination, under oath, by the creditors, an indenture trustee, the United States trustee, or any trustee or examiner in the case. n24 Most courts have held that an agent of a creditor may examine the debtor on the creditor's behalf even if the agent is not an attorney, because the meeting is not a judicial proceeding n25 and such participation is now specifically authorized on behalf of creditors holding consumer claims in chapter 7 and chapter 13 cases. n26 Section 105(b) of the Bankruptcy Reform Act of 1994 provides that for states where the bankruptcy system is administered by a bankruptcy administrator instead of a United States trustee (Alabama and North Carolina), the bankruptcy administrator or his or her designee may examine the debtor and administer the oath under section 343 of the Code. n27

At the outset of the examination, the debtor is normally asked to sign an oath form stating that the testimony to be given will be true and correct under penalty of perjury. The questions asked generally concern the debtor's financial affairs, assets and liabilities, as initially set forth in the schedules and statements filed by the debtor. The purpose of the examination is to make a determination as to whether assets have been concealed, whether there has been any improper disposition of assets, whether a chapter 7 debtor's case might be considered an abuse under section 707(b), n28 or if there are grounds for objections to exemptions or to discharge. n29 In chapters 11, 12 and 13, the questions may also go to the feasibility of the debtor's proposed or anticipated plan.

The trustee will normally have available for use in such examination the statements and schedules filed by the debtor pursuant to section 521, n30 as well as the tax returns or transcripts provided pursuant to that section and, in chapter 13 cases, pursuant to section 1308. n31 However, because the information in such returns or transcripts may be subject to confidentiality protections, n32 the trustee may have to be careful not to ask questions that would impermissibly reveal such information. The length of the examination will vary depending on the nature of the case, ranging from a few minutes in a simple consumer bankruptcy case to many hours, or even days, in a complicated corporate case.

If the debtor asserts the privilege against self-incrimination, it is the responsibility of the court to determine whether the debtor has reasonable grounds to fear that his or her answer may be self-incriminating. n33 If the court is convinced that the question cannot possibly incriminate the debtor, the testimony can be compelled. If the contrary is true, the debtor may still be compelled to testify if the United States Attorney requests and obtains immunity from the district court. n34

Disputes Arising During Meeting. Although the United States trustee or a private trustee presides at the meeting of creditors, any disputes arising at that meeting must be resolved by the court. Thus, if the debtor believes that questions are beyond the scope permitted, or unduly repetitious, the debtor may object and even refuse to answer. However, if the court finds that such a refusal was unjustified, the debtor will usually be required to reappear at another meeting and, in cases where the objections were clearly unwarranted, may suffer sanctions.

Under *Federal Rule of Bankruptcy Procedure 2003*, the United States trustee may not resolve a disputed election. The 1991 Advisory Committee Note states that for purposes of expediency, the results of the election should be obtained, if feasible, for each alternative presented by the dispute and, if the disputed vote would affect the result of the election, reported to the court. A copy of the report must be mailed to any party in interest that has requested one, and unless a motion for resolution of the dispute is filed within 10 days after the report is filed, the interim trustee becomes the trustee for the case. n35 If a motion is made to resolve the dispute pursuant to Rule 2003(d), the court will determine the outcome and a new or adjourned meeting to conduct the election may not be necessary. The court may also make other orders, such as reopening the meeting after clarifying issues of a creditor's voting rights, so that the creditor might have a fair chance to vote. n36

As to the right to vote, Rule 2003(b)(3) states that a chapter 7 creditor is entitled to vote at a meeting if the creditor has filed a proof of claim at or before the meeting or a writing setting forth facts evidencing the creditor's right to vote,

n37 unless objection is made or unless the proof of claim is insufficient on its face. In the event of an objection to the amount or allowability of a claim for the purpose of voting, unless the court orders otherwise, the United States trustee shall tabulate the votes for each alternative presented by the dispute and, if resolution of the dispute is necessary to determine the result of the election, report the findings to the court. n38

Miscellaneous Business. In some jurisdictions, the meeting of creditors may also be an occasion for discussion among the parties of future steps in the case. Particularly in chapter 12 and 13 cases, the trustee may advise the debtor of objections the trustee may have to the debtor's plan and suggest amendments. In addition, secured creditors may attend a chapter 12 or chapter 13 creditors' meeting to attempt to negotiate the treatment of their claims in the plan proposed by the debtor.

Adjournment of Meeting. Once it is scheduled and takes place, the meeting of creditors may be adjourned or continued to another date and time, with notice given only to those in attendance at the meeting. Such a continuance may be necessary, for example, if the debtor is unable to attend due to illness, or if further questions or investigation of the debtor appear necessary. n39 The practice of keeping meetings alive in such cases by successive continuances has been common and has much to commend it; it saves delay and expense in calling creditors together to consider special matters and often makes prompt action possible.

However, meetings of creditors should not be routinely continued if no special circumstances warrant such action. In a few jurisdictions, United States trustees have permitted all creditors' meetings to be continued indefinitely in order to prevent the expiration of the 30-day time period for objecting to exemptions, which commences at the conclusion of the meeting. n40 This practice plainly violates the intention of the Federal Rules of Bankruptcy Procedure that there be a deadline for trustees and creditors to object to exemptions so that exemption issues can be settled expeditiously. n41 If a trustee needs further information in order to decide whether to object to an exemption, the trustee should either continue the section 341 meeting to a definite date or seek an extension of time to file objections to the exemption.

Thus, the Court of Appeals for the Ninth Circuit held, in *Smith v. Kennedy (In re Smith)*, n42 that a trustee could not adjourn a section 341(a) creditors' meeting indefinitely and that objections to exemptions filed some eight months after the indefinite adjournment were untimely. The court noted that *Federal Rule of Bankruptcy Procedure 2003* requires that for a Rule 2003(e) adjournment to be effective, it must be accompanied by an announcement of the adjourned date and time.' No other procedure for adjournment is provided by rule or statute, and no other method of adjournment is permitted under Rule 2003(e). n43 The court found that an announcement of the new date and time may be made within a reasonable period of time after the adjourned meeting, but in no case more than 30 days from the meeting. n44 The court went on to hold that once property the debtor claimed as exempt had been exempted due to the lack of a timely objection, the conversion of the case to chapter 7, with a new creditors' meeting, did not provide a new opportunity to object to the exemption of that property because it was no longer a part of the bankruptcy estate. n45

Record of Meeting

The examination of the debtor at the meeting of creditors is required to be recorded verbatim by electronic sound recording or other method of recording. n46 The record must be preserved by the United States trustee until two years after the meeting is concluded, and made available for public access. Thus, under Rule 2003(c), it is possible that the transcript might be destroyed before the conclusion of the case, although presumably the United States trustee would ordinarily preserve it until the case is over. Any entity may request a certified copy of the recording or transcript to be provided at that entity's expense.

Report to the Court

The presiding officer must report to the court the name and address of any person elected trustee or any entity elected to the creditors' committee. Similarly, any dispute concerning an election must be reported. In addition, the United States trustee will normally notify the clerk that the meeting has been concluded so that information can be

recorded on the docket of the case. However, the requirement of a report in every case concerning exemptions and other matters no longer exists under the current Federal Rules of Bankruptcy Procedure.

For a complete discussion of Code section 341, *see* Collier on Bankruptcy, ch. 341 (Matthew Bender).

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n1 *Fed. R. Bankr. P. 2003(b)(1)* was amended in 2003 to reflect the fact that a trustee cannot be elected in a case under subchapter V of chapter 7.

n2 Although this sentence was deleted from the rule by the 1991 amendments, the creditors may still make such a recommendation. *See* 1991 Advisory Committee Note to *Fed. R. Bankr. P. 2003*.

n3 *See* 2 Collier Bankruptcy Practice Guide, 35.1035.15 (Matthew Bender).

n4 *See* 11 U.S.C. § 702(b); *Fed. R. Bankr. P. 2003(b)*, 2009. Rule 2003(b) and Rule 2009 were amended in 2003 to reflect the fact that a trustee cannot be elected in a case under subchapter V of chapter 7.

n5 *See* 11 U.S.C. § 705.

n6 *See* 11 U.S.C. § 343. Under section 341(d), as added by the Bankruptcy Reform Act of 1994 (1994), in chapter 7 cases only, the meeting should also include the trustee's oral examination of the debtor to ensure that he or she is aware of the effects of commencing a chapter 7 case, both positive and negative. *See Collier on Bankruptcy*, 341.05 (Matthew Bender).

n7 *Fed. R. Bankr. P. 9010(a)*; *In re Looney*, 262 F. 209 (W.D. Tex. 1920) (In all the courts of the United States the parties may plead and manage their own cases personally or by an attorney and counselor at law); *In re H.E. Ploof Machinery Co.*, 243 F. 421 (S.D. Fla. 1916) (A person may, of course, represent himself in any of the courts of the United States. The bankruptcy court is not an exception to this general rule.).

n8 State Unauthorized Practice of Law Comm. v. Paul Mason & Assocs., 46 F.3d 469 (5th Cir. 1995); *Staiano v. Schwab (In re Maloney)*, 44 C.B.C.2d 404, 249 B.R. 71 (M.D. Pa. 2000)

n9 Cases permitting the preparing and filing of a proof of claim on behalf of another on the part of an individual exercising a power of attorney who is not a lawyer, are: *In re Mayflower Hat Co.*, 65 F.2d 330 (2d Cir. 1933); *Rinderknecht v. Toledo Ass'n of Credit Men*, 13 F. Supp. 555 (N.D. Ohio 1936); *In re Scott*, 53 F.2d 89 (W.D. Mich. 1931). *Contra In re H.E. Ploof Machinery Co.* 243 F. 421 (S.D. Fla. 1916). As to form for such proof of claim, see Official Form 10. An examination of the debtor may not be performed for another by a nonlawyer, as it constitutes the practice of law. *Rinderknecht v. Toledo Ass'n of Credit Men*, *supra*; *In re Scott*, 53 F.2d 89 (W.D. Mich. 1931); *In re Looney*, 262 F. 209 (W.D. Tex. 1920). State courts have enjoined all of the above activities generally in state proceedings as constituting the unauthorized practice of law. See *Depew v. Toledo Ass'n of Credit Men*, 142 Kan. 403, 49 P.2d 1041 (1935); *L. Meisel & Co., v. National Jewelers Board of Trade*, 90 Misc. 19, 152 N.Y.S. 913 (1st Dept. App. Term 1915), *aff'd without op.*, 173 App. Div. 889, 157 N.Y. S. 1133 (1916).

n10 11 U.S.C. § 341(c), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n11 *Id.*

n12 Entity is defined in section 101 to include corporations, partnerships, estates, trusts, governmental units, and the United States trustee; see *Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n13 The solicitation and voting of proxies is only available in liquidation cases. See *Fed. R. Bankr. P. 2006* and the 1983 Advisory Committee Note.

n14 See *Fed. R. Bankr. P. 2006* and the 1983 Advisory Committee Note; see also *In re Brent Indus.*, 20 C.B.C.2d 814, 96 B.R. 193 (Bankr. N.D. Iowa 1989) (when a power of attorney given to an attorney by a creditor fails to indicate whether or not it is held by an unsecured claim holder, it becomes invalid when it is being used to vote for a permanent trustee).

n15 *Central Loan Co. v. Russell*, 16 F.2d 35 (5th Cir. 1926) (authority of creditor's attorney revoked after dividend had been declared).

n16 See *Berg v. Esposito (In re Oxborrow)*, 913 F.2d 751, 23 C.B.C.2d 876 (9th Cir. 1990) (trustee election dispute).

n17 *Fed. R. Bankr. P. 2003(b)*, 2009. Rule 2003(b) and Rule 2009 were amended in 2003 to reflect the fact that a trustee cannot be elected in a case under subchapter V of chapter 7.

n18 See *Rusch Factor Division v. Miller (In re Mission Carpet Mills, Inc.)*, 4 C.B.C.2d 502, 10 B.R. 494 (B.A.P. 9th Cir. 1981) (when there was evidence of confusion relating to a creditor's power of attorney and vote in the election of a permanent trustee, the bankruptcy court could reopen the section 341(a) meeting of creditors for the purpose of allowing the creditor to file a new proof of claim or power of attorney).

n19 See 11 U.S.C. §§ 701, 702(d); see also *Berg v. Esposito (In re Oxborrow)*, 913 F.2d 751, 23 C.B.C.2d 876 (9th Cir. 1990) (the 20% requesting requirement is distinct from and independent from the twenty percent voting requirement).

n20 See *Collier on Bankruptcy*, ch. 1104 (Matthew Bender).

n21 See *Collier on Bankruptcy*, ch. 321, ch. 322 and ch. 324 (Matthew Bender).

n22 11 U.S.C. § 705; see *Collier on Bankruptcy*, 705.02 (Matthew Bender)

n23 See 11 U.S.C. § 705(b).

n24 See 11 U.S.C. § 343; see *Collier on Bankruptcy*, 343.03[1] (Matthew Bender).

n25 *State Unauthorized Practice of Law Comm. v. Paul Mason & Assocs.*, 46 F.3d 469 (5th Cir. 1995);

Staiano v. Schwab (In re Maloney), 44 C.B.C.2d 404, 249 B.R. 71 (M.D. Pa. 2000).

n26 11 U.S.C. § 341(c), as amended by Pub. L. No. 109-8 (April 20, 2005), effective in cases filed on or after October 17, 2005; *see* Collier on Bankruptcy, Creditors' Appearances at Creditors' Meetings *supra*.

n27 Pub. L. No. 103-394 (1994).

n28 11 U.S.C. § 707(b), as amended by Pub. L. No. 109-8 (April 20, 2005), effective in cases filed on or after October 17, 2005; *see* Collier on Bankruptcy, ch. 707 (Matthew Bender).

n29 H.R. Rep. No. 595, 95th Cong., 1st Sess. 331 (1977); S. Rep. No. 989, 95th Cong. 2d Sess. 42 (1978).

n30 11 U.S.C. § 521(a)(1), (c), as amended by Pub. L. No. 109-8 (April 20, 2005), effective in cases filed on or after October 17, 2005; *see* Collier on Bankruptcy, ch. 521 (Matthew Bender).

n31 11 U.S.C. §§ 521(f); 1308, as amended by Pub. L. No. 109-8 (April 20, 2005), effective in cases filed on or after October 17, 2005; *see* Collier on Bankruptcy, ch. 521 and ch. 1308 (Matthew Bender).

n32 *See* Pub. L. No. 109-8, § 315(c) (April 20, 2005); 11 U.S.C. § 107(b); *Collier on Bankruptcy* 107.04 and ch. 521 (Matthew Bender).

n33 *See* Collier on Bankruptcy, ch. 344 (Matthew Bender); *see also In re French*, 24 C.B.C.2d 1979, 127 B.R. 434 (Bankr. D. Minn. 1991).

n34 *See* Collier on Bankruptcy, ch. 344 (Matthew Bender).

n35 *Fed. R. Bankr. P. 2003(d)(2)*, as amended by the 1999 amendments to the Federal Rules of Bankruptcy Procedure.

n36 *Rusch Factor Division v. Miller (In re Mission Carpet Mills, Inc.)*, 4 C.B.C.2d 502, 10 B.R. 494 (B.A.P. 9th Cir. 1981).

n37 See *In re I.J.F., Inc.*, 1 C.B.C.2d 907 (Bankr. S.D. Fla. 1980); *In re Tartan Constr. Co.*, 2 C.B.C.2d 295, 4 B.R. 655 (Bankr. D. Neb. 1980).

n38 *Fed. R. Bankr. P. 2003(b)(3)*, as amended in 1991.

n39 See *Petit v. Fessenden*, 182 B.R. 57 (D. Me. 1995), *aff'd on other grounds*, 80 F.3d 29, 35 C.B.C.2d 968 (1st Cir. 1996) (trustee has power to adjourn and reconvene meeting of creditors).

n40 *Fed. R. Bankr. P. 4003(b)*, as amended by the 2000 amendments to the Federal Rules of Bankruptcy Procedure.

n41 *Fed. R. Bankr. P. 4003(b)*, as amended by the 2000 amendments to the Federal Rules of Bankruptcy Procedure; see *Taylor v. Freeland & Kronz*, 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed. 2d 280, 26 C.B.C.2d 487 (1992); cf. *McGowan v. Ries (In re McGowan)*, 226 B.R. 13 (B.A.P. 8th Cir. 1998) (local rule providing that section 341 meeting was deemed concluded 30 days after first date set for meeting construed not to apply if meeting was not actually held on that date, so it did not conflict with Bankruptcy Rule 4003(b)).

n42 235 F.3d 472 (9th Cir. 2000).

n43 235 F.3d 472, 476 (citations omitted).

n44 *Id.*; see also *Chubb & Son, Inc. v. Clark (In re Clark)*, 46 C.B.C.2d 549, 262 B.R. 508 (B.A.P. 9th Cir.

2001) (trustee had continued meeting to a date certain when he had, within 30 days of prior meeting, announced date for continuing the meeting and rectified erroneous worksheet entry stating that prior meeting was concluded). *But see Premier Capital, Inc. v. DeCarolus (In re DeCarolus)*, 259 B.R. 467 (B.A.P. 1st Cir. 2001) (trustee is not necessarily limited to 30 days in announcing new date for meeting).

n45 235 F.3d, 472, 478.

n46 *Fed. R. Bankr. P.* 2003(c); see *Collier on Bankruptcy*, 2003.03 (Matthew Bender).

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165 of 197 DOCUMENTS

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Collier on Payment of Fees & Expenses Following Confirmation of Chapter 13 Plan

2008 Emerging Issues 1051

Collier on Payment of Fees and Expenses Following Confirmation of Chapter 13 Plan

By Collier

November 19, 2007

SUMMARY: Section 1326(b) of the Bankruptcy Code sets forth the requirements for payment of administrative expenses, fees, charges and percentage fees. This Emerging Issues Analysis discusses the payment of fees and expenses following the confirmation of a Chapter 13 plan.

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ARTICLE: *Section 1326(b) of the Bankruptcy Code* sets forth the requirements for payment of administrative expenses, fees, charges and percentage fees. Under section 1326(b)(3), added in 2005, these fees may include limited amounts awarded to a chapter 7 trustee in a prior case under certain conditions. n1

Payment of Administrative Expenses, Filing Fees and Other Charges. Section 1326(b)(1) requires the disbursing agent, ordinarily the chapter 13 trustee, n2 to pay in full all unpaid priority administrative expense claims allowed under section 503(b), n3 as well as unpaid filing fees and other charges assessed against the estate under title 28, *United States Code*, chapter 123, n4 either before or with each distribution to creditors under the plan. n5

Under *Federal Rule of Bankruptcy Procedure 1006(b)*, the \$155 filing fee required in each chapter 13 case under 28 U.S.C. § 1930(a)(1) may be paid in installments. Under a 1996 amendment to Rule 1006, the debtor is also permitted to pay the miscellaneous administrative noticing fee, normally required at the time of filing, in installments. n6 The net effect of section 1326(b)(1) is to require payment in full of the chapter 13 case filing fee no later than the date of the first distribution to creditors under the plan.

Certain other charges promulgated by the Judicial Conference of the United States for assessment in chapter 13 cases n7 must be paid in full no later than the date of the first distribution to creditors under the plan. n8 Of course, these special charges may be assessed from time to time throughout the course of the proceedings. The effect of section 1326(b)(1) is to require all such charges to be paid as assessed or not later than the next distribution to creditors.

Other administrative expenses, such as the debtor's attorney's fees and costs, are also within the scope of section 1326(b)(1). Some courts have promulgated rules of procedures which delay the payment of attorney's fees in chapter 13 cases by spreading them out over some or all of the duration of the plan. n9 However, such delay contravenes section 1326(b)(1). n10

Payment of Percentage Fee of Standing Chapter 13 Trustee. The United States trustee, with the approval of the Attorney General, n11 or the bankruptcy court, n12 may appoint one or more individuals to serve as chapter 13 trustee where warranted by the chapter 13 caseload. n13 The standing chapter 13 trustee is to receive a salary and reimbursement of actual necessary expenses as authorized by the Attorney General or by the court. n14 The salary and expenses of the standing chapter 13 trustee are to be defrayed with funds derived from a percentage fee, fixed in accordance with 28 U.S.C. § 586(e)(1)(B), assessed against all payments received by the trustee under chapter 13 plans administered by the standing trustee. Section 1326(b)(2) requires that payment of the accrued percentage fee remaining unpaid be made by and to the standing chapter 13 trustee either before or with each distribution to creditors under the plan.

Full payment need not be made to the trustee in advance of any payment to creditors. Since the percentage fee is computed on payments into the plan, percentage fees accrue throughout the extension period as additional payments are made under the plan by the debtor. The accrued percentage fee is to be disbursed not later than the next distribution to creditors. n15

It should be noted that the statutory limitations of trustees' fees are not absolute. Particular circumstances may warrant an equitable adjustment of the trustee's fee. n16 In *Foster v. Heitkamp (In re Foster)*, n17 the Fifth Circuit Court of Appeals opined that the Congress left much discretion to the bankruptcy court in computing trustee fees. While a fixed percentage fee is usually considered reasonable, the Fifth Circuit was of the view that where a large portion of the funds are disbursed on mortgage payments the bankruptcy court should adjust the percentage fee to better reflect the trustee's actual efforts in administering the disbursements. However, the *Foster* court's holding that the trustee may charge a percentage fee on payments not made through the trustee has been overruled by changes in the statutory language. n18

Payment of Compensation and Expenses of Chapter 13 Trustee for Particular Case. Although section 1326(b) does not expressly authorize payment of compensation and reimbursement of the expenses of a chapter 13 trustee appointed to serve in a particular case n19 contemporaneously with payments to creditors, n20 the same result is required under those provisions where an administrative expense claim is approved under section 503(a) and (b)(2) and interim compensation is authorized under section 331.

A trustee appointed to serve in a particular chapter 13 case may seek an interim allowance of compensation and reimbursement of expenses by application to the court under sections 330, n21 331, n22 503(a) n23 and 503(b)(2). n24 After notice and a hearing, n25 the court may authorize an interim allowance and disbursement of compensation and reimbursement. To the extent that such an allowance represents compensation and reimbursement allowed under section 503(b)(2), it constitutes a priority administrative expense claim under section 507(a)(2), n26 which must be paid in full to the chapter 13 trustee before or with the next distribution made to creditors under the plan. n27

It has been held that section 1326(b)(1) itself does not require that the trustee be fully paid in advance of disbursing payment on other claims and that unless such a requirement is imposed by the terms of the plan the trustee's fee may be disbursed simultaneously with disbursements to creditors. n28

Compensation to Chapter 7 Trustee in Prior Case. Section 1326(b)(3), added by the 2005 amendments to the

Bankruptcy Code, n29 provides for limited payments by the chapter 13 trustee to a person who was a chapter trustee in a prior case under certain circumstances. In order to qualify for such payments all of the following conditions must be met:

- . The debtor filed a prior case under chapter 7. The references to a prior case makes clear that a trustee in a case that is converted to chapter 13 does not qualify under this provision because that case is the same case and not a prior case.

- . The chapter 7 trustee in the prior case was allowed compensation.

- . The compensation was allowed due to the conversion or dismissal of the case under section 707(b). In other words, compensation for efforts to administer assets or otherwise administer the case is not permitted.

- . Some portion of the compensation awarded due to the conversion or dismissal has not been paid.

If all of the requirements are met, there are limits on the amounts that can be distributed to the former trustee. The monthly amount cannot exceed the total compensation divided by the number of months in the plan. n30 It also cannot exceed the greater of (1) \$25 or (2) 5 percent of the total amount payable to general unsecured creditors under the plan divided by the number of months in the plan. n31 The practical effect of this provision is to cap the former trustee's payments at \$1,500 in a 60-month plan and \$900 in a 36-month plan unless the dividend payable to general unsecured creditors is greater than \$30,000 in a 60-month plan or \$18,000 in a 36-month plan, with proportionate amounts in between for plans of lengths between 36 and 60 months. Of course, each of these amounts would be received only if the debtor completed the plan, since the payments are to be pro-rated.

Section 1326(d), also added in 2005, n32 provides that notwithstanding any other provision in title 11 the compensation referred to in section 1326(b)(3) is payable and may be collected in a chapter 13 case, even if it has been discharged in a prior case, but it is payable only to the extent permitted by section 1326(b)(3). Presumably, a former chapter 7 trustee who qualifies for payments under section 1326(b)(3) will have to file proof of claim or other request for the payments to be made.

[Return to Text](#)

n1 1. Pub. L. No. 109-8, § 1224(1) (2005), effective in cases commenced on or after October 17, 2005; *see* Compensation to Chapter 7 Trustee in Prior Case *infra*.

n2

2. *See 11 U.S.C. § 1326(c); Collier on Bankruptcy, 1326.04* (Mathew Bender).

n3

3. See 11 U.S.C. §§ 503(b), 507(a)(2); Collier on Bankruptcy, 1300.72[2] and 1300.74 (Matthew Bender). 11 U.S.C. § 507(a)(2) was formerly designated as section 507(a)(1) and was redesignated by Pub. L. No. 109-8, § 212 (2005), effective in cases commenced on or after October 17, 2005. See generally, *Collier on Bankruptcy*, 503.04 and 507.02 (Matthew Bender).

n4

4. See 28 U.S.C. §§ 1914(b), 1930. In addition to the filing fee, a debtor or couple commencing the chapter 13 case must also pay a miscellaneous administrative noticing fee of \$39 imposed by the Judicial Conference of the United States under 28 U.S.C. § 1930(b). See Judicial Conference Bankruptcy Court Miscellaneous Fee Schedule, Item 8; *Collier on Bankruptcy*, 1325.03[1][a][ii] (Matthew Bender); see also *Collier on Bankruptcy*, 1300.42, 1300.43, 1322.03, 1325.01 and 1325.03[1] (Matthew Bender).

n5

5. 11 U.S.C. § 1326(b)(1); *In re Parker*, 5 C.B.C.2d 913, 15 B.R. 980 (Bankr. E.D. Tenn. 1981).

n6

6. See 1996 Advisory Committee Note to *Fed. R. Bankr. P. 1006*; see also *Collier on Bankruptcy*, 1325.03[1][a][i] (Matthew Bender).

n7

7. See 18 U.S.C. § 1930(b); *Collier on Bankruptcy*, 1325.02[1] (Matthew Bender).

n8

8. 11 U.S.C. §§ 507(a)(1) and 1326(b)(1).

n9

9. E.g., *In re Lanigan*, 101 B.R. 530 (Bankr. N.D. Ill. 1989); see also *In re Pedersen*, 229 B.R. 445 (Bankr. E.D. Cal. 1999) (attorney could agree to deferred payment of fees).

n10

10. *In re Shorb*, 101 B.R. 185 (B.A.P. 9th Cir. 1989) (fees cannot be deferred to six months after confirmation of plan); *In re Harris*, 304 B.R. 751 (Bankr. E.D. Mich. 2004) (no payment may be made to any other creditor under the plan unless unpaid administrative expense is paid in full, either first or at the same time).

n11

11. 28 U.S.C. § 586(b); see *Collier on Bankruptcy*, 1302.04[1] (Matthew Bender).

n12

12. See *Collier on Bankruptcy*, 1302.04[2] (Matthew Bender).

n13

13. The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, amended section 1326(b)(2) by substituting section 586(b) of title 28 for section 1302(d) of this title [11] and substituting section 586(e)(1)(B) of title 28 for section 1302(e) of this title [11]. This amendment became effective in a judicial district when that district became part of the nationwide United States trustee system; except for the judicial districts in Alabama and North Carolina, all districts now have United States trustees. In the judicial districts without a United States trustee, the chapter 13 trustee is appointed by the court.

n14

14. 28 U.S.C. § 586(b); see *Collier on Bankruptcy*, 1300.55[1] and 1302.05[1] (Matthew Bender).

n15

15. *In re Shorb*, 21 C.B.C.2d 274, 101 B.R. 185 (B.A.P. 9th Cir. 1989); *In re Parker*, 5 C.B.C.2d 913, 15 B.R. 980 (Bankr. E.D. Tenn. 1981).

n16

16. *Foster v. Heitkamp (In re Foster)*, 6 C.B.C.2d 285, 670 F.2d 478 (5th Cir. 1982); *In re Eaton*, 1 C.B.C.2d 358, 1 B.R. 433 (Bankr. M.D.N.C. 1979).

n17

17. 670 F.2d 478, 6 C.B.C.2d 285 (5th Cir. 1982).

n18

18. See *Collier on Bankruptcy*, 1302.05[1][c] (Matthew Bender).

n19

19. See 11 U.S.C. §§ 1302(a), 28 U.S.C. § 586(b); see also *Collier on Bankruptcy*, 1300.55[3], 1302.02 and 1302.05 (Matthew Bender).

n20

20. 11 U.S.C. § 1326(b)(1); see *Payment of Administrative Expenses, Filing Fees and Other Charges* supra.

n21

21. See 11 U.S.C. § 330(a)(4)(B), providing that in chapter 13 cases, court may allow reasonable compensation to debtor's attorney for representing interests of debtor in connection with bankruptcy case based on consideration of benefit and necessity of services to debtor and other factors set forth in section 330(a); 11 U.S.C. § 330(a)(5), providing that court may reduce compensation awarded by amount of interim compensation previously awarded under section 331 and, if interim compensation exceeds total compensation awarded, may order return of excess to estate.

n22

22. See 11 U.S.C. § 331; *Collier on Bankruptcy*, 1300.59[1] (Matthew Bender).

n23

23. See 11 U.S.C. § 503(a), providing that request for allowance of administrative expense must be timely filed unless court, for cause, allows it to be tardily filed.

n24

24. See 11 U.S.C. § 503(b)(2), allowing compensation and reimbursement awarded under section 330(a).

n25

25. See 11 U.S.C. § 102(1); *Collier on Bankruptcy*, 1300.07[1][a] and 1300.12 (Matthew Bender).

n26

26. 11 U.S.C. § 507(a)(2) (formerly designated as § 507(a)(1) and redesignated by Pub. L. No. 109-8, § 212 (2005), effective in cases commenced on or after October 17, 2005); see *Collier on Bankruptcy*, 1300.72[2] and 1300.74 (Matthew Bender); see also *In re Powell*, 5 C.B.C.2d 775, 15 B.R. 465 (Bankr. N.D. Ga. 1981).

n27

27. 11 U.S.C. §§ 330, 507(a)(2) (formerly designated as § 507(a)(1) and redesignated by Pub. L. No. 109-8, § 212 (2005), effective in cases commenced on or after October 17, 2005), § 1326(b)(1).

n28

28. *In re Parker*, 5 C.B.C.2d 913, 15 B.R. 980 (Bankr. E.D. Tenn. 1981).

n29

29. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1224(1) (2005), effective in cases commenced on or after October 17, 2005.

n30

30. 11 U.S.C. § 1326(b)(3)(A).

n31

31. 11 U.S.C. § 1326(b)(3)(B).

n32

32. Pub. L. No. 109-8, § 1224(2) (2005), effective in cases commenced on or after October 17, 2005.

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166 of 197 DOCUMENTS

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Collier on the Scope of the Debtors Examination at 341 Meeting

2008 Emerging Issues 1052

Collier on the Scope of the Debtors Examination at 341 Meeting

By Collier

November 19, 2007

SUMMARY: The debtor is required under section 343 of the Bankruptcy Code to appear and submit to examination under oath at the meeting of creditors provided for under section 341(a). The examination may be conducted by creditors, any indenture trustee, any trustee or examiner or the United States trustee. The scope of examination is governed by the Federal Rules of Bankruptcy Procedure. This Emerging Issues Analysis discusses the examination of debtor.

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ARTICLE: The debtor is required under *section 343 of the Bankruptcy Code* to appear and submit to examination under oath at the meeting of creditors provided for under section 341(a). The examination may be conducted by creditors, any indenture trustee, any trustee or examiner or the United States trustee. The scope of examination is governed by the Federal Rules of Bankruptcy Procedure.

Examination of the Debtor at the Meeting of Creditors

Section 343 of the Bankruptcy Code was derived from Section 21a of the former Bankruptcy Act. n1 The scope of the examination of the debtor under section 343 is substantially the same as that under Section 21a as expanded by *Federal Rule of Bankruptcy Procedure 2004(b)*, n2 i.e., the examination may relate only to the acts, conduct, or property, or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to his right to discharge. In cases commenced under chapter 11, except for a railroad reorganization, and in cases under chapter 12 and chapter 13 of the Code, the debtor's examination may relate to the operation of the debtor's business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefore, and any other matter relevant to the case or to the formulation of a plan. n3

Wide Range of Inquiry Permitted under Rule 2004(b). The scope of the questions permitted at a creditors'

meeting and in a Rule 2004 examination is the same. n4 Under the broad scope of Rule 2004(b), an examination, including an examination of the debtor at either the section 341(a) meeting or a later examination, is inquisitorial in nature, and consequently the field of inquiry is wide. Within the limitations prescribed, any question is permissible which seeks to ascertain facts concerning the debtor's conduct property and affairs. n5 As the Supreme Court stated in considering Section 21(a) of the former Bankruptcy Act: The need for truthful testimony in a § 21(a) bankruptcy proceeding is great, since the proceeding is a searching inquiry into the condition of the estate of the bankrupt, to assist in discovering and collecting the assets, and to develop facts and circumstances which bear upon the question of discharge. n6

The Court of Appeals for the Second Circuit was similarly expansive in describing the scope of the examination: [F]rom the beginning it has been recognized that the trustee may inquire at large and without limit except in cases of plain abuse, to be determined in the court's discretion. n7

The inquiry undertaken, therefore, is one to aid in the discovery of assets and to assist in all particulars in the administration of the estate, n8 and the fact that no specified issue is or can be made up is not grounds for objecting to the examination. n9

[Any] fact or circumstance is relevant and material which fairly tends to establish something which may become important in the administration of the estate. The existence of property rights or interests not scheduled, or rights to defend against apparent claims, or rights of creditors to reclaim property in the hands of the bankrupt [now debtor], or rights of a debtor to discharge-all these are instances of matters properly subject to such investigation on such a proceeding. n10

Similarly, the fact that the information sought from the debtor may be of use in other litigation is not grounds for limiting the broad range of inquiry normally permitted. n11

It is the traditional rule, therefore, that a trustee is granted a virtually unfettered right to inquire into all transactions that relate to a debtor so as to discover the existence and location of assets of the estate. n12 The examination of a witness regarding the acts, conduct and property of a debtor may be as broad in scope as that permitted of the debtor, n13 and the fact that the trustee's examination may lead to the prosecution of an action against the witness does not foreclose the inquiry. n14

Examination of Relatives and Associates of the Debtor. When the witness is the spouse of the debtor, n15 or known to have been closely connected with the debtor in business dealings, n16 great latitude will be allowed. n17 The examination, of course, must be confined within the limits of the general inquiry permitted, n18 and if the questions are not relevant to such matters, the witness is justified in refusing to answer them. n19 The examination cannot be used to delve into the private affairs of a witness when such affairs have no connection with the acts, conduct or property of the debtor, n20 and there are limits with respect to examinations that are unduly burdensome for the witness. n21 However, if the acts inquired of are interwoven with those of the debtor in such a way as to cause a reasonable suspicion that the witness has been preferred or is colluding with the debtor to secret property, the witness will be required to answer and even to produce his or her own books. n22

Relation of Examination to Possible Litigation. The fact that the examination is for the purpose of securing information regarding the prosecution of suits by the trustee will not render the inquiry objectionable. n23 But it has been held that if an examination is used to obtain facts as to the solvency or insolvency of the debtor, or to gain evidence to support an involuntary petition, the court, in its discretion, may refuse to allow the examination. n24

With regard to preferential or fraudulent transfers, the scope of examination under the former Bankruptcy Act was not limited to transactions within either the four-month period or one-year period before the filing of a petition, but could pertain to all matters material or relevant to the debtor's acts, conduct or property, irrespective of remoteness of time. n25 Similarly, under the Code there is no reason why the scope of the examination would be limited to

transactions within either the 90-day period before the date of the filing of the petition, with regard to preferential transfers, n26 or the one-year period before the date of the filing of the petition, with regard to preferential transfers to insiders n27 or fraudulent transfers. n28

Examination Regarding Certain Postpetition Acts Permitted. Although the time of filing of the petition will ordinarily represent the forward limit of the scope of the inquiry, it appears that the examination may explore matters concerning the debtor's acts after that time, if such acts affect or concern the debtor's property or conduct prior to the filing of the petition. Moreover, since under the terms of section 541, the trustee takes title to certain after-acquired property of the debtor, the examination should be permitted to touch upon conduct or facts as will pertain to such property, even though they occur after the filing of the petition. In cases under chapters 11, 12 and 13, questions pertaining to the postpetition business operations of the debtor and issues relating to the formulation of a plan may also be asked. n29

Books and Records of the Debtor

The debtor may at any time be ordered to produce the debtor's books, papers and documents for examination and be examined concerning them. n30 The debtor has a duty pursuant to section 521(a)(4) of the Code to surrender to the trustee the books, documents, records, and papers relating to property of the estate. n31

Under prior law, which also included the books and papers of the debtor as property of the estate, n32 the debtor could not refuse to turn them over to the trustee if requested, n33 and clearly has at least an equal obligation under the Code. The legislative history to section 541 of the Code indicates that Congress intended section 541(a)(1) to include tangible or intangible property, causes of action, and all other forms of property currently specified in section 70a of the Bankruptcy Act. n34 Bankruptcy Rule 2004(c) Bankruptcy Rule 2004(c) indicates that the production of documentary evidence may be obtained from any person, including the debtor, by a subpoena. n35

In addition, section 521(e)(2), added in 2005, n36 requires the debtor to provide to the trustee, at least seven days before the section 341(a) meeting, a copy of the debtor's federal income tax return for the most recent tax year ending before the petition and for which a return was filed, or a transcript thereof. n37 Local rules may require the production of other documents at the meeting.

Books and Records of Third-Party Witnesses. A witness other than the debtor may be compelled to produce upon subpoena books, papers and documents that relate to the acts, conduct, or property of the debtor and to testify as to their contents. n38 It has been suggested in connection with an examination under former Bankruptcy Act Section 21a that the bankruptcy court might impound the books in a proper case. n39

When Third-Party Books and Records Need Not Be Produced. When the witness shows that the records sought are not in his or her possession, the order requiring the witness to produce them must be set aside. n40 Such books or papers must have some relation to or bearing on the inquiry, n41 although the latitude is wide. n42 The court, however, on application or *sua sponte*, may, when justice requires, protect the estate or any person from the disclosure of secret, confidential, scandalous or defamatory matter by appropriate order. n43 In addition, the court may for cause protect individuals from disclosure of other types of information if disclosure would create an undue risk of identity theft or other unlawful injury to a person or property. The applicant for an examination cannot obtain evidence by such means as to transactions between other persons with which the debtor had no connection. n44

When Third-Party Books and Records Must Be Produced. Thus, when third parties have had dealings with the debtor and it appears that property of the debtor has been turned over to them in violation of the Code, such parties may be examined and may be compelled to produce their books of account. n45 And a witness cannot avoid production of books or the answering of questions in reference thereto by a mere plea that they are personal or do not relate to the debtor. [T]his matter is not left to the opinion of the witness but must be determined by the court. n46 For example, in *Marx v. Chase National Bank*, n47 a bank was compelled to produce certain documents for inspection when the affairs

of a debtor corporation, its sole stockholder and its subsidiaries were inextricably commingled, because it would be impossible otherwise to unravel such a tangled corporate skein. An officer of a corporation may refuse to answer questions regarding entries in corporate books on the grounds that they will incriminate him or her, but the officer cannot refuse to produce the books for the same reason. n48

Under these principles, the books, papers and documents of a third person, such as a corporation, may be ordered produced for examination relating to the debtor's conduct or property, n49 or any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge. n50 A corporation is presumed to be in the possession and control of its own books, and this presumption cannot be rebutted by the bald statement of some officer that he or she does not know where they are; to be excused from the requirement of production, the corporation must show clearly that it does not have and cannot obtain possession of them. n51

For a complete discussion of Code section 343, see Collier on Bankruptcy, ch. 343 (Matthew Bender).

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[Return to Text](#)

n1 H.R. Rep. No. 595, 95th Cong., 1st Sess. 332 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 43 (1978).

n2 Congress intended that the scope of the examination under section 343 would be governed by the Bankruptcy Rules. H.R. Rep. No. 595, 95th Cong., 1st Sess. 332 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 43 (1978).

n3 Rule 2004(b) was amended in 1991 to allow the same scope of examination in chapter 12 cases as in chapter 11 and 13 cases. Under prior law, the scope of examination in chapter 13 cases was governed by former Rule 13-206(d). *See Fed. R. Bankr. P. 2004* and the 1983 Advisory Committee Note.

n4 *Carlson v. Boucher (In re Boucher)*, 728 F.2d 1152 (8th Cir. 1984).

n5 *Todd v. Bradley*, 99 Conn. 307, 122 Atl. 68 (1923); *In re Williams*, 123 F. 321 (D. Tenn. 1903); *In re Insull Utility Investments, Inc.*, 27 F. Supp. 887 (S.D.N.Y. 1934).

n6 *Bronston v. United States*, 409 U.S. 352, 357, 93 S. Ct. 595, 599, 34 L. Ed. 2d 568 (1973) (citing *Travis v. United States*, 123 F.2d 268, 271 (10th Cir. 1941)).

n7 *Marx v. Chase Nat'l Bank*, 117 F.2d 800, 801 (2d Cir. 1941); see also *In re Autocue Sales and Distributing Corp.*, 151 F. Supp. 798, 800 (S.D.N.Y. 1957) (district court, using the same test applied under *Federal Rule of Civil Procedure* 26, stated that such an inquiry must be carried on in an atmosphere which permits great leeway and scope of questions); *In re Foerst*, 93 F. 190 (S.D.N.Y. 1899); *In re GHR Energy Corp.*, 9 C.B.C.2d 516, 33 B.R. 451 (Bankr. D. Mass. 1983) (citing *Foerst*).

n8 *In re Eastern Util. Inv. Corp.*, 98 F.2d 620 (3d Cir. 1938); *Travis v. United States*, 123 F.2d 268 (10th Cir. 1941).

n9 *In re Youroveta Home & Foreign Trade Co.*, 288 F. 507 (2d Cir. 1923); *Ulmer v. United States*, 219 F. 641 (6th Cir. 1915); *In re Samuels and Lesser*, 215 F. 845 (2d Cir. 1914); *In re Bogen*, 19 F.2d 935 (E.D.S.C. 1927); *In re Fixen & Co.*, 96 F. 748 (S.D. Cal. 1899).

n10 *Ulmer v. United States*, 219 F. 641 (6th Cir. 1915).

n11 *In re Larkham*, 24 B.R. 70 (Bankr. D. Vt. 1982).

n12 *Stonitsch v. St. Louis Banana & Tomato Co. (In re Isis Foods, Inc.)*, 9 C.B.C.2d 591, 33 B.R. 45 (Bankr. W.D. Mo. 1983); *In re Arkin-Medo, Inc.*, 11 C.B.C.2d 878, 44 B.R. 138 (Bankr. S.D.N.Y. 1984).

n13 *Chereton v. United States*, 286 F.2d 409 (6th Cir. 1961); *Ulmer v. United States*, 219 F. 641 (6th Cir. 1915).

n14 *Marx v. Chase Nat'l Bank*, 117 F.2d 800 (2d Cir. 1941); see *In re Mantolesky*, 14 B.R. 973, 979 (Bankr. D. Mass. 1981).

n15 *In re Worrell*, 125 F. 159 (E.D. Pa. 1903); *Travis v. United States*, 123 F.2d 268 (10th Cir. 1941).

n16 *In re Olin of N.Y., Inc.*, 1979 Bankr. LEXIS 886 (Bankr. S.D.N.Y. Jan. 10, 1979).

n17 *In re Mantolesky*, 14 B.R. 973, 976 (Bankr. D. Mass. 1981) (examination under predecessor to Rule 2004 may cut a broad swath through the debtor's affairs, those associated with him, and those who might have had business dealings with him or who even participated in [business dealings with the debtor]).

n18 *See In re Howard*, 95 F. 415 (2d Cir. 1899); *In re Underwriters Fin. Corp.*, 13 F. Supp. 690 (S.D.N.Y. 1935).

n19 *In re Youroveta Home & Foreign Trade Co.*, 288 F. 507 (2d Cir. 1923).

n20 *Id.*; *In re Wilcher*, 56 B.R. 428 (Bankr. N.D. Ill. 1985); *In re Mittco, Inc.*, 44 B.R. 35 (Bankr. E.D. Wis. 1984); *Keene Corp. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 42 B.R. 362 (S.D.N.Y. 1984); *In re G.H.R. Energy Corp.*, 9 C.B.C.2d 516, 33 B.R. 451 (Bankr. D. Mass. 1983); *see also In re Continental Forge Co., Inc.*, 73 B.R. 1005 (Bankr. W.D. Pa. 1987) (manufacturer's right to privacy in its business affairs exceeded debtor's interest in obtaining proprietary information not relevant to potential cause of action nor to administration of the estate).

n21 *In re Texaco Inc.*, 17 C.B.C.2d 1084, 79 B.R. 551 (Bankr. S.D.N.Y. 1987), *aff'd on other grounds*, 18 C.B.C.2d 331, 82 B.R. 678 (S.D.N.Y. 1988).

n22 *In re Carley*, 106 F. 862 (D. Ky. 1901); *In re Fixen*, 96 F. 748 (S.D. Cal. 1899); *see In re Dependable Merchandise Corp.*, 14 F.R.D. 257 (S.D.N.Y. 1953).

n23 *Marx v. Chase Nat'l Bank*, 117 F.2d 800 (2d Cir. 1941); *In re Paramount Publix Corp.*, 82 F.2d 230 (2d Cir. 1936); *In re Underwriters Finance Corp.*, 13 F. Supp. 690 (S.D.N.Y. 1935); *In re Insull Utility Investments, Inc.*, 27 F. Supp 887 (S.D.N.Y. 1934); *In re Cliffe*, 97 F. 540 (E.D. Pa. 1899); *In re Larkham*, 24 B.R. 70 (Bankr. D. Vt. 1982).

n24 See *Collier on Bankruptcy*, 343.03[2] and 343.11(Matthew Bender).

n25 *In re Mallow Hotel Corp.*, 18 F. Supp 18 (M.D. Pa. 1937) (examination as to transactions occurring 1215 years previously which reasonably related to the transactions and conduct of debtor and whereabouts of its property).

n26 11 U.S.C. § 547(b)(4)(A); see *Collier on Bankruptcy*, 547.03[6] (Matthew Bender).

n27 11 U.S.C. § 547 (b)(4)(B); see *Collier on Bankruptcy*, 547.03[6] (Matthew Bender).

n28 See 11 U.S.C. § 548, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, ch. 548 (Matthew Bender).

n29 *Fed. R. Bankr. P.* 2004(b).

n30 See *In re Horgan and Slattery*, 98 F. 414 (2d Cir. 1899); *In re Rukeyser*, 1 F. Supp. 711 (S.D.N.Y. 1932); *In re Hyman J. Herr* (No. 1), 182 F. 715 (M.D. Pa. 1910); *In re Alper*, 162 F. 207 (S.D.N.Y. 1907); see also *In re Soloway & Katz*, 195 F. 103 (D. Conn. 1912).

n31 11 U.S.C. § 521(a)(4), formerly § 521(4), as redesignated by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 521.12 (Matthew Bender).

n32 Section 70(a)(1) of the former Bankruptcy Act included documents relating to the debtor's property as property of the estate.

n33 *In re Fuller and McGee*, 262 U.S. 91, 43 S. Ct. 496, 67 L. Ed. 881 (1923); *Babbitt, Trustee v. Dutcher*,

216 U.S. 102, 30 S. Ct. 372, 54 L. Ed. 402 (1910); see also *In re Shapiro*, 110 F. Supp. 288 (W.D. Pa. 1953).

n34 H.R. Rep. No. 595, 95th Cong., 1st Sess. 539 (1977); see also 11 U.S.C. § 542(e) (indicating that the debtor's books and records continue to be property of the estate).

n35 *Fed. R. Bankr. P. 2004(c)*, as amended by the 2002 amendments to the Federal Rules of Bankruptcy Procedure (attendance of an entity for examination and production of documentary evidence may be compelled in the manner provided in Rule 9016 for the attendance of witnesses at a hearing or trial); see *Collier on Bankruptcy*, 2004.03 (Matthew Bender). Bankruptcy Rule 9016 incorporates Civil Rule 45. See *Collier on Bankruptcy*, 9016.01 (Matthew Bender). For a discussion of Rule 45, see 9 Moore's Federal Practice, ch. 45 (Matthew Bender 3d ed.).

n36 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n37 See *Collier on Bankruptcy*, 521.20 (Matthew Bender).

n38 *In re Fox*, 96 F.2d 20 (3d Cir. 1938); *In re Landquist*, 70 F.2d 929 (7th Cir.), cert. denied, 293 U.S. 584, 55 S. Ct. 98, 79 L. Ed. 680 (1934); see 11 U.S.C. § 542(e); see also *In re Manufacturers Trading Corp.*, 194 F.2d 948 (6th Cir. 1952). Bankruptcy Rule 2004(c) authorizes the use of a subpoena to compel the attendance of a witness or the production of documentary evidence.

n39 *In re Fox*, 96 F.2d 20 (3d Cir. 1938); *In re Iron Clad Mfg. Co.*, 201 F. 66 (2d Cir. 1912).

n40 *In re Charlotte Textile Co.*, 94 F. Supp. 872 (S.D.N.Y. 1950).

n41 *In re Carley*, 106 F. 862 (D. Ky. 1901) (insofar as this case holds that there is less latitude in the examination of third persons, it is not good law).

n42 See *Freeman v. Seligson*, 405 F.2d 1326 (D.C. Cir. 1968); *Marx v. Chase Nat'l Bank*, 117 F.2d 800 (2d Cir. 1941).

n43 11 U.S.C. § 107(b) provides that the court may enter an order protecting against disclosure of confidential information or to protect a person with respect to scandalous or defamatory matter. See *Collier on Bankruptcy*, 107.03 (Matthew Bender). Bankruptcy Rule 9018 provides the court with similar powers to protect against unwarranted disclosures. See *Collier on Bankruptcy*, 9018.02 (Matthew Bender).

n44 *In re Fox*, 96 F.2d 20 (3d Cir. 1938).

n45 *In re Fixen & Co.*, 96 F. 748 (S.D. Cal. 1899).

n46 *In re Fixen & Co.*, 96 F. 748 (S.D. Cal. 1899); see also *In re E.S. Wheeler & Co.*, 158 F. 603 (2d Cir. 1907); *In re Fox*, 96 F.2d 23 (3d Cir. 1938).

n47 117 F.2d 800 (2d Cir. 1941).

n48 *In re Bleecker*, 14 F.2d 1018 (S.D.N.Y. 1925), *aff'd*, 14 F.2d 1019 (2d Cir. 1926).

n49 See *In re Fox*, 96 F.2d 23 (3d Cir. 1938); *In re Charlotte Textile Co.*, 94 F. Supp. 872 (S.D.N.Y. 1950); *In re United States Graphite Co.* 159 F. 300 (E.D. Pa. 1908); *In re Fixen & Co.*, 96 F. 748 (S.D. Cal. 1899).

n50 Fed. R. Bankr. P. 2004(b).

n51 *In re Iron Clad Mfg. Co.*, 201 F. 66 (2d Cir. 1912).

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167 of 197 DOCUMENTS

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Collier on the Reimbursement of Actual and Necessary Expenses under Section 330

2008 Emerging Issues 1053

Collier on the Reimbursement of Actual and Necessary Expenses under Section 330

By Collier

November 19, 2007

SUMMARY: Section 330(a)(1)(B) of the Bankruptcy Code authorizes the reimbursement of officers of the estate for their actual and necessary expenses. This Emerging Issues Analysis discusses issues such as the definition of actual and necessary expenses, the expenses of the trustees and the examiners, the expenses of professional persons, compensation for travel time, and the cost of paraprofessionals.

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ARTICLE:

Section 330(a)(1)(B) of the Bankruptcy Code authorizes the reimbursement of officers of the estate for their actual and necessary expenses.

Definition of Actual and Necessary Expenses

Expenses are deemed actual when they are, in fact, incurred rather than based upon guesswork, formula or *pro rata* allocation, n1 and when they are obviously attributable to a bankruptcy client. n2 Expenses are deemed necessary if they are incurred because they were properly required to accomplish the task for which the professional was employed, n3 and when they do not raise a substantial question of necessity in light of all available alternatives. n4 Under section 330, compensation for services and reimbursement of expenses is determined according to the same standard of reasonableness. n5 Consequently, the factors employed to determine the reasonableness of compensation for services are also applicable with regard to the reimbursement of expenses. n6

Although section 330(a)(1)(B) authorizes reimbursement of expenses, it does not create an automatic entitlement to reimbursement. n7 Reimbursement of expenses is more readily allowed, however, than is compensation of services. A court might disallow interim compensation to debtor's attorney but award full reimbursement of expenses. n8 When the court denies compensation it will neither necessarily nor automatically deny reimbursement for necessary expenses

incurred. n9 The determination as to whether to allow reimbursement of expenses depends, in part, upon whether such expenses are considered non-reimbursable overhead charges.

Prior to the enactment of the Bankruptcy Reform Act, the Bankruptcy Code did not specifically provide for the reimbursement of members of a creditors' committee for their actual and necessary expenses, although courts generally held that such expenses should be compensable as long as they are reasonable. n10 For example, in *In re The George Worthington Co.*, n11 the Court of Appeals for the Sixth Circuit held that, although the Bankruptcy Code at that time did not expressly authorize reimbursement of committee expenses, authority for such reimbursement was implied in the overall scheme for reorganization and in the legislative history of the Code and its amendments. The Sixth Circuit further recognized that many courts construed section 503(b) broadly to include official committees, based on the fact that reimbursement is necessary to effectuate the policies underlying the statutory scheme for reorganization under the Code. n12 Finally, the Sixth Circuit incorporated some courts' reliance on logic and equity to support an interpretation of the Code that authorized reimbursement of the expenses of official committees. The court pointed out that a more restrictive interpretation of the Code would create the anomalous situation in which unofficial committees would be entitled to compensation, but those committees required to be appointed under chapter 11 would not. n13

Section 503(b)(3)(F) now codifies a court's authority to allow reimbursement of expenses incurred by members of a committee appointed under section 1102 to the extent that the expenses for which reimbursement is sought were incurred in the performance of the duties of the committee. n14 Regardless of the status qualifying an applicant for reimbursement of expenses, the applicant must set forth in detail specific expenses and may not request a flat surcharge intended to cover such expenses. n15

Expenses of Trustees and Examiners

Section 330 does not specifically identify what the phrase actual, necessary expenses includes. It does not set forth which expenses may properly be allowed and which may not be allowed, aside from the requirement that the expenses were incurred necessarily in the performance of the officer's duties. n16 Expenses for which reimbursement may be allowed to trustees may range from rental payments necessary to preserve estate assets to the cost of publicity designed to attract a crowd and induce it to purchase estate assets.

Section 330(b)(3) covers: (1) expenditures incident to the authorized operation of a business; (2) rent; (3) insurance; (4) salaries; (5) wages; (6) costs of merchandise and production; (7) royalties; and (8) taxes. Also falling within the ambit of section 330 are: (1) expenses of investigation; (2) litigation; (3) arbitration and settlement; (4) travel.

Expenses Must Be Properly Documented. In order to be allowed, a trustee's expenses must be documented adequately and in detail, so as to enable the court to render an independent decision as to the reasonableness of the expenses. n17

Limitation of Trustee Compensation under Section 326. The limitation in section 326 on compensation for the trustee's services applies whether or not a particular duty is actually performed by the trustee or delegated to another. n18 If the trustee delegates to another a statutory duty that may be performed by someone other than the trustee without prior court approval, the delegate cannot be paid independently of the trustee's compensation because that could result in compensation in excess of the statutory maximum for trustee services. n19 If the trustee receives the maximum compensation allowable under section 326(a), then the delegate's compensation must be subtracted from that amount to the extent that the delegate is being compensated for trustee services. n20 In *In re Hance Meyer, Inc.*, n21 the trustee had sought the maximum compensation allowed by section 326(a) *in addition* to reimbursement of expenses for the

trustee's paralegal staff. The bankruptcy court held that section 326(a) sets an absolute maximum on the amount of compensation the court may award a trustee, and when the maximum amount of compensation is awarded, the allowance as an expense of any amount over the trustee's actual out-of-pocket costs violates section 326. The limitation applies as well to professionals employed by the trustee. Therefore, an attorney employed by the trustee will not be compensated separately for services statutorily required of the trustee. n22

Expenses of Professional Persons

Professionals employed by the trustee, particularly attorneys, carry the major responsibility for administering the estate, uncovering funds, recovering property and bringing the case to a successful conclusion. Their expenses incurred are generally reimbursable pursuant to section 330(b), but there has been a wide divergence of policy among the bankruptcy courts concerning the treatment of costs and expenses considered by some courts to be non-reimbursable because they constitute expenses allocable to overhead.

Overhead Nonreimbursable. Nonreimbursable overhead has been defined as regular administrative and general expenses incident to the operation of a business that cannot be attributed to a particular client or cost. n23

At least one district court has held that the cost of copying, postage, long distance telephone calls, travel and other like expenses are incurred on behalf of a particular client. Therefore, they can be differentiated from true overhead expenses such as rent, utilities and salaries. n24 Similarly, another district court has held that clerical expenses, postage, express mail services, local travel expenses and computer time were reimbursable expenses because they were attributable to a particular client through the law firm's billing system. n25

The trend in allowing reimbursement of arguably overhead expenses requires that expenses be specifically allocable to the bankruptcy case and be documented. n26 Courts have held that a debtor's attorneys were entitled to reimbursement of their legal expenses incurred in the retention of another law firm to defend against meritless lawsuits commenced against them by the chapter 7 trustee; n27 that special litigation counsel retained by a debtor was entitled to reimbursement of interest that he had paid on money borrowed to pay litigation expenses; n28 that computerized legal research expenses n29 and word processing charges are reimbursable; n30 and that a debtor's attorney was entitled to reimbursement for costs related to indemnification against actions by trustee. n31

Compensation for Travel Time. One of the major issues over which courts disagree with respect to compensation is travel time.

Local Travel Time Not Compensable. Courts generally agree that local travel time should not be billed and paid as an expense to the bankruptcy estate. Local travel to the courthouse beyond a minimal time should be included in overhead. n32

Non-local Travel Time Compensable; Extent Varies. Courts generally permit compensation for a professional's non-local travel time; however, the courts are not in agreement with respect to what extent the time spent traveling should be compensable.

Full Compensation If Travel Time Was Reasonable and Necessary. On one side of the issue are courts that view travel time in the same manner as any other billable activity. In *In re Frontier Airlines, Inc.*, n33 for example, the bankruptcy court held that time spent in traveling should be compensated at the professional's full hourly rate. The *Frontier Airlines* court asserted that travel time is not soft time and that the notion that only travel during normal business hours is compensable imposes penalties on those professionals who forego their personal time on weekends or at night to fly to a location for an early meeting. Rather than focusing on the potential lack of productivity of travel

time, the court focused on whether the travel time was reasonable and necessary. The court stated nonbankruptcy attorneys typically bill their travel time at the full hourly rate because it precludes them from engaging in other billable professional work. n34

Other courts have refused to award full compensation for travel, based on reasons such as lack of productivity, burden to the estate and the availability of local counsel. For example, in *In re Landing, Inc.*, n35 the court reduced compensation for time spent traveling by the trustee's attorneys to 50 percent of their normal hourly billing rate, focusing on the non-productivity of travel. The *Landing* court indicated that it would permit a greater award for travel time when the applicant specifically shows that travel time was concurrently used for preparing for meetings or court appearances. Determining that charging the bankruptcy estate at the full rate for travel time would be burdensome to the estate, the bankruptcy court in *In re Environmental Waste Control*, n36 also limited compensation of professionals' travel time to one-half their normal hourly rate. The court in *In re Grimes*, n37 reduced the debtor's out-of-state attorney reimbursement of travel fees and expenses to 25 percent of the requested amount, deeming it to be unnecessary. Although the *Grimes* court indicated that travel time could be reimbursed at a full hourly billing rate, it emphasized that compensation for travel may be denied as unnecessary if an attorney located far from the situs of the bankruptcy is employed when adequate local representation is available. n38

Reimbursement for a Field Office. Courts have also denied reimbursement to a debtor's out-of-state attorney for overhead costs, such as rent, payroll and furniture, for establishing a temporary field office when the bankruptcy case was pending. n39

Paraprofessionals Separately Compensable. Section 330 specifically provides that the cost of paraprofessionals n40 employed by professional persons serving the estate is separately compensable and is not an ordinary expense of operation. n41 This provision was included as a measure to reduce the cost of administering bankruptcy cases. In other areas, professionals are able to charge for a paraprofessional's time on an hourly basis, and not include it in overhead. If a similar practice were not allowed in bankruptcy cases, then there would be less inclination to use paraprofessionals even when the work could easily and perhaps more efficiently be handled by these individuals at a lower cost to the estate. n42 The provision is designed to encourage attorneys and other professionals to use paraprofessional assistance when possible, and to ensure that the estate, not the professional, will bear the cost. n43 Whether a task is appropriate for assignment to a paraprofessional is a matter of professional judgment, and the bankruptcy court generally should not substitute its own judgment. n44

The allowance of paraprofessional fees in bankruptcy cases is not without limitation, however. Several courts have imposed restrictions on the compensation of paraprofessionals. For example, the court in *In re Grimes*, n45 concluded that if paralegal work is to be compensated, the qualifications of the paralegal should be established in order to justify the charge. In *In re C&F Fabricators of Utah, Inc.*, n46 the court held that although the cost of paraprofessional service is reimbursable, the fees charged must be reasonable in relation to the specific services rendered. Finally, in *In re Grenoble Apartments, II*, n47 the district court ruled that in awarding compensation for paralegal services, the bankruptcy court is limited to the prevailing market rate approach.

For a complete discussion of Code section 330, see Collier on Bankruptcy, ch. 330 (Matthew Bender).

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n1 1. *Max Rouse & Sons, Inc. v. Specialty Plywood, Inc. (In re Specialty Plywood, Inc.)*, 30 C.B.C.2d 199, 160 B.R. 627 (B.A.P. 9th Cir. 1993) (citing *In re Williams*, 102 B.R. 197, 199 (Bankr. N.D. Cal. 1989)).

n2

2. *In re Mulberry Phosphates, Inc.*, 169 B.R. 750 (M.D. Fla. 1994) (citing *In re New Hampshire Elec. Coop., Inc.*, 146 B.R. 890, 903 (Bankr. D.N.H. 1992)).

n3

3. *Max Rouse & Sons, Inc. v. Specialty Plywood, Inc. (In re Specialty Plywood, Inc.)*, 30 C.B.C.2d 199, 160 B.R. 627 (B.A.P. 9th Cir. 1993) (citing *In re Williams*, 102 B.R. 197, 199 (Bankr. N.D. Cal. 1989)); *In re Spanjer Bros., Inc.*, 191 B.R. 738 (Bankr. N.D. Ill. 1996).

n4

4. *In re Mulberry Phosphates, Inc.*, 169 B.R. 750 (M.D. Fla. 1994) (citing *In re New Hampshire Elec. Coop., Inc.*, 27 C.B.C.2d 1337, 1354, 146 B.R. 890, 903 (Bankr. D.N.H. 1992)).

n5

5. See *Max Rouse & Sons, Inc. v. Specialty Plywood, Inc. (In re Specialty Plywood, Inc.)*, 30 C.B.C.2d 199, 160 B.R. 627 (B.A.P. 9th Cir. 1993).

n6

6. For a discussion of the factors considered in determining the reasonableness of compensation, see *Collier on Bankruptcy*, 330.04 (Matthew Bender).

n7

7. See *Collier on Bankruptcy*, 330 (Matthew Bender); see also *Milbank, Tweed & Hope v. McCue*, 111 F.2d

100 (4th Cir. 1940); *In re Prudence Bonds Corp.*, 122 F.2d 258 (2d Cir. 1941).

n8

8. See, e.g., *In re Gloria Mfg. Corp.*, 6 C.B.C.2d 1028, 20 B.R. 603 (Bankr. E.D. Va. 1982).

n9

9. See *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 61 S. Ct. 493, 85 L. Ed. 820 (1941) (denying compensation to fiduciary on the basis of conflict of interest but granting reimbursement of expenses that benefited estate).

n10

10. See e.g., *In re Toy & Sports Warehouse, Inc.*, 37 B.R. 141 (Bankr. S.D.N.Y. 1984); *In re Global Int'l Airways Corp.*, 11 C.B.C.2d 1211, 45 B.R. 258 (Bankr. W.D. Mo. 1984); *In re GHR Energy Corp.*, 35 B.R. 539 (Bankr. D. Mass. 1983); *In re Grynberg*, 6 C.B.C.2d 541, 19 B.R. 621 (Bankr. D. Col. 1982); *In re Farm Bureau Serv., Inc.*, 32 B.R. 69 (Bankr. E.D. Mich. 1982); *In re Fireside Office Supply, Inc.*, 5 C.B.C.2d 111, 17 B.R. 43 (Bankr. D. Minn. 1981); see also *Collier on Bankruptcy*, 330.01[2] (Matthew Bender).

n11

11. 921 F.2d 626, 24 C.B.C.2d 308 (6th Cir. 1990).

n12

12. 921 F.2d 626, 633, 24 C.B.C.2d 308, 317 (6th Cir. 1990).

n13

13. 921 F.2d 626, 633, 24 C.B.C.2d 308, 318 (6th Cir. 1990).

n14

14. See discussion of 503(b)(3)(F) in *Collier on Bankruptcy*, 330.01 (Matthew Bender)..

n15

15. See *In re Belknap, Inc.*, 103 B.R. 842 (Bankr. W.D. Ky. 1989).

n16

16. See *In re National Paragon Corp.*, 76 B.R. 73 (E.D. Pa. 1987).

n17

17. *In re Central Pac. Boiler & Piping, Ltd.*, 88 B.R. 277 (Bankr. D. Haw. 1988).

n18

18. *In re Lowry Graphics, Inc.*, 86 B.R. 74 (Bankr. S.D. Tex. 1988).

n19

19. See *In re Lanier Spa, Inc.*, 21 C.B.C.2d 75, 99 B.R. 490 (Bankr. N.D. Ga. 1989); *In re Prairie Cent. Ry. Co.*, 87 B.R. 952 (Bankr. N.D. Ill. 1988); *In re Lowry Graphics, Inc.*, 86 B.R. 74 (Bankr. S.D. Tex. 1988); *In re Impact Publications, Inc.*, 24 B.R. 980 (Bankr. N.D. Tex. 1982). But see *Cavazos v. Simmons*, 90 B.R. 234 (N.D. Tex. 1988) (statutory limit on trustee compensation not applicable to paraprofessionals employed by trustee). See generally *Collier on Bankruptcy*, ch. 323 (Matthew Bender).

n20

20. *In re Lowry Graphics, Inc.*, 86 B.R. 74, 80 (Bankr. S.D. Tex. 1988).

n21

21. 30 C.B.C.2d 449, 161 B.R. 839 (Bankr. N.D. Cal. 1993).

n22

22. *In re Air Vermont*, 114 B.R. 48 (Bankr. D. Vt. 1988) (improperly billed trustee services is an unwarranted double dipping).

n23

23. *In re Convent Guardian Corp.*, 103 B.R. 937 (Bankr. N.D. Ill. 1989).

n24

24. *In re National Paragon Corp.*, 76 B.R. 73 (E.D. Pa. 1987).

n25

25. *In re Mulberry Phosphates, Inc.*, 151 B.R. 948, 951 (M.D. Fla. 1992). *But see In re Michaelson*, 222 B.R. 595 (Bankr. C.D. Ill. 1997) (clerk's time is considered part of overhead).

n26

26. *See, e.g., In re Motor Freight Express*, 80 B.R. 44 (Bankr. E.D. Pa. 1987); *In re Mayflower Associates*, 78 B.R. 41 (Bankr. E.D. Pa. 1987) (photocopying, postage, long distance telephone calls, and travel costs compensable only if properly documented). *But see In re Convent Guardian Corp.*, 103 B.R. 937 (Bankr. N.D. Ill. 1989) (denying reimbursement for items such as secretary costs, postage, messenger costs absent extraordinary circumstances).

n27

27. *In re Met-L-Wood Corp.*, 115 B.R. 133 (N.D. Ill. 1990). *See In re American Preferred Prescription, Inc.*, 218 B.R. 680 (Bankr. E.D.N.Y. 1998) (chapter 11 debtor's accountants were entitled to reimbursement of their legal expenses incurred to defend against meritless motion for disqualification made by debtor) (citing *In re Met-L-Wood Corp.*).

n28

28. *In re Central Ice Cream Co.*, 114 B.R. 956 (N.D. Ill. 1989).

n29

29. *In re Wizard Enterprises, Inc.*, 109 B.R. 708 (Bankr. W.D. La. 1990). But see *In re Belknap, Inc.*, 103 B.R. 842 (Bankr. W.D. Ky. 1989) (disallowing clerical pay and computer research charges as overhead).

n30

30. *In re Jensen-Farley*, 47 B.R. 557 (Bankr. D. Utah 1985). But see *In re D'Lite of Am. Inc.*, 92 B.R. 554 (Bankr. N.D. Ga. 1988) (word-processing charges are nonreimbursable overhead).

n31

31. *In re Met-L-Wood Corp.*, 103 B.R. 972 (Bankr. N.D. Ill. 1989).

n32

32. See, e.g., *In re Ginji Corp.*, 24 C.B.C.2d 216, 117 B.R. 983 (Bankr. D. Nev. 1990); *In re Metro Transp. Co.*, 78 B.R. 416 (Bankr. E.D. Pa. 1987); *In re Tavern Motor Inn, Inc.*, 69 B.R. 138 (Bankr. D. Vt. 1987) (local travel time should be treated as part of overhead).

n33

33. 74 B.R. 973 (Bankr. D. Colo. 1987).

n34

34. See also *In re Cano*, 122 B.R. 812 (Bankr. N.D. Ga. 1990).

n35

35. 122 B.R. 701 (Bankr. N.D. Ohio 1990).

n36

36. 122 B.R. 341 (*Bankr. N.D. Ill. 1990*).

n37

37. 115 B.R. 639 (*Bankr. D.S.D. 1990*).

n38

38. 115 B.R. 639, 643 (*Bankr. D.S.D. 1990*).

n39

39. *In re Braniff, Inc.*, 117 B.R. 702 (*Bankr. M.D. Fla. 1990*).

n40

40. A paraprofessional is one who assists a professional person but is not a member of the profession. *In re Balli*, 228 B.R. 546 (*Bankr. M.D. Pa. 1998*) (citing Black's Law Dictionary and finding that a nonprofessional trustee, by definition, is not capable of employing a paraprofessional).

n41

41. For cases allowing compensation of paraprofessional services, see *In re Wolverine Knitting Mills, Inc.*, 107 B.R. 546 (*Bankr. E.D. Mich. 1989*) (allowing accountants separate compensation for clerical services rendered to the estate); *In re Marsh*, 5 C.B.C.2d 106, 14 B.R. 615 (*Bankr. E.D. Va. 1981*); *In re D & W Motel Enters.*, 3 C.B.C.2d 861, 9 B.R. 355 (*Bankr. D.S.D. 1981*) (allowing cost of paraprofessional services performed by secretaries engaged in creative work beyond secretarial duties); *In re Quick Release, Inc.*, 3 C.B.C.2d 230, 6 B.R. 713 (*Bankr. D.S.D. 1980*).

n42

42. *In re Klemen*, 21 B.R. 77 (*Bankr. N.D. Ill. 1982*) (inclusion of paraprofessional services in section 330 was for purpose of lowering the overall costs to the estate).

n43

43. H.R. Rep. No. 595, 95th Cong., 1st Sess. 330 (1977).

n44

44. *In re St. Rita's Assocs. Private Placement, L.P.*, 216 B.R. 490 (Bankr. W.D.N.Y. 1998).

n45

45. 115 B.R. 639 (Bankr. D.S.D. 1990).

n46

46. 25 C.B.C.2d 779, 131 B.R. 474 (Bankr. D. Utah 1991).

n47

47. 152 B.R. 608 (D.S.D. 1993).

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168 of 197 DOCUMENTS

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Collier on the Effect of Rejection of an Executory Contract or Unexpired Lease

2008 Emerging Issues 959

Collier on the Effect of Rejection of an Executory Contract or Unexpired Lease

By Collier

November 16, 2007

SUMMARY: This Emerging Issues Analysis discusses issues that arise under Section 365(g), including the rights of sublessees and leasehold mortgages, the ability of a real property lessor to retake the premises, the effect of the rejection of a contract or lease previously assumed, and the protection of personal property lessors.

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ARTICLE: *Section 365(g) of the Bankruptcy Code* deals generally with the effect of a rejection of an executory contract or unexpired lease. When the contract or lease has not been previously assumed, rejection constitutes a breach immediately before the date of the filing of the petition. n1

Other Party Becomes General Unsecured Creditor

The purpose of section 365(g) is to make clear that, under the doctrine of relation-back, the other party to a contract that has not been assumed is simply a general unsecured creditor. Section 502(g) provides much the same. n2 The effect of the breach is to permit the creditor to seek allowance of its claim under section 502. n3 This is confirmed by the definition of the term "creditor" in section 101, n4 which provides that the term includes any entity that has a claim of the type specified in section 502(g). Thus, the effect of a rejection is that a breach is deemed to exist, which in the ordinary case will give rise to a claim for damages. n5 Rejection does not, however, affect the parties' substantive rights under the contract or lease, such as the amount owing or a measure of damages for breach, n6 and does not waive any defenses to the contract. n7

Treatment of Special Cases

Several unique situations are dealt with by other provisions of section 365. Section 365(h) deals with leases of real property under which the debtor is lessor and with timeshare plans under which the debtor is the seller of the timeshare

interest. n8 Section 365(i) deals with land sale contracts and with timeshare sale contracts under which the debtor is seller and the buyer is already in possession of the property. n9 Finally, rejection of intellectual property licenses under which the debtor is licensor is addressed in section 365(n). n10 In general, these provisions represent special cases in which the other party to the contract may be permitted, after rejection, to opt to retain most or all of its rights under the contract, other than those that require affirmative performance from the trustee or debtor in possession.

Breach Is Not Termination of Contract

Although the Bankruptcy Code explicitly provides that, in general, rejection of an executory contract or unexpired lease constitutes a breach, one question that has troubled courts is whether rejection terminates the contract or lease. n11 If rejection terminates the contract or lease, such termination may have consequences that affect parties other than the debtor and the other party to the contract or lease. For example, termination upon a lessee's rejection may affect the rights of a leasehold mortgagee, a sublessee or an assignee of the lessee's rights. Similarly, termination upon a lessor's rejection may affect the rights of a lessee, sublessee or, at times, a leasehold mortgagee.

Unlike other provisions of section 365, n12 which mention the "termination" of a contract or lease, section 365(g) describes the effect of rejection as a "breach" of the contract or lease. Indeed, section 365 uses the terms "rejection," "breach" and "termination" differently. n13 Thus, "rejection" is the decision of the trustee or the debtor, as the case may be, not to assume a burdensome contract or lease. "Rejection" constitutes a "breach" pursuant to section 365(g), except to the extent that a contract or lease is "terminated" pursuant to section 365(h) or (i). Subsections (h) and (i) authorize lessees of real property, timeshare purchasers or buyers of real property to remain in possession of the property after rejection by a lessor or seller or, alternatively, to treat the lease or sale agreement as "terminated" by the rejection. Other than the option given to lessees and purchasers to treat rejection as termination, section 365 does not explicitly provide for termination of a party's or lessee's contract interests. n14 Moreover, if rejection of the lease worked a termination, it would be difficult to justify granting the other party to the contract or lease a damage claim for rejection, which the lessor is given by section 502(g). n15 Similarly, because a rejection constitutes only a breach, not a termination, a covenant not to compete in a rejected contract continues to bind the debtor, unless the obligation is discharged. n16

This suggests that the effect of rejection of an executory contract or unexpired lease is limited to a breach or abandonment by the trustee or debtor in possession rather than a complete termination of the lease. n17 Rejection should not operate to damage the rights of third parties with rights in the leasehold estate. n18 When the lease is deemed rejected by reason of the expiration of the time set pursuant to section 365(d)(4), the debtor's right to possession of the premises is extinguished but the leasehold itself is not. n19

Rights of Sublessees and Leasehold Mortgages. This issue has arisen most frequently with respect to real property leases in which the debtor is a lessee who granted a sublease of or leasehold mortgage on real property or in which the debtor is a lessor whose lessee granted such an interest. Typically, a party down the chain is seeking to protect its interest that flows from the debtor's rights. When the debtor is lessee, recognition that rejection of the lease does not terminate all rights under the lease leaves it open to the sublessee or leasehold mortgagee to prove that, under nonbankruptcy law, it is entitled to retain its interest even if the debtor-lessee breached the lease. This is particularly important in view of section 365(d)(4), which deems rejected a lease that is not assumed by a debtor-lessee within 60 days after the order for relief. n20

When the rejection is by a debtor-lessor, an amendment enacted in 1994 protects parties who derive their rights through the lessee. n21 Section 365(h) now provides that, upon rejection by a lessor of real property, the lessee may retain not only its own possessory rights, but other rights appurtenant thereto, including rights to sublet, assign or hypothecate the lease.

Abandonment to Debtor of Lease or Contract Rejected by Trustee. The effect of rejection on third parties is also an issue in chapter 7 cases, particularly in the case of leases, since leases are rarely assumed by chapter 7 trustees and are therefore automatically rejected pursuant to section 365(d)(1). Because rejection does not effect a termination of the lease, most courts that have considered the issue have held the rejection to have the effect of abandoning the lease back to the debtor. n22 The 1984 amendments to the Code support this interpretation for leases other than leases of nonresidential real property. While section 365(d)(4) requires a nonresidential tenant to vacate a property where the lease is not assumed, there is no such requirement for a residential tenant. In addition, if a landlord accepts rental payments after the expiration of the 60-day period, the debtor may argue that any breach of the lease has been waived. n23 Subsection (p) provides special rules for the trustee's rejection of a personal property lease. n24

Ability of Real Property Lessor to Retake Premises

The courts are split on the issue whether the bankruptcy court has the power to order a surrender of the premises to the landlord upon a proper request or whether the landlord should have to exercise its remedies under applicable state law. n25 The better approach in a case involving a lease of nonresidential real property is to analogize to section 365(d)(4) and to require the debtor to surrender leased premises after rejection of the lease, without the necessity to suffer further delay by engaging in eviction proceedings under nonbankruptcy law. However, in other cases involving disputes between the debtor and the lessor about possession, the most the bankruptcy court should do is grant relief from the automatic stay, if appropriate, to allow the lessor to proceed in state court.

Effect of Rejection of a Contract or Lease Previously Assumed

Section 365(g) provides that if a contract or lease was assumed previously and is then rejected, the breach is at the time of rejection unless the case was converted under section 1112, n26 1208 n27 or 1307, n28 in which case the breach is immediately before the date of the conversion, unless the assumption itself took place after the conversion, in which case the breach is at the time of rejection. The reason for the somewhat complicated wording is to make it clear that when a contract or lease is assumed in a case under chapter 11, 12 or 13 and then breached in the ensuing liquidation under chapter 7, any administrative priority claim flowing from the breach will not fall within the superpriority of section 726(b). n29

Although section 365(g) indicates that, in general, a post-assumption rejection constitutes a breach as of the time of rejection, it does not clearly indicate that damages from that breach are entitled to administrative priority. One might argue that if the estate gets no benefit from the breach, there is no basis for administrative priority under section 503. The better approach, however, is to recognize that the estate receives the benefit of the assumed contract, which presumably was viewed as beneficial at the time it was assumed, and takes that contract *cum onere*. Therefore, any damages flowing from the breach of a previously assumed contract should be considered first priority administrative expenses. n30

This suggests that a trustee or debtor in possession should proceed cautiously in electing to assume a contract or lease, since an assumption will have the effect of making the expenses and liabilities incurred expenses of administration. n31 Similarly, once a contract is rejected it stays rejected. This view is supported by the wording of section 1123(b)(2) and section 1322(b)(7), which permit the assumption or rejection in the plan of contracts "not previously rejected." n32

The limitation upon the amount of an allowed claim arising from breach of a real property lease in section 502(b)(6) n33 of the Code does not apply to leases assumed and thereafter rejected in the case. n34 However, a similar

limitation applies upon the amount of the administrative expense that arises upon rejection of a real property lease that has previously been assumed in the case. n35

Protection of Personal Property Lessors

Section 365(p)(1) Section 365(p)(1) gives relief to personal property lessors by providing that upon rejection or deemed rejection, the leased property is no longer property of the estate, "and the stay under section 362(a) is automatically terminated." n36 The provision is analogous to the protection provided to lessors of nonresidential real property under section 365(d)(4), under which the trustee is required to surrender the property immediately to the lessor upon the deemed rejection of the lease. However, it differs markedly. Section 365(p)(1) applies not only on deemed rejection, but also upon the trustee's affirmative rejection of a personal property lease. On the other hand, it does not require surrender of the property; it merely terminates the automatic stay. This provision applies equally under all chapters, n37 and to all kinds of debtors, whether individual or corporate, whether consumer or business.

Under section 365(p)(1), the leased personal property is no longer property of the estate. Although not stated, that suggests that the property returns to being property of the debtor, and the debtor may deal with it free of any restrictions of the Bankruptcy Code. n38 The lessor may apparently also deal with the property free of any such restrictions, because the provision automatically terminates the automatic stay under section 362(a). The stay ordinarily protects both the debtor and the estate and property of the debtor and the estate. The stay termination under section 365(p)(1) is broad enough to terminate the stay as to both entities. Interestingly, the literal language of section 365(p)(1) is even broader than that. It appears to effect a total termination of the automatic stay, for all creditors, for all property, for all actions, in any case in which "a lease [any lease!] of personal property is rejected or not timely assumed by the trustee." Such a result would be absurd and appear to be demonstrably at odds with clear congressional intent. A more charitable reading suggests that Congress intended only to terminate the stay as to the particular lessor, lease, and leased property that has been rejected. Such a reading is supported by section 365(p)(2), which provides safe harbors from the stay for certain of the lessor's post-rejection activities, discussed below, and by section 365(p)(3), which provides for termination of the stay in individual chapter 11 or 13 cases after rejection.

Subsection (p)(2) n39 permits an individual chapter 7 debtor to notify the lessor in writing that the debtor desires to assume a personal property lease that the trustee has rejected or that has been deemed rejected. It is a curious provision, in that there is nothing in the Code that suggests that a debtor could not contact a lessor, whether or not its lease had been rejected. One could infer that the provision is an indirect prohibition on contacting the lessor other than in writing or other than after rejection, but nothing in the language, the history, or the context suggests that such an inference is warranted. After the lessor (referred to in the statute as "the creditor") is contacted, it may notify the debtor that it is willing to have the debtor assume the lease. The lessor's action is entirely optional. Again, one might wonder why statutory authorization was required for the lessor's act. The lessor may condition the assumption on cure of outstanding defaults on terms set by the lease. If the debtor notifies the lessor in writing not later than 30 days "after notice is provided under subparagraph (A)" that the lease is assumed, then the debtor, and not the estate, assumes the liability for the lease. The provision does not specify which "notice provided under subparagraph (A)" triggers the 30-day clock.

In sum, the procedure in subsection (p)(2) envisions three possible steps: The debtor may notify the lessor of a desire to assume; the lessor may notify the debtor of its willingness to have the lease assumed and of the terms of cure; and the debtor may accept. If the lessor does not set terms of cure, it appears the debtor still may assume the lease; although other Code provisions expressly limit the estate's general right to assume executory contracts or leases in certain cases, n40 subsection (p)(2) does not contain any limitation on the debtor's right to assume other than the lessor's ability to condition assumption on cure of any outstanding default on terms set by the contract. n41 The Code does not specify what happens if either of the parties does not meet any of the deadlines, nor does it indicate whether they may reach an agreement between themselves on terms or times different from those specified. The provision does not appear to prohibit any such alternative agreement.

Finally, the creditor's conduct in contacting the debtor in response to the debtor's request to assume is expressly excepted from both the automatic stay and the discharge injunction. The exception does not cover, however, any contact by the lessor to request that the debtor assume before the debtor first contacts the lessor. However, section 362(h) terminates the stay in an individual case as to particular property if the debtor does not timely perform the statement of intentions required under section 521(a)(2). n42

Section (p)(3) Section 365(p)(3) applies only in a chapter 13 or an individual chapter 11 case. It provides that if a personal property "lease is not assumed in the plan confirmed by the court" then it "is deemed rejected as of the conclusion of the hearing on confirmation." Implementation of the timing requirements of this section may be challenging in some cases. Upon rejection, the automatic stay of section 362 and the codebtor stay of section 1301 in chapter 13 cases are automatically terminated as to the leased property. The provision does not expressly terminate the automatic stay as to the debtor or the estate, so any effort to collect any amounts owing from the debtor, the estate or a codebtor remains stayed.

In some cases, the court does not confirm a plan immediately upon conclusion of the confirmation hearing. For example, a plan amendment may be required before the court will sign the order, or an order might not have been submitted to the court before the hearing. A literal reading of the language would seem to suggest that in those cases, all of the debtor's personal property leases would be deemed rejected, before the court actually confirmed the plan, because the rejection operates at the conclusion of the hearing, but not on leases "assumed in the plan *confirmed by the court*." A court could resolve this apparent anachronism by keeping the confirmation hearing open until the confirmation order is actually entered. To avoid problems with the plain meaning rule of statutory construction, that may be the best solution. Alternatively, the court could read the two clauses as referring to the same point in time.

For a complete discussion of Code section 365, see Collier on Bankruptcy, ch. 365 (Matthew Bender).

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n1 1. *See 11 U.S.C. § 365(g)*. Reference to chapter 12 (Adjustment of Debts of a Family Farmer with Regular Annual Income) in subsection (g)(1) was added by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554 (1986).

n2

2. Section 502(b)(6) contains significant limitations on the allowance of a possible claim for damages flowing from a breach in the case of leases of real property and employment contracts. *See* Collier on Bankruptcy, ch. 502 (Matthew Bender)..

n3

3. *See* Collier on Bankruptcy, ch. 502 (Matthew Bender); *see Stewart Title Guaranty Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735 (5th Cir. 1996); *Leasing Serv. Corp. v. First Tennessee Bank N.A.*, 826 F.2d

434 (6th Cir. 1987) (rejection of equipment leases does not affect grant of security interest in lease); *Trustees of the Amalgamated Ins. Fund v. McFarlins, Inc.*, 789 F.2d 98, 14 C.B.C.2d 1075 (2d Cir. 1986).

n4

4. See *Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n5

5. *Aslan v. Sycamore Inv. Co. (In re Aslan)*, 909 F.2d 367 (9th Cir. 1990); *In re Chi-Feng Huang*, 7 C.B.C.2d 639, 23 B.R. 798 (B.A.P. 9th Cir. 1982); *Mazirow v. Grigsby (In re White Motor Corp.)*, 12 C.B.C.2d 183, 44 B.R. 563 (N.D. Ohio 1984). A damage claim is not limited to monetary relief. See *In re West Chestnut Realty of Haverford, Inc.*, 177 B.R. 501 (Bankr. E.D. Pa. 1995) (specific performance may be available if authorized under state law).

n6

6. *Megafoods Stores, Inc. v. Flagstaff Realty Assocs. (In re Flagstaff Realty Assocs.)*, 60 F.3d 1031, 1034, 34 C.B.C.2d 152, 155 (3d Cir. 1995).

n7

7. *Durkin v. Benedor Corp. (In re G.I. Indus., Inc.)*, 204 F.3d 1276 (9th Cir. 2000).

n8

8. See *Collier on Bankruptcy*, 365.10 (Matthew Bender).

n9

9. See *Collier on Bankruptcy*, 365.11 (Matthew Bender).

n10

10. See *Collier on Bankruptcy*, 365.14 (Matthew Bender).

n11

11. See, e.g., *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1082 (5th Cir.) ("the terms rejection, breach and termination are used differently, but not inconsistently or interchangeably, as some courts have suggested"), *cert. denied*, 513 U.S. 874, 115 S. Ct. 201, 130 L. Ed. 2d 132 (1994); *In re Tri-Glied, Ltd.*, 33 C.B.C.2d 670, 179 B.R. 1014 (Bankr. E.D.N.Y. 1995); *In re Empire Knitting Mills, Inc.* 123 B.R. 688, 691 (Bankr. D. Me. 1991). See generally Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. Colo. L. Rev. 845 (1988).

n12

12. See, e.g., 11 U.S.C. § 365(e), (h), (i).

n13

13. See, e.g., *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir.), *cert. denied*, 513 U.S. 874, 115 S. Ct. 201, 130 L. Ed. 2d 132 (1994).

n14

14. A similar option is given to licensees of intellectual property by section 365(n).

n15

15. See, e.g., *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir.), *cert. denied*, 513 U.S. 874, 115 S. Ct. 201, 130 L. Ed. 2d 132 (1994).

n16

16. *Sir Speedy, Inc. v. Morse*, 256 B.R. 657 (D. Mass. 2000).

n17

17. See *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir.) (effect of rejection is a breach of the lease rather than termination), *cert. denied*, 513 U.S. 874, 115 S. Ct. 201, 130 L. Ed. 2d 132 (1994); *In re Continental Airlines*, 981 F.2d 1450, 28 C.B.C.2d 538 (5th Cir. 1993); *CASC Corp. v. Milner (In re Locke)*, 180 B.R. 245 (Bankr. C.D. Cal. 1995); Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. Colo. L. Rev. 845, 921 (1988).

n18

18. See *Commercial Trading Co. v. Lansburgh (In re Garfinkle)*, 577 F.2d 901 (5th Cir. 1978); *Blue Barn Assocs. v. Picnic'N Chicken, Inc. (In re Picnic'N Chicken, Inc.)*, 14 C.B.C.2d 475, 58 B.R. 523 (Bankr. S.D. Cal. 1986).

n19

19. *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077 (5th Cir.), *cert. denied*, 513 U.S. 874, 115 S. Ct. 201, 130 L. Ed. 2d 132 (1994); *Anderson v. Elm Inn, Inc. (In re Elm Inn, Inc.)*, 942 F.2d 630 (9th Cir. 1991); *In re Tri-Glied, Ltd.*, 33 C.B.C.2d 670, 179 B.R. 1014 (Bankr. E.D.N.Y. 1995).

n20

20. See, e.g., *CASC Corp. v. Milner (In re Locke)*, 180 B.R. 245 (Bankr. C.D. Cal. 1995).

n21

21. Pub. L. No. 103-394, § 205 (1994).

n22

22. *In re Reed*, 94 B.R. 48 (E.D. Pa. 1988) (rejection results in abandonment of lease to debtor); *In re Rodall*, 30 C.B.C.2d 1322, 165 B.R. 506 (Bankr. M.D. Fla. 1994) (same); see also *In re Austin Dev. Co.*, 19 F.3d 1077 (5th Cir.), *cert. denied*, 513 U.S. 874, 115 S. Ct. 201, 130 L. Ed. 2d 132 (1994) (rejection of lease does not terminate lease with respect to parties that have not rejected it nor does it affect their rights); *In re Szymecski*, 87 B.R. 14 (W.D. Pa. 1988) (automatically rejected public housing lease is abandoned to debtor); *In re Knight*, 3 C.B.C.2d 742, 8 B.R. 925 (Bankr. D. Md. 1981).

n23

23. *In re Ranch House of Orange-Brevard, Inc.*, 773 F.2d 1166, 13 C.B.C.2d 1073 (11th Cir. 1985); *In re T.F.P. Resources, Inc.*, 56 B.R. 112 (Bankr. S.D.N.Y. 1985); *In re Storage Technology Corp.*, 53 B.R. 471 (Bankr. D. Colo. 1985) (rejection is a breach of lease that may be waived, not a termination of lease).

n24

24. See *Collier on Bankruptcy*, 365.09[6] (Matthew Bender).

n25

25. Compare *In re Elm Inn, Inc.*, 942 F.2d 630 (9th Cir. 1991) (court has power to order immediate possession), with *In re Williams*, 171 B.R. 420 (Bankr. S.D. Ga. 1994) (lessor must commence adversary proceeding or state court action). Such a request would also have to include a request for relief from the stay, as section 365 is not an exception to the stay. See *In re Tri-Glied, Ltd.*, 33 C.B.C.2d 670, 179 B.R. 1014 (Bankr. E.D.N.Y. 1995).

n26

26. See *Collier on Bankruptcy*, ch. 1112 (Matthew Bender).

n27

27. See *Collier on Bankruptcy*, ch. 1208 (Matthew Bender). Reference to chapter 12 (Adjustment of Debts of a Family Farmer with Regular Annual Income) in subsection (g)(2) was added by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554 (1986).

n28

28. See *Collier on Bankruptcy*, ch. 1307 (Matthew Bender).

n29

29. See *Collier on Bankruptcy*, ch. 726 (Matthew Bender). The Code deals with priorities in both section 503 and section 726 if the case is under chapter 7. See *Devan v. Simon DeBartolo Group, L.P. (In re Merry-Go-Round Enters., Inc.)*, 180 F.3d 149 (4th Cir. 1999) (for an application of the principles to a lease entered into during chapter 11 and breached during the chapter 7 case).

n30

30. See *Adventure Resources v. Holland*, 137 F.3d 786 (4th Cir. 1998); *Nostas Assocs. v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996); *Elliott v. Four Seasons Props. (In re Frontier Props., Inc.)*, 979 F.2d 1358, 27 C.B.C.2d 1515 (9th Cir. 1992).

n31

31. See *Samore v. Boswell (In re Multech Corp.)*, 12 C.B.C.2d 562, 47 B.R. 747 (Bankr. N.D. Iowa 1985).

n32

32. See *Nostas Assocs. v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996).

n33

33. See *Collier on Bankruptcy*, 502.03[7] (Matthew Bender).

n34

34. See *Adventure Resources v. Holland*, 137 F.3d 786 (4th Cir. 1998); *Nostas Assocs. v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996); *Samore v. Boswell (In re Multech Corp.)*, 12 C.B.C.2d 562, 47 B.R. 747 (N.D. Iowa 1985). But see *Penn Ctr. Management Corp. v. Ultimate Restaurants Group, Inc. (In re Ultimate Restaurants Group, Inc.)*, 144 B.R. 291 (Bankr. W.D. Pa. 1992).

n35

35. 11 U.S.C. § 503(b)(7).

n36

36. 11 U.S.C. § 365(p)(1), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 309(b) (2005), effective in cases commenced on or after October 17, 2005.

n37

37. *11 U.S.C. § 103(a)* (chapter 3 applies in cases under chapter 7, 11, 12 or 13).

n38

38. It is unclear how a corporate chapter 11 debtor in possession would reacquire property upon lease rejection in its capacity as the debtor during the chapter 11 case. Presumably, the debtor in possession would surrender the property to the lessor, but other outcomes are possible.

n39

39. *11 U.S.C. § 365(p)(2)*, added by Pub. L. No. 109-8, § 309(b) (2005), effective in cases commenced on or after October 17, 2005.

n40

40. *E.g., 11 U.S.C. § 365(c)*.

n41

41. Alternatively, section 365(p)(2) could be read to permit assumption only if the lessor notifies the debtor that it is willing to have the lease assumed. However, if this is the intent, it is curious that the restriction on assumption is not stated anywhere in the subsection, unlike other restrictions on assumption in section 365.

n42

42. *11 U.S.C. § 362(h)*; see Collier on Bankruptcy, ch. 362 (Matthew Bender). Although section 362(h) refers to the statement of intention under section 521(a)(2), that section does not mention leases. However, the Official Form for the statement of intention does permit the debtor to state, for purposes of section 362(h), whether a lease of personal property will be assumed. This statement of intention should not be construed to be the notice that the debtor desires to assume a lease under section 365(p)(2)(A).

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169 of 197 DOCUMENTS

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Financial Management Instructional Course Requirement under the Code

2008 Emerging Issues 960

Collier on the Financial Management Instructional Course Requirement under the Code

By Collier

November 16, 2007

SUMMARY: This Emerging Issues Analysis addresses issues pertaining to the financial management instruction course requirements in the Code, including exceptions to the requirements, approval of financial management courses, timing of financial management courses, the consequences of a failure to obtain mandated financial management courses, and the credit reporting prohibition.

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ARTICLE: Individual Debtors

Individual debtors, subject to certain limited exceptions, are now required to complete a financial management instructional course in order to obtain a discharge in chapters 7 and 13. Section 727(a)(11), added as part of the 2005 Act, provides that an individual who has failed to complete an instructional course related to personal financial management, subject to certain statutorily prescribed exceptions, shall not be granted a discharge. n1 Section 1328(g)(1) provides that an individual may not obtain a discharge unless there has been completion of a financial management course described in section 111; as with section 727(a)(11), there are certain important exceptions. n2

There appear to be no similar provisions in chapters 11 and 12, although individuals can be debtors in these two chapters. In the absence of a provision analogous to sections 727(a)(11) and 1328(g)(1), one can make a valid argument that the postfiling debtor education is not a mandate for debtors in chapters 11 and 12. Whether a court will read in such a requirement will await future litigation. A similar gap does not exist with respect to prebankruptcy counseling, which leads to an anomalous result, namely, that all debtors have a new entry requirement (regardless of chapter choice) but only certain debtors have the new exit requirement (those in chapters 7 and 13). While there are recent data suggesting that debtors are not a homogenous group, there does not appear to be any justification for treating who should be subjected to these two requirements differently based on chapter choice. There are no data to suggest that individuals in chapter 11 and 12 are, as a group, less in need of financial management courses. To be sure, there are likely to be debtors whose reasons for seeking bankruptcy relief are unrelated to their financial acumen, and hence they are less likely to benefit from a financial management course, particularly one designed to offer increased financial sophistication.

As is true with respect to prebankruptcy counseling, it is legitimate to ask why financial management courses are not required of businesses, at least small businesses. At least some businesses may fail because of inadequate management and that management team might benefit from increased financial acumen. Perhaps the real reason for the absence of parity is that part of the goal was to add an additional hurdle that individual debtors must overcome to partake of the benefits of bankruptcy. The expectation is, one might suspect, that these added hurdles will signal the significance of bankruptcy and perhaps curtail the number of debtors participating, or at least discourage their participation, in the process.

Exceptions

In an earlier version of Pub. L. No. 109-8, financial management education was required of all individual debtors in chapters 7 and 13, unless there were not enough adequate approved courses. ⁿ³ However, when the Senate considered S. 256 in 2005, a change was made. Sections 727(a)(11) and 1328(g)(2) now provide that debtors who qualify for an exception from prebankruptcy counseling under section 109(h)(4) are also entitled to be relieved from postfiling financial management education requirement. ⁿ⁴ Section 109(h)(4) specifically provides that a court can eliminate the prefiling counseling requirements because of the "incapacity, disability, or active military duty in a military combat zone" of the debtor. ⁿ⁵ Section 109(h)(4) goes on to define incapacity and disability very narrowly. When cross-referenced in sections 727 and 1328, the language with respect to "paragraph 1" (dealing with pre-filing counseling) in section 109(h)(4) will need to be ignored.

"Incapacity" is defined in section 109(h)(4) as being "incapable of realizing or making rational decisions" by reason of mental illness or mental deficiency. Whether such a person can seek bankruptcy relief, without the guidance of a custodian, is a different issue. ⁿ⁶ "Disability" is defined as physical impairment of such a level that the individual cannot participate in person, after reasonable effort, in counseling by telephone or through the Internet. ⁿ⁷ Because financial management education can be delivered through these three means, an individual would have to be extraordinarily impaired to be incapable of even telephone or Internet education. ⁿ⁸ "Reasonable efforts" is not a defined term and case law will need to flesh out its meaning. The final exception relates to those in active military duty--but only if they are a combat zone; this is a very limited exception.

Sections 727(a)(11) and 1328(g)(2) do reflect a change in language from that which appears in section 109(h)(4). Under section 109(h)(4), to get the benefit of the exception, individual debtors need a court order. This suggests that a debtor would need to bring a motion--which would likely require counsel. ⁿ⁹ Sections 727 and 1328 permit the exception if the debtor "is a person described in section 109(h)(4)." The open question, then, is whether it is enough to describe the person seeking an exemption (perhaps in an affidavit or in the plan) or whether a hearing is required. The changed language in sections 727 and 1328 suggests that seeking the exception requires less than what is required in section 109(h)(4) with respect to prebankruptcy counseling.

Providers of Financial Management Courses

Section 111 provides that financial management courses must be approved by the United States trustee (or the bankruptcy administrator) in order for the debtor to be eligible for a discharge. ⁿ¹⁰ Section 111(a)(1) provides that the clerks of court are required to maintain a list of approved courses. This list must be publicly available, although section 111(a)(1) does not clarify the means by which it will be available. One would hope that the list of approved courses will be accessible at the courthouse as well as online and perhaps even via a telephone hotline. ⁿ¹¹ Moreover, if only the course is approved, one would hope there would be information about the provider of the course and the course's content as well--to enable thoughtful comparisons. One would hope also that the public lists would clearly distinguish between prebankruptcy and postfiling offerings since they could be easily confused.

With respect to approval, there is an important distinction between prebankruptcy counseling and debtor education. In the context of prebankruptcy counseling, the nonprofit budget and credit counselors--the agencies that provide the services--must be approved. For instructional courses in financial management education, the courses--as distinguished from the providers--must be approved. To be sure, significant aspects of what is needed to approve a course relates to the qualifications of the providers, as shown in section 111(d).ⁿ¹² However, there is no equivalent to the detailed requirements in section 111(c)(2) with respect to providers of postfiling debtor education. Why this distinction exists is unknown, and while the credit counseling agencies have been subjected to considerable criticism, the absence of providers of postfiling education should still be structured in a manner that is protective of consumers.

Approval Process. The approval process rests in the hands of the United States trustee (or bankruptcy administrator) pursuant to sections 111(a)(2), (b) and (d). The legislation does not clearly indicate who will make the approvals, namely the Executive Office for United States Trustees or the regional offices or some combination thereof (the most likely result).ⁿ¹³ Nor is it clear whether approvals, by whomever made, will be done on a court-by-court basis, a region-by-region basis or a national basis. However, there is a suggestion in section 111(b)(3) that listings will be on a "district" basis since that section speaks to entities not appearing on the initial "district" list.ⁿ¹⁴ This suggests that whoever makes the decisions, those approved will be listed by district, and, although not defined, a district can and should be read to mean "judicial district" as Web site listings for the offices of the United States trustee program are done by region and within the regions by judicial districts based on location. These are relevant questions in that there may be providers of financial management courses who have a broad national reach and it is unclear whether, as a practical matter, they have to get approval from each court or each region or district (which would be cumbersome) or whether there can be some nationwide approval process.ⁿ¹⁵ One can also anticipate a thorny issue if a course is approved by one district or one region but not approved by another.

Section 111(b) identifies three specific steps that must be followed by the United States trustee (or bankruptcy administrator) in the context of the providers of financial management course. These are the same three steps that apply with respect to nonprofit budget and credit agencies.ⁿ¹⁶ First, pursuant to section 111(b)(1), the United States trustee must have thoroughly reviewed the qualifications of the potential provider and can require additional information from said applicants. While some of the specific qualifications are identified in section 111(d), it is unclear what other qualifications might be assessed and what particular information might be solicited. The nature of what will be reviewed is not specified.ⁿ¹⁷ One can assume that the Executive Office for United States Trustees will create some sort of checklist for its regional offices, unless all of the decisions, including initial vetting, are to be made at the national level. Given the paucity of specific requirements, it is hoped that added requirements will be considered in the approval process, including an assessment as to whether for-profit providers of financial literacy education present added risks for consumers, something that is an issue in the content of for-profit credit counseling.ⁿ¹⁸

Second, section 111(b)(2) provides that the United States trustees must have determined that the provisions contained more generally in section 111 have been met. For providers of debtor education, these are the specific requirements set forth in section 111(d). The statutory language says the requirements must be "fully satisfied," suggesting that the identified requirements are mandatory as distinguished from discretionary.

Third, section 111(b)(3) provides, in somewhat awkward language, that if an instructional course does not appear immediately on the initial approved district list, the course shall have provisional approval for a period not to exceed six months. Section 111(b)(4) then provides that this provisional period can be extended for successive one-year periods if the applicable course meets the applicable standards and can meet them in the future. Section 111(b)(4) is clear in terms of the length of approvals; they cannot exceed one year, suggesting that there will be some ongoing evaluation process of the approved courses. The mechanisms for ongoing evaluation have not been determined.

The legislative history to this section suggests that all appointments are probationary and that none can be for a

period in excess of one year. n19 Although the statute itself is not as clear as it should be on this point, all approvals for courses should proceed under section 111(b) and (c), not section 111(a); section 111(a) should apply only to the maintenance of lists, not who gets approved and for what time period. Section 111(b)(3) speaks about instructional courses that did not appear on the approved list required under section 111(a). The language in section 111(b)(3) is hard to decipher and states, in relevant part, that if an agency "did not appear on the approved list for the district under subsection (a) immediately before approval under this section [section 111(b)(3)], approval under this subsection shall be for a probationary period not to exceed six months." Section 111(b)(4) then specifically cross-references section 111(b)(3). This suggests that the term of approval is a probationary six months, following by one year approvals, only for those approved under section 111(b)(3), not those approved initially. This is because the limitation of term (either probationary or one year) does not cross-reference section 111(a)(1), which contains the list of those approved. Thus, there is a seeming gap in terms of the length of term for those who appear on the initial list. If a course is approved initially, the term of that approval should both be probationary and thereafter for a term not to exceed one year. While at first blush, it would appear to make a significant difference if a course appeared on the initial or subsequent lists, that position cannot be supported. The statutory gap is eliminated if all approvals are treated as covered by sections 111(b) and (c).

The most reasonable approach, despite this gap, is to read into the course-approval process a probationary period followed by a one-year approval term; otherwise, courses would be approved in perpetuity, which is inconsistent with at least the intent of the statute. Support for this position is clearly found in sections 727(a)(11) and 1328(g)(3); these two sections explicitly mention terms not to exceed one year and that renewals must be made no less frequently than annually. The one-year approval term should, then, be read into section 111. There is also some ambiguity in terms of how a course gets approved "immediately" as opposed to approved in a probationary manner. The Executive Office for United States Trustees will need to provide some initial approval process, and the criteria in sections 111(b) and (d) will need to be satisfied. One should also assume that initial approvals are probationary under section 111(b)(1), although that is not clear in the statute. How many courses will get approved initially and how many will be approved for a probationary period is unclear. Nor is it clear whether the question of immediate or probationary approval is based on the differing qualities of the courses (and their providers) or timing alone. How providers in the pilot financial management program will be approved and treated is not specified. n20 This gap becomes significant because the pilot program extends for 18 months, and one would want those pilot programs being studied to be approved for an 18-month period. Moreover, since the pilot regions will be educating consumers within the bankruptcy system, they would need to be approved providers, likely listed pursuant to section 111(a); otherwise, the debtors in those pilot programs will be precluded from obtaining a discharge. n21 Clearly, individuals obtaining their education through the pilot should be in no different position than those obtaining the education outside the pilot. One would expect that the existence of the pilot program would be disclosed to participants in the pilot program, although such disclosure is not specifically mandated. n22

Review Process. Section 111(b)(5) provides that within 30 days after final decisions are made under section 111(b)(4), they can be reviewed by an appropriate district court. Appeals can be brought by any interested person, a term not defined in the Code, although the term "party in interest" is defined in section 1109. One could posit several groups that might be particularly interested in appealing a decision on an instructional financial management course: the provider of the course who is denied approval under section 111(b)(4) or a group or a person that believes that an approval under section 111(b)(4) was improvidently granted. It is unclear why approvals or denials under section 111(b)(4) are the only ones referenced in section 111(b)(5). Suppose that someone objected to a course or its provider approved pursuant to section 111(b)(1) and (2) and listed pursuant to section 111(a); does the specificity in section 111(b)(4) preclude an interested party from seeking judicial review under section 111(b)(5)? The authority to review these decisions is housed in the district court; this could be an effort to comply with 28 U.S.C. § 1334, and one needs to consider whether those reviews will be delegated to the bankruptcy court pursuant to 28 U.S.C. § 157, which contemplates a referral from the district court to the bankruptcy court. It is also possible that decisions by the United

States trustee will be considered as administrative decisions and governed by the Administrative Procedure Act instead. It is also not evident how interested parties, other than those participating directly in the process, would know of the decision under section 111(b)(4) in sufficient time to have it reviewed, although this issue may be resolved by internal procedures established by the Office for United States Trustees. One could assume that positive decisions might be made public somehow (perhaps by the name of the approved course appearing on the public list referenced in section 111(a)(1)). It is unclear how parties (other than the one directly affected) would hear about negative decisions. The process would also be facilitated if the names of those seeking approval were disclosed before a decision was made as that would enable both comments during the process by interested parties and a sense of decisions to follow after the process was completed. As noted in the context of prebankruptcy counseling, the question of when and how one can review decisions of the United States trustee is not unique to this situation. n23

Section 111(e) adds that the district court can review the qualifications of nonprofit budget and counseling agencies "currently" approved and request needed documentation; the district court can also remove previously approved agencies. n24 This provision does not extend to instructional financial management courses or their providers. It speaks only to nonprofit counseling agencies. It is unclear why this review and removal right would be eliminated in the context of the postfiling educational requirement. It is true that there was voiced concern over the quality of credit counselors. But that does not justify deletions of these important protections for consumers in the context of instructional course providers. If they are unsatisfactory, they too need to be reviewed and removed. This oddity is further evidenced by the requirement in section 111(f) to notify the court clerk of removal of a previously approved course. That said, section 111(b)(5) permits interested persons to seek review of instructional courses (in addition to nonprofit budget and credit counselors). Nonrenewal under section 111(b)(4) also remains possible, but renewal is different from review and removal specified in section 111(e).

Requirements. Section 111(d) sets forth general criteria that must be met before a budget and credit counselor can be approved. These are far less specific than the mandatory minimum requirements set forth in sections 111(c)(1) and (2) with respect to nonprofit budget and credit counselors. Section 111(d) provides that instructional courses on financial management will be approved only if the course satisfies five minimum requirements. It is worth observing that these minimum requirements appear to apply only to approval under section 111(b)(3), which references approval for those who do not appear on the initial list. Were this literally true, those appointed and listed under section 111(a) and approved pursuant sections (b)(1) and (2) would not be required to satisfy the requirements in section 111(d)(1). Even if seemingly permissible by virtue of the language of the statute, this cannot be what was intended. Moreover, section 111(d)(2) references one-year approvals but does not cross-reference them to sections 111(b)(3) or (b)(4). Sections 727(a)(11) and 1328(g)(3) add further support for one-year approvals. It would appear, then, although the language in section 111 is far from clear, that Congress intended one-year periods for approvals of financial management courses, and the statute should be read accordingly. Probationary approvals should be operative regardless of how approvals are made, followed by one-year terms.

Section 111(d)(1) then identifies five minimum requirements for financial management instruction courses, four of which relate to the provider and one of which relates to the content of the course itself. Since they are minimum requirements, other requirements could be added. In addition, one would have expected that the approvals for instructional financial management courses would be informed by the results of the pilot debtor education program referenced in section 105 of the 2005 Act. n25 However, the pilot program commences after mandatory debtor education is required (with the pilot program commencing 270 days after, and the mandatory education commencing 180 days after enactment). Once the results of the pilot study are released, one would hope that these would inform decisions under section 111(d). Since the pilot runs for 18 months and the evaluation is not due to Congress until 30 days after completion of the pilot initiative, the benefits of this knowledge are a long way off.

Section 111(d)(1)(A) requires, somewhat awkwardly, that the course provide "trained personnel with adequate experience and training in providing effective instruction and services." None of the key terms is defined. n26 The term

"trained personnel" and "adequate experience" are the same as those appearing in section 111(c)(2)(F) involving nonprofit budget and credit counselors. It is not clear what training is required or who will do the training. The statute does not reference a nationwide certification program, such as exists in Canada. However, in order to insure quality debtor education, it is critical that there be quality training. n27 One can imagine a certification program or mandates that personnel attend at least one of certain predetermined programs annually or semiannually in order to be considered trained within the meaning of this section. Although it is possible for providers of instructional courses to do their own training internally, caution should be taken if this is deemed an acceptable approach in that the quality of the education may be inferior to that provided by outside providers or through participation in outside programs. The statutory language does suggest that the personnel must have adequate experience and training. How much experience is needed is unknown. n28 What this does suggest, as it did in the context of approval of nonprofit agencies for counseling, is that new entrants may have a harder time obtaining approval. n29 Whether the mandates mean that everyone providing the courses or counseling must be trained or whether it is sufficient if some staff members have the training (and oversee others) is unclear. Perhaps the most nettlesome term in this section is "effective." It is a word that is repeated in sections 111(d)(1)(C), (d)(1)(D) and (d)(2)(A). The fact that there must be a determination of effectiveness suggests that there will be some empirical measure of outcome; how else would one determine effectiveness? n30 Effectiveness could reference different types of outcomes, ranging from improved skills in budgeting to navigating the bankruptcy process to understanding the world of credit. It is noteworthy that sections 111(d)(2)(A) and (B) address similar issues. Section 111(d)(2)(A) speaks to programming that is effective in helping individuals "to understand personal financial management," and section 111(d)(2)(B) speaks about courses "likely to increase substantially the debtor's understanding of personal financial management." Both of these sections, then, also suggest the need to empirically assess effectiveness. The quality of that empirical assessment remains an important open issue; if the evaluative devices are weak or flawed, the determinations of effectiveness will be equally weak and flawed.

Section 111(d)(1)(C) requires that courses take place at adequate facilities located in convenient locations. This is a two part requirement. The setting must be adequate (the building, the classrooms, the facilities) and the location must be reasonably convenient. How exactly one makes these assessments is unknown. n31 Certainly, adequacy of facilities will need to be measured on a location-by-location basis. The contours of adequate facilities in Manhattan may not be the same as adequate in Bangor, Maine. However, this does hint at the fact that locations in a private home, for example, or in an apartment may not qualify as adequate. Convenience will also be location specific. In regions of the country where there is mass transit, one would suppose that convenience would mean proximate to public transportation. In regions without easy public transit, one would need a location that is easily accessible by car. In rural areas, how close is close enough to qualify as "convenient" is presently unknown. A lack of either facilities or convenience is, and should be, a basis for objecting to a course (and consequently, its provider). There is an important exception carved into section 111(d)(1)(C), namely, that the facilities can include courses by telephone or through the Internet. The phraseology suggests that delivery by telephone or through the Internet must be located at the approved facility. One could also read this to mean that approved facilities will also provide delivery of their educational product by telephone or through the Internet. It would seem odd to require that those providing in-person courses would be the only locations from which Internet or telephone courses could be handled. On the other hand, perhaps this is signaling the possibility that the same providers of in-person instructional courses will also provide alternative delivery systems for the same educational materials. That said, it would seem better to permit a bifurcation and allow there to be telephone and Internet providers that do not perform in-person education, if these non-in-person providers are qualified.

The most striking aspect of section 111(d)(1)(C) is the last five words of the section, which state, "if such instructional course is effective." These words seem to modify the reference to courses delivered by telephone or through the Internet. This means that there appears to be some initial concern about educational delivery systems that are not in person. This suggests that in-person programs, although they too need to be effective under section 111(d)(2), are the norm. This would reflect a difference then between debtor education postfiling and prefiling counseling. It is anticipated that the prefiling counseling could take one of three forms--in person, by telephone or through the Internet--and there does not seem to be a preference expressed statutorily between them. n32 With respect to the instructional financial management courses, in-person seems to be the preferred delivery system. Yet, there is an

alternative reading of this language. Perhaps the five indicated words refer to the course generally--although such a reading is strained--in which event, there is no statutorily expressed preference for one form of the course over another.

Section 111(d)(1)(D), again awkwardly worded, requires that the course--which should be read to mean course provider--will prepare and retain reports that will permit an evaluation of the effectiveness of the financial management course. This means that there will be some sort of ongoing evaluation of the instructional courses. The section goes on to require retention of evidence of satisfaction of the course requirements by "each" individual in attendance. This suggests that course providers will need to demonstrate by some means--perhaps a test or some certificate of completion--that each of the course participants has completed the course requirements. The evidence of this latter requirement must be available for inspection by three identified entities: the Executive Office for United States Trustees, the United States trustee (or bankruptcy administrator) or the chief bankruptcy judge for the district in which the course is operated. The identification of these three parties is unusual. First, the specific reference to the Executive Office is unusual, suggesting that every Code reference to the United States trustee does not reference or mean the Executive Office. Next, although courts are referenced in the Code, there is usually no specific mention of a special role within the Code for the chief judge. Yet, with respect to evaluating whether a course is adequate, these three entities have inspection and evaluation powers. The designation of this triumvirate is interesting in that none of them contain particular expertise in the evaluation of educational programming and hence none is necessarily in a position to provide a determination whether the course provided to debtors is effective--unless the evaluation consists of passage of a certain test (which in and of itself would need to be a quality testing instrument) or evidence of hours of class attendance or some other indicia of satisfaction.

Section 111(d)(1)(E) addresses the question of fees. The lead-in language is, again, awkward, but provides that the financial management course shall only be approved if the fee is reasonable and services are provided without regard to ability to pay. This language is ambiguous and is virtually the same language that appears in section 111(c)(2)(B) with respect to nonprofit credit counselors. n33 Neither of these suggestions provides any guidance with respect to what is reasonable. Nor is there any guidance in terms of whether providing pro bono services must be provided to all who ask for or need same. As with prefiling counseling, there is a question whether providers of postfiling education can "cherry pick" their students to insure that some can and will pay. Failure to permit free services should be a basis for removal from the list of approved providers. That said, if a provider needs to balance its services between those who pay and those who cannot and is providing free services, it is unclear whether that means that the provider must accept additional clients who cannot pay. It is unclear whether there can be any rejection of clients or only a rejection if there are already free services being provided and there is neither the ability nor the space for more clients needing free services. This is an issue that must be addressed. This is not the only provision in the legislation addressing the inability of debtors to pay for services; the addition of *in forma pauperis* filing of chapter 7 cases is another example. n34

Section 111(d)(1)(B) is the only provision addressing the actual content of the financial management course, although the description is vague and lacks some of the already limited specificity that exists with respect to prebankruptcy counseling. n35 This section provides that, to be approved, the course must have "learning materials and teaching methodologies designed to assist debtors in understanding personal financial management." The provision goes on to state that these materials must be consistent with "stated objectives directly related to the goals" of the proffered course. As with the other subsections of section 111(d), this section lacks definiteness. There are no guidelines for determining what learning materials and teaching methodologies will satisfy this standard. Moreover, since it will be the United States trustee making these assessments, one has to wonder upon what basis these determinations will be made. The pedagogical effectiveness of materials and teachers is hard to determine even with trained educators and evaluators. Importantly, too, this section notes that any evaluation of effectiveness must be linked to course goals, and there are no guidelines as to what goals these courses may have. It is possible and indeed likely that different providers of financial management courses will have different course goals in mind, and these differences will affect how the materials are taught. There appears to be no effort, at least in the statute itself, to suggest which goals are more significant or useful than others.

The determination of course goals is critical in terms of teaching and materials. For example, if the goal of a

financial management course in a chapter 13 case is to assist consumers in obtaining plan confirmation by living within their budget, managing without credit and learning to navigate the chapter 13 process, then there will a set of materials designed to achieve these goals. For these goals to be met, the debtor would need to take the course early in the life of the chapter 13 case, despite the fact that there is no requirement as to when an approved course must be taken. On the other hand, if the instructional course goal is to teach chapter 7 debtors to navigate the world of credit upon receipt of their discharge and how to distinguish among prospective lenders, including determining which are predatory, then the course materials will be designed to further these goals. Courses premised on empowering consumers will be different from courses that seek to scare consumers out of spending. Educative models based on financial failure as a symptom of other failures (such as job loss, death, divorce, illness) will differ from those that view nonpayment as evidence of deviant behavior.

One could posit that a goal, whether or not explicit, of some providers could be to get debtors to purchase their products or products of related entities. Such a result should be viewed as problematic. However, there is nothing in section 111(d), unlike section 111(c) with respect to prebankruptcy counselors, that requires that providers of financial management education be nonprofit organizations. n36 Nor does the legislation provide that the course providers must lack a pecuniary interest in the products about which they are teaching. n37 Nor is there a requirement that the providers disclose their relationship to the products about which the debtor is learning. This is another troubling aspect of the absence of these disclosures. An educational offering could serve a dual purpose. The debtors could obtain accurate and useful information from the provider; however, the provider is seeking to establish a trust relationship with the debtor so that postbankruptcy, that debtor will come to that provider (or one of its affiliates) to purchase product. n38 This is not a far-fetched notion. For example, in today's consumer financial markets, many programs are a vehicle for advancing a particular product in the guise of objective education. n39

Another unaddressed aspect of the legislation is the likely bifurcation between the creators of the materials and the teachers of the courses, although these are addressed together in section 111(d)(1)(B). It is probable that there may be many developers of educative materials. Then, individuals will need to be trained to teach these materials to their particular clients, even through the instructors did not develop the materials. Some of the course developers may be expert in adult pedagogy, while others may not. Thus, some may be in a position to train those who use their materials; others will lack this pedagogical orientation. Consider, for example, three developers of educational materials: a lending institution, an educational institution and a nonprofit organization. All three can develop materials addressing financial management. It is unclear which of the three will have expertise in training others to teach the materials, for the training encompasses not just the substantive materials but the pedagogy as well (which may not be within the expertise of the lender for example). There is a growing recognition that teaching about money and finance is more complex than it first appears. This is because money means more to most individuals than dollars and cents; it is a nuanced concept imbued with meaning based on gender, race, ethnicity, religion, family background and culture. n40

Removal. Section 111(f) provides that the United States trustee (or a bankruptcy administrator) is required to notify the court clerk if a previously approved instructional course is no longer approved. That course then needs to be removed from the list of approved providers maintained pursuant to section 111(a). This is the same provision that exists with respect to prebankruptcy budget and credit counseling agencies. n41

There seems to be one primary avenue pursuant to which removal could occur, namely, if the term of a formerly approved agency is not renewed pursuant to sections 111(d)(2)(A) and (B). Under these provisions, the term of course approval is one year, provided, however, that renewal is only continued if three conditions are met: (1) the course satisfied the requirements of section 111(d)(1); (2) the course has been effective in assisting a "substantial" number of debtors; and (3) the course is "otherwise likely to increase substantially the debtor's understanding of personal financial management." The latter two requirements seem to require empirical assessment. Section 111(d)(2)(A) suggests that helping some debtors is not enough; approved courses must help a substantial number of debtors. This requirement does not identify what "substantial" means. Suppose that the educational provider educated only 30 individuals. It is unclear if this is "substantial." This requirement and the requirement in section 111(d)(2)(B) suggest some sort of comparative

analysis between where debtors were before the educational offering and where they are postcourse. How else would one determine an increase in understanding personal finance and ascertain effectiveness? This suggests that pre- and post-course testing will need to be done. The development of effective test measures requires careful planning, and many course providers are not experienced empiricists or test designers. If the measurement devices are poorly designed, then the results are not useful. For example, many programs present attendees with postcourse evaluations (often termed "smile" sheets) in which participants answer questions about whether they liked the course and whether they think it helped them. These types of evaluations are problematic in that they are not a true measure of learning; they are a measure of how students perceive the course at completion. Better measures might be pre and post-tests, some of which would be administered months or even years after the courses were provided. This depth of empirical assessment would be expensive and difficult for most providers to administer. Because of the differences among courses, no single nationwide test should be required, particularly given the differences among debtors, regional practices and language barriers. So, one has to speculate that the mandates might not require rigorous and replicable testing. Instead, the results will be measured less scientifically, although how determinations of effectiveness and improvement as a result of the course will be made is unknown. Since renewal hinges on showing both effectiveness and increased understanding, some guidance will be needed. If a provider's course is not effective, that is a basis for denial of renewal and hence, there is a sense in which rigorous empirical assessment matters.

With respect to prebankruptcy counseling, removal is also possible under section 111(e); n42 however, that section does not extend to providers of financial management courses. There is no reason to justify the omission of instructional courses from this investigation and removal process.

Timing of Financial Management Courses

General Rule. Section 111 does not specify when the instructional financial management course must be provided. Obviously, it must occur after a petition is filed and before a discharge is sought in a chapter 7 or a chapter 13 case. In a chapter 7 case, the window for obtaining the course is small, given that the time period between filing and obtaining a discharge can range from three to nine months. In a chapter 13 case, the educational program could occur early or late in the case. For example, it could occur shortly after filing, in which event a course related to how the plan process works and how to satisfy plan requirements over the life of the plan (which could range from three to five years depending on the case) would be useful. On the other hand, the course could occur shortly before plan completion, in which event a course geared to how to re-enter the credit marketplace as a thoughtful participant would be particularly useful. Such a course would be given to far fewer debtors because most debtors do not complete their plans. Given the existing failure rate in chapter 13 cases, the education may not even be received by those chapter 13 debtors whose plans fail before completion. There is nothing in the legislation that addresses these issues. This is another instance in which there are differences between how prebankruptcy counseling and postfiling financial management education will operate. n43

Exceptions. Sections 727(a)(11) and 1328(g)(2) specifically provide that if there are not adequate available courses, debtors are not required to complete a course as a condition of discharge. n44 For these purposes, "adequacy" references the numeric availability of courses, not their substantive adequacy. That will be determined pursuant to section 111(d). The adequacy of availability is not a permanent determination. Section 717(a)(11) specifically provides that the determination must be revisited within the year in which it was made and annually thereafter. Section 1328(g)(3) contains the same language. One could posit that within the lifetime of a debtor's chapter 13 plan, there could be a change in the availability of eligible courses. For example, it is possible that early in the life of the 2005 Act, courses will not be available but that in year four of a five-year plan, such courses would become available. This suggests that debtors' lawyers will need to remain vigilant; otherwise, debtors would have relied on the absence of a course at the inception of their plan only to learn that such a course has become available. One reading of the language in sections 727(a)(11) and 1328(g)(3) is that if the status of course availability changes during the life of a case, the

debtor's exception will not last and the debtor must take a course if it becomes available. The monitoring aspects of this are significant.

Consequences of Failure to Obtain Mandated Financial Management Courses; Denial of Discharge

If an individual debtor does not fulfill the requirement of participating in a financial management course, then that debtor can be denied a discharge in a chapter 7 or chapter 13 case. Other than the previously enumerated exceptions in sections 109(h), 111(d)(2), 727(a)(11) and 1328(g), there are no other bases upon which a debtor can be excepted from the requirements, unless section 105 is invoked. n45

Costs and Fees

Costs of Course. As previously observed, section 111(d)(1)(E) states that, to be approved, financial management courses must be offered at a reasonable fee. n46 However, there are no guidelines presently in place for what constitutes "reasonable." Since courses can be offered in person, by telephone or through the Internet, one would expect that the fees would be different depending on how the course was delivered. In-person courses would seem likely to be the most expensive. Section 109(h) provides the prebankruptcy counseling can be conducted one-on-one or in group sessions; there is no similar provision with respect to financial management courses. n47 However, the language in section 111(d) speaks to debtors in the collective in section 111(d)(1)(B), although there are references to "debtor" in the singular in section 111(d)(1)(D). The term "instructional course" suggests more than one participant in a class. This suggests that postfiling financial management courses would usually be in a group if they are in person, although that is not a requirement. However, telephonic and Internet courses would usually be one-on-one, although one can imagine an online chat room with multiple debtors or a telephone call where more than one debtor is conferenced in. Moreover, one might expect that there could be different types of approved courses, and the fees might depend on the nature, length and provider of that counseling. n48 For example, a short Internet course might be less expensive than an intensive full-day financial management session. In Canada, which has mandatory financial management education in addition to counseling, individual sessions are more expensive than group sessions. n49

Fees raise a serious concern about a race to the bottom. With more than two million individuals needing financial management instructional courses, providing these educational offerings will be a growth industry. However, it is likely that there will be considerable effort among providers to provide relatively cheap courses to increase their clientele. Providers with perhaps higher quality products and thus somewhat higher (but still reasonable) fees may be driven from the market, a problematic outcome. Moreover, it is also possible that providers of financial management education will provide a short and inexpensive course that satisfies the requirements of the 2005 Act and then offer attending debtors the opportunity to sign up for longer and more expensive courses. To the extent that providers use the longer course for the more useful information and the shorter class as a type of "loss leader," the result is problematic. Another troubling possibility is for providers to offer consumers a package of courses for a bulk course rate, with the first course being the only requirement of the new law. Like other bundled services outside the bankruptcy arena, consumers could often end up purchasing things that they do not need. By way of analogy, with the advent of free credit reports, credit reporting agencies are now offering that "free" report with other services, including monitoring and credit scoring. It is easy for consumers who simply wanted the free credit report to find that they have purchased other unneeded or undesired products. This bundling problem is more likely to occur in the context of postfiling financial management education than prebankruptcy counseling, although a bundling of the pre and postfiling products is possible. n50 In part, this is because the prebankruptcy counseling session may be brief, although one could offer limited services that satisfy the statutory requirements and more complex counseling for additional monies, thereby circumventing the requirement of a

"reasonable" fee.

It is also possible that fees will be different in different parts of the country. Courses in cities may be more expensive given higher overhead costs. One can also foresee added costs if the course is needed immediately or if it is needed in a language other than English. Whether these added fees would be "reasonable" is certainly open to question.

An unaddressed issue is whether the fees in the pilot instructional program created by section 105 will be different from the fees in the mandated program. Typically, individuals who agree to be "subjects" of study are required to pay less, and perhaps nothing, for the provided services. This is a common approach. Sometimes, subjects are paid to participate. n51 Thus, it would be important for the United States trustees to consider a different and smaller payment requirement, or no payment at all, in the pilot project. n52 The Congressional Budget Office suggested a fee per debtor in the pilot program of \$40.00, to paid by the government. n53 Whether this is a reasonable fee for debtors outside the pilot program should be considered. Exactly how the \$40.00 number was derived is unclear. At present, the mandate appears to be unfunded.

Fee Waivers. As noted previously, section 111(d)(1)(E) states that approved courses must be provided without regard to ability to pay. What is unclear is how many nonpaying clients a provider must take, or which clients should be paying for this counseling. For example, course providers could not survive, unless grant supported or supported by outside contributions, if all of their clients were nonpaying. That said, it is unclear as to how determinations will be made as to who should be paying for their counseling.

Section 111(d)(1)(E) recognizes the possibility of approved courses without any fees at all to the individual. For example, legal aid offices, if they are permitted to offer financial management courses, could provide them to their clients without charge. Typically, such clients will fit within prescribed income guidelines. There may be others willing to provide counseling without charge; however, the requirements for approval may discourage some pro bono educational efforts.

Referral Fees. An unaddressed issue in the statute is whether approved course providers can pay fees to lawyers for referring clients to them. n54 For example, one can imagine contractual or informal relationships between approved for-profit course providers and lawyers pursuant to which all of a lawyer's clients are directed to a particular entity in exchange for a fee paid by that entity to the lawyer.

Tying Arrangements. Section 111 does not explicitly address whether there can be a relationship between approved courses, nonprofit budget and credit counselors and lawyers of a law firm. n55 While the statute does make clear that no one on the board of approved credit counseling agencies can benefit economically, there is nothing to preclude benefits where there are no board members. n56 This would permit lawyers and counselors to have arrangements where each serviced the clients of the other. There are no restrictions expressed with respect to the relationship among course providers and either or both approved credit counselors and attorneys. While there might be no referral fees among these entities, there would be expectations that the clients of each would service the other's clients. From the perspective of the consumer, this would affect--if they were aware of this--their choice of counselor, lawyer or course. If the client were first to visit the counselor, then the counselor would arguably be required to make disclosure of the fact that all its clients in need of bankruptcy assistance are referred to a single firm or lawyer. There would also seem to be an obligation to disclose a relationship with a course provider, whether or not monies changed hands. Such a disclosure requirement would be found in section 111(c)(2)(D). It seems that the entity with the most possibility of effectuating these relationships is the credit counselor since that entity sees the debtor first. That may be why the disclosure requirements only appear with respect to credit counselors. However, there could be separate relationships between lawyers and course providers and if that relationship were economic, there is nothing to prohibit that and no mandated disclosure. If a course were developed and taught by an entity that could benefit from the debtor as a long-standing

customer (perhaps a bank providing the education and then seeking to have this student as a prospective customer), that fact is worth disclosing. To be sure, section 111(d)(1) provides that the listed requirements reflect the minimum needed for approval, and this type of contact might require additional information at the behest of the United States trustee. It is also unclear whether disclosures, even if made, would affect consumer decision-making. n57

Credit Reporting Prohibition

As previously noted, section 111(g)(1) provides that budget and credit counseling agencies are prohibited from reporting that individuals sought or received personal financial management instruction. n58 If counseling itself is viewed as "financial management instruction," then the prohibition makes sense. But, the language used is unclear in that it could also be referencing the postfiling financial management courses. What some prebankruptcy counselors provide might not, then, be characterized as financial management instruction. It is the choice of the word "instruction" that is problematic. It is clear that the postfiling financial management courses would fit within the term "instruction." However, it would be ironic if those could not be reported to credit reporting agencies since these courses can actually work to a consumer's benefit. Indeed, at least one of the newer credit reporting agencies is noting completion of financial management courses in its database and using the information to create consumer achievement scores. n59 Thus, the prohibition with respect to postfiling courses is, it seems, the inverse of what it should be. That said, unless the credit counselor is tied into the course provider, it is unclear how the counselor would become aware of the postfiling course--unless the financial management course intended to be referenced in section 111(g)(1) is one that was obtained before the bankruptcy filing.

Compliance with Applicable State Laws

There do not appear to be specific state laws that govern financial management courses, and in this way, financial management courses differ from the extensive state regulation of budget and credit counselors. n60 Still, there are some states that require licensing of those providing education, and some states require evidence of qualification to do business within the state if one is offering courses. Some states prohibit the issuance of degrees or other formal certification without appropriate licensing. One would expect that nothing in the 2005 Act ameliorates the obligation to satisfy these legal requirements. n61

Provider Noncompliance

There is no counterpart to section 111(g)(2) for financial management course providers who act willfully or negligently. Although the presence of that section is somewhat helpful to individuals harmed by credit counselors, there is no reason why this benefit should not be extended to recipients of educational programming. The critical question is whether the absence of a provision should be intended to preclude a debtor from pursuing a cause of action. There is no reason to deny a debtor access to the judicial system in the event that a course provider fails to comply with the requirements of the Code. Moreover, with respect to both course providers and credit counselors, there is no reason to believe that the presence or absence of section 111(g) eliminates any other cause of action unrelated to the requirements under title 11. So, for example, if a credit counselor or course provider failed to comply with state law or breached some other obligation to its clients, those causes of action would remain.

Implementation

As with prebankruptcy counseling, there are enormous issues with respect to implementing mandatory nationwide

postfiling debtor education. Each step of the process--from the providers to the content of the programming to the removal of unsatisfactory providers--is complex. Moreover, in addition to the initial steps, there will need to be thoughtful ongoing monitoring of this entire aspect of the bankruptcy system. Courts will also need to be apprised of the details of this program since they will have to address at least some of these issues, especially the specifically mentioned chief judges. n62 There will need to be opportunities for the participants in the system to provide their input as well.

Empirical Assessment--Pilot Financial Management Program

Although there is an absence of explicit empirical assessment with respect to prebankruptcy counseling, there are several significant empirical aspects in place with respect to the postfiling financial management education, some of which have already been addressed. n63 The most significant of these is the pilot financial management program that will be conducted under the auspices of the Executive Office for United States Trustees. n64 The Congressional Budget Office estimates that 90,000 consumers would participate in this project if it were administered by the Executive Office for United States Trustees. n65

This pilot program is to commence no later than 270 days after the new legislation was signed into law, meaning that the pilot program commences after the mandated program under section 111 is commenced (180 days after signing). This pilot initiative is based on a detailed report that appears as Appendix G-3.a. to the National Bankruptcy Review Commission Report, and the pilot should be guided by that report. n66 First, the pilot program will use six beta sites, selected by the Executive Office, and it is anticipated that these sites will be diverse because there is a likelihood that different programs may work better in certain locations.

There are several specific requirements placed upon the Executive Office for United States Trustees with respect to this project. First, they must consult with a wide range of debtor education experts who operate financial literacy programs. One would assume, then, that the Executive Office would look in particular at programs designed for consumers in the bankruptcy system. Some of these programs have already been the subject of articles and some have been empirically assessed. Programs that fit within this category include those offered by the Coalition for Consumer Bankruptcy Debtor Education, located in New York City, which trained more than 600 consumer debtors over an 18-month period and then studied whether the program changed debtor knowledge, attitudes and behavior with respect to money and spending. n67 Certain chapter 13 trustees have operated programs for many years, and some of these have been studied. n68 Certain financial institutions have created programming as well. There are other educational programs, but these have not been directed at consumers within the bankruptcy system; an assessment of them is not within the mandate, although consideration of them might prove useful. Second, the Executive Office is charged with developing a financial management training curriculum and materials. Third, the Executive Office must evaluate the effectiveness of pilots and consider other programs that are operational. The House Report specifically directs the Executive Office to look at programs sponsored by the credit industry, chapter 13 trustees and consumer counseling. Indeed, the House Report specifically directs the Executive Office to the work of the National Bankruptcy Review Commission on this topic. n69 Fourth, the Executive Office must submit its finding to Congress within three months after the evaluation is completed (and that is expected to run for 18 months coterminous with the pilot study). That report will detail the findings and specifically address the effectiveness and costs of the curricula, materials and programs.

The Congressional Budget Office has estimated the costs of the pilot project to be \$4 million. n70 In reaching this figure, the Budget Office estimated a cost of \$40 per debtor; one has to wonder whether this should be the guidepost for determining the reasonableness of the fee for financial management education. Compared to the estimated cost of the pilot contain in Appendix G-3.a. of the Report of the National Bankruptcy Review Commission, the per-debtor cost is similar, depending on which of the models for the pilot is employed. n71 All costs for the pilot project should be borne by the Executive Office for United States Trustees and participating debtors should have no-cost or low-cost financial

management instruction while the programs are being studied.

For a complete discussion of Code section 111, see Collier on Bankruptcy, ch. 111 (Matthew Bender).

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Return to Text

n1 1. See "Exceptons" *infra*.

n2

2. See "Exceptions" *infra*.

n3 3. See "Timing of Financial Management Courses" *infra*.

n4

4. See Collier on Bankruptcy, 111.02[2] (Matthew Bender).

n5

5. See Collier on Bankruptcy, ch. 109 (Matthew Bender).

n6

6. *Federal Rule of Bankruptcy Procedure 1004.1* cannot be ignored. It addresses the need for a guardian, representative or other similar person to petition for those individuals who are incompetent. See Collier on Bankruptcy, ch. 1004.1 (Matthew Bender).. The educational mandate surely would not extend to those designated to file for the incompetent person.

n7

7. Section 111(d)(1)(C) provides that can be done in person, by telephone or through the Internet, and

individually or in groups. *See* "Requirements" *infra*.

n8

8. There does seem to be a sense that most financial management education will be in person, rather than by telephone or through the Internet. *See* "Requirements" *infra*. If that is the case, then there will be more individuals who can claim an exemption as it is harder to access a physical facility outside the home than a telephone or the Internet.

n9

9. *See Collier on Bankruptcy*, 111.02[2] (Matthew Bender).

n10

10. On October 7, 2005, the Executive Office for United States Trustees announced approval of 41 providers of courses in personal financial management. According to the press release, available at <http://www.usdoj.gov/ust/>, "[t]here are approved debtor education course providers serving all federal judicial districts for which the United States Trustee Program is responsible."

n11

11. A list of course providers can be found on the United States Trustee Program's Web site, <http://www.usdoj.gov/ust/>, and will be updated as more providers are approved.

n12

12. *See* "Requirements" *infra*.

n13

13. The specific reference to the Executive Office for United States Trustees in section 111(d)(1)(D) does suggest that when the Executive Office is not mentioned, the specific reference to the United States trustee is the regional offices and the trustees within those offices. Of course, it is possible that the specificity of the reference in section 111(d)(1)(D) was not meant to signal that the Executive Office would not be in charge of or responsible for other decisions under section 111. *See* "Requirements" *infra*.

n14

14. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

n15

15. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

n16

16. *See Collier on Bankruptcy, 111.03*[1] (Matthew Bender). The nonprofit credit organizations are termed "agencies" and those who provide the instructional financial management courses are termed "providers."

n17

17. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01* note 2 (Matthew Bender).

n18

18. *See Collier on Bankruptcy, 111.03* (Matthew Bender). It is worth observing that for-profit credit counselors cannot be approved under section 111.

n19

19. *See Rep. No. 109-31*, 109th Cong., 1st Sess. (2005).

n20

20. *See "Empirical Assessment Pilot Financial Management Program" infra.*

n21

21. See "Who Must Obtain Financial Management Instruction" *infra*.

n22

22. See "Requirements" and "Tying Arrangements" *infra*.

n23

23. See *Collier on Bankruptcy*, 111.03[2] (Matthew Bender).

n24

24. See *id*.

n25

25. See "Empirical Assessment Pilot Financial Management Program" *infra*.

n26

26. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n27

27. See note 26 *supra*.

n28

28. See note 26 *supra*.

n29

29. See *Collier on Bankruptcy*, 111.03[4] (Matthew Bender).

n30

30. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n31

31. See note 30 *supra*.

n32

32. See *Collier on Bankruptcy*, ch. 109 and 111.04 (Matthew Bender).

n33

33. See *Collier on Bankruptcy*, 111.07[1] (Matthew Bender).

n34

34. See 28 U.S.C. § 1930(f).

n35

35. See *Collier on Bankruptcy*, 111.04 (Matthew Bender)l

n36

36. See "Providers of Financial Management Courses" *infra*.

n37

37. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n38

38. See note 37 *supra*.

n39

39. On military bases, for example, there have been efforts to address insurance needs and the providers of the information are insurance salesmen, often former military officers. This practice has been roundly criticized.

n40

40. See, e.g., Karen Gross, *Learning Money's Language*, University Bus., Mar. 2005, and available at www.universitybusiness.com/page.cfm?p=749; see also Karen Gross, Joanne Ingham & Richard Matasar, *Strong Palliative But Not a Panacea: Results of an Experiment Teaching Students About Financial Literacy*, NASFAA J. (forthcoming 2005).

n41

41. See *Collier on Bankruptcy*, 111.03[5] (Matthew Bender).

n42

42. See *Collier on Bankruptcy*, 111.03[5] (Matthew Bender).

n43

43. See *Collier on Bankruptcy*, 111.05 (Matthew Bender).

n44

44. On October 7, 2005, the Executive Office for United States Trustees announced a temporary waiver of the requirement for an instructional course in personal financial management for bankruptcy filers in areas affected by Hurricane Katrina. According to the press release announcing the waiver, available at <http://www.usdoj.gov/ust/>:

The [2005 Act] permits United States Trustees to waive the debtor education requirement within a judicial district where approved debtor education courses are not adequate to serve bankruptcy filers. The United States Trustee for Region 5 made this determination with respect to the Eastern, Middle, and Western Districts of Louisiana, and the Southern District of Mississippi.

n45

45. *See Collier on Bankruptcy*, 111.03[5] (Matthew Bender).

n46

46. *See* "Requirements" *supra*.

n47

47. *See Collier on Bankruptcy*, 111.04 (Matthew Bender) and "Requirements" *supra*.

n48

48. The Forms promulgated by the Executive Office hint at a suggestion that courses be at least two hours in length. *See Collier on Bankruptcy*, 111.01 note 2 (Matthew Bender).

n49

49. *See Collier on Bankruptcy*, 111.04 (Matthew Bender) and "Requirements" *supra*.

n50

50. *See Collier on Bankruptcy*, 111.07[4] (Matthew Bender).

n51

51. The Coalition for Consumer Bankruptcy Debtor Education paid those who participated in its pilot study. See Susan Block-Lieb, Karen Gross, Richard Wiener & Corinne Donovan, *The Coalition for Consumer Bankruptcy Debtor Education: An Overview of Its Pilot Project*, 21 *Emory Bankr. Dev. J.* 233 (2004).

n52

52. See "Empirical Assessment Pilot Financial Management Program" *infra*.

n53

53. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 38 (2005).

n54

54. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01 note 2 (Matthew Bender).

n55

55. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01 note 2 (Matthew Bender).

n56

56. See *Collier on Bankruptcy*, 111.03[4] (Matthew Bender).

n57

57. See *Collier on Bankruptcy*, 111.03[4] (Matthew Bender).

n58

58. See *Collier on Bankruptcy*, 111.08 (Matthew Bender).

n59

59. For an example of a credit reporting agency that does consider financial management programs, see PayRent Build Credit's Achiever's 100+ score which takes into account consumer completion of approved courses. See <http://prbc.com/partners/achievers.php?>.

n60

60. See *Collier on Bankruptcy*, 111.03[4] (Matthew Bender).

n61

61. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n62

62. See "Requirements" *supra*.

n63

63. See "Providers of Financial Management Courses" *supra*.

n64

64. This pilot program was created by the section 105 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005).

n65

65. Rep. No. 109-31, 109th Cong., 1st Sess. 38 (2005).

n66

66. See *Collier on Bankruptcy*, 111.01 note 9 (Matthew Bender). The applicable appendix bears number G-3.a. and is available at <http://govinfo.library.unt.edu/nbrc/report/g3a.pdf>.

n67

67. See *Collier on Bankruptcy*, 111.01 note 9 (Matthew Bender).

n68

68. Two appendices to the National Bankruptcy Review Commission Report address chapter 13 trustee programs, namely Appendices G-3.b. and G-3.c., available at <http://govinfo.library.unt.edu/nbrc/report/g3a.pdf>. The success of some of these programs has been challenged. See *Collier on Bankruptcy*, 111.01, note 9 (Matthew Bender).

n69

69. Rep. No. 109-31, 109th Cong., 1st Sess. 54 (2005).

N70

70. Rep. No. 109-31, 109th Cong., 1st Sess. 38 (2005).

n71

71. For a useful and detailed discussion of the costs of a pilot initiative, see Appendix G-3 of the Report of the National Bankruptcy Review Commission, available at <http://govinfo.library.unt.edu/nbrc/report/g3a.pdf>.

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170 of 197 DOCUMENTS

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Collier on Time Limitations under the Bankruptcy Code

2008 Emerging Issues 961

Collier on Time Limitations under the Bankruptcy Code

By Collier

November 16, 2007

SUMMARY: Periods of limitation for causes of action arising under the Code are separately governed by sections 546(a), 549(d) and 550(e). This Emerging Issues Analysis addresses issues pertaining to Section 108, including the time limitation on a suit by the trustee, the extension of time for doing certain acts, the extension of the statute of limitations for the creditor, and the relation of Section 108 to Federal Rule of Bankruptcy Procedure 9006.

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ARTICLE: Time Limitation on Suit by Trustee--11 U.S.C. § 108(a)

Sections 108(a) and (b) operate to extend time periods for actions that could have been taken by the debtor prepetition that may then be taken on behalf of the estate by the trustee. n1 Section 108 makes clear that it refers to suits continued by the trustee, in the place of the debtor, in addition to those suits which are initiated postpetition. It is important to note, however, that periods of limitation for causes of action arising under the Code are separately governed by sections 546(a), 549(d) and 550(e). n2

Extension of Nonbankruptcy Statutes of Limitation. Subsection (a) of section 108 extends any statute of limitation for commencing an action by the debtor for two years after the date of the order for relief, unless it would expire later. In contrast, subsection (b) gives the trustee 60 days to take over actions not covered under subsection (a), such as filing a pleading, demand, notice or proof of claim or loss (such as an insurance claim), unless the period for doing the relevant act expires later than 60 days after the date of the order for relief. n3 Hence, section 108 clearly allows for the commencement or continuation of an action beyond two years from the order for relief if applicable nonbankruptcy law fixes a time period which extends beyond that two year limitation. This aspect of section 108(a) incorporates any rule regarding tolling of statutes of limitation that would govern under applicable non-bankruptcy law. n4

Because the language of section 108(a) refers to an "action," the Court of Appeals for the Fifth Circuit has held that it does not apply to an administrative refund application to the Internal Revenue Service. n5 The court held that the ordinary meaning of the term "action" envisioned litigation in a court rather than an administrative claim. The opinion

suggested that the refund application might have been encompassed in the categories listed in section 108(b), but did not decide the issue because the application was not filed within the time limits of section 108(b). n6 Similarly, the term "action" does not encompass an appeal in litigation that is already pending. As the Court of Appeals for the Eleventh Circuit held in *Roberts v. Commissioner of Internal Revenue*, n7 the filing of an appeal does not constitute the "commencement of an action." The court found that the filing of an appeal by a debtor in possession fits within section 108(b).

The same principles were applied by the Court of Appeals for the Fifth Circuit in deciding whether a debtor could proceed under the Federal Tort Claims Act. n8 That statute requires a claimant, prior to filing suit, to present an administrative claim to the appropriate federal agency within two years of when the claim accrues. n9 In *Ramming v. United States*, n10 the court held that the filing of an administrative claim is not the "commencement of an action" because it is not a lawsuit brought in a court. Instead, the court held that it is governed by section 108(b), which extends the time allowed to 60 days after the order for relief.

The language of section 108(a) referring to the date of the order for relief eliminates some confusion that had arisen under the Bankruptcy Act in cases in which an adjudication occurred on a later date than the original bankruptcy filing. n11 When a case is converted from one chapter to another, section 348(a) provides that the conversion does not change the date of the order for relief for purposes of section 108.

The key phrase is "applicable non-bankruptcy law," n12 which apparently replaces the necessity for the varying results created by the wording of former Bankruptcy Act Section 11e. The Code provision cannot operate to shorten the period of time available to the trustee to commence or continue an action, or file a pleading or other similar act. The wording of section 108 allows the trustee "the later of" two periods, one being the end of the period prescribed by applicable non-bankruptcy law, and the other a specific extension granted by this section. Section 108 was amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984 n13 to substitute the word "or" for the word "and" at the end of each of subsection (a)(1), (b)(1) and (c)(1). This amendment has the effect of emphasizing that the actions specified may be taken at the end of either period, whichever is later.

Order for Relief Is Operative Date. Section 108 provides that the period for bringing suit is two years after the date of the order for relief n14 in bankruptcy, unless applicable non-bankruptcy law allows for a longer period. The date of closing the estate has no significance in this regard; hence a suit by the trustee ordinarily could not be instituted after two years have elapsed since the order for relief, irrespective of the later reopening of the estate. n15 Only when an applicable state or federal non-bankruptcy statute of limitations, an order entered in a non-bankruptcy proceeding, or an agreement fixing a period, as per subsection (a) of section 108 is of longer duration than the two years specified, could such a suit be maintained, and then only within the time remaining under such other governing time period.

Parties Who May Take Advantage of Extension. Although section 108 refers only to the trustee, it also extends time periods for a chapter 11 or chapter 12 debtor in possession, since a debtor in possession has all the rights and powers of a trustee serving under those chapters. n16 For similar reasons, section 108 should be applicable to a chapter 13 debtor, who is entitled to remain in possession of all property of the estate and thus retains the right to any cause of action which would otherwise pass to a trustee. n17 However, the benefits of subsections (a) and (b), which refer to the trustee, do not pass to a debtor in a case under chapter 7, or under chapter 11 or 12 when a trustee has been appointed and the debtor is no longer a debtor in possession. n18 Once property has reverted in a chapter 11 debtor upon confirmation of a plan, the benefit of the extension may also be lost unless the plan provides that the particular causes of action involved remain property of the estate subject to administration in the bankruptcy court. n19 Similarly, subsections (a) and (b) may not be invoked by a creditor who is not authorized to bring an action on behalf of the bankruptcy estate. n20 Nor may those subsections normally be utilized by an assignee of the debtor. n21

Extension Not Applicable to Causes of Action Arising after Order for Relief. Finally, section 108(a) applies only to causes of action which the debtor possesses on the date of the order for relief and not to those which arise or are acquired by the trustee thereafter. n22 In *Independent Fire Insurance Co. v. Pender (In re Phillip)*, n23 the Court of

Appeals for the Fifth Circuit held that "at least in the ordinary case," section 108(a) had no applicability to a claim of the estate that had arisen after the order for relief in a chapter 11 case, even though the case had been converted to chapter 7 and the claim had been brought within one year of the conversion. The court held that, under section 348(a), the conversion did not change the date of the order for relief, so that even if the claim had arisen prior to the order for relief, the time period permitted by section 108(a) had expired. n24

Extension of Time for Doing Certain Acts--11 U.S.C. § 108(b)

Section 108(b) is designed to apply when there is a time limit set for the doing of certain acts, such as the filing of pleadings or claims, and when such period has not expired before the date of the filing of the petition in bankruptcy. n25 The last sentence of Section 11e of the former Bankruptcy Act formed the basis for subsection (b). It was the thought, under the Act, that an extension of time should be given the trustee (or receiver) in such cases, as in cases affected by a state or federal statute of limitation, so that the trustee could take the necessary steps to preserve for the estate rights which might otherwise be barred. n26 The Code continues this rationale through section 108(b), under which the trustee is given 60 days to take other actions not covered under subsection (a), such as filing a pleading, demand notice, or proof of claim or loss (such as an insurance claim) unless the period for doing the relevant act expires later than 60 days after the date of the order for relief. n27 Like section 108(a), section 108(b) has been held to apply only to deadlines that existed at the time the petition was filed. n28

Types of Acts to Which Extension Is Applicable. An insurance policy, for example, may require proof of loss within 60 days and, if the claim is rejected, that action be brought within six months thereafter. In such a case, if the time for filing proof of loss has not expired before the filing of the petition, the trustee, under the terms of section 108(b), may make proof of loss within 60 days subsequent to the order for relief even though the contract period expired immediately after the bankruptcy petition was filed. n29 Similarly, section 108(b) would extend a contractual deadline for the exercise of an option to renew a lease. n30 If a debtor has a right to cure a default on an insurance contract, with the insurance to remain in effect during the period in which the debtor may cure, that period may be extended for 60 days under section 108(b). n31

In *Autoskill v. National Educational Support Systems*, n32 the Court of Appeals for the Tenth Circuit held that, in an appeal which was not stayed by section 362(a), section 108(b) afforded an extension of time for filing a notice of appeal from a district court and that, to the extent that *Federal Rule of Appellate Procedure 4(a)(1)* was inconsistent with section 108(b), the statute prevailed because it was enacted after promulgation of the rule. n33 The Court of Appeals for the Second Circuit agreed with this reasoning and result in *Local Union No. 38 v. Custom Air Systems, Inc.* n34 Both courts also agreed that a chapter 11 debtor in possession could take advantage of the provision because the debtor in possession has the powers of a trustee. n35

Several courts have held that administrative claims, even those which must precede a lawsuit, are governed by section 108(b), rather than section 108(a). Thus, the Court of Appeals for the Fifth Circuit held in *Ramming v. United States* n36 that an administrative claim under the Federal Tort Claims Act n37 is not the commencement of an action. Likewise, the same court held that an administrative tax refund application is governed by section 108(b). n38

In *Noonan v. Secretary of HHS (In re Ludlow Hospital Society, Inc.)*, n39 the Court of Appeals for the First Circuit held that a Medicare regulatory deadline for the sale of capital assets also fell within the ambit of section 108(b). The court found that the pertinent inquiry in construing section 108(b) for purposes of the case was whether the undertaking in question involved "the exercise of a right, or the performance of a duty, prescribed by non-bankruptcy law in the prepetition environment encountered by the debtor, failing which any related prepetition legal right would be forfeit." n40 The court also held that a bankruptcy court was not empowered by Code section 105(a) to grant an extension of time longer than that which section 108(b) specifically permitted. n41

Section 108(b) specifies that the trustee shall have the benefit of the longer period whenever the limitation fixed by contract or in a non-bankruptcy proceeding is longer in duration than the period prescribed in subsection (b).

Section 108(b) Not Applicable to Time Periods for Stayed Litigation Against Debtor or Codebtor. It is important to note that section 108(b) does not apply to time periods in actions against the debtor, or against a codebtor protected by the codebtor stay of section 1201 or 1301 of the Code. Such actions are stayed by section 362, 922, 1201 or 1301 and may proceed only when the stay under the applicable section terminates. n42 At that point, the time available is governed by section 108(c), which provides at least 30 days to take action when an act or proceeding had been stayed. n43 Thus, when the debtor has a deadline for filing an appeal prior to bankruptcy, if the action was originally brought against the debtor, the trustee need not meet the 60 day time limit of section 108(b) since the action would have been stayed by section 362. n44 There is no need to file pleadings or other briefs in a proceeding which has been stayed; section 108(c) will be applicable if the stay terminates. n45 However, section 108(b) would probably be applicable to time periods for the trustee to act in proceedings against the debtor that are not automatically stayed, such as police or regulatory enforcement actions, n46 since section 108(c) is intended to deal only with those actions which are stayed as a result of the bankruptcy filing.

Relationship to Other Code Sections Providing for Powers of Debtor and Trustee. The courts have not agreed upon how the provisions of section 108(b) relate to other Code sections that give debtors or trustees specific powers, such as the power to cure defaults and the power to assume or reject executory contracts.

Several courts of appeals have held that, when a mortgage foreclosure sale has taken place and the debtor has a statutory time period in which to redeem the property, section 108(b) is the sole section of the Bankruptcy Code governing the debtor's rights in the property, extending the redemption period for a maximum of 60 days. n47 These courts have held that if the debtor's rights would have become divested by the mere passage of time and no further necessary step in the sale process was automatically stayed by section 362, then the specific language of section 108(b) left no room for the debtor to extend further the redemption period through a plan curing the mortgage default or otherwise modifying the creditor's rights. n48

This conclusion, which undermines the effect of other provisions of the Code designed to help debtors save their homes and farms, is far from self evident. While section 108(b) might well govern the right of a trustee to redeem in such a situation, there is no reason to conclude automatically that it overrides other provisions of the Code which allow debtors' plans to cure defaults or modify creditors' rights. n49 Other courts have held that section 108(b) does not eliminate these protections. n50

Especially when the automatic stay prevents further action required to complete the sale and the debtor's right to redeem extends until that action is taken, section 108(b) should not constitute a bar to the exercise of other powers granted to debtors and trustees in title 11 cases. Even the leading case holding that redemption rights are governed by section 108(b) implied that its result might be different if any additional act were necessary to complete the foreclosure sale. n51 In such cases section 108(c) may be applicable rather than section 108(b), at least if a court action is involved.

Extension of Statute of Limitations for Creditor--11 U.S.C. § 108(c)

Section 108(c) extends time periods for commencing or continuing civil actions that are stayed by section 362, 922, 1201 or 1301 of the Code. n52 It provides that if an action on a claim against the debtor in a court other than a bankruptcy court is stayed due to the bankruptcy case, any time deadline for commencing and continuing the action is extended to 30 days after notice of termination of the stay, if the deadline would have occurred on an earlier date. n53 The termination of the stay may occur due to a grant of relief from the stay, closing of the case, dismissal of the case, the granting or denial of the debtor's discharge or the fact that the property involved is no longer property of the estate. n54 The statute contains an exception that incorporates the prohibition in section 524 against actions to collect discharged debts as personal liabilities of the debtor. n55

Scope of Section 108(c). Section 108(c), derived from Section 11f of the former Bankruptcy Act, is broader than former Section 11f in that it applies to the commencement *or continuation* of actions. However, section 108(c) is narrower in scope than section 108(b). It applies only to civil actions in courts on claims against the debtor, or against codebtors protected by the codebtor stay. n56 Courts have generally held that it does apply to time periods within which a creditor must bring an action to enforce a lien before the lien expires. n57 It also applies to the time period to renew a judgment to maintain its enforceability. n58 But it does not appear to apply to other types of acts against the debtor or codebtor that do not involve litigation, such as the filing of documents other than in court proceedings. n59 In many such cases, the party seeking to act must seek relief from the automatic stay to act before its time period expires. This problem was ameliorated to a large degree for certain types of actions by the Bankruptcy Reform Act of 1994, n60 which amended section 362(b)(3) to provide that the automatic stay does not prevent an act to maintain or continue the perfection of an interest in property to the extent that the trustee's rights and powers are subject to such continued perfection under section 546(b). n61 Section 546(b) was in turn amended by the same legislation to provide that the trustee's rights are subject to applicable law that provides for maintenance or continuation of an interest in property to be effective against an entity that acquires rights in the property before action is taken to effect that maintenance or continuation. n62 If, due to the exception in section 362(b)(3), a party is not stayed from perfecting its lien, section 108(c) is inapplicable. n63

Like section 108(b), section 108(c) does not apply to actions brought by the trustee based upon powers granted by the Code. n64 Nor does it apply to actions against codebtors which are not automatically stayed. n65

Amount of Time Permitted for Further Action. Section 108(c) permits the commencement or continuation of an action until the later of two periods. The first is the end of a time period fixed by applicable non-bankruptcy law, an order entered in a non-bankruptcy proceeding or an agreement. Such time period expressly includes any suspension of such period occurring on or after the commencement of the case.' Such a suspension may result from either state or federal law. The legislative history discusses one important example that is applicable in certain tax cases: For example, *section 6503(b) of the Internal Revenue Code* suspends collection of tax liabilities while the debtor's assets are in the control or custody of a court, and for six months thereafter. By adopting the language of the Senate amendment, the House amendment insures not only that the period for collection of the taxes outside bankruptcy will not expire during the title 11 proceedings, but also that such period will not expire until at least six months thereafter, which is the minimum suspension period provided by the Internal Revenue Code. n66

Other examples are suspensions of a statute of limitations during periods when a party is a minor or incompetent. In some jurisdictions state law may dictate suspension of a statute of limitations when a bankruptcy or another court proceeding has stayed the initiation of an action. Such suspensions would presumably be included within the terms of section 108(c), adding the entire duration of the automatic stay to the applicable time period. n67

However, absent such a provision in applicable non-bankruptcy law, a statute of limitations or other deadline for an action against a debtor which would have expired while an automatic stay was applicable is extended by only the second period set forth in section 108(c), 30 days after notice of the termination or expiration of the automatic stay barring the action. n68 It is important to note that this extension continues not simply until 30 days after the termination of the stay, but until 30 days after *notice* of that termination. When a party has no such notice, the 30 days never begin to run. n69 Occasionally, the stay will halt litigation in which there is a series of impending deadlines. At least one court has held that, in this situation, only the act required by the first deadline is due to be performed within 30 days, and subsequent acts are to be performed thereafter according to the sequence and timing provided by non-bankruptcy law. n70

Applicability to Time Periods under Sections 507(a)(8) and 523(a)(1). Prior to 2002, there was considerable confusion in the courts regarding whether section 108(c) has any applicability to the time periods in section 507(a)(8) n71 or section 523(a)(1) n72 for determining priority and dischargeability of certain prepetition tax debts in subsequent bankruptcy cases. n73 As the Court of Appeals for the Fifth Circuit held in *Quenzer v. United States (In re Quenzer)*, n74 the plain language of section 108(c) refers only to periods for commencing or continuing a civil action, and only to

periods set by non-bankruptcy law, non-bankruptcy orders or agreements. Thus, that court held that section 108(c) did not provide for any tolling of the time limits in section 507(a)(7) (currently designated as section 507(a)(8)). n75 The Court of Appeals for the Eleventh Circuit similarly found that the plain language of the statute does not support tolling of the time limits in section 507(a)(8), but held that the court can use its equitable powers under section 105 to "toll" those time limits where there is a showing that the circumstances of the case warrant such an extension. n76 Other courts held that the time period was automatically tolled under section 108(c), not only during the pendency of the automatic stay in a prior bankruptcy case but also for six additional months, finding that section 108(c) incorporated *Internal Revenue Code section 6503*. n77

The Supreme Court resolved this issue in *Young v. United States*. n78 The Court held that it did not have to decide whether section 108(c) tolled the time periods in sections 507(a)(8) and 523(a)(1) because those time periods were equitably tolled during the period that the Internal Revenue Service was precluded from collecting its debt by the automatic stay in a prior bankruptcy case filed by the debtors. Although the Court concluded that "the lookback period of 11 U.S.C. § 507(a)(8)(A)(i) is tolled during the pendency of a prior bankruptcy petition," n79 the Court also stated that "the IRS was disabled from protecting its claim during the pendency of the Chapter 13 petition, and this period of disability tolled the three-year lookback period " n80 Thus, the reasoning of the decision suggested that the lookback period would be tolled only for the period during which the automatic stay prevented the taxing agency's collection actions if that period were shorter than the duration of the previous case.

A slightly different resolution, with respect to issues under section 507(a)(8) at least, is brought about by amendments to section 507(a)(8) made in 2005. n81 Section 507(a)(8)(A)(ii)(II) was added to provide that the 240-day period therein is extended by the amount of time during which a stay of proceedings against collections was in effect in a prior case during that period, plus 90 days. In addition, language was added at the end of section 523(a)(8) stating that any time period stated in the paragraph is suspended during any period in which a stay of proceedings was in effect in a prior case or during which collection was precluded by the existence of a confirmed plan under title 11, plus 90 days. Neither of these changes affect the time periods in section 523(a)(1), except to the extent that section 523(a)(1) incorporates section 507(a)(8).

Relation to Federal Rule of Bankruptcy Procedure 9006

Federal Rule of Bankruptcy Procedure 9006(a) governs the methods of computing periods of time for acts to be done and proceedings to be had in cases under title 11 of the United States Code. n82 In situations in which section 108 is pertinent to setting a time period for some action in a bankruptcy case or a proceeding in a bankruptcy case, Rule 9006(a) is thus applicable. Rule 9006(b) gives the court discretion to authorize extensions of time for certain acts required or allowed under or pursuant to court order. n83 Thus, this portion of the rule could be applicable only to extensions of time under section 108 involving court orders, and it is not entirely clear that the rule even applies to orders other than those in bankruptcy cases or proceedings. Subdivision (b)(1) states that the court may for cause shown at any time in its discretion: (a) with or without motion or notice order the period enlarged if the request therefore is made before the expiration of the period originally prescribed or as extended by a previous order; or (b) on motion made after the expiration of the specified period permit the act to be done where the failure to act was the result of excusable neglect. However, the rule excludes in the interests of prompt administration of bankruptcy cases' n84 certain time periods that may not be extended. Subdivision (b)(2) lists the rules in which the time periods that are established cannot be extended:

- . Rule 1007(d) time for filing a list of 20 largest creditors;
- . Rule 2003(a)--meeting of creditors not more than 40 days after order for relief;
- . Rule 2003(d)--10 days for filing a motion for resolution of an election dispute;
- . Rule 7052(b)--10-day period to move to amend findings of fact;

. Rule 9023--10-day period to move for a new trial; and

. Rule 9024--time to move for relief from judgment. n85

Subdivision (b)(3) of Rule 9006 further limits the availability of an extension of time for:

. the time for paying the filing fee in installments under Rule 1006(b)(2);

. the time limits for a motion to dismiss a chapter 7 case for substantial abuse under Rule 1017(e); n86

. the 90-day period for filing a claim in a chapter 7 or 13 case pursuant to Rule 3002(c);

. the 30-day period under Rule 4003(b) for filing an objection to a claim exemption; n87

. the 60-day periods to object to a discharge under Rule 4004(a) and to file a dischargeability complaint under Rule 4007(c);

. the 10-day period for filing a notice of appeal under Rule 8002; n88 and

. the time to file objections to proposed findings of fact and conclusions of law under Rule 9033. n89

Unless a rule with a specific authorization to extend time is listed in Rule 9006(b)(3), an extension of time may be granted under Rule 9006(b)(1).

For a complete discussion of Code section 108, see Collier on Bankruptcy, ch 108 (Matthew Bender).

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Return to Text

n1 Under Section 11e of the Bankruptcy Act of 1898, this extension was also applicable to a receiver. However, since section 105(b) of the Code expressly prohibits a court from appointing a receiver in a case under title 11, section 108 now refers to trustees only.

n2 11 U.S.C. §§ 546(a), 549(d), 550(e); see *In re Dry Wall Supply, Inc.*, 11 B.R. 933 (D. Colo. 1990); *In re Topcor, Inc.*, 132 B.R. 119 (Bankr. N.D. Tex. 1991); *Collier on Bankruptcy*, 546.02, 549.03[4] and 550.03[3] (Matthew Bender); see also *Wolf v. Degner*, 243 Neb. 702, 502 N.W.2d 440 (1993) (not mentioning section 546(a) but holding that section 108(a) did not extend time for trustee's fraudulent conveyance action on behalf of creditors). But see *Belford v. Martin-Trigona (In re Martin-Trigona)*, 763 F.2d 503 (2d Cir. 1985) (trustee's suit to avoid fraudulent conveyance by debtor held timely due to application of section 108(c)).

n3 *Spears Carpet Mills v. Century Nat'l Bank*, 85 B.R. 86 (W.D. Ark. 1988); *In re Carter*, 125 B.R. 832 (Bankr. D. Kan. 1991); H.R. Rep. No. 595, 95th Cong., 1st Sess. 318 (1977).

n4 *Ambrose Branch Coal Co., Inc. v. Tankersley*, 106 B.R. 462 (W.D. Va. 1989).

n5 *TLI, Inc. v. United States*, 100 F.3d 424 (5th Cir. 1996). But see *CGE Shattuck LLC v. Town of Jaffrey, N.H. (In re CGE Shattuck LLC)*, 272 B.R. 514 (Bankr. D.N.H. 2001) (appeal from refusal of property tax abatement was commencement of action because standard of review was de novo and new evidence could be presented).

n6 *TLI, Inc. v. United States*, 100 F.3d 424, 427 n.2 (5th Cir. 1996).

n7 175 F.3d 889 (11th Cir. 1999).

n8 28 U.S.C. § 2401.

n9 28 U.S.C. § 2401(b).

n10 281 F.3d 158 (5th Cir. 2001).

n11 See, e.g., *Kamerman & Kamerman v. Seligson (In re Ira Haupt & Co.)*, 390 F.2d 251 (2d Cir. 1968); *Estate of B.J. McAdams, Inc. v. Sugar Foods Corp.*, 171 B.R. 12 (S.D.N.Y. 1994); see also *Rothenberg v. Ralph D. Kaiser Co. (In re Rothenberg)*, 173 B.R. 4 (Bankr. D.D.C. 1994) (section 108(a)(2) inapplicable to involuntary case in which order for relief never entered).

n12 The word "nonbankruptcy" was added to subsections 108(a), (b) and (c) by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353.

n13 Pub. L. No. 98-353 (1984).

n14 "Order for relief" means entry of an order for relief as defined in 11 U.S.C. § 102(6). See *T.C.I., Ltd. v. Sears Bank & Trust Co. (In re T.C.I., Ltd.)*, 6 C.B.C.2d 1316, 21 B.R. 876 (Bankr. N.D. Ill. 1982); *M & M Cattle Co. v. Reliable Drywall, Inc. (In re Reliable Drywall, Inc.)*, 6 C.B.C.2d 1257, 20 B.R. 386 (Bankr. D. Ariz. 1982).

n15 *Fed. R. Bankr. P. 5010* governs the reopening of cases in conjunction with section 350 of the Code. See *Collier on Bankruptcy*, ch. 350 and ch. 5010 (Matthew Bender).

n16 *Martinson v. First Nat'l Bank of Oakes (In re Martinson)*, 731 F.2d 543 (8th Cir. 1984); *DiSalvo v. DiSalvo (In re DiSalvo)*, 224 B.R. 763 (B.A.P. 9th Cir. 1998), reversed on other grounds, 219 F.3d 1035 (2000); *Flying S' Land & Cattle Co., Inc. v. Beaumont (In re Flying S' Land & Cattle Co., Inc.)*, 71 B.R. 183 (Bankr. D. Nev. 1987); see 11 U.S.C. §§ 1107(a), 1203; *Collier on Bankruptcy*, 1107.02, 1203.011 (Matthew Bender); see also *Rudin v. Tax Comm'n of New York City (In re Olympia & York Maiden Lane Co.), LLC*, 233 B.R. 662 (Bankr. S.D.N.Y. 1999) (state court receiver whose appointment to manage property of the debtor was continued by order of bankruptcy court could invoke section 108(a) to extend time for challenging tax assessment).

n17 11 U.S.C. § 1306(b); *Gaskins v. Metropolitan Home Imp. Ctr., Inc. (In re Gaskins)*, 98 B.R. 328 (Bankr. E.D. Tenn. 1989); see *Thomas v. GMAC Residential Funding Corp.*, 52 C.B.C.2d 865, 309 B.R. 453 (D. Md. 2004) (chapter 13 debtor given benefit of extension under section 108(b) to give notice of rescission under Truth in Lending Act); see *Collier on Bankruptcy*, 1306.01 (Matthew Bender).

n18 See *Rousseau v. Diemer*, 24 F. Supp. 2d 137 (D. Mass. 1998) (permitting trustee to be substituted as plaintiff to take advantage of tolling provision in action brought by chapter 7 debtor); *Craig v. Barclays Am. Fin., Inc. (In re Craig)*, 7 B.R. 864 (Bankr. E.D. Tenn. 1980); *Tingley v. Harrison*, 125 Idaho 86, 867 P.2d 960 (1994) (trustee could not, after deadline had passed, ratify suit brought in debtor's name within deadline).

n19 *National Env't'l Waste Corp. v. Stephens, Berg & Lasaster (In re National Env't'l Waste Corp.)*, 200 F.3d 1266, 43 C.B.C.2d 796 (9th Cir. 2000) (statute of limitations extended under section 108(a) where chapter 11 plan reserved right to enforce claims, even though specific claim was not identified in plan); *United States for Use of Am. Bank v. C.I.T. Construction, Inc.*, 944 F.2d 253 (5th Cir. 1991) (*dictum*); *Cunningham v. Healthco, Inc.*, 824 F.2d 1448 (5th Cir. 1987); *Natco Indus. Inc. v. Fed. Ins. Co.*, 69 B.R. 418 (S.D.N.Y. 1987); *Solar Constr. Co., Inc. v. Department of Gen. Servs.*, 105 Pa. Commw. 609, 525 A.2d 28 (Pa. Commw. Ct. 1987).

n20 *United States for Use of Am. Bank v. C.I.T. Constr., Inc.*, 944 F.2d 253 (5th Cir. 1991).

n21 *Motor Carrier Audit & Collection Co. v. Lighting Products, Inc.*, 113 B.R. 424 (N.D. Ill. 1989). *But cf. Coliseum Cartage Co. v. Rubbermaid Statesville*, 975 F.2d 1022 (4th Cir.1992) (when debtor in possession and assignee of cause of action obtained *ex parte* court approval of amended agreement under which debtor in possession retained an interest in the cause of action, debtor could be joined in action and section 108(a) could be invoked).

n22 *Northern Specialty Sales, Inc. v. INTV Corp. (In re Northern Specialty Sales, Inc.)*, 14 C.B.C.2d 439, 57 B.R. 557 (Bankr. D. Or. 1986); *Waldschmidt v. Edgcomb Metals (In re Ward)*, 11 C.B.C.2d 569, 42 B.R. 946 (Bankr. M.D. Tenn. 1984).

n23 948 F.2d 985 (5th Cir. 1991).

n24 948 F.2d 985, 987. *Accord Huennekens v. Nicoll (In re Southern Int'l Co., Inc.)*, 29 C.B.C.2d 1230, 159 B.R. 192 (Bankr. E.D. Va. 1993); *Baltensperger v. Wellensiek*, 250 Neb. 938, 554 N.W.2d 137 (1996).

n25 A reference to section 1201 was added to section 108(b) by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554 (1986).

n26 See Statement of David Teitelbaum, representing the Bankruptcy Committee of the New York City Bar Association, in House Hearings on H.R. 6439, 75th Cong., 1st Sess., 33-35 (1937).

n27 H.R. Rep. No. 595, 95th Cong., 1st Sess. 318 (1977); see, e.g., *Henry v. Department of Transp.*, 255 Ga. 467, 339 S.E.2d 715 (1986); *Di Maggio v. Blache*, 466 So. 2d 489 (La. App. 1985).

n28 *Dougherty v. IRS (In re Dougherty)*, 187 B.R. 883 (Bankr. E.D. Pa. 1995).

n29 *Federal Ins. Co. v. Sheldon*, 150 B.R. 314 (S.D.N.Y. 1993); see also *Weiner v. Sprint Mortgage Bankers Corp.*, 235 A.D.2d 472, 652 N.Y.S.2d 629 (A.D. 1997) (time for reporting unauthorized endorsement to bank subject to extension under § 108(b)).

n30 *In re Future Growth Enter., Inc.*, 14 C.B.C.2d 1410, 61 B.R. 469 (Bankr. E.D. Pa. 1986); *In re Dulan*, 13 C.B.C.2d 737, 52 B.R. 739 (Bankr. C.D. Cal. 1985). However, some courts have held that the provisions of section 108(b) do not apply to the exercise of options of various types because they are not acts "similar" to those enumerated in that section. Compare *In re P.I.N.E., Inc.*, 52 B.R. 463 (Bankr. W.D. Mich. 1985) (relying on *Good Hope Refineries v. Benavides*, 602 F.2d 998 (1st Cir.)), cert. denied, 444 U.S. 992, 100 S. Ct. 523, 62 L. Ed. 2d 421 (1979), which reached a similar holding under Section 11e of the 1898 Act, with *Santa Fe Dev. and Mortgage Corp. v. McCormack* (*In re Santa Fe Dev. and Mortgage Corp.*), 5 C.B.C.2d 1186, 16 B.R. 165 (Bankr. 9th Cir. 1981) (section 108(b) should be broadly construed to best serve the purpose of the debtor's rehabilitation).

n31 *Kirtley v. Sovereign Life Ins. Co. (In re Durability, Inc.)*, 212 F.3d 551, 44 C.B.C.2d 25 (10th Cir. 2000); *Counties Contracting & Constr. Co. v. Constitution Life Ins. Co.*, 855 F.2d 1054 (3d Cir. 1988); *Sentry Insurance v. John J. Sullivan, Inc. (In re John J. Sullivan, Inc.)*, 128 B.R. 7 (D. Mass. 1991).

n32 994 F.2d 1476 (10th Cir.), cert. denied, 510 U.S. 916, 114 S. Ct. 307, 126 L. Ed. 2d 254 (1993). Accord *Production Credit Ass'n of Minot v. Burk*, 427 N.W.2d 108 (N.D. 1988).

n33 See also *Roberts v. Commissioner of Internal Revenue*, 175 F.3d 889 (11th Cir. 1999) (debtor in possession's time to appeal from tax court governed by section 108(b); *In re Howard Indus., Inc.*, 170 B.R. 358 (Bankr. S.D. Ohio 1994) (section 108(b) applicable to claim for tax refund).

n34 333 F.3d 345 (2d Cir. 2003).

n35 333 F.3d 345, 347-48 (citing *Autoskill, Inc. v. National Educ. Support Sys.*, 994 F.2d 1476, 1484 n.4 (10th Cir. 1993)).

n36 281 F.3d 158 (5th Cir. 2001).

n37 28 U.S.C. § 2401(b).

n38 *TLI, Inc. v. United States*, 100 F.3d 424 (5th Cir. 1996). *Accord In re Howard Indus., Inc.*, 170 B.R. 358 (Bankr. S.D. Ohio 1994).

n39 124 F.3d 22 (1st Cir. 1997).

n40 124 F.3d 22, 29; *see also Thomas v. GMAC Residential Funding Corp.*, 52 C.B.C.2d 865, 309 B.R. 453 (D. Md. 2004) (chapter 13 debtor given benefit of extension under section 108(b) to give notice of rescission under Truth in Lending Act).

n41 124 F.3d 22, 27.

n42 11 U.S.C. §§ 362, 922, 1201 and 1301; *see Collier on Bankruptcy*, ch. 362, ch. 922, ch. 1201 and ch. 1301 (Matthew Bender). Section 362 was extensively amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n43 11 U.S.C. § 108(c); *see* "Extension of Statute of Limitations for Creditor; § 108(e)" *infra*. *But see Production Credit Ass'n of Minot v. Burk*, 427 N.W.2d 108 (N.D. 1988) (erroneously holding that debtors were required by section 108(b) to file appeal in state court foreclosure action against them within 60 days of order for relief).

n44 *See, e.g., Cathey v. Johns-Manville Sales Corp.*, 711 F.2d 60, 8 C.B.C.2d 1179 (6th Cir. 1983); *Association of St. Croix Condo. Owners v. St. Croix Hotel Corp.*, 682 F.2d 446, 7 C.B.C.2d 137 (3d Cir. 1982).

n45 *Bunch v. Hoffinger Indus. (In re Hoffinger Indus.)*, 329 F.3d 948, 952 (8th Cir. 2003) (citing *Treatise*).

n46 11 U.S.C. § 362(b)(4), as amended by the Omnibus Consolidated Emergency Supplemental

Appropriations Act, 1999, Pub. L. No. 105-277 (1998); *see* (Collier on Bankruptcy, 362.05[5] (Matthew Bender). *But see* *EEOC v. Guerdon Indus.*, 76 B.R. 102 (W.D. Ky. 1987).

n47 *Canney v. Merchants Bank (In re Canney)*, 284 F.3d 362, 47 C.B.C.2d 1508 (2d Cir. 2002); *In re Roach*, 824 F.2d 1370, 17 C.B.C.2d 493 (3d Cir. 1987); *Goldberg v. Tynan (In re Tynan)*, 773 F.2d 177, 13 C.B.C.2d 655 (7th Cir. 1985); *Johnson v. First Nat'l Bank of Montevideo*, 719 F.2d 270, 9 C.B.C.2d 579 (8th Cir. 1983), *cert. denied*, 465 U.S. 1012, 104 S. Ct. 1015, 79 L. Ed. 2d 245 (1984). However, the *Roach* decision was overruled by amendments made to section 1322 by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994 and effective with respect to cases filed on or after that date). To the extent that a sale is not finalized until a redemption period expires, some of the other cases cited in this note may also have been overruled. *See* *Collier on Bankruptcy*, 1322.09[6] (Matthew Bender).

n48 *See* cases cited in preceding note. Some courts adopting this reasoning have, however, found that either the bankruptcy court, by specific order, or the parties themselves could extend the time for redemption. *See In re G-N Partners*, 48 B.R. 462 (Bankr. D. Minn. 1985); *Federal Land Bank of Omaha v. Bollin*, 408 N.W.2d 56 (Iowa 1987).

n49 *See In re Pellegrino*, 284 B.R. 326 (Bankr. D. Conn. 2002) (*Canney*, note 20 *supra*, not applicable in chapter 13 case due to operation of chapter 13 cure provisions); *see* *Collier on Bankruptcy*, 1322.09[6] (Matthew Bender). Interestingly, the Court of Appeals for the Seventh Circuit held that the cure provisions in section 365 did override section 108(b) in *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 11 C.B.C.2d 1 (7th Cir.), *cert denied*, 469 U.S. 982, 105 S. Ct. 386, 83 L. Ed. 2d 321 (1984), a holding seemingly contrary to its holding in *Goldberg v. Tynan (In re Tynan)* 773 F.2d 177, 13 C.B.C.2d 655 (7th Cir. 1985). Besides *Moody*, several courts have held that section 108(b) does not limit a debtor's rights under section 365 with respect to leases and executory contracts. *See, e.g., Coleman Oil Co. v. Circle K Corp. (In re Circle K Corp.)*, 127 F.3d 904, 909 n.4 (9th Cir. 1997), *cert. denied*, 522 U.S. 1148, 118 S. Ct. 1166, 140 L. Ed. 2d 176 (1998); *Econo-Therm Energy Sys. Corp. v. Prudential Ins. Co. (In re Econo-Therm Energy Systems Corp.)*, 80 B.R. 137 (Bankr. D. Minn. 1987); *In re Round Hill Travel, Inc.*, 52 B.R. 807 (Bankr. D. Nev. 1985). *But see* *Counties Contracting & Constr. v. Constitution Life Ins. Co.*, 855 F.2d 1054 (3d Cir. 1988) (once 60-day extension of insurance policy grace period expired, insurance contract was no longer in existence and could not be assumed because it had expired according to its terms); *see also Hamblen v. Fed. Sav. & Loan Ins. Corp. (In re Thomas J. Grosso Inv. Co., Inc.)*, 457 F.2d 168 (9th Cir. 1972).

n50 *In re Chambers*, 27 B.R. 687 (Bankr. S.D. Fla. 1983); *Sapphire Inv. v. Stewart Title & Trust (In re Sapphire Inv.)*, 6 C.B.C.2d 639, 19 B.R. 492 (Bankr. D. Ariz. 1982); *see also Maanum v. Rieffer (In re Maanum)*, 838 F.2d 991 (8th Cir. 1988) (Heaney, J., dissenting); *Justice v. Valley Nat'l Bank*, 849 F.2d 1078, 1088, 19 C.B.C.2d 172, 183 (8th Cir. 1988) (Heaney, J., dissenting).

n51 *Johnson v. First Nat'l Bank of Montevideo*, 719 F.2d 270, 277, 9 C.B.C.2d 579, 586 (8th Cir. 1983), cert. denied, 465 U.S. 1012, 104 S. Ct. 1015, 79 L. Ed. 2d 245 (1984); see also 11 U.S.C. § 1322(c)(1), enacted by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to cases filed on or after October 22, 1994), providing that a chapter 13 debtor can cure a mortgage default until the property "is sold," which implies completion of all steps in a sale.

n52 11 U.S.C. §§ 362, 922, 1201 and 1301; see Collier on Bankruptcy, ch. 362, ch. 922, ch. 1201 and ch. 1301 (Matthew Bender). Section 362 was extensively amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n53 11 U.S.C. § 108, as amended by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554 (1986).

n54 11 U.S.C. § 362(c) and (d), as both subsections were amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, 362.06, 362.07 (Matthew Bender).

n55 11 U.S.C. § 524(a), as amended by a technical amendment in Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 524 (Matthew Bender).

n56 See *Roberts v. Commissioner of Internal Revenue*, 175 F.3d 889 (11th Cir. 1999) (tax court proceeding for redetermination of deficiencies assessed against debtor was not an action against the debtor); *New Pentax Film, Inc. v. Trans World Airlines*, 936 F. Supp. 142 (S.D.N.Y. 1996) (section 108(a) applies to statute of limitations for claims under Warsaw Convention).

n57 *Valley Transit Mix of Ruidoso, Inc. v. Miller*, 928 F.2d 354 (10th Cir. 1991); *Miner Corp. v. Hunter's Run Ltd. P'ship (In re Hunter's Run Ltd. P'ship)*, 875 F.2d 1425, 21 C.B.C.2d 491 (9th Cir. 1989); *Morton v. Nat'l Bank of New York City (In re Morton)*, 866 F.2d 561, 20 C.B.C.2d 465 (2d Cir. 1989); *City of Bridgeport v. Debek*, 210 Conn. 175, 554 A.2d 728 (1989). But see *Hazen First State Bank v. Speight*, 888 F.2d 574 (8th Cir. 1988) (section 108(c) did not apply to time period set by agreement during which creditor had to bring lawsuit to preserve priority of its lien).

n58 *Spirtos v. Moreno (In re Spirtos)*, 221 F.3d 1079 (9th Cir. 2000); *Wessinger v. Raab (In re Greenberg)*, 288 B.R. 612 (Bankr. S.D. Ga. 2002).

n59 *Maiona v. Vassilowitch (In re Vassilowitch)*, 72 B.R. 803 (Bankr. D. Mass. 1987); *RDR Sys. Development, Inc. v. Guaranty Bank & Trust Co. (In re RDR Sys. Dev., Inc.)*, 57 B.R. 540 (Bankr. M.D. La. 1986). But see *Bond Enterprises, Inc. v. Western Bank of Farmington (In re Bond Enterprises, Inc.)*, 54 B.R. 366 (Bankr. D.N.M. 1985) (time for filing continuation statement to preserve security interest extended by section 108(c)).

n60 Pub. L. No. 103-394 (enacted on October 22, 1994 and effective with respect to cases filed on or after that date).

n61 11 U.S.C. § 546(b); see *Collier on Bankruptcy*, 546.03 (Matthew Bender).

n62 11 U.S.C. § 546(b); see *Collier on Bankruptcy*, 546.03 (Matthew Bender).

n63 *Premier Inv. Group v. Premier Hotel Dev. Group (In re Premier Hotel Dev. Group)*, 47 C.B.C.2d 573, 270 B.R. 234 (Bankr. E.D. Tenn 2001); see also *In re Durango Ga. Paper Co.*, 297 B.R. 316 (Bankr. S.D. Ga. 2003) (when required act served to create lien, rather than perfect or maintain lien it was stayed and therefore within ambit of section 108(c)).

n64 See *McCoy v. Grinnell (In re Radcliffe's Warehouse Sales, Inc.)*, 9 C.B.C.2d 628, 31 B.R. 827 (Bankr. W.D. Wash. 1983); see also "Time Limitation on Suit by Trustee; § 108(a)" *supra*. But see *Belford v. Martin-Trigona (In re Martin-Trigona)*, 763 F.2d 503 (2d Cir. 1985).

n65 *Cockerham v. Armstrong World Indus.*, 717 F. Supp. 433 (M.D. La. 1989); *Cardinal Fed. Sav. & Loan Ass'n. v. Flugum*, 10 Ohio App. 3d 243, 461 N.E.2d 932 (1983).

n66 124 Cong. Rec. H11,109 (daily ed., Sept. 28, 1978); S17,426 (daily ed., Oct. 6, 1978); see also *Brickley v. IRS (In re Brickley)*, 70 B.R. 113 (B.A.P. 9th Cir. 1986).

n67 See, e.g., *Smith v. Lachter (In re Smith)*, 293 B.R. 220 (B.A.P. 9th Cir. 2003) (if state law tolls time to renew judgment, longer period permitted by state law would apply); *Panzella v. Hills Stores Co.*, 171 B.R. 22 (E.D. Pa. 1994); *Schumacher v. Worcester*, 55 Cal. App. 4th 376, 64 Cal. Rptr. 2d 1 (1997); *First Nat'l Bank of Lancaster County v. Brewer*, 301 Pa. Super. 104, 447 A.2d 263 (1982).

n68 *Husman v. TWA*, 169 F.3d 1151 (8th Cir. 1999); *Simon v. Navon*, 116 F.3d 1, 38 C.B.C.2d 38 (1st Cir. 1997); *Rogers v. Corrosion Products, Inc.*, 42 F.3d 292 (5th Cir.), cert denied, 515 U.S. 1160, 115 S. Ct. 2614, 132 L. Ed. 2d 857 (1995); *Aslanidis v. U.S. Lines*, 7 F.3d 1067 (2d Cir. 1993); *Grotting v. Hudson Shipbuilders, Inc.*, 85 B.R. 568 (Bankr. W.D. Wash. 1988); *Hazel v. Van Beek*, 135 Wash. 2d 45, 954 P.2d 1301 (1998); *Thurman v. Tafoya*, 895 P.2d 1050 (Colo. 1995); *Raikes v. Langford*, 701 S.W.2d 142 (Ky. App. 1986); *Howard v. Howard*, 670 S.W.2d 737 (Tex. App. 1984). But see *Garbe Iron Works, Inc. v. Priester*, 75 Ill. 2d 84, 75 Ill. Dec. 428, 457 N.E.2d 422 (1983) (interpreting section 108(c) to provide for extension of statute of limitations by time period equal to duration of automatic stay despite apparent absence of state law tolling provisions).

n69 *Schumacher v. Worcester*, 55 Cal. App. 4th 376, 64 Cal. Rptr. 2d 1 (1997).

n70 *Roadside Stations, Inc. v. 7HBF, Ltd.*, 905 S.W.2d 1 (Tex. App. 1994).

n71 11 U.S.C. § 507(a)(8), formerly § 507(a)(7), as renumbered by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994); see *Collier on Bankruptcy*, 507.10 (Matthew Bender).

n72 11 U.S.C. § 523(a)(1); see *Collier on Bankruptcy*, 523.07 (Matthew Bender).

n73 Section 507(a)(7)(A) (now (a)(8)(A)) addresses only prepetition taxes. *Missouri Dep't of Revenue v. L.J. O'Neill Shoe Co. (In re L.J. O'Neill Shoe Co.)*, 64 F.3d 1146 (8th Cir. 1995).

n74 19 F.3d 163 (5th Cir. 1993).

n75 19 F.3d 163, 165.

n76 *Morgan v. United States (In re Morgan)*, 182 F.3d 775 (11th Cir. 1999).

n77 E.g., *West v. United States (In re West)*, 5 F.3d 423, 426, 29 C.B.C.2d 1039 (9th Cir. 1993), cert. denied, 511 U.S. 1081, 114 S. Ct. 1830, 128 L. Ed. 2d 459 (1994); *Montoya v. United States (In re Montoya)*, 965 F.2d 554 (7th Cir. 1992).

n78 535 U.S. 43, 122 S. Ct. 1036, 152 L. Ed. 2d 79 (2002).

n79 535 U.S. 43, 53, 122 S. Ct. 1036, 1043, 152 L. Ed. 2d 79, 89.

n80 535 U.S. 43, 50-51, 122 S. Ct. 1036, 1041, 152 L. Ed. 2d 79, 87.

n81 Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n82 *Fed. R. Bankr. P. 1001, 9006*. Rule 9006(a) was amended by the 1991 amendments to the Bankruptcy Rules and Official Forms to govern the computation of time prescribed by the Federal Rules of Civil Procedure when a civil rule is made applicable by the Bankruptcy Rules to a bankruptcy case or proceeding. Rule 9006 was amended again, by the 2001 amendments to the Federal Rules of Bankruptcy Procedure, to provide for time periods service in by electronic or other means not otherwise authorized under *Fed. R. Civ. P. 5(b)*. See Collier on Bankruptcy, ch. 9006 (Matthew Bender).

n83 *Fed. R. Bankr. P. 9006(b)*, as amended in 1999.

n84 1983 Advisory Committee Note to *Fed. R. Bankr. P. 9006*.

n85 *Id.*

n86 The reference to *Fed. R. Bankr. P. 1017(e)* was added to *Fed. R. Bankr. P. 9006(b)(3)* by the 1991 amendments.

n87 *Fed. R. Bankr. P. 4003(b)* was amended by the 2000 amendments to the Federal Rules of Bankruptcy Procedure, effective December 1, 2000.

n88 *Fed. R. Bankr. P. 8002*; see *Collier on Bankruptcy*, ch. 8002 (Matthew Bender).

n89 *Fed. R. Bankr. P. 9033*; see *Collier on Bankruptcy*, ch. 9033 (Matthew Bender).

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171 of 197 DOCUMENTS

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Collier on Who May Be a Debtor under Chapter 13

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Collier on Who May Be a Debtor under Chapter 13

By Collier

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SUMMARY: This Emerging Issues Analysis addresses issues pertaining to section 109, including the requirement that a Chapter 13 debtor be an individual with regular income, debt limitations applicable to eligibility for Chapter 13 relief, method of determining eligibility to be a Chapter 13 debtor, and debts of spouses in application of Chapter 13 limitations.

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ARTICLE: The eligibility requirements for status as a debtor under chapter 13, which governs the adjustment of debts of an individual, are contained in section 109(e). One of the purposes of chapter 13 is to allow the small sole proprietor, for whom the reorganization process provided in chapter 11 is too cumbersome or otherwise inappropriate, to obtain relief under the Bankruptcy Code. n1 The eligibility criteria set forth in section 109(e) are specific and restrictive, with monetary amounts established to govern eligibility so as to ensure that those persons for whose benefit the chapter is directed are those who employ its provisions. Thus, the fundamental purpose of section 109(e) is to establish the dollar limitation on the amount of indebtedness that an individual with regular income can incur and still file under chapter 13. n2

Requirement That the Chapter 13 Debtor Be an Individual with Regular Income

The first requirement found in subsection (e) is that the chapter 13 debtor be an "individual with regular income," or such an individual and that individual's spouse. The phrase "individual with regular income" is defined in section 101 of the Code to mean an "individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title, other than a stockbroker or a commodity broker." n3 This definition, barring debtors from chapter 13 eligibility if they are unable to make plan payments, is closely related to the standard of plan feasibility for chapter 13 plan confirmation under section 1325(a)(6). n4

Since "individual" is a narrower term than "person," which as defined by section 101 includes individual, partnership and corporation, it is clear that partnerships and corporations are not eligible to file chapter 13 cases. n5 However, an individual who is a member of a partnership is eligible to file on his or her own behalf, in which case the assets of the partnership would not be property of the estate but the debtor's interest in the partnership would be property of the estate. n6 Similarly, although a trust is not an individual eligible to file a chapter 13 case, n7 an individual who is the trustee of a trust may file a chapter 13 case. n8

The section 101 definition of "individual with regular income" is a much more encompassing concept than was the "wage earner" entitled to chapter 13-type relief under pre-1978 bankruptcy laws. Chapter 13 relief is not limited to those whose regular income comes from employment, but encompasses "individuals on welfare, social security, fixed pension incomes, or who live on investment incomes." n9 In *Bibb County Department of Family & Children Services v. Hope (In re Hammonds)*, n10 the Court of Appeals for the Eleventh Circuit held that public assistance benefits were regular income and that a recipient of those benefits could be a chapter 13 debtor. The standard is based not on the source of the income but, rather, on its regularity and sufficiency to meet plan payments. n11 Although the debtor must demonstrate an ability to meet plan payments, eligibility under chapter 13 does not require that the debtor receive regular income at the time of the petition or that the exact amount of future income be ascertainable at that time. n12 It also does not require that the regular income be weekly or monthly, as long it is reasonably predictable and sufficient to make the proposed plan payments. n13 However, an extremely irregular income pattern, or an income that is too low to allow for plan payments, will fail to meet the eligibility requirements of section 109(e). n14 Often issues of this nature are dealt with as part of the feasibility test for chapter 13 plan confirmation. n15

Although the receipt of Social Security payments entitles an individual to file a chapter 13 petition, the anti-assignment provision of 42 U.S.C. § 407 is still valid, so the court cannot order the Social Security Administration to make payments directly to the chapter 13 trustee. In *In re Buren*, n16 the Court of Appeals for the Sixth Circuit held that, in accordance with the anti-assignment provision to the Social Security Act, a bankruptcy court could not compel the Social Security Administration to pay a chapter 13 debtor's SSI benefits directly to the trustee. The overriding authority of the anti-assignment provision had been clarified in an amendment among the Social Security Amendments of 1983: "No other provision of law, enacted before, on or after the date of the enactment of this section may be construed to limit, supersede, or otherwise modify the provisions of this section except to the extent that it does so by express reference to this section." n17

The legislative history to this amendment states that some bankruptcy courts n18 had mistakenly "considered Social Security and SSI benefits listed by the debtor to be income for purposes of Chapter XIII bankruptcy and had ordered SSA in several hundred cases to send all or part of a debtor's benefit check to the trustee in bankruptcy." n19 The amendment was apparently written to correct this application of the bankruptcy law in the future because, as stated in the House Report, the "bill specifically provides that Social Security and SSI benefits may not be assigned notwithstanding any other provisions of law, including, P.L. 95-598, the Bankruptcy Reform Act of 1978." n20 Since the amendment to the Social Security Act, bankruptcy courts have generally found that they cannot make orders for payment of federal benefits to the trustee when those benefits cannot be assigned pursuant to federal law. n21 However, nothing in any of these statutes prevents the recipient of the benefits from being a chapter 13 debtor, and since the definition of an individual with regular income does not include the ability to have income paid directly to the trustee, they do not pose a barrier to chapter 13 eligibility.

Another issue that sometimes arises concerning the source of the debtor's income is whether a nonworking spouse may assert that the support he or she receives from the other spouse is "regular income." It is clear that alimony or support received by a separated spouse or parent was meant to be encompassed within the term "regular income," and also that the spouse of an individual with regular income need not have his or her own separate source of income if the spouse is a joint debtor with that individual. Based on the obvious intent of Congress that the term be construed broadly, most courts have permitted the spouse of an individual with regular income to file without the necessity of that individual filing jointly, at least if there is a commitment of the nonfiling spouse to provide the income. n22 They have even permitted a debtor to file based on the commitment of friends and relatives to provide the necessary income. n23

Occasionally other issues arise, such as whether a debtor who owns real estate in trust for another must have regular income from the trust to be eligible for chapter 13. Since the test applies to the debtor, who is the individual and not the trust, income from the trust is not required. n24

The definition specifically excludes stockbrokers n25 and commodity brokers. As an additional protection, to ensure that there is no avoidance of the customer protection provisions set forth in chapter 7, section 109(e) provides that an individual's spouse may join in seeking chapter 13 relief, as long as that spouse is not a stockbroker or commodity broker. Thus, the combination of the section 101 definition and the spousal petition provision of section 109(e) guarantees that stockbrokers and commodity brokers are completely excluded from the scope of chapter 13.

Debt Limitations Applicable to Eligibility for Chapter 13 Relief

In contrast to provisions involving chapter 7 debtors, the language of section 109(e) is drafted explicitly to require that a chapter 13 debtor owe debts n26 on the date that the petition is filed. However, while the debtor must owe some debts, the debtor cannot owe debts in too large an amount and still expect to take advantage of the streamlined rehabilitative scheme provided in chapter 13. Thus, the core of subsection (e) is its monetary limitation on eligibility for chapter 13 relief. The monetary limitations of subsection (e) reflect Congress's recognition that a chapter 11 reorganization might be too cumbersome a procedure for a sole proprietor or individual with a small amount of debt. n27 At the same time, they ensure that chapter 13 is not used by individuals with large businesses in which the creditor protections of chapter 11, such as voting and the disclosure statement, are more important.

Dollar Amounts of Chapter 13 Debt Limitations. The debtor must owe less than \$336,900 in unsecured debt and less than \$1,010,650 in secured debt when the petition is filed. n28 As originally enacted in 1978, the debtor had to owe less than \$100,000 in unsecured debts and less than \$350,000 in secured debts. n29 Under section 104(b) of the Code, the dollar amounts of the chapter 13 debt limitations were adjusted for changes in the cost of living on April 1, 1998, on April 1, 2001 on April 1, 2004, and again on April 1, 2007. The dollar amounts will next be adjusted on April 1, 2010, and will be adjusted every three years thereafter. n30

The dollar limits on both categories of debts, unsecured and secured, apply only to debts that are noncontingent and liquidated at the decisive petition filing date. n31 Debts owed by related entities, but not by the debtor or debtors filing the case, are not counted. n32 However, one court in a community property state has held that the amount of the "community claims" under section 101(7) n33 against the other spouse must be included in the calculation of the dollar-amount jurisdictional eligibility applied to the chapter 13 debtor because such claims will be entitled to participate under any plan proposed by the debtor. n34

Only Noncontingent Debts Counted Toward Chapter 13 Limitations. In deciding whether a claim is noncontingent, and therefore counted toward the debt limits, courts have generally ruled that if a debt does not come into existence until the occurrence of a future event, the debt is contingent. A claim is contingent as to liability if the debtor's legal duty to pay does not come into existence until triggered by the occurrence of a future event. Thus, a creditor's claim is not contingent when the "triggering event" occurred before the filing of the chapter 13 petition. n35 In some cases, there may be a dispute regarding whether the "triggering event" has occurred—for example, because the party whose debt the debtor guaranteed raises defenses to the principal debt. In others, the debtor may be found to be jointly and severally liable under state law, and no prior recourse to the principal debtor is required. n36

In certain circumstances, a criminal conviction may support a claim that is noncontingent and thus must be included in the section 109(e) calculations. n37 However, a criminal conviction does not allow the court to impute civil liability stemming from the same occurrence, and therefore a pending tort claim is contingent. n38 A disputed debt can be a

noncontingent debt within the meaning of section 109(e),ⁿ³⁹ although it may be unliquidated, as discussed below.

Only Liquidated Debts Counted Toward Chapter 13 Limitations. A debt must also be liquidated to count toward the debt limits. Although for purposes of this section, "liquidated" is not defined, courts have generally held that a debt is liquidated if its amount is readily and precisely determinable, as where the claim is determinable by reference to an agreement or by a simple computation. For example, a tort cause of action against the debtor for personal injuries, pain and suffering would obviously be an unliquidated claim, and not counted no matter how large the potential damages. In *In re Wenberg*,ⁿ⁴⁰ the Court of Appeals for the Ninth Circuit held that when a creditor's claim was unliquidated, but an award of attorney's fees to the creditor was readily ascertainable, the attorney's fees were liquidated but the damages were not.ⁿ⁴¹ If a judgment has already been entered in excess of the eligibility limits, the debtor is ineligible even if there remains additional litigation about punitive damages. In *In re Nikoloutsos*,ⁿ⁴² the Court of Appeals for the Fifth Circuit held that a debtor was ineligible to convert his case to chapter 13 because at the time of his petition there had already been a judgment for compensatory damages entered against him in excess of \$600,000.

A debt is not liquidated if there is a substantial dispute regarding liability or amount.ⁿ⁴³ Although there may be issues whether a substantial dispute exists, the Court of Appeals for the Ninth Circuit has held that one exists when determination of liability requires an extensive and contested evidentiary hearing involving substantial evidence.ⁿ⁴⁴ However, in the context of statutory obligations, it has been held that the fact that a debtor disputes the amount of the obligation does not necessarily make the obligation unliquidated. In *United States v. Verdunn*,ⁿ⁴⁵ the Court of Appeals for the Eleventh Circuit held that federal income tax deficiencies, as well as interest and penalties stated in a deficiency notice issued by the Internal Revenue Service, were liquidated debts, notwithstanding the fact that the debtor disputed them. They were readily ascertainable and calculable using fixed legal standards. In *Mazzeo v. United States (In re Mazzeo)*,ⁿ⁴⁶ the Court of Appeals for the Second Circuit held that the alleged "responsible person" liability of a corporate officer for withholding taxes owed by a corporation was neither contingent nor unliquidated despite the fact that the officer disputed whether he was a responsible person. The debt was not contingent because the debtor's liability on the debt did not depend on any future event, and the debt was not unliquidated because the concept of liquidation related to the amount of liability rather than whether liability existed. Similarly, in *In re Knight*,ⁿ⁴⁷ the Court of Appeals for the Seventh Circuit held that a readily determinable statutory penalty debt was not unliquidated even though it was disputed by the debtor.

Treatment of Secured Debts in Application of Chapter 13 Limitations. There has also been litigation to resolve the issue as to how a court should determine the amount of a secured debt for the purposes of section 109(e). Most courts, including the Courts of Appeals for the Fourth, Seventh and Eighth Circuits, have held that the valuation test of section 506(a) should be used in making a determination as to whether there is an unsecured deficiency.ⁿ⁴⁸ That test deems a debt secured only to the extent of the value of the collateral. Thus, if a debtor had a liquidated, noncontingent debt of \$700,000, secured by a \$300,000 property, the debtor would be ineligible for chapter 13 because the \$400,000 unsecured portion of the debt would exceed the \$336,900 limit for unsecured debts.ⁿ⁴⁹

The Court of Appeals for the Ninth Circuit applied similar reasoning to debts which are secured by a lien that impairs an exemption and that is avoidable under section 522(f). In *Scovis v. Henrichsen (In re Scovis)*,ⁿ⁵⁰ the court held that such a debt should be treated as an unsecured debt because, even though the lien was not avoided on the date of the petition, the ultimate status of the debt as unsecured is "readily ascertainable."ⁿ⁵¹ This conclusion seems incorrect, because it is not certain as of the date of the petition that the lien will be avoided. A lien is avoided under section 522(f) only if the debtor files a motion to avoid the lien. Unlike a determination under section 506(a) that a lien is undersecured, avoidance of a lien under section 522(f) can be sought only by the debtor, and a debtor could decide not to seek avoidance of the lien.

Courts have disagreed on whether a debt is deemed secured for purposes of section 109(e) if it is secured by

property other than property of the debtor. n52

Method of Determining Eligibility to Be a Chapter 13 Debtor

There has been some dispute as to whether the bankruptcy court may look beyond the debtor's schedules to determine eligibility under section 109(e). The Courts of Appeals for the Sixth, Seventh and Ninth Circuits have held that, just as a court does in evaluating whether a diversity plaintiff meets the federal amount in controversy requirement under section 1332 of title 28, a court should look beyond the amounts asserted by the debtor in the schedules only if it determines that they were not filed in good faith. n53 In addition, cases have held that the petition date is the crucial reference point for determining eligibility. n54

However, when the debtor does not exercise reasonable diligence or good faith in completing and filing the schedules, the bankruptcy court may look to other evidence, including postpetition events such as proofs of claim, to determine eligibility. n55

Debts of Spouses in Application of Chapter 13 Limitations

Subsection (e) recognizes that a debtor under chapter 13 must deal with future family expenses and family income as well as preexisting family debts. It attempts to facilitate the treatment of the family as a unit to the extent possible by authorizing spouses to achieve chapter 13 debtor status jointly if the aggregate of their debts is within the applicable limits. n56 However, in some cases, adding the debts of a spouse will cause those debts to exceed the statutory limits, and the limits are not doubled in a joint case. In such cases, only one spouse may be able to file as a chapter 13 debtor. n57 Alternatively, if few of the debts are joint, each spouse may be eligible to file a separate chapter 13 case. As noted earlier, neither spouse may be a stockbroker or commodity broker.

For a complete discussion of Code section 109, see Collier on Bankruptcy, ch 109 (Matthew Bender).

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n1 1. H.R. Rep. No. 595, 95th Cong., 1st Sess. 320 (1977).

n2

2. S. Rep. No. 989, 95th Cong. 2d Sess. 31 (1978). 11 U.S.C. § 109(e) was amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394. The amendment raised the debt limits applicable to a chapter 13 petition. See "Debt Limitations Applicable to Eligibility for Chapter 13 Relief" *infra*.

n3

3. See Collier on Bankruptcy, ch. 101(Matthew Bender).

n4

4. See Collier on Bankruptcy, 1325.07 (Matthew Bender).

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5. See Collier on Bankruptcy, ch. 101 (Matthew Bender).

n6

6. See Collier on Bankruptcy, 1304.01[3] (Matthew Bender).

n7

7. *In re W.F.C. Real Estate Trust #1*, 236 B.R. 90 (Bankr. S.D. Fla. 1999).

n8

8. See *In re Foster*, 19 B.R. 28 (Bankr. E.D. Pa. 1982).

n9

9. H.R. Rep. No. 595, 95th Cong., 1st Sess. 313.

n10

10. 729 F.2d 1391, 1393, 10 C.B.C.2d 754, 756 (11th Cir. 1984) (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 313).

n11

11. See *In re Lapin*, 302 B.R. 184 (Bankr. S.D. Tex. 2003) (income can include withdrawals from IRA account); *In re Ristic*, 27 C.B.C.2d 366, 142 B.R. 856 (Bankr. E.D. Wis. 1992); see also *In re Ellenburg*, 19 C.B.C.2d 443, 89 B.R. 258 (Bankr. N.D. Ga. 1988) (debtor who receives \$500 monthly from spouse for bookkeeping services is eligible for chapter 13 relief).

n12

12. See *In re Bradley*, 7 C.B.C.2d 119, 18 B.R. 105 (Bankr. D. Vt. 1982) (evidence of future income is sufficient to qualify debtor under chapter 13).

n13

13. *In re Fiegi*, 61 B.R. 994 (Bankr. D. Or. 1986) (farmer's projected proceeds from harvests sufficient to make annual payments were regular income).

n14

14. See *In re Wilhelm*, 3 C.B.C.2d 147, 6 B.R. 905 (Bankr. E.D.N.Y. 1980).

n15

15. 11 U.S.C. § 1325(a)(6); see *Collier on Bankruptcy*, 1325.07 (Matthew Bender).

n16

16. 725 F.2d 1080, 10 C.B.C.2d 236 (6th Cir. 1984), cert. denied, 469 U.S. 818, 105 S. Ct. 87, 83 L. Ed. 2d 34 (1985).

n17

17. Pub. L. No. 98-21 (1983).

n18

18. In fact, before the amendment, at least one appellate court had also ruled that the provisions of the Bankruptcy Code overrode those of 42 U.S.C. § 407. *United States v. Devall*, 704 F.2d 1513 (11th Cir. 1983).

n19

19. H.R. Rep. No. 98-25, 98th Cong., 1st Sess. 82, 83 (1983).

n20

20. H.R. Rep. No. 98-25, 98th Cong., 1st Sess. 302 (1983).

n21

21. *E.g.*, *In re Roach*, 94 B.R. 440 (W.D. Mich. 1988), *aff'g*. 90 B.R. 286 (Bankr. W.D. Mich.); *see Collier on Bankruptcy*, 1325.09[2] (Matthew Bender).

n22

22. *In re Antoine*, 37 C.B.C.2d 1763, 208 B.R. 17 (Bankr. E.D.N.Y. 1997) (oral commitment of spouse to devote salary to plan payments); *In re Varian*, 91 B.R. 653 (Bankr. D. Conn. 1988).

n23

23. *In re Baird*, 228 B.R. 324 (Bankr. M.D. Fla. 1999) (debtor's son was making chapter 13 payments); *In re Campbell*, 38 B.R. 193 (Bankr. E.D.N.Y. 1984).

n24

24. *Federal Home Loan Mortgage Corp. v. Wynn*, 8 C.B.C.2d 615, 29 B.R. 679 (Bankr. D.N.J. 1983).

n25

25. An employee and account executive of a stock brokerage firm is not a "stockbroker" and, therefore, may

be a debtor eligible for relief under section 109(e). *In re Berry*, 7 C.B.C.2d 270, 22 B.R. 950 (Bankr. N.D. Ohio 1982).

n26

26. A loan, guaranteed by a debtor, is not included in the calculation of debt for purposes of chapter 13 eligibility as long as the borrower does not default on the loan. *In re Fischel*, 22 C.B.C.2d 1461, 103 B.R. 44 (Bankr. N.D.N.Y. 1989).

n27

27. *In re Toronto*, 30 C.B.C.2d 2019, 165 B.R. 746 (Bankr. D. Conn. 1994).

n28

28. 11 U.S.C. § 109(e). Pursuant to 11 U.S.C. § 104(b), the amounts are subject to periodic adjustment and were raised from \$307,675 to \$336,900 for unsecured debt and from \$922,975 to \$1,010,650 for secured debt, effective in cases commenced on or after April 1, 2007. For cases commenced before April 1, 2004, the amounts were \$290,525 and \$871,550, respectively. See Collier on Bankruptcy, 104.03 (Matthew Bender).

n29

29. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 raised the debt limitation to \$250,000 for unsecured debt and \$750,000 for secured debt and provided for periodic adjustment of the dollar amounts.

n30

30. 11 U.S.C. § 104(b); see Collier on Bankruptcy, 104.03 (Matthew Bender).

n31

31. See *Slack v. Wilshire Ins. Co. (In re Slack)*, 187 F.3d 1070 (9th Cir. 1999) (calculation not affected by events subsequent to filing date that affect numbers); *Cavaliere v. Sapir*, 208 B.R. 784 (D. Conn. 1997) (debt discharged in previous chapter 7 case not counted toward debt limits); *In re Horne*, 277 B.R. 320 (Bankr. E.D. Tex. 2002) (fact that debt was reduced to judgment after petition filing date did not render it liquidated); *In re Stern*, 266 B.R. 322 (Bankr. D. Md. 2001) (date of original petition remains relevant point of reference when debtor seeks to convert to chapter 13); *People's Bank v. Winder (In re Winder)*, 31 C.B.C.2d 1601, 171 B.R. 728

(*Bankr. D. Conn. 1994*) (the chapter 13 petition date is the reference point of both section 109(e) and a debtor's schedules).

n32

32. *Ho v. Dowell (In re Ho)*, 274 B.R. 867 (B.A.P. 9th Cir. 2002) (debt owed by corporation of which debtor was principal not counted).

n33

33. See *Collier on Bankruptcy*, 101.07 (Matthew Bender).

n34

34. See *In re Monroe*, 282 B.R. 219 (*Bankr. D. Ariz. 2002*). The rationale for the decision appears faulty, however, as there are other types of claims, such as contingent and unliquidated claims, that participate under any plan proposed yet do not count in applying the jurisdictional amount limitation. Moreover, the case does not discuss the statutory requirement of section 109(e) that the debts to be included in calculating chapter 13 eligibility are those certain noncontingent, liquidated debts that the debtor "owes." In many community property states, while the debtor's interest in community property may be utilized to satisfy a debt of the other spouse, the nondebtor spouse does not "owe" the obligation as a personal liability.

n35

35. See, e.g., *In re Hatzenbuehler*, 282 B.R. 828 (*Bankr. N.D. Tex. 2002*) (when bank exercised option creating liability on guarantee after petition was filed, liability was contingent on petition date); *In re Robertson*, 21 C.B.C.2d 825, 105 B.R. 504 (*Bankr. D. Minn. 1989*) (claim against debtor-guarantor is not contingent when principal defaulted before filing of petition); *DeKalb Bank v. Flaherty (In re Flaherty)* 4 C.B.C.2d 343, 10 B.R. 118 (*Bankr. N.D. Ill. 1981*) (same); *In re Wilson*, 3 C.B.C.2d 912, 9 B.R. 723 (*Bankr. E.D.N.Y. 1981*) (same).

n36

36. See *In re Fostvedt*, 823 F.2d 305 (9th Cir. 1987).

n37

37. See *In re Gordon*, 25 C.B.C.2d 5, 127 B.R. 574 (*Bankr. E.D. Pa. 1991*) (a claim for criminal restitution

that is conditioned on the debtor's ability to pay is not a contingent claim because the liability has already attached, and must be counted toward the ceiling set forth in section 109(e)).

n38

38. See *In re Belt*, 21 C.B.C.2d 1065, 106 B.R. 553 (Bankr. N.D. Ind. 1989). There is also some authority for the proposition that an unliquidated tort claim is not always a contingent debt. See *In re Taylor & Assocs., L.P.*, 193 B.R. 465 (Bankr. E.D. Tenn. 1996) (court must accept allegation that unliquidated tort claim is not contingent debt for purposes of section 303(b) unless it appears to a legal certainty that petitioning creditor could not obtain judgment). However, the *Taylor* case relies on the principle that the allegations of a petition should be accepted unless it appears to a legal certainty they are inaccurate. In the case of a voluntary chapter 13 petition, this same principle dictates that a good faith allegation of eligibility due to contingency of a debt must be accepted. See "Method of Determining Eligibility to Be a Chapter 13 Debtor" *infra*.

n39

39. *In re Albano*, 14 C.B.C.2d 237, 55 B.R. 363 (N.D. Ill. 1985); *In re Pennypacker*, 24 C.B.C.2d 64, 115 B.R. 504 (Bankr. E.D. Pa. 1990).

n40

40. 902 F.2d 768 (9th Cir. 1990) *aff'g*. 94 B.R. 631 (B.A.P. 9th Cir. 1988).

n41

41. See also *Slack v. Wilshire Ins. Co. (In re Slack)*, 187 F.3d 1070 (9th Cir. 1999) (when debtor had stipulated to amount of damages, debt was liquidated even though debtor contested liability); *Sylvester v. Dow Jones & Co. (In re Sylvester)*, 6 C.B.C.2d 586, 19 B.R. 671 (B.A.P. 9th Cir. 1982) (a debt is liquidated if the amount due can be determined with some degree of precision); *In re Toronto*, 30 C.B.C.2d 2019, 165 B.R. 746 (Bankr. D. Conn. 1994); *In re Sitarz*, 28 C.B.C.2d 640, 150 B.R. 710 (Bankr. D. Minn. 1993).

n42

42. 199 F.3d 233 (5th Cir. 2000); see also *Elliott v. Papatones (In re Papatones)*, 143 F.3d 623 (1st Cir. 1998) (judgment ordered by court before bankruptcy petition filed but not docketed until after petition filed was liquidated debt).

n43

43. See *In re Lambert*, 11 C.B.C.2d 693, 43 B.R. 913 (Bankr. D. Utah 1984); *In re King*, 4 C.B.C.2d 130, 9 B.R. 376 (Bankr. D. Or. 1981).

n44

44. *In re Wenberg*, 902 F.2d 768 (9th Cir. 1990); *Ho v. Dowell (In re Ho)*, 274 B.R. 867 (B.A.P. 9th Cir. 2002).

N45

45. 89 F.3d 799 (11th Cir. 1996).

n46

46. 131 F.3d 295, 39 C.B.C.2d 38 (2d Cir. 1997).

n47

47. 55 F.3d 231 (7th Cir. 1995).

n48

48. *Ficken v. United States (In re Ficken)*, 2 F.3d 299, 29 C.B.C.2d 947 (8th Cir. 1993); *Brown & Co. Sec. Corp. v. Balbus (In re Balbus)*, 933 F.2d 246, 24 C.B.C.2d 1841 (4th Cir. 1991) (also holding that, in determining whether a debtor satisfies the limit on unsecured debt under section 109(e), hypothetical costs of the sale of real property securing debt are not to be deducted from the value of the property when the debtor intends to retain the property); *In re Day*, 747 F.2d 405, 11 C.B.C.2d 733 (7th Cir. 1984).

n49

49. But see *Cavaliere v. Sapir*, 208 B.R. 784 (D. Conn. 1997) (if undersecured nonrecourse debt is bifurcated under section 506(a) no unsecured claim is created).

n50

50. 249 F.3d 975 (9th Cir. 2001).

n51

51. 249 F.3d at 984.

n52

52. Compare *In re Belknap*, 174 B.R. 182 (Bankr. W.D.N.Y. 1994) (considered secured); *In re Gorman*, 58 B.R. 372 (Bankr. E.D.N.Y. 1986) (considered secured), with *In re Tomlinson*, 116 B.R. 80 (Bankr. E.D. Mich. 1990) (considered unsecured). See also *Branch Banking & Trust Co. v. Russell*, 188 B.R. 542 (E.D.N.C. 1995) (finding debt secured by assets of corporation which was wholly owned by debtors to be secured); *In re Lower*, 311 B.R. 888 (Bankr. D. Colo. 2004) (debt secured by assets of corporation owned by debtor not secured).

n53

53. *Scovis v. Henrichsen (In re Scovis)*, 249 F.3d 975 (9th Cir. 2001); *In re Lybrook*, 951 F.2d 136, 138-39 (7th Cir. 1991); *Comprehensive Accounting Corp. v. Pearson (In re Pearson)*, 773 F.2d 751, 756, 13 C.B.C.2d 749, 756 (6th Cir. 1985) (also holding that a claim whose amount can only be determined after a hearing must have been unliquidated when the petition was filed).

n54

54. See *Scovis v. Henrichsen (In re Scovis)*, 249 F.3d 975 (9th Cir. 2001); *People's Bank v. Winder (In re Winder)*, 31 C.B.C.2d 1601, 171 B.R. 728 (Bankr. D. Conn. 1994) (also stating that because a debtor's schedules are subscribed under penalty of perjury, and because chapter 13 eligibility is to be determined efficiently, it is appropriate to use the debtor's schedules in determining the amount of qualifying debt for purposes of section 109(e) eligibility).

n55

55. *De Jounghe v. Mender (In re De Jounghe)*, 334 B.R. 760 (B.A.P. 1st Cir. 2001).

n56

56. A debtor may not exclude a joint debt with the nondebtor spouse for which the debtor is fully liable, from the debt ceiling which determines eligibility under section 109(e). *In re Marchetto*, 7 C.B.C.2d 963, 24 B.R. 967 (B.A.P. 1st Cir. 1982). The increased debt limits effected by Pub. L. No. 103-394, and adjusted by section 104(b) to \$307,675 of unsecured debt and \$922,975 of secured debt, are also applicable to joint filings.

n57

57. See *In re Tabor*, 232 B.R. 85 (Bankr. N.D. Ohio 1999) (joint case dismissed only as to debtor-husband because debtor-wife's debts alone were within eligibility limits). But see *In re Monroe*, 282 B.R. 219 (Bankr. D. Ariz. 2002) (claim against debtor's husband that was enforceable against community property of debtor filing separately counted toward debt limit even though she did not "owe" the debt, as would seem to be required by the literal language of section 109(e)).

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172 of 197 DOCUMENTS

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Collier on Who May Be a Debtor under Chapter 7

2008 Emerging Issues 963

Collier on Who May Be a Debtor under Chapter 7

By Collier

November 16, 2007

SUMMARY: Chapter 7 of the Bankruptcy Code contains the provisions governing liquidation of debtors' estates. This Emerging Issues Analysis discusses issues pertaining to Chapter 7 debtors, including the type of entity that may be a debtor and the exclusions from Chapter 7 eligibility.

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ARTICLE: Chapter 7 of the Bankruptcy Code contains the provisions governing liquidation of debtors' estates. The standards for determination of which types of entities may file for relief under chapter 7 are found in section 109(b). This subsection provides for a broad category of eligible persons, with a few specifically enumerated exclusions.

Type of Entity That May Be a Debtor under Chapter 7

Basically, "persons" may be debtors under chapter 7. The definition of the word "person" in section 101 provides a small measure of limitation upon the scope of the category of those eligible for liquidation, in that the definition, while including individuals, corporations and partnerships, excludes, for eligibility purposes, governmental units. (One type of governmental unit, municipalities, is specifically embraced by a separate rehabilitative segment of the Bankruptcy Code, chapter 9.) n1 Certain entities that are not included in the definition of "person," such as probate estates and most trusts, are also ineligible to file under chapter 7. n2 However, a business trust is eligible to file a chapter 7 case, since it is encompassed within the definition of "corporation" in section 101. n3

Insolvency Not Required for Chapter 7 Eligibility

It is worth noting that a chapter 7 "debtor" need not be insolvent to be eligible for chapter 7 relief. n4 Nor does the standard established for those persons who "may be" a debtor under chapter 7 contain any specific or implied requirement that persons who file for relief be heavily burdened by debts.

Various legislative attempts to set a minimum debt amount as a criterion for eligibility have been unsuccessful,

such minimum requirements being seen as an unnecessary burden upon hard-pressed debtors. n5 A debtor under chapter 7 may be solvent or insolvent, and the debtor's motive is generally considered to be immaterial, n6 except that the debtor may not file a petition for the purpose of perpetrating a fraud. n7 Thus, a solvent person that prefers to have its property distributed among its creditors through chapter 7 liquidation may do so, n8 provided, of course, that the debtor is otherwise eligible. While the Code structure in no way requires a debtor to allege insolvency in its petition, or to prove it, neither does bankruptcy law make it obligatory on an insolvent person to accept the benefits of the Code. n9

Although only section 109(e), governing eligibility for chapter 13 relief, n10 limits its application to an individual "that owes debts," it seems obvious that there can be no bankruptcy without the existence of *some* fixed or contingent debts, and thus the omission of such an explicit requirement in no way affects the operation of the Code. A person must owe a debt or debts to have any rational use for orderly liquidation and protection of the debtor under chapter 7. n11 Of course, ownership of property--something to be liquidated--is not essential, since protection of the debtor is as much a part of chapter 7 as fair distribution to creditors. n12

Exclusions from Chapter 7 Eligibility

Exclusions from eligibility for chapter 7 relief are explicitly set forth in subsections (b) and (g), and an individual, corporation or partnership should be considered eligible unless it is within the scope of the expressly excluded categories. Subsection (b), as amended in 1994 n13 and 2005, n14 enumerates those exclusions by stating that a person may be a debtor under chapter 7 only if such person is *not*--

1. a railroad;

2. a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, a New Markets Venture Capital company as defined in section 351 of the Small Business Investment Act of 1958, small business investment company licensed by the Small Business Administration section 301 of the Small Business Investment Act of 1958, credit union, or industrial bank or similar institution that is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (except that an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Improvement Corporation Act of 1991 may be a debtor if a petition is filed at the direction of the Board of Governors of the Federal Reserve System); or

3. a foreign insurance company engaged in such business in the United States, foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union, that has a branch or agency in the United States.

But the excluded categories are not necessarily as simply defined as they may appear to be on the surface, and a debtor may have to look to underlying congressional intent.

The Exclusion of Small Business Investment Companies. The 1994 Act amended subsection (b)(2) to exclude small business investment companies licensed by the Small Business Association under subsection (c) or (d) of section 301 of the Small Business Investment Act of 1958' from eligibility as debtors under chapter 7. n15 The Congressional Record indicates that this change was made to preclude debtors from using chapter 7 to subordinate the Small Business Administration's interests to other creditors. n16

Even before the 1994 amendment, the access of small business investment companies had been limited when alternative federal liquidation procedures had been invoked. In *United States v. Royal Business Funds Corp.*, n17 the

Court of Appeals for the Second Circuit held that a debtor lost its absolute right to file for bankruptcy relief when it willingly entered into a stipulation that (1) provided for a receivership by the SBA, (2) limited the power of the debtor's board of directors and (3) provided for additional loans by the SBA to the debtor, all of which was subject to federal court supervision.

The Exclusion of Debtors Engaged in the Business of Insurance and Banking. There has been a legion of cases in which the principal issue was whether a certain corporation was engaged in the insurance business so as to be excluded. n18 The same may be said with respect to the exception for banks and similar institutions. n19

There appear to be no clear rules for determining whether a particular corporation falls within the two exclusions. Two available approaches to the problems have been suggested and used at times by the courts: (1) a classification based upon the law of the state of incorporation; n20 and (2) an independent classification by the bankruptcy court based upon its own definition of the words of the Bankruptcy Code. Although the first of these approaches, commonly called the "state classification test," is more favored by the courts, this does not mean that state law is followed literally without regard for the real activities of the corporation, n21 particularly when the corporation has failed to use the powers conferred on it by its charter or has developed into a different type of corporation. Nor does the fact that a state may have provided for state supervision and liquidation of a kind of corporation by itself bring such a business into the excepted class. n22

Generally, in determining whether a corporation is a bank or an insurance company, the court will first look to the state statute under which the corporation was formed. If that statute defines the corporation as one of a kind that the Code excludes, the immediate, if not final, inference should be that the corporation is not amenable to status as a debtor under chapter 7. n23 This approach was followed by the Court of Appeals for the Seventh Circuit in the *In re Estate of Medcare HMO*, n24 in which the court stated that it should look "primarily" to state law to determine whether an entity is within an excluded category. In making its determination, a court should evaluate the degree to which the entity is regulated by state law; the more extensive the regulation, the greater the state's interest and the more likely it is that Congress intended to exclude the entity from bankruptcy relief. n25 Courts are especially likely to consider whether the state provides special machinery for the entity's liquidation. n26 Once the entity's status under state law is determined, state law should be overlooked only if there is good reason to conclude that following it will frustrate the full effectiveness of the Code. n27

Even application of the "state classification test" does not prevent a bankruptcy court from looking into the substance of both the state statute and the actual operations of the business under consideration. Hence, it has been said that an essential element of a banking corporation is the power to receive deposits, n28 but, on the other hand, the mere fact that a corporation has the power to receive deposits does not *ipso facto* make it a banking corporation. n29 Also, it has been held that when a corporation operates in such a manner as to be classified as a banking corporation, this will not exclude it from bankruptcy if such operations are *ultra vires*. n30

In this regard, it is important to recognize the reason why these exclusions are made, i.e., that the excluded entities are those types for which there commonly are provided state or other federal statutory methods of liquidation and rehabilitation. Banking institutions and insurance companies are excluded from liquidation under the bankruptcy laws because alternate provision is made for their liquidation under various regulatory laws. n31 This accounts for the addition of credit unions to the list of excluded entities. The same reasoning applies when a foreign banking or insurance company is engaged in business in the United States and, therefore, subject to the same regulatory laws.

This explains the import of paragraph (3) of section 109(b). When a foreign insurance company, bank or the like, as designated in that provision, has assets in the United States but is not engaged in business in the United States, it has no recourse to alternate liquidation provisions. Thus, it should be, and is, covered by the Bankruptcy Code, since the provisions of chapter 7 are the only ones available for liquidation of any of the company's assets in the United States.

Therefore, a foreign bank or insurance company not engaged in banking or insurance business in this country, but with assets here, may avail itself of the bankruptcy laws. n32

It is noteworthy that the exclusion of banking institutions is stated in encompassing language, covering "domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, a New Markets Venture Capital company as defined in section 351 of the Small Business Investment Act of 1958, a small business investment company licensed by the Small Business Administration under section 301 of the Small Business Investment Act of 1958, credit union, or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act" (as well as foreign entities of the same nature when engaged in business in the United States). Expansive language was chosen to ensure that the exception would be stated in terms current with banking laws.

The sweeping language of section 109(b)(3) was amended by the Consolidated Appropriations Act, 2001, n33 which allows some banking institutions to file cases under chapter 7 or chapter 11 in certain circumstances. The amendment permits an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Improvement Corporation Act of 1991 to be a debtor, but only if the bankruptcy petition is filed at the direction of the Board of Governors of the Federal Reserve System. This limited exception allows the Federal Reserve the option of using the bankruptcy system to liquidate these particular kinds of entities, but makes clear that otherwise such entities may not file a chapter 7 case.

These amendments were accompanied by an amendment to the definition of "financial institution" in section 101 n34 and the addition of sections 781 through 784 in a new subchapter V of chapter 7, "Clearing Bank Liquidation," to govern such liquidations. n35

Section 109(b)(3) was amended again in 2005 in conjunction with the enactment of chapter 15 governing ancillary and other cross-border cases. n36 The amendment limits the exclusion of foreign insurance companies to those engaged in business in the United States, and clarified that the exclusion of foreign banks is for those with a branch or agency, as defined in section 1(b) of the International Banking Act of 1978, in the United States. The legislative history accompanying these amendments states:

Section 802(d) amends *section 109 of the Bankruptcy Code* to permit recognition of foreign proceedings involving foreign insurance companies and involving foreign banks which do not have a branch or agency in the United States (as defined in *12 U.S.C. § 3101*). While a foreign bank not subject to United States regulation will be eligible for chapter 15 as a consequence of the amendment to section 109, section 303 prohibits the commencement of a full involuntary case against such a foreign bank unless the bank is a debtor in a foreign proceeding. n37

For a complete discussion of Code section 109, see *Collier on Bankruptcy*, ch. 109 (Matthew Bender).

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[Return to Text](#)

n1 1. As amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394. *See Collier on Bankruptcy*, 109.04 (Matthew Bender).

n2

2. See *In re Goerg*, 844 F.2d 1562, 18 C.B.C.2d 1125 (11th Cir. 1988), cert. denied, 488 U.S. 1034, 109 S. Ct. 850, 102 L. Ed. 2d 981 (1989) (decedent's estate not a "person"); *In re Wayson Trust*, 8 C.B.C.2d 677, 29 B.R. 58 (Bankr. D. Md. 1982) (a testamentary trust under which the trustees operate a business may not be a debtor); *In re Jarrett*, 6 C.B.C.2d 496, 19 B.R. 413 (Bankr. M.D.N.C. 1982) (the probate estate of a deceased chapter 13 debtor is not a person eligible for chapter 7 relief); see also *Collier on Bankruptcy*, 109.02[1][a] (Matthew Bender).

n3

3. See *Brady-Morris v. Schilling (In re Knight Trust)*, 303 F.3d 671 (6th Cir. 2002) (trusts created with the primary purpose of transacting business or carrying on commercial activity for the benefit of investors qualify as business trusts, while trusts designed merely to preserve the trust *res* for beneficiaries generally are not business trusts; the determination is fact-specific, and it is imperative that bankruptcy courts make thorough and specific findings of fact regarding what was the intention of the parties, and how the trust operated); *Shawmut Bank Conn. v. First Fidelity Bank (In re Secured Equipment Trust of Eastern Airlines)*, 38 F.3d 86, 32 C.B.C.2d 1069 (2d Cir. 1994) (discussing attributes of a business trust); *In re Affiliated Food Stores, Inc.* 26 C.B.C.2d 104, 134 B.R. 215 (Bankr. N.D. Tex. 1991) (a business trust may qualify as a corporation under the Code and, therefore, be eligible for bankruptcy relief if it meets the definition of "business trust" under applicable state law); *In re Constitutional Trust #2-562*, 23 C.B.C.2d 1577, 1586, 114 B.R. 627, 633 (Bankr. D. Minn. 1990) (emphasizing the need to evaluate carefully an entity alleged to be a business trust and noting that "merely calling something a duck does not make it a duck" and "[p]ouring gravy on cotton candy does not make it mashed potatoes").

n4

4. But see *Connell v. Coastal Cable T.V., Inc. (In re Coastal Cable T.V., Inc.)*, 709 F.2d 762, 8 C.B.C.2d 1211 (1st Cir. 1983) (a person in bankruptcy, while not necessarily insolvent, must at least owe debts, and a question of the propriety of a bankruptcy case is accordingly raised when the debtor's debts are incurred through parties who allegedly do not legitimately control the debtor).

n5

5. See 1 *Collier on Bankruptcy*, 4.03 n.1 (Matthew Bender 14th ed. 1974).

n6

6. *In re Fike*, 117 F.2d 667 (7th Cir. 1941).

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7. *Zeiting v. Hargadine-McKittrick Dry Goods Co.*, 244 F. 719 (8th Cir. 1917), cert. denied, 245 U.S. 667, 38 S. Ct. 64, 62 L. Ed. 538 (1917).

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8. *In re Harriman*, 31 F. Supp. 50 (S.D.N.Y. 1939).

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9. *Summers v. Abbott*, 122 F. 36 (8th Cir. 1903).

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10. See *Collier on Bankruptcy*, 109.06 (Matthew Bender).

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11. See *In re Fox West Coast Theatres*, 25 F. Supp. 250 (S.D. Cal. 1936), *aff'd*, 88 F.2d 212 (9th Cir. 1937), cert. denied, 301 U.S. 710, 57 S. Ct. 944, 81 L. Ed. 1363 (1937); see also *Connell v. Coastal Cable T.V., Inc. (In re Coastal Cable T.V., Inc.)*, 709 F.2d 762, 8 C.B.C.2d 1211 (1st Cir. 1983). The debt need not be dischargeable, however; bankruptcy confers some benefits that do not depend on a discharge. There was a division of judicial authority under bankruptcy law prior to 1978 as to whether a debtor needed to have at least one dischargeable debt, but the majority view was that it did not. 1 *Collier on Bankruptcy*, 4.03 (Matthew Bender 14th ed. 1974).

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12. *In re Schwaninger*, 144 F. 555 (E.D. Wis. 1906).

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13. Pub. L. No. 103-394 (1994).

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14. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

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15. The 2005 amendments deleted the references to "subsection (c) or (d)." Pub. L. No. 109-8, § 1204(1) (2005).

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16. See 140 Cong. Rec. H10,796 (daily ed. Oct. 4, 1994), stating that "[t]his section specifies that small business investment companies are ineligible to file for bankruptcy protection. This will prevent such filings from being utilized to subordinate the interests of the Small Business Administration to other creditors."

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17. 724 F.2d 12 (2d Cir. 1983).

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18. See *In re Grouphealth P'ship, Inc.*, 137 B.R. 593 (Bankr. E.D. Pa. 1992) (determination of whether a health maintenance organization (HMO) is a domestic insurance company barred from filing a petition for relief under the Bankruptcy Code is made by using the "state classification test," whereby a court looks to the applicable state law under which the HMO was formed to determine whether it is a type of corporation excluded by the Code and gives particular deference to the state's regulatory interest in the business of insurance at the outset of the section 109 analysis); see also *In re Beacon Health, Inc.* 21 C.B.C.2d 1108, 105 B.R. 178 (Bankr. D.N.H. 1989); *Solomon v. St. Joseph's Mercy Hosp. (In re Michigan Master Health Plan, Inc.)*, 11 C.B.C.2d 1192, 44 B.R. 642 (Bankr. E.D. Mich. 1984). In *Portland Metro Health, Inc. v. Driscoll (In re Portland Metro Health, Inc.)*, 5 C.B.C.2d 651, 15 B.R. 102 (Bankr. D. Or. 1981), the debtor was held to be an insurance company and, therefore, ineligible for relief under chapter 7.

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19. See *Deltacorp, Inc., v. Office of Thrift Supervision (In re Deltacorp, Inc.)* 22 C.B.C.2d 803, 111 B.R. 419 (Bankr. S.D.N.Y. 1990); *Central Mortgage & Trust Co. v. Texas (In re Central Mortgage & Trust Co.)* 13 C.B.C.2d 617, 50 B.R. 1010 (S.D. Tex. 1985).

n20

20. See *In re Estate of Medcare HMO*, 998 F.2d 436, 29 C.B.C.2d 255 (7th Cir. 1993) (if the law of the state in which an entity is incorporated classifies such entity as one which is excluded from relief under section 109(b)(2) or if it is substantially similar to one excluded under this section, that entity may not be a debtor).

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21. *Cash Currency Exch. v. Shine (In re Cash Currency Exch., Inc.)*, 762 F.2d 542, 12 C.B.C.2d 1499 (7th Cir. 1985), cert. denied, 474 U.S. 904, 106 S. Ct. 233, 88 L. Ed. 2d 232 (1985); *Central Mortgage & Trust, Inc. v. State of Texas (In re Central Mortgage & Trust, Inc.)* 13 C.B.C.2d 617, 50 B.R. 1010 (S.D. Tex. 1985).

n22

22. *Sims v. Fidelity Assurance Ass'n*, 129 F.2d 442 (4th Cir. 1942) (a bank holding company whose main assets are five state chartered subsidiary banks who are not themselves debtors is not eligible to be a debtor under chapter 7); *In re Peoples Bankshares, Ltd.* 16 C.B.C.2d 124, 68 B.R. 536 (Bankr. N.D. Iowa 1986).

n23

23. *Kansas ex rel. Roynton v. Hayes*, 62 F.2d 597 (10th Cir. 1932).

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24. 998 F.2d 436, 29 C.B.C.2d 255 (7th Cir. 1993).

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25. 998 F.2d 436, 446, 29 C.B.C.2d 255, 268.

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26. *In re Prudence Co., Inc.*, 79 F.2d 77 (2d Cir. 1935), cert. denied, 296 U.S. 646, 56 S. Ct. 248, 80 L. Ed. 459 (1936); see also *Oil & Gas Ins. Co. v. Illinois*, 9 F.3d 771 (9th Cir. 1993) (finding debtor in state insurance company liquidation proceedings ineligible to file). But see *In re Guaranteed Ins. Underwriters, Inc.* 9 C.B.C.2d 593, 33 B.R. 582 (Bankr. S.D. Fla. 1983) (corporation engaged in the general insurance agency business, and which controls a corporate subsidiary that has received state permission to organize as a domestic insurance

company, is not a domestic insurance company).

n27

27. *In re Estate of Medcare HMO*, 998 F.2d 436, 442, 29 C.B.C.2d 255, 263-64 (7th Cir. 1993).

n28

28. See *Cash Currency Exch. v. Shine (In re Cash Currency Exch., Inc.)*, 762 F.2d 542, 12 C.B.C.2d 1499 (7th Cir.), cert. denied, 474 U.S. 904, 106 S. Ct. 233, 88 L. Ed. 2d 232 (1985); *Gamble v. Daniel*, 39 F.2d 447 (8th Cir.), appeal dismissed, 281 U.S. 705, 50 S. Ct. 464, 74 L. Ed. 1129, cert. denied, 282 U.S. 848, 51 S. Ct. 27, 75 L. Ed. 752 (1930). But see *Pokela v. Gildor (In re Trade Fin. Bank)*, 163 B.R. 558 (Bankr. D.S.D. 1994) (merchant bank was a bank even though it could not accept deposits).

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29. See *Clemons v. Liberty Savings & Real Estate Corp.*, 61 F.2d 448 (5th Cir. 1932).

n30

30. See *Gamble v. Daniel*, 39 F.2d 447 (8th Cir.), appeal dismissed, 281 U.S. 705, 50 S. Ct. 464, 74 L. Ed. 1129, cert. denied, 282 U.S. 848, 51 S. Ct. 27, 75 L. Ed. 752 (1930).

n31

31. H.R. Rep. No. 595, 95th Cong., 1st Sess. 318 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 31 (1978); see *In re Affiliated Food Stores, Inc. Group Benefit Trust*, 26 C.B.C.2d 104, 114, 134 B.R. 215, 222 (Bankr. N.D. Tex. 1991) (citing *First Am. Bank & Trust Co. v. George*, 540 F.2d 343 (8th Cir. 1976), cert. denied, 429 U.S. 1011, 97 S. Ct. 634, 50 L. Ed. 620 (1976)).

n32

32. *Israel-British Bank (London), Ltd. v. FDIC*, 536 F.2d 509 (2d Cir. 1976). 11 U.S.C. § 303(k) limits involuntary cases against a foreign bank not engaged in business in the United States to a case under chapter 7 and only where a foreign proceeding respecting such bank is pending. This limitation does not apply to voluntary cases commenced by a foreign bank and does not apply to any of the other entities identified in section 109(b)(3).

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33. Pub. L. No. 106-554 (2000). The same Act added New Markets Venture Capital companies, as defined in section 351 of the Small Business Investment Act of 1958, to the list of entities excluded from chapter 7.

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34. See Collier on Bankruptcy, ch. 101 (Matthew Bender).

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35. 11 U.S.C. §§ 781784; see Collier on Bankruptcy, ch. 780, ch. 781, ch. 782, ch. 783 and ch. 784 (Matthew Bender).

n36

36. Pub. L. No. 109-8, § 802(d)(1) (2005), effective in cases commenced on or after October 17, 2005. See generally Collier on Bankruptcy, ch. 1501 (Matthew Bender).

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37. H. R. Rep. No. 109-31, 109th Cong., 1st Sess. 118-19 (2005).

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173 of 197 DOCUMENTS

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Collier on Who May File an Involuntary Petition

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Collier on Who May File an Involuntary Petition

By Collier

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SUMMARY: Bankruptcy Code section 303(b) contains a host of requirements addressing who is eligible to file an involuntary bankruptcy case and the 2005 amendments provide some clarifications of existing provisions. This Emerging Issues Analysis addresses the general requirements of Section 303(b), which entities can commence an involuntary case, the payment of costs and fees to petitioning creditors, and counsel for petitioning creditors.

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ARTICLE: *Bankruptcy Code section 303(b)* contains a host of requirements addressing who is eligible to file an involuntary bankruptcy case and the 2005 amendments provide some clarifications of existing provisions. n1 Despite the detail of this section, it has generated controversy, and courts have been called upon to resolve disputes over who may be a petitioning creditor and how many creditors are required to initiate the involuntary case. n2

General Requirements of Section 303(b)

Section 303(b) provides that the only entities that can commence an involuntary case are those holding claims n3 (or an indenture trustee representing the holder) that (1) are not contingent as to liability and (2) are not subject to a bona fide dispute as to liability or amount, the latter five words being added by the 2005 amendments. There is no specific term within the Code defining the entities that file involuntary petitions, and they are not statutorily referred to in section 303(b) as creditors. n4 The term "petitioning creditors" can be used to refer to entities that are commencing the case, whether or not they are statutorily authorized to do so. Those that satisfy the requirements can be termed "qualifying creditors." n5 The aggregate of the claims of such entity or entities must be at least \$13,475 of unsecured debt. n6 Section 303(b)(1) also provides that an involuntary filing must be made by three or more entities. Under section 303(b)(2), if the debtor has fewer than 12 eligible holders (not counting certain interested parties), an involuntary filing can be made by as few as one qualifying creditor. If the debtor is a partnership, fewer than all general partners can initiate an involuntary filing. If the debtor is the subject of a foreign proceeding, the foreign representative may commence an involuntary case.

Petitioning Entities

To determine if the requirements of section 303(b) are met with respect to the number of petitioning creditors and the dollar amount of their claims, it is first necessary to look closely at which entities may commence an involuntary case. Only entities that are holders of claims or indenture trustees representing such a holder are permitted to file. The term "entity" is broadly defined to include a person, estate, trustee, governmental unit and the United States trustee. n7 The term "claim" also is broadly defined within the Bankruptcy Code, n8 but only the holders of claims that are not contingent as to liability or the subject of a bona fide dispute as to liability or amount may be petitioning creditors. The fact that there is a joint obligee on the claim does not preclude one holder of that claim from being an eligible entity. n9

There is one noteworthy threshold question--namely, whether a debtor can defeat an involuntary petition by paying the debts owed to one or more of the petitioning creditors in the period between the filing and a decision on the merits of the involuntary petition. If permitted, the debtor would be disabling the petitioning creditors not only from holding a claim but also from contesting debtor's motion to dismiss. n10 The limited decisional law provides that "buying out" all petitioning creditors is impermissible; however, repaying one of the petitioning creditors is not per se prohibited. n11 There is an additional twist: If repaying one of the petitioning creditors results in the three-creditor requirement not being met, then other creditors are accorded an opportunity to join in the involuntary petition under section 303(c) and Rule 1003(b). n12

Contingent Claims. Normally, the term "claim" includes interests that are contingent as to liability. The limitation in section 303(b)(1) means that creditors with claims contingent as to liability cannot be petitioning creditors. Although the term "contingent" is not defined in the Bankruptcy Code, a claim that is contingent as to liability is one as to which the debtor's obligation to pay does not come into being until the happening of some future event, and that event was within the contemplation of the parties at the time their relationship originated. n13 Thus, when the duty to pay does not rest upon a future event, the claim is not contingent. n14

The standard for determining whether a claim is contingent as to liability has been articulated in a variety of ways. One detailed and useful standard has been articulated by the court in *In re Taylor & Associates, L.P.* n15 It adopts the standard from *Longhorn 1979-II Drilling*. n16 Quoting in part from *Longhorn*, the Taylor court stated as follows: "When all the events have occurred which allow a court to adjudicate a claim and determine whether or not payment should be made, there is no contingency concerning the claim itself" unless "it is apparent, to a legal certainty," that the petitioning creditors would be unable to obtain a judgment against the debtor upon adjudication of its claim. n17

For example, past due rental payments under a lease are not contingent as to liability. n18 Promissory notes in default or invoices from trade creditors that are overdue are not claims that are contingent as to liability. n19 An example of a claim that is contingent as to liability is that of a guarantor of payment; until it is clear that the principal obligor is unable to pay, the obligation of the guarantor remains contingent. Another example concerns a debtor who owes a sales agent commissions only if potential purchasers actually buy the goods in question. If no sales have been made as of the date the involuntary petition is filed, the debtor's obligation to the sales agent is contingent as to liability since commission payment hinges on the happening of a future event, namely a sale. n20

A claim is not contingent just because a debtor disputes the creditor's claim and asserts a counterclaim against it. n21 However, issues of counterclaims can affect other aspects of section 303(b), including whether the \$13,475 aggregation requirement is satisfied and whether the claim is subject to a bona fide dispute as to liability or amount. n22

A judgment rendered by a state court should be sufficient to demonstrate that a claim is noncontingent. n23 A creditor whose right to payment depends on obtaining an as-yet unobtained judgment raises a complex issue. If a judgment is treated as a condition of payment rather than a condition to liability, a creditor so positioned may be able to file an involuntary case. n24

In those states, such as New York, in which a judgment is considered final and is not affected by the prosecution or pendency of an appeal, the underlying obligation should not be contingent as to liability. n25 If a stay pending appeal has been obtained, however, the strength of the foregoing position is brought into question. n26 In the rare situation in which a judgment is attacked by the debtor based on the theory that the judgment was obtained through fraud or a lack of subject matter jurisdiction over the parties and the issues being litigated, the claim may be contingent as to liability.

Claims of petitioning creditors involving tort, fraud or antitrust allegations raise particular problems. In these situations, it can be argued that the claim is contingent as to liability before judgment. n27 It would become noncontingent when a judgment is entered. Alternatively, it could be argued that the claim is disputed rather than contingent since liability for tort, fraud or antitrust actions does not hinge on the happening of a future event, such as entry of a judgment; liability hinges on findings of fact and issues of law to be determined by a court, and a court determination is not the type of future event that renders a claim contingent. n28 Under this approach, a tort action accrues when the tort is committed or when the injured party acquires a right to sue. The latter is the stronger position, and is a position hinted at in *In re B.D. International Discount Corp.* n29 and taken by the court in *In re Taylor & Associates, L.P.* n30 A final approach is to consider a claim to be both contingent and disputed, a position that, in essence, adopts both approaches.

Subject of a Bona Fide Dispute. Petitioning creditors cannot hold a claim that is subject to a bona fide dispute as to liability or amount. Prior to the addition of the words "as to liability or amount," added by the 2005 amendments, the term "bona fide" dispute had been the subject of considerable litigation. n31 The term "bona fide dispute as to liability or amount" also appears in section 303(h), and although many courts treat the terms interchangeably, they refer to different situations. n32

In the context of section 303(b), bona fide disputes disqualify specific entities from filing an involuntary petition. Under section 303(h), a debtor is subject to an involuntary filing if it is generally not paying its debts as they become due. The standard in section 303(h), however, contains an important qualification: The determination of "generally not paying" excludes debts that are subject to a bona fide dispute as to liability or amount. n33 It is possible that the petitioning creditor (whose claim is subject to a bona fide dispute under section 303(b)) is also the creditor whose claim is excluded from the calculation of the generally-not-paying standard under section 303(h). However, satisfying the standard under section 303(h) could involve many other creditors, including in appropriate circumstances, one or more of the petitioning creditors. Thus, while the term "bona fide dispute as to liability or amount" is the same in subsections (b) and (h) of section 303, it relates to satisfying different requirements under the Code and may involve entirely different parties or a party with different types of claims. n34

As a definitional matter, the term "bona fide dispute" (before the addition of the words "as to liability or amount") had been given the same meaning by courts whether used in subsection 303(b) or (h). n35 It should be noted that some courts have not even addressed the complex issue of "bona fide dispute" if they can determine that the debtor is generally paying its debts as they became due. n36 If a court determines that the petitioning creditor's claim is the subject of a bona fide dispute under section 303(b), the court may never get to the issues under section 303(h). Alternatively, a court may focus on the issue of bona fide dispute in the context of section 303(h), in which case the issue might not need to be determined under section 303(b). Nothing in the 2005 amendments should affect the reasoning of these pre-amendment cases.

The Meaning of a Bona Fide Dispute. The meaning of the term "bona fide dispute": has been somewhat clarified by the 2005 amendments with the addition of the words "as to liability or amount." However, what actually constitutes a "bona fide dispute" remains undefined in the Bankruptcy Code, and it is uncertain, for example, whether a small dispute as to the amount due (such as under an attorney's fee clause) will disqualify an otherwise liquidated debt in its entirety. n37 The term is intended to balance the interests of debtors and creditors in involuntary cases. n38 If creditors with clearly disputed claims could initiate an involuntary filing, the filing could simply be harassing a debtor into paying the troublesome creditors. n39 Moreover, it has been suggested that Congress wanted creditors to settle disputed claims

outside of bankruptcy given the severity of an involuntary bankruptcy as a remedy. n40 On the other hand, if a debtor could challenge an involuntary filing merely by alleging that a claim is disputed, especially if the dispute lacks merit, creditors' ability to commence involuntary cases would be curtailed. Cases decided prior to the addition in 1984 of the term "subject to a bona fide dispute." n41 reveal the confusion that existed and the effort to resolve the tension between the interests of debtors and creditors. n42 However, the addition of the wording in 1984 did not end the litigation, leading to the 2005 amendment, which itself might engender additional litigation.

There currently exist a series of interpretations of the term "subject to a bona fide dispute." Some courts have adopted a summary judgment standard; if there are material issues of law or fact regarding the claim, it will be considered disputed. n43 Other courts have utilized a multi-factored test which takes into account the debtor's subjective state of mind. n44 The current trend is to utilize an objective standard. This approach has been adopted by the Second, n45 Third, n46 Fifth, n47 Seventh, n48 Eighth n49 and Tenth n50 Circuits, although the actual articulation of the standard varies. The Bankruptcy Appellate Panel for the Sixth Circuit has also adopted the objective approach, n51 as has a district court in the First Circuit. n52 Relying on *In re Lough*, n53 the Court of Appeals for the Third Circuit held that a bona fide dispute exists "[i]f there is a genuine issue of material fact that bears upon the debtor's liability, or a meritorious contention as to the application of law to disputed facts " n54 The gloss on this definition is that if there are substantial factual or legal questions raised by the debtor, the debtor can preclude the creditor from being an eligible petitioning creditor. The Courts of Appeals for the Seventh and Tenth Circuits suggest that the court must "determine whether there is an objective basis for either a factual or legal dispute as to the validity of the debt." n55 The Second Circuit explicitly adopted the Seventh Circuit's approach. n56

The application of the objective standard has presented courts with considerable difficulty, some of which may diminish with the added language "as to liability or amount." Affirmative defenses to a creditor's claim suggest that a bona fide dispute exists, but the debtor's assertion of a counterclaim that does not go to the merits of the creditor's claim does not necessarily demonstrate a bona fide dispute. n57 Prior to the 2005 amendments, some courts took the position that a debtor's counterclaim disputing the amount of a creditor's claim, and not the legitimacy or the existence of such claim, did not make the creditor's claim the subject of a bona fide dispute. n58 It appears that this result may change as a consequence of the 2005 amendments, since a dispute as to amount is sufficient to disqualify the petitioning creditor.

All complications, though, are not resolved by the 2005 amendments. Even with the new statutory language in section 303(b), a counterclaim arising out of a different transaction (and hence not creating a right of recoupment) does not evidence the existence of a bona fide dispute. n59 However, it may be relevant in determining whether the requisite dollar amount is met under section 303(b)(1), especially with the addition of further new language in 2005 that "the noncontingent undisputed claims" must aggregate at least \$13,475. n60 This added language suggests that the language "as to liability or amount" clearly must be taken into account to determine the requisite dollar amount. A counterclaim may also matter in determining whether the debtor is generally not paying its debts as they become due under section 303(h)(1). n61 The existence of litigation before the filing of an involuntary case is also not dispositive of a bona fide dispute, n62 although pending litigation between a petitioning creditor and the debtor should be examined. An unstayed judgment suggests the absence of a bona fide dispute, n63 although there is case law to the contrary. n64 A bona fide dispute can exist when a claim has not yet matured and prerequisites to payment have not yet been satisfied. n65 Even if state law holds that an agent, acting as an undisclosed principal, is personally liable for the underlying transaction, there can remain critical factual issues and difficulty determining if a bona fide dispute exists. n66 For example, just because an officer operates under a fictitious name does not mean the officer is personally liable; being merely an officer is not enough to confer liability. n67

Even a well-articulated and substantiated legal argument does not insulate the petitioning creditors from a bona fide dispute challenge by the debtor, especially in view of the added language in 2005. This is because the new language enlarges the opportunity for a debtor to argue that a bona fide dispute exists.

Burdens of Proof as to a Bona Fide Dispute. The burden is on the petitioning creditor to establish a prima facie case that there is no bona fide dispute as to both liability and amount. n68 A debtor's listing of the petitioning creditor's

claim pursuant to Bankruptcy Rule 1003(b) is not an admission sufficient to carry petitioning creditor's burden of proof. Compliance with Bankruptcy Rule 1003 does not obviate the need for the petitioning creditor to demonstrate that its claim is neither contingent as to liability nor the subject of a bona fide dispute as to liability and amount. n69 Once the creditor satisfies its burden, the burden shifts to the debtor to demonstrate that a bona fide dispute exists as to either liability or amount. n70 The debtor's subjective intent or belief as to the amount of the debt or value of services provided is insufficient proof. n71 To resolve the issue, a court may, but is not required to, address the merits of the underlying dispute. n72 The determination may well hinge on an assessment of the credibility of witnesses and other factual considerations. n73 Moreover, a debtor's whole or partial postpetition payment to a petitioning creditor may evidence that the claim is not the subject of a bona fide dispute. n74

When disputed claims are an issue, some courts have suggested balancing the interests of the debtor and the petitioning creditors. The interest of the debtor to be protected from an unwarranted bankruptcy case is balanced against the need for creditors to be protected from a debtor's wasting of assets. n75 Although the balancing approach has some appeal, the issue is better resolved by relying on the objective test.

Disputes in Whole or in Part. Before the 2005 amendments, n76 there was considerable question whether disputes as to amount alone were enough to make a petitioning creditors' claim invalid for purposes of filing an involuntary case. Prior to 2005, disputes as to the entire amount of the claim (hence liability) were enough to eliminate a creditor as a petitioning creditor. n77 That still remains true. However, there were courts that held that a counterclaim by the debtor was insufficient to create a bona fide dispute, a position that is weakened, albeit not eliminated, by the 2005 amendments. This is because, with the new language, disputes as to amount--not just liability--are sufficient to create a bona fide dispute. n78 Hence, one will now need to look at the basis for the counterclaim to assess whether it qualifies as to a dispute as to amount or is completely unrelated to the amount owed. Based on the 2005 legislation, a stronger argument can be made that partial disputes are sufficient to disqualify a petitioning creditor. Thus, the cases prior to the legislation that indicated that disputes as to a portion of the creditor's claims did not disqualify that creditor from filing an involuntary case will have less potency based on the 2005 amendments to section 303(b)(1). n79 That said, if the dispute is limited to the portion of the amount owed, the creditor is not precluded from arguing that there is some "undisputed" claim and it should be entitled to seek the protection offered by the Code through an involuntary filing--although that argument may fail.

Standards of Review. In terms of the standard of review regarding the determination of whether a bona fide dispute as to liability or amount exists, courts have had differing views. Some have viewed a determination of whether there is a bona fide dispute as a factual matter, thus leading to a review on the clearly erroneous standard. n80 Other courts have noted that a determination regarding a bona fide dispute might, in some circumstances, involve conclusions of law, in which case a de novo standard of review would apply. n81 Yet another approach is to look at a given case and then decide, based on the presented situation, which standard of review would apply. Thus, if the particular situation involved a factual question, the standard would be clearly erroneous but when the situation involved conclusions of law, the standard would be de novo. n82 The essence of this latter approach is that the determination of which type of review (factual or legal) is not made ahead of time; instead, it is made on the basis of the presented situation and then, at that point, the applicable standard of review is applied.

Requirement That Petitioning Creditors Hold a Claim. In addition to the requirement that petitioning creditors cannot hold claims contingent as to liability or claims subject to a bona fide dispute as to liability or amount, they must also be holders of a claim. n83 The term "claim" is broadly defined. n84 A creditor holds a claim even if the claim is not due, since claims can be unmatured. n85 Being nonrecourse does not disqualify an entity from filing an involuntary case. n86 However, a nonrecourse secured creditor in a chapter 7 case cannot be the sole petitioning creditor, since there is no unsecured claim against the debtor, even if the secured creditor is undersecured. n87 If the secured creditor waived its security interest, the debt would, nevertheless, remain nonrecourse. n88 If a petitioning creditor becomes a debtor and a trustee is appointed or elected, the trustee substitutes for the creditor. Also, if a petitioning creditor holds a claim against the debtor "for which another entity is jointly liable," this claim may still serve as the basis for the

petitioning creditor's claim. n89

Transferors and Transferees. A transferor or a transferee of a claim can be a petitioning creditor if there has been compliance with Bankruptcy Rule 1003(a). This rule requires that the petitioning creditor affirmatively state that the transfer was not for the purpose of commencing an involuntary case. n90 Thus, a creditor who acquired, transferred or split a claim for the purpose of commencing an involuntary case is not qualified as a petitioning creditor. n91 Determining a transferor or transferee's motivation in this context can be difficult and hotly contested. n92

Secured Creditors. The general rule is that fully n93 and partially secured creditors n94 can be petitioning creditors. With respect to a fully secured creditor, the other petitioning creditors' noncontingent, undisputed, unsecured claims must aggregate at least \$13,475. Since the fully secured creditor has no unsecured claim, the unsecured indebtedness of the other petitioning creditors must at least equal \$13,475. n95 Whether a creditor's claim is actually secured is not always easy to determine, and the issue is often governed by state law. n96 The use of the word "aggregate" in section 303(b) means that it is the total of the claims of the petitioning creditors that matters, not whether one particular petitioning creditor is owed a prescribed amount. Further, the use of the word "aggregate" in section 303(b) applies only to the creditors commencing the case; fully secured creditors are still entitled to be counted to determine the debtor's total number of creditors. n97 The permissibility of secured creditors serving as petitioning creditors is reinforced by the language in section 303(c) that specifically provides that only creditors "holding an unsecured claim" may join in a petition. n98 As to a partially secured creditor, the amount of its claim for purposes of being a petitioning creditor is the amount of the unsecured portion of its debt (the amount over and above the value of the collateral securing the claim). n99 A fully secured creditor (with recourse) may also serve as the sole petitioning creditor if it waives its security interest, although any such waiver is valid for all purposes in a case. n100 An oversecured or nonrecourse secured creditor may serve as one of the three petitioning creditors, provided, however, that the other two creditors hold unsecured claims that aggregate at least the amount specified in section 303(b) and are not contingent as to liability or subject to a bona fide dispute as to liability or amount. n101

Limited Partners. The ability of limited partners to file an involuntary case against the partnership is problematic. Courts are of the general view that limited partners are not creditors since they do not have a right to payment or a right to an equitable remedy as required under the definition of "claim." n102 Instead, limited partners have made a contribution to capital. n103 The characterization of a limited partner's debt is not based on the debtor's characterization; instead, the nature of the transaction should be examined. In addition to assessing whether the transaction was arm's length, courts have looked at other factors: which include: (1) whether the transaction bears the formality of a loan agreement; (2) the financial situation of the partnership; (3) when the loan was made; (4) the relationship between the limited partners' equity ownership and the parties participating in the making of the loan; and (5) whether a reasonable outside creditor would have made a loan to the debtor on similar terms. n104

However, if the limited partners are proceeding on the basis of a tort or contract action, they may well be the holders of claims and be qualified as involuntary petitioners. n105

Spouses, Children, Other Relatives. Although insiders are not counted as holders of claims for purposes of establishing the minimum number of petitioning creditors requirement in section 303(b), n106 these individuals can be petitioning creditors if they satisfy the other requirements. Former spouses and their children (either through their parent or a third party) may be petitioning creditors because their entitlement to alimony and child support, respectively, makes them entities holding claims. n107

Creditors Holding Avoidable Claims. Creditors holding avoidable claims are not counted for purposes of establishing the numerosity requirement in section 303(b). n108 But, despite some case law to the contrary, n109 creditors who received avoidable transfers can be petitioning creditors if they hold claims. n110 This prevents the debtor from paying off the petitioning creditors' claims so as to avoid the involuntary petition. n111

Stockholders, Officers, Directors and Employees. Although insiders, defined in section 101, cannot be included for purposes of the numerosity requirement, they can serve as petitioning creditors if they hold claims. If the interests the stockholders hold are equity interests, they cannot be petitioning creditors since their interests are not claims; i.e., a right to payment. n112 If the employees have unpaid wages entitled to a priority, they can still be petitioning creditors. n113 A debtor attorney's prepetition claim against the debtor can be counted for section 303(b) purposes; whether the attorney can continue to represent the debtor is another matter. n114

Indenture Trustees. Section 303(b)(1) specifically provides that indenture trustees may commence involuntary petitions although they are not actually creditors themselves. The indenture trustee may join two debenture holders as petitioning creditors, and such joinder would not extinguish the claims of the other holders. n115 Thus, the three petitioning creditors requirement under section 303(b), unless prohibited by some express language in the debenture itself, is satisfied by a combination of debenture holders and indenture trustees. n116 However, the wording of subsection 303(b)(1) and (2) suggests that if the debtor has fewer than 12 creditors, an indenture trustee cannot be a petitioning creditor. Thus, the indenture trustee can be one of the three petitioning creditors but not the sole petitioning creditor.

Claims Against Spouses in Community Property States. In community property states, entities holding claims against one spouse should not have standing to file an involuntary petition against the other spouse even though these entities will have "creditor" status in relation to the debtor upon entry of an order for relief because they hold "community claims." n117 Although it could be argued that a creditor of the other spouse holds a claim, section 303(b) states that the claim must be against the "person" as distinguished from against the "debtor." To allow creditors of one spouse to file an involuntary petition against the other spouse would complicate the distributional scheme contemplated by section 726(c)(2)(D), and would encourage involuntary filings in situations not intended by Congress. n118 It should be noted, however, that the filing of an involuntary petition creates an estate under section 541 which includes the nondebtor's interests in community property. The property of nondebtors, therefore, can be dealt with in the involuntary bankruptcy of their spouses. n119

Other Entities Including the Government, Debtors, Pension Funds and Tenants. The government, which is included within the definition of "entity," n120 can be a petitioning creditor if it holds a claim. n121 A debtor in an unrelated title 11 case can also be a petitioning creditor because it does not need authority to sue or recover an outstanding debt. However, a pension, health or welfare fund cannot be a petitioning creditor as a fund per se unless that is expressly provided for in the underlying fund documents, since only a real party can commence actions on a fund's behalf. Thus, only parties entitled to bring actions on behalf of a fund, such as the fund trustee, can be petitioning creditors. n122 Some courts have refused to allow tenants to act as petitioning creditors solely on the basis of the landlord's possession of their security deposits. This is because, under certain state laws, until default, a tenant has full ownership of its security deposit and hence there is no debt owed to the tenant by the nondefaulting landlord; arguably, there is no claim. n123

Death of Petitioning Creditor. If a petitioning creditor dies, the personal representative should be substituted pursuant to Bankruptcy Rule 7025, which incorporates *Federal Rule of Civil Procedure 25(a)*.

Payment of Costs and Fees to Petitioning Creditors

A petitioning creditor, after notice and a hearing, may be entitled to costs and expenses for filing an involuntary case under section 303. This is specifically contemplated by section 503(b)(3)(A). n124 This allowed administrative

expense is referenced in the legislative history. n125 In determining the amount that the petitioner (and its professionals) may be entitled to receive, courts have determined that costs and expenses can go beyond the mere preparation and filing of the petition; they can go to the adjudication of the issue. n126 The entry of an order for relief following the filing of an involuntary petition is also not a prerequisite to petitioning creditors (and their professionals) receiving compensation. n127 However, if petitioning creditors lose litigation on the permissibility of the involuntary filing, they can be denied compensation. n128

Counsel for Petitioning Creditors

Counsel for the petitioning creditors is not automatically disqualified from representing the trustee. n129 However, when there is an objection by a creditor or the United States Trustee, "the court shall disapprove such employment if there is an actual conflict." n130 Counsel for the petitioning creditors could serve, instead, as special counsel if it is in the best interests of the estate and counsel does not hold or represent an adverse interest with respect to the matter as to which counsel is being employed. n131 If a petitioning creditor receives an administrative claim for actual and necessary costs of filing an involuntary case under section 503(b)(3)(A), counsel to the creditor can also receive an administrative claim for reasonable compensation under section 503(b)(4), a point made clear in the 2005 amendments by a specific cross-reference to subsection (b)(3)(A) in subsection (b)(4). n132

For a complete discussion of Code section 303, see *Collier on Bankruptcy*, ch. 303 (Matthew Bender).

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n1 1. See Pub. L. No. 109-8, § 1234 (2005).

n2

2. See *Collier on Bankruptcy*, 303.04.

n3

3. "Claim" is broadly defined in 11 U.S.C. § 101. See *Collier on Bankruptcy*, ch. 101.

n4

4. They are referred to as creditors elsewhere in the Code. See 11 U.S.C. §§ 303(c), 503(b)(3)(A).

n5

5. *In re Atwood*, 124 B.R. 402 (S.D. Ga. 1991).

n6

6. 11 U.S.C. § 303(b). This dollar amount is effective for cases filed on or after April 1, 2007. Pursuant to 11 U.S.C. § 104(b), the amount is adjusted every three years to account for changes in the cost of living. See Collier on Bankruptcy, 104.03. For cases commenced during the three-year period beginning April 1, 2004, the dollar amount was \$12,300.

n7

7. 11 U.S.C. § 101.

n8

8. *Id.*

n9

9. *In re Brooklyn Resource Recovery, Inc.*, 216 B.R. 470 (Bankr. E.D.N.Y. 1997).

n10

10. See William L. Medford, *Dismissal of Involuntary Petitions--Can You Buy Your Way Out?*, Am. Bankr. Inst. J., Dec. 2001.

n11

11. *In re Vortex Fishing Sys., Inc.*, 277 F.3d 1057 (9th Cir. 2002) (holding, *inter alia*, that repaying one petitioning creditor is permissible); *In re Faberge Restaurant of Florida, Inc.*, 222 B.R. 385 (Bankr. S.D. Fla. 1997) (holding repayment to all petitioners is inappropriate).

n12

12. In *Vortex, supra*, there were four petitioning creditors, so the repayment of one of them did not implicate the need to solicit other creditors, an issue that was problematic because the list of creditors was sealed.

n13

13. *Subway Equip. Leasing Corp. v. Sims (In re Sims)*, 994 F.2d 210, 29 C.B.C.2d 443 (5th Cir. 1993). See *Collier on Bankruptcy*, 109.06[2][b]. (discussion of contingent debts in chapter 13 eligibility context).

n14

14. *In re All Media Props., Inc.*, 2 C.B.C.2d 449, 5 B.R. 126 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981).

n15

15. 193 B.R. 465 (Bankr. E.D. Tenn. 1996), *stay granted, vacated, remanded*, 249 B.R. 431 (E.D. Tenn. 1997), *on remand, petition dismissed*, 249 B.R. 448 (Bankr. E.D. Tenn.), *aff'd*, 249 B.R. 474 (E.D. Tenn. 1998) (grounds unrelated).

n16

16. *In re Longhorn 1979-II Drilling Program, L.P.*, 32 B.R. 923, 927 (Bankr. W.D. Okla. 1983).

n17

17. 193 B.R. 465, 475.

n18

18. *Subway Equip. Leasing Corp. v. Sims (In re Sims)*, 994 F.2d 210, 220, 29 C.B.C.2d 443, 455-56 (5th Cir. 1993).

n19

19. *In re Mavellia*, 149 B.R. 301, 304 (Bankr. E.D.N.Y. 1991); *In re All Media Props., Inc.*, 2 C.B.C.2d 449, 454-55, 5 B.R. 126, 132-33 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981). *Contra In re Atlas Mach. & Iron Works, Inc.*, 190 B.R. 796 (Bankr. E.D. Va. 1995).

n20

20. *In re Skye Mktg. Corp.*, 4 C.B.C.2d 954, 11 B.R. 891 (Bankr. E.D.N.Y. 1981).

n21

21. *In re McNeil*, 5 C.B.C.2d 402, 404, 13 B.R. 434, 436 (E.D. Tenn. 1981); *In re North County Chrysler-Plymouth, Inc.*, 4 C.B.C.2d 1533, 13 B.R. 393 (Bankr. W.D. Mo. 1981); *In re Skye Mktg. Corp.*, 4 C.B.C.2d 954, 11 B.R. 891 (Bankr. E.D.N.Y. 1981); *see In re Elsub Corp.*, 70 B.R. 797 (Bankr. D.N.J. 1987).

n22

22. *See Collier on Bankruptcy*, 303.05 (Matthew Bender).

n23

23. *In re Drexler Assocs., Inc.*, 57 B.R. 312 (Bankr. S.D.N.Y. 1986); *In re Drexler*, 56 B.R. 960 (Bankr. S.D.N.Y. 1986); *In re Arker*, 3 C.B.C.2d 121, 6 B.R. 632 (Bankr. E.D.N.Y. 1980); *see In re Pan Am Corp.*, 31 C.B.C.2d 903, 166 B.R. 538 (S.D.N.Y. 1994).

n24

24. *In re Pan Am Corp.*, 31 C.B.C.2d 903, 166 B.R. 538 (S.D.N.Y. 1994); *In re Bowers*, 5 C.B.C.2d 1376, 16 B.R. 298 (Bankr. D. Conn. 1981).

n25

25. *In re Arker*, 3 C.B.C.2d 121, 125, 6 B.R. 632, 635 (Bankr. E.D.N.Y. 1980).

n26

26. *In re Raymark Indus., Inc.*, 99 B.R. 298 (Bankr. E.D. Pa. 1989).

n27

27. *In re Taylor & Assocs., L.P.*, 193 B.R. 465 (Bankr. E.D. Tenn. 1996), stay granted, vacated, remanded, 249 B.R. 431 (E.D. Tenn. 1997), on remand, petition dismissed, 249 B.R. 448 (Bankr. E.D. Tenn.), *aff'd*, 249 B.R. 474 (E.D. Tenn. 1998) (grounds unrelated).

n28

28. *In re Dill*, 13 B.R. 9 (D. Nev. 1981), *aff'd*, 731 F.2d 629, 10 C.B.C.2d 1119 (9th Cir. 1984).

n29

29. 5 C.B.C.2d 813, 15 B.R. 755 (Bankr. S.D.N.Y. 1981), *aff'd*, 701 F.2d 1071, 8 C.B.C.2d 300 (2d Cir.), cert. denied, 464 U.S. 830, 104 S. Ct. 108, 78 L. Ed. 2d 110 (1983).

n30

30. 193 B.R. 465 (Bankr. E.D. Tenn. 1996), stay granted, vacated, remanded, 249 B.R. 431 (E.D. Tenn. 1997), petition dismissed, 249 B.R. 448 (Bankr. E.D. Tenn.), *aff'd*, 249 B.R. 474 (E.D. Tenn. 1998) (grounds unrelated).

n31

31. See generally Lawrence Ponoroff, *Involuntary Bankruptcy and the Bona Fides of a Bona Fide Dispute*, 65 Ind. L.J. 315 (1990).

n32

32. See *In re Seko Inv.*, 156 F.3d 1005, 40 C.B.C.2d 1384 (9th Cir. 1998) (recognizing that the same term could mean different things under subsections 303(b) and (h)).

n33

33. See *Collier on Bankruptcy*, 303.14[1][c].

n34

34. See *In re Seko Inv.*, 156 F.3d 1005, 40 C.B.C.2d 1384 (9th Cir. 1998) (petitioning creditor held a claim as an assignee and also served as the title insurer).

n35

35. Determining what constitutes a bona fide dispute under section 303(b) involves a higher standard than determining what constitutes a disputed claim for purposes of determining eligibility under section 702. See *In re Williams*, 277 B.R. 114 (Bankr. C.D. Cal. 2002).

n36

36. *In re Palace Oriental Rugs, Inc.*, 193 B.R. 126 (Bankr. D. Conn. 1996).

n37

37. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003); *In re Elsa Designs, Ltd.*, 155 B.R. 859 (Bankr. S.D.N.Y. 1993).

n38

38. Comments of Sen. Baucus, 130 Cong. Rec. S7618 (daily ed. June 19, 1984), cited in *In re Cates*, 62 B.R. 179, 180-81 (Bankr. S.D. Tex. 1986).

n39

39. *In re West Side Community Hosp., Inc.*, 112 B.R. 243 (Bankr. S.D. Ill. 1990).

n40

40. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003); *In re Cates*, 62 B.R. 179 (Bankr. S.D. Tex. 1986); *In re Hope Communications, Inc.*, 59 B.R. 939 (Bankr. W.D. La. 1986).

n41

41. See Lawrence Ponoroff, *Involuntary Bankruptcy and the Bona Fides of a Bona Fide Dispute*, 65 *Ind. L.J.* 315 (1990).

n42

42. *In re Covey*, 650 F.2d 877, 4 C.B.C.2d 719 (7th Cir. 1981); *In re Blaine Richards & Co., Inc.*, 16 B.R. 362 (Bankr. E.D.N.Y. 1982); *In re B.D. Int'l Discount Corp.*, 5 C.B.C.2d 813, 15 B.R. 755 (Bankr. S.D.N.Y. 1981), *aff'd*, 701 F.2d 1071, 8 C.B.C.2d 300 (2d Cir.), *cert. denied*, 464 U.S. 830, 104 S. Ct. 108, 78 L. Ed. 2d 110 (1983).

n43

43. See, e.g., *In re Stroop*, 51 B.R. 210 (D. Colo. 1985). However, the Tenth Circuit now utilizes another standard. See *Bartmann v. Maverick Tube Corp.*, 853 F.2d 1540, 19 C.B.C.2d 940 (10th Cir. 1988).

n44

44. See, e.g., *In re Johnston Hawks, Ltd.*, 12 C.B.C.2d 1188, 49 B.R. 823 (Bankr. D. Haw. 1985).

n45

45. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003).

n46

46. *B.D.W. Assocs., Inc. v. Busy Beaver Bldg. Ctrs., Inc.*, 865 F.2d 65 (3d Cir. 1989); see also *In re Enviro-Hort, Inc.*, 2000 U.S. Dist. LEXIS 6965 (E.D. Pa. May 22, 2000); *IBM Credit Corp. v. Compuhouse Sys., Inc.*, 179 B.R. 474 (W.D. Pa. 1995).

n47

47. *Subway Equip. Leasing Corp. v. Sims (In re Sims)*, 994 F.2d 210, 29 C.B.C.2d 443 (5th Cir. 1993).

n48

48. *In re Busick*, 831 F.2d 745, 17 C.B.C.2d 788 (7th Cir. 1987).

n49

49. *In re Rimell*, 946 F.2d 1363 (8th Cir. 1991).

n50

50. *Bartmann v. Maverick Tube Corp.*, 853 F.2d 1540, 19 C.B.C.2d 940 (10th Cir. 1988).

n51

51. *In re Eastown Auto Co.*, 215 B.R. 960 (B.A.P. 6th Cir. 1998).

n52

52. *Efron v. Gutierrez*, 226 B.R. 305 (D.P.R. 1998).

n53

53. 14 C.B.C.2d 375, 57 B.R. 993 (Bankr. E.D. Mich. 1986).

n54

54. *B.D.W. Assocs., Inc. v. Busy Beaver Bldg. Ctrs., Inc.*, 865 F.2d 65, 66-67 (3d Cir. 1989).

n55

55. *Bartmann v. Maverick Tube Corp.*, 853 F.2d 1540, 1544, 19 C.B.C.2d 940, 944-45 (10th Cir. 1988); *In re Busick*, 831 F.2d 745, 750, 17 C.B.C.2d 788, 794 (7th Cir. 1987).

n56

56. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003).

n57

57. *IBM Credit Corp. v. Compuhouse Sys., Inc.*, 179 B.R. 474 (W.D. Pa. 1995); *In re Elsa Designs, Ltd.*, 155 B.R. 859, 869 (Bankr. S.D.N.Y. 1993).

n58

58. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003) (noting that a bona fide dispute exists where a claim for offset arises out of the same transaction and is directly related to the creditor's underlying claim, and, if valid, could serve as a complete defense to that claim).

n59

59. *In re Seko Inv.*, 156 F.3d 1005, 40 C.B.C.2d 1384 (9th Cir. 1998).

n60

60. This dollar amount applies in cases commenced on or after April 1, 2007. See Collier on Bankruptcy, 104.03. For cases commenced in the three-year period beginning April 1, 2004, the dollar amount was \$12,300.

n61

61. *In re Seko Inv.*, 156 F.3d 1005, 40 C.B.C.2d 1384 (9th Cir. 1998); *In re Biogenetic Technologies, Inc.*, 248 B.R. 852 (Bankr. M.D. Fla. 1999); *In re Audio Visual Workshop, Inc.*, 211 B.R. 154, 158-59 (Bankr. S.D.N.Y. 1997).

n62

62. *IBM Credit Corp. v. Compuhouse Sys., Inc.*, 179 B.R. 474 (W.D. Pa. 1995).

n63

63. See *In re Cohn-Phillips, Ltd.*, 193 B.R. 757 (Bankr. E.D. Va. 1996); *In re Raymark Indus., Inc.*, 99 B.R. 298 (Bankr. E.D. Pa. 1989).

n64

64. *In re Prisuta*, 121 B.R. 474 (Bankr. W.D. Pa. 1990).

n65

65. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003).

n66

66. *In re Vinales*, 268 B.R. 749 (Bankr. W.D. Va. 2001).

n67

67. *Id.*

n68

68. *Liberty Tool & Mfg. v. Vortex Fishing Sys., Inc. (In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057 (9th Cir. 2002); *In re Reid*, 773 F.2d 945, 13 C.B.C.2d 781 (7th Cir. 1985).

n69

69. *In re Gutfran*, 210 B.R. 672, 673-74 (Bankr. D. Conn. 1998).

n70

70. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003); *McGinnis v. Jenkins & Assocs., Inc. (In re McGinnis)*, 296 F.3d 730 (8th Cir. 2002); *Subway Equip. Leasing Corp. v. Sims (In re Sims)*, 994 F.2d 210, 221, 29 C.B.C.2d 443, 456 (5th Cir. 1993); *In re Vinales*, 268 B.R. 749 (Bankr. W.D. Va. 2001).

n71

71. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003).

n72

72. *In re Everett*, 32 C.B.C.2d 1565, 178 B.R. 132 (Bankr. N.D. Ohio 1994).

n73

73. *In re Rimell*, 946 F.2d 1363, 1364 (8th Cir. 1991).

n74

74. *In re Faberge Restaurant of Florida, Inc.*, 222 B.R. 385, 388 (Bankr. S.D. Fla. 1997).

n75

75. *In re Drexler*, 56 B.R. 960, 971 (Bankr. S.D.N.Y. 1986).

n76

76. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005).

n77

77. *In re Fox*, 162 B.R. 729 (Bankr. E.D. Va. 1993).

n78

78. See, e.g., *IBM Credit Corp. v. Compuhouse Sys., Inc.* 179 B.R. 474 (W.D. Pa. 1995); *In re Onyx Telecomm., Ltd.*, 60 B.R. 492, 498 (Bankr. S.D.N.Y. 1985); see also Pub. L. No. 109-8, § 1234 (2005), and accompanying legislative history.

n79

79. *Key Mechanical, Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003) (noting that if a claim for offset arises out of the same transaction and works as a complete defense, a bona fide dispute exists); *IBM Credit Corp. v. Compuhouse Sys., Inc.* 179 B.R. 474 (W.D. Pa. 1995).

n80

80. See *Liberty Tool & Mfg. v. Vortex Fishing Sys., Inc. (In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057 (9th Cir. 2002).

n81

81. See *McCarthy v. Navistar Fin.Corp. (In re Vogel Van & Storage)*, 59 F.3d 9 (2d Cir. 1995).

n82

82. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003).

n83

83. 11 U.S.C. § 303(b).

n84

84. 11 U.S.C. § 101.

n85

85. *In re Win-Sum Sports, Inc.*, 5 C.B.C.2d 248, 14 B.R. 389 (Bankr. D. Conn. 1981).

n86

86. *ALI Inc. v. Cold Harbor Assocs., L.P.*, 1996 U.S. App. LEXIS 10852 (4th Cir. May 9, 1996). *But see In re Allen-Main Assocs., Ltd. P'ship*, 223 B.R. 59 (B.A.P. 2d Cir. 1998).

n87

87. *In re Allen-Main Assocs., Ltd. P'ship*, 223 B.R. 59 (B.A.P. 2d Cir. 1998).

n88

88. *In re Allen-Main Assocs., Ltd. P'ship*, 223 B.R. 59 (B.A.P. 2d Cir. 1998).

n89

89. *In re Brooklyn Resource Recovery, Inc.*, 216 B.R. 470, 481 (Bankr. E.D.N.Y. 1997) (citing *In re Elsub Corp.*, 15 C.B.C.2d 1256, 1275, 66 B.R. 172, 187 (Bankr. D.N.J. 1986)).

n90

90. *In re McMeekin*, 18 B.R. 177 (Bankr. D. Mass. 1982).

n91

91. *See Collier on Bankruptcy*, 303.04.

n92

92. *In re Beaucrest Realty Assocs.*, 1 C.B.C.2d 1095, 4 B.R. 166 (Bankr. E.D.N.Y. 1980).

n93

93. *Paradise Hotel Corp. v. Bank of Nova Scotia*, 842 F.2d 47, 18 C.B.C.2d 838 (3d Cir. 1988); *In re Everett*, 32 C.B.C.2d 1565, 178 B.R. 132 (Bankr. N.D. Ohio 1994).

n94

94. *In re R.N. Salem Corp.*, 23 B.R. 452 (Bankr. S.D. Ohio), *aff'd*, 29 B.R. 424 (S.D. Ohio 1983).

n95

95. 11 U.S.C. § 303(b). This dollar amount is effective for cases commenced on or after April 1, 2007. Pursuant to 11 U.S.C. § 104(b), the amount is adjusted every three years to account for changes in the cost of living. See *Collier on Bankruptcy*, 104.03. For cases commenced during the three-year period beginning April 1, 2004, the dollar amount was \$12,300. In the preceding three-year period, the amount was \$11,625.

n96

96. *In re Harman*, 243 B.R. 671 (Bankr. N.D. Tex. 1999) (if a debtor no longer had legal title, there was nothing to which the judgment creditor's lien could attach).

n97

97. *In re Evans*, 1997 Bankr. LEXIS 1073, at *36 (Bankr. E.D. Va. June 6, 1997).

n98

98. 11 U.S.C. § 303(c) (emphasis added); see *Collier on Bankruptcy*, 303.09.

n99

99. 11 U.S.C. § 506.

n100

100. *In re All Media Props., Inc.*, 2 C.B.C.2d 449, 5 B.R. 126 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981); *In re American Gypsum Co.*, 31 B.R. 187 (Bankr. D.N.M. 1983).

n101

101. *Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC)*, 330 F.3d 111 (2d Cir. 2003); *In re Allen-Main Ltd. P'ship*, 223 B.R. 59 (B.A.P. 2d Cir. 1998); *In re Apache Trading Group, Inc.*, 210 B.R. 869, 875 (Bankr. S.D. Fla. 1997).

n102

102. 11 U.S.C. § 101; *In re Royal Gate Assocs., Ltd.*, 18 C.B.C.2d 664, 81 B.R. 165 (Bankr. M.D. Ga. 1988); *In re Equidyne Props., Inc.*, 60 B.R. 245 (Bankr. S.D.N.Y. 1986).

n103

103. *In re Riverside-Linden Inv. Co.*, 85 B.R. 107 (Bankr. S.D. Cal. 1988), *aff'd*, 99 B.R. 439 (B.A.P. 9th Cir. 1989), *aff'd*, 925 F.2d 320, 24 C.B.C.2d 1210 (9th Cir. 1991); *In re Taylor & Assocs., L.P.*, 193 B.R. 465 (Bankr. E.D. Tenn. 1996), *stay granted, vacated, remanded* 249 B.R. 431 (E.D. Tenn. 1997), *on remand, petition dismissed*, 249 B.R. 448 (Bankr. E.D. Tenn.), *aff'd*, 249 B.R. 474 (E.D. Tenn. 1998) (grounds unrelated).

n104

104. *In re Cold Harbor Assocs., L.P.*, 37 C.B.C.2d 753, 763-68, 204 B.R. 904, 915-19 (Bankr. E.D. Va. 1997).

n105

105. *In re Riverside-Linden Inv. Co.*, 85 B.R. 107 (Bankr. S.D. Cal. 1988), *aff'd*, 99 B.R. 439 (B.A.P. 9th Cir. 1989), *aff'd*, 925 F.2d 320, 24 C.B.C.2d 1210 (9th Cir. 1991); *In re Taylor & Assocs., L.P.*, 193 B.R. 465 (Bankr. E.D. Tenn. 1996), *stay granted, vacated, remanded*, 249 B.R. 431 (E.D. Tenn. 1997), *on remand, petition dismissed*, 249 B.R. 448 (Bankr. E.D. Tenn.), *aff'd*, 249 B.R. 474 (E.D. Tenn. 1998) (grounds unrelated).

n106

106. *See Collier on Bankruptcy*, 303.04.

n107

107. *In re Hopkins*, 177 B.R. 1 (Bankr. D. Me. 1995).

n108

108. *See Collier on Bankruptcy*, 303.04.

n109

109. *In re Kreidler Import Co.*, 2 C.B.C.2d 159, 4 B.R. 256 (Bankr. D. Md. 1980).

n110

110. *In re Kenval Mktg. Corp.*, 38 B.R. 241 (Bankr. E.D. Pa. 1984).

n111

111. *In re Atwood*, 124 B.R. 402 (S.D. Ga. 1991).

n112

112. *In re Runaway II, Inc.*, 168 B.R. 193 (Bankr. W.D. Mo. 1994).

n113

113. *In re United Kitchen Assocs., Inc.*, 33 B.R. 214 (Bankr. W.D. La. 1983).

n114

114. *In re Cold Harbor Assocs., L.P.*, 37 C.B.C.2d 753, 760, 204 B.R. 904, 912 (Bankr. E.D. Va. 1997).

n115

115. *In re Federated Group, Inc.*, 107 F.3d 730, 732-33, 37 C.B.C.2d 795, 798-99 (9th Cir. 1997).

n116

116. *Id.*

n117

117. *In re Karber*, 25 B.R. 9, 13 (Bankr. N.D. Tex. 1982) (Section 303(c) further prevents a holder of a claim against a nondebtor spouse from joining in an involuntary petition once filed.)

n118

118. Testimony of Professor Stefan A. Riesenfeld Before the House Judiciary Committee makes this point. Hearings on H.R. 31 & 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong., 2d Sess. 1530 (1976).

n119

119. *See Collier on Bankruptcy*, 541.13.

n120

120. 11 U.S.C. § 101.

n121

121. *In re Crabtree*, 32 B.R. 837 (Bankr. E.D. Tenn. 1983).

n122

122. *In re Admiral Merchants Motor Freight, Inc.*, 11 B.R. 63 (Bankr. D. Minn. 1981). See generally *United States v. Larkin, Hoffman Daly & Lingreen*, 841 F. Supp. 899 (D. Minn. 1993).

n123

123. *In re Cold Harbor Assocs., L.P.*, 37 C.B.C.2d 753, 760-61, 204 B.R. 904, 912-13 (Bankr. E.D. Va. 1997).

n124

124. 11 U.S.C. § 503(b)(3)(A).

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125. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 355 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 66-67 (1978).

n126

126. *In re On Tour, LLC*, 276 B.R. 407 (Bankr. D. Md. 2002); *In re Indian Motorcycle Apparel & Accessories Co.*, 26 BCD 377 174 B.R. 659 (Bankr. D. Mass. 1994); *In re Stroeker*, 21 BCD 1239, 128 B.R. 205 (Bankr. N.D. Ill. 1991).

n127

127. *In re Indian Motorcycle Apparel & Accessories Co.*, 26 BCD377, 174 B.R. 659 (Bankr. D. Mass. 1994); *In re Stroeker*, 21 BCD 1239, 128 B.R. 205 (Bankr. N.D. Ill. 1991); *In re Hanson Indus., Inc.*, 90 B.R. 405 (Bankr. D. Minn. 1988).

n128

128. *In re Stroeker*, 21 BCD. 1239, 128 B.R. 205 (Bankr. N.D. Ill. 1991).

n129

129. 11 U.S.C. § 327(c). See generally *In re Renninger Mason Contrs., Inc.*, 58 B.R. 516 (Bankr. E.D. Pa. 1986) (decided under section 327(c) before that section was amended).

n130

130. 11 U.S.C. § 327(c). See generally *In re Renninger Mason Contrs., Inc.*, 58 B.R. 516 (Bankr. E.D. Pa. 1986).

n131

131. 11 U.S.C. § 327(e); see *In re Renninger Mason Contrs., Inc.*, 58 B.R. 516 (Bankr. E.D. Pa. 1986).

n132

132. See *Collier on Bankruptcy*, 503.11; *In re Crazy Eddie, Inc.*, 120 B.R. 273 (Bankr. S.D.N.Y. 1990). One court has held that a lawyer who conducts limited research on affirmative defenses to an involuntary petition filed against a debtor may not necessarily be disqualified from representing a creditor interested in purchasing that debtor's assets if no attorney-client privilege was formed with the debtor, there was no relationship between the issues, and the lawyer acquired no information related to the subsequent representation. *In re Spivey Chevrolet, Inc.*, 204 B.R. 32, 36 (Bankr. E.D. Ark. 1996).

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174 of 197 DOCUMENTS

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Collier on the Discharge Exception for Domestic Support Obligations

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Collier on the Discharge Exception for Domestic Support Obligations

By Collier

November 16, 2007

SUMMARY: Bankruptcy Code section 523(a)(5) excepts from discharge debts for a domestic support obligation. The term domestic support obligation is a new defined term, added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. This Emerging Issues Analysis addresses issues pertaining to Section 523(a).

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ARTICLE: Collier on the Discharge Exception for Domestic Support Obligations

Bankruptcy Code section 523(a)(5) excepts from discharge debts for a domestic support obligation. The term "domestic support obligation" is a new defined term, added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. n1 It is defined in section 101(14A) n2 as a debt that accrues before, on, or after the date of the order for relief in a case under this title, including interest that accrues on that debt as provided under applicable nonbankruptcy law notwithstanding any other provision of this title, that is--

(A) owed to or recoverable by--

- (i) a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative; or
- (ii) a governmental unit;

(B) in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) of such spouse, former spouse, or child of the debtor or such child's parent, without regard to whether such debt is expressly so designated;

(C) established or subject to establishment before, on, or after the date of the order for relief in a case under this title, by reason of applicable provisions of--

- (i) a separation agreement, divorce decree, or property settlement agreement;

(ii) an order of a court of record; or

(iii) a determination made in accordance with applicable nonbankruptcy law by a governmental unit; and

(D) not assigned to a nongovernmental entity, unless that obligation is assigned voluntarily by the spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative for the purpose of collecting the debt.

Use of the words "former spouse" should serve to overrule pre-Code cases holding that annulment of a marriage voided in its inception and therefore an agreement to support the debtor's wife was dischargeable in his bankruptcy. n3 A party to an annulled marriage would still be a "former spouse." Also, the language makes it absolutely clear that alimony payable after divorce is nondischargeable. The use of the term "spouse" makes it clear that alimony, maintenance and support due to a husband from a debtor-wife falls within the exception.

The meaning of the new defined term, "domestic support obligation" was explained in the legislative history of the 2005 Act:

As defined in the Act, the term includes a debt owed to or recoverable by: (1) a spouse, former spouse, or child of the debtor, or such child's parent, legal guardian, or responsible relative; or (2) a governmental unit. To qualify as a domestic support obligation, the debt must be in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit), without regard to whether such debt is expressly so designated. It must be established or subject to establishment before, on, or after the date of the order of relief pursuant to: (1) a separation agreement, divorce decree, or property settlement agreement; (2) an order of a court of record; or (3) a determination made in accordance with applicable nonbankruptcy law by a governmental unit. It does not apply to a debt assigned to a nongovernmental entity, unless it was assigned voluntarily by the spouse, former spouse, child, or parent solely for the purpose of collecting the debt. n4

Before the 2005 Act, the debts excepted from discharge by section 523(a)(5) were not the defined term, "a domestic support obligation." Rather, the discharge exception was described as any debt to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement, but not to the extent that--

(A) such debt is assigned to another entity, voluntarily, by operation of law, or otherwise (other than debts assigned pursuant to section 408(a)(3) of the Social Security Act, or any such debt which has been assigned to the Federal Government or to a State or any political subdivision of such State); or

(B) such debt includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance, or support.

The new defined term, domestic support obligation, which now governs the scope of the section 523(a)(5) exception to discharge, is more expansive than the type of debt covered under the prior version of section 523(a)(5). n5 Under prior law, to be nondischargeable under section 523(a)(5), an obligation must have arisen "in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement." n6 The new term, as defined in section 101(14A), also encompasses debts that "are subject to establishment" in a separation agreement, divorce decree, property settlement agreement, court order or other determination by a governmental unit on "or after the date of the order for relief" in a bankruptcy case. Also, the new term differs from the prior section 523(a)(5) exception to discharge in that it encompasses support debts owed or recoverable by a governmental unit without any of the qualifications previously set forth in section 523(a)(5).

The new term is broader than the type of debt included in former section 523(a)(5) in that a domestic support

obligation includes a debt arising after the commencement of the bankruptcy case. n7 This more expansive aspect of the term is of no consequence under section 523(a)(5) because, even under prior law, debts arising postpetition were not dischargeable in most circumstances. n8 The more expansive term is much more significant to a debtor seeking a discharge under chapter 11 or 12. n9 The new defined term is also significant in that it is employed in several other sections of the Code which determine the rights of debtors and creditors in connection with a variety of subjects including the priority of distribution, n10 exemptions, n11 preferences, n12 dismissal of chapter 7 cases for abuse, n13 dismissal of chapter 11 cases, n14 dismissal of chapter 12 cases, n15 dismissal of chapter 13 cases, n16 and calculation of disposable income in chapter 13 cases. n17

Relationship of a "Domestic Support Obligation" to Section 523(a)(15); Dischargeability. Since its enactment, for purposes of dischargeability, the Code has drawn a distinction between an obligation that is in the nature of alimony, maintenance and support and other types obligations arising out of a marital relationship, more specifically, a debt arising in the course of a divorce or separation or in connection with a separation agreement or divorce decree. The latter type of debt is commonly referred to as a property settlement obligation. It is not always simple to distinguish whether an obligation is alimony, maintenance or support as opposed to a property settlement. Nevertheless, before the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, n18 the distinction between the two types of debts was critical in evaluating the dischargeability of a domestic relations related obligation under section 523(a).

Prior to the 2005 Act, section 523(a)(15) provided an exception to discharge for a debt:

not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, a determination made in accordance with State or territorial law by a governmental unit unless--

(A) the debtor does not have the ability to pay such debt from income or property of the debtor not reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor and, if the debtor is engaged in a business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business; or

(B) discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to a spouse, former spouse, or child of the debtor[.] n19

Thus, a debt in the nature of alimony, maintenance and support was nondischargeable under section 523(a)(5). A property settlement debt was subject to a dischargeability balancing test set forth in section 523(a)(15).

As part of the 2005 Act, the balancing test previously set forth in former subsections (A) and (B) of section 523(a)(15) was deleted. Section 523(a)(15) now provides unqualifiedly that a debt encompassed by section 523(a)(15) is nondischargeable. Thus, with respect to dischargeability in cases under chapters 7, 11 and 12, all of which base dischargeability on section 523(a), n20 the distinction between a domestic support obligation and other types of obligations arising out of a marital relationship is of no practical consequence. However, in chapter 13, debts encompassed by section 523(a)(5) are not dischargeable, while debts encompassed by section 523(a)(15) are dischargeable. n21 The distinction also remains significant in other contexts under the Code. n22

Broad Construction Given to Terms Alimony and Support. The terms "alimony" and "support" are given a broad construction to promote the congressional policy that favors enforcement of obligations for spousal and child support. In this respect, Congress has recognized the legitimate needs of the dependents of a bankruptcy debtor and has overridden the general bankruptcy policy in which exceptions to discharge are construed narrowly. n23 The determination whether an obligation is in the nature of alimony, support or maintenance is one of federal bankruptcy law, not state law. n24 To ensure that the underlying policy of section 523(a)(5) is given effect, a federal court's determination as to whether an obligation is "actually in the nature of alimony, maintenance, or support" is governed

neither by state law treatment of the obligation nor by the label the parties have affixed to the obligation. n25 Payments that would not be considered alimony or support under state law may be considered alimony or support for purposes of section 523(a)(5). n26 Nevertheless, although state law is not dispositive, the bankruptcy court will examine state law for guidance in making its decision. n27

Requirement That Obligation Be in Connection with or Subject to Establishment in a Separation Agreement, Divorce Decree or Court Order. To be nondischargeable under section 523(a)(5), a debt must have been established or be subject to establishment before, on or after the commencement of the case through the provisions of a separation agreement, property settlement agreement, divorce decree, other order of a court of record or a determination made in accordance with State or territorial law by a governmental unit. n28 The reference to court orders was originally added to the Code in 1984, n29 making it clear that the exception covers cases in which there was no marriage, such as support orders for children born out of wedlock. Before 1984, courts had divided on the issue whether debts for support of children born out of wedlock were dischargeable in chapter 7 cases. n30 The scope of the exception has been further expanded to include cases where a court has not yet entered an order creating an obligation in the nature of alimony or support, but such an order "is subject" to be being entered. Prior to the 2005 amendments, a mere agreement to pay for support and maintenance did not fall within the exception. n31 Nor did section 523(a)(5) except from discharge contracted for liabilities for goods purchased (even if they were necessities), n32 medical attention furnished n33 or board supplied n34 by a parent for the use and benefit of a wife and child. n35 It is likely that the expanded scope of the exception established by the 2005 amendments will apply to claims for alimony or support that have actually been filed or otherwise asserted but have not yet been determined as of the filing of the bankruptcy case. However, since, under applicable nonbankruptcy law, such claims ordinarily relate back only to the date of filing, claims which might be "subject" to a support order, but cannot be included in a support order because they predate the initiation of support proceedings should continue to be dischargeable debts.

Requirement That Debt Be to a Spouse, Former Spouse or Child or to a Governmental Unit. To be nondischargeable as a domestic support obligation under section 523(a)(5), a debt must be owed to "a spouse, former spouse or child of the debtor or such child's parent, legal guardian or responsible relative [or] a governmental unit." n36 The reference to the child's parent, legal guardian or responsible relative was added by the 2005 Act. n37 Under section 523(a)(5), prior to the 2005 Act, most courts held that the determination whether a particular obligation is owed to a spouse, former spouse or child of the debtor was not dependent on the identity of the payee of the obligation.

An obligation may be nondischargeable support even though it is not payable directly to the spouse or child of the debtor. n38 As one court has reasoned, "the pertinent inquiry is whether payment has been ordered in recognition and fulfillment of a duty to provide for the well-being of his or her child." n39 This issue arises frequently in the context of a debtor's obligation to pay: (1) attorneys' fees incurred by a spouse or former spouse in divorce proceedings n40 and post-divorce proceedings where the award of attorneys' fees under state law is based on financial need; n41 (2) attorneys' fees incurred for a court-appointed counsel or a guardian ad litem for a debtor's child; n42 and (3) attorneys' fees awarded to the mother in a paternity action against the debtor and medical expenses (i.e., birth expenses) incurred by the mother of a child of the debtor born out of wedlock. n43

Although the courts have not been consistent, the language of the statute dictates that if the obligation is not one owed to the spouse, former spouse, former spouse or child of the debtor or such child's parent, legal guardian or responsible relative, it is dischargeable under section 523(a)(5), even though it is in the nature of support. n44 A debt owed to or recoverable by a governmental unit is nondischargeable if it is in the nature of alimony, maintenance or support. However, if the support obligation is assigned involuntarily to the governmental unit by a spouse, former spouse, child of the debtor or such child's legal guardian or relative responsible for the purpose of collecting the debt, the debt is not a domestic support obligation, it does not fall within the scope of section 523(a)(5) and it is

dischargeable. n45

Requirement That Debt Be in Nature of Alimony, Maintenance or Support. The term "domestic support obligation" expressly includes within its definition the requirement that the debt be "in the nature of alimony, maintenance, or support without regard to whether such debt is expressly so designated." Former section 523(a)(5)(B) expressed the same principle, albeit through a convoluted, double negative. Former section 523(a)(5)(B) provided that a debt was excluded from scope of section 523(a)(5)'s nondischargeability provision if the debt was designated as alimony, maintenance, or support "unless such liability is actually in the nature of alimony, maintenance, or support." Notwithstanding the change in the statutory text, the scope of the exception remains the same. Regardless of designation, debts which are actually in the nature of alimony, maintenance, or support are nondischargeable under section 523(a)(5) and those debts which are not of that nature are not encompassed by the exception to discharge of that provision.

When a debt characterized as alimony, maintenance or support is in dispute, the court should hold an evidentiary hearing to determine whether the debt is actually in the nature of alimony, maintenance or support within the meaning of section 523(a)(5). If a debt is determined to be in the nature of alimony, maintenance or support, it is nondischargeable and the bankruptcy court has no power to balance the need of the recipient spouse against the need of the debtor for a fresh start. n46 The critical issue is whether the parties intended the obligation to provide support to the debtor's spouse, former spouse or child. The question whether a debt is in the nature of alimony, maintenance or support often arises in cases also raising the issue whether the debt is owed to a spouse, former spouse or child of the debtor. n47 Regardless how these issues are framed, the proper inquiry is whether the payment obligation derived from a duty to provide for the well-being of the spouse, former spouse or child. When that is the case, courts have not hesitated to find that the obligation is nondischargeable. For example, in *Strickland v. Shannon (In re Strickland)*, n48 the court held that an award of attorneys' fees granted in favor of the debtor's former spouse and against the debtor, which arose from the debtor's unsuccessful attempt to modify the child custody and support provisions of a divorce judgment and was based upon a state statute authorizing the award on the basis of the relative need and ability to pay of the parties, was in the nature of support and thus nondischargeable under section 523(a)(5). If a debt is found dischargeable under section 523(a)(5), it may nonetheless be nondischargeable if it is a property settlement obligation covered by the discharge exception in section 523(a)(15), added by the Bankruptcy Reform Act of 1994, n49 as modified by the 2005 amendments. n50

Factors Considered in Distinguishing Alimony, Maintenance and Support Claims from Property Settlement Claims. The issue whether a particular debt is a nondischargeable alimony, maintenance or support claim is one of federal bankruptcy law. n51 However, it is not always easy to distinguish domestic support obligations, covered by section 523(a)(5), from property settlement claims, which are not covered by section 523(a)(5). Particularly when the debt arises from a negotiated separation agreement, the parties often focused on the state law implications of their agreement, not how the obligation would be characterized in a bankruptcy case. Thus, the bankruptcy court's retrospective inquiry is into the intentions of the parties with respect to an issue that they may not have fully considered.

When the obligation arises from a state court order, the order has been based on state statutes or doctrines that may or may not be helpful in characterizing the nature of the obligation for purposes of section 523(a)(5). State law generally recognizes that the issues of property division and support are inextricably intertwined. State law governing support and division of property takes into account comparable factors--primarily the financial resources and needs of the parties. Similarly, separation agreements often treat support and property division as somewhat interchangeable. A spouse who receives more property may need less support. An obligation denominated as a property settlement may be essential to the support of the recipient of the property. Conversely, an obligation denominated as alimony may be a substitute for property that the obligee would otherwise have received. These trade-offs are often made by the parties with a view toward tax or business consequences.

The main principle guiding bankruptcy courts in determining whether a debt is nondischargeable alimony, maintenance or support is the intent of the parties or the state court in creating the obligation and the purpose of the

obligation in light of the parties' circumstances at that time. n52 If the intent is not explicitly expressed, the bankruptcy court must attempt to infer the intent by examining the underlying facts of the case. To assist in this difficult inquiry, the courts have developed a series of factors that may be considered in distinguishing alimony, maintenance or support obligations from property division obligations. n53

Labels in Agreement or Order. It is well established that the bankruptcy court is not bound by the labels given to a debt in the parties' agreement or in the order creating the debt. n54 The bankruptcy court must look behind the label and determine the true nature of the obligation. Even so, the label given to an obligation may well be an accurate indication of the parties' intent and deference to that characterization may be given by the bankruptcy court. n55 Similarly, when a state court enters an order after articulating the factors it considers, the label attached to the obligation by the court is entitled to great weight. n56 Because extraneous factors, such as business or tax considerations, are less likely to affect court orders, more weight is generally given to the labeling of an obligation in a court order as opposed to the labels in an agreement. In cases involving marital agreements, the bankruptcy court will consider the labels in the agreement, but other factors are also given weight in the ultimate determination under section 523(a)(5). The amount of deference given by the bankruptcy court to the labels in an agreement will often depend on the detail, precision and structure of the entire agreement. Thus, the bankruptcy court may defer to the language of an agreement that contains a consistent and clear designation of different types of payment obligations. n57 On the other hand, an agreement that contains a waiver of alimony but that also creates an obligation to make payments to help provide the other spouse with housing may be construed as only a limited waiver of alimony for purposes of section 523(a)(5). n58

Income and Needs of the Parties at the Time the Obligation Became Fixed. Perhaps the most important factor considered by the bankruptcy courts in evaluating the intentions of the parties is their financial situation when they entered into their agreement or when the state court entered its order fixing the obligation. n59 If the obligee spouse or former spouse would have had difficulty in providing for himself or herself and the parties' children, it is likely that the obligation will be determined to be in the nature of alimony, maintenance or support and therefore nondischargeable, regardless of how the obligation is labeled. n60 In *In re Calhoun*, n61 the Sixth Circuit stated that the inquiry must focus on whether the purpose and effect of the obligation at the time it was created was to provide for the daily needs of the former spouse and any children. The court also held that an additional consideration is the current abilities and needs of the parties. n62 However, virtually all other courts have held that the current financial posture of the parties is not relevant. n63

Amount and Outcome of Property Division. A factor closely related to the parties' relative financial needs is an analysis of the property divided at the time of the divorce. As stated earlier, the fact that a spouse received or did not receive a substantial amount of marital property can affect the need for ongoing support. In addition, when a payment obligation is directly linked to the sale of identifiable property, the obligation is more likely to be determined to have arisen from property division and therefore, to be dischargeable as far as section 523(a)(5) is concerned. However, the source of the payment obligation does not conclusively determine the nature of the obligation, and if the payment is necessary for the support of the obligee, the bankruptcy court may determine the debt to be nondischargeable. n64

Whether the Obligation Terminates on Obligee's Death or Remarriage or on Emancipation of Children. An obligation that terminates on the death or remarriage of the obligee or the emancipation of the parties' children is likely to have been intended for support. n65 However, the absence of termination provisions does not dictate the conclusion that the debt is a property settlement obligation. n66

Number and Frequency of Payments. An obligation due to be paid in a lump sum or in a limited number of payments over a short period of time is more likely to be considered a property settlement rather than for support. On the other hand, a long-term obligation to make regular monthly payments is more characteristic of support. By itself, this factor may be of limited use in the inquiry, particularly as the number of installments increases. Since an award of alimony may be made for a limited duration, the mere fact that there are a limited number of installment payments due cannot be dispositive. n67 Conversely, tax considerations may lead parties to spread out the payment of a property settlement obligation. n68 Most commonly, this factor will be considered in conjunction with other, more significant factors. n69

Waiver of Alimony or Support Rights in Agreement. Provisions in marital agreements for the waiver of alimony or support may be considered by the bankruptcy court in determining whether an obligation is in the nature of alimony, maintenance or support. n70 However, this factor is of limited utility. If an agreement provides for payments to the nondebtor spouse designated as a property division but lacks other meaningful provisions for support, the obligation is nonetheless likely to be characterized as nondischargeable support. n71

Availability of State Court Procedures to Modify the Obligation or Enforce it Through Contempt Remedy. If an obligation is judicially modifiable or enforceable by contempt-of-court remedies, it is more likely to be determined to be in the nature of alimony, maintenance or support. However, this factor must be considered in connection with the other factors discussed above. The fact that an obligation is not modifiable may be due to the parties' agreement itself and, therefore, does not bear on the issue whether the obligation was intended to support the nondebtor spouse. Other indicia may require that a nonmodifiable obligation be determined to be nondischargeable support. n72

Tax Treatment of Obligation. In applying *section 523(a)(5) of the Bankruptcy Code*, some courts have considered the tax treatment given to marital obligations under the Internal Revenue Code, since both Codes attempt to distinguish obligations in the nature of alimony, maintenance or support from property division obligations. The interests of the debtor are at cross-purposes under the two statutes. Thus, when a debtor treated his payments as a nondeductible expense, one court held that the obligation was dischargeable since it was unlikely the debtor would have foregone the favorable tax treatment had the parties intended the obligation to be support. n73 A debtor who attempted to qualify payments as deductible alimony or support for purposes of federal income tax treatment may be unable to successfully assert that the obligation is not alimony, maintenance or support for purposes of section 523(a)(5). Some courts have even held that a debtor is estopped from doing so. n74 The Bankruptcy Code and the Internal Revenue Code have different purposes; tax treatment by itself should not be dispositive of dischargeability under section 523(a)(5). n75 As with other factors, courts can and should look to the tax treatment given to the obligation in conjunction with the other factors discussed above.

Distinguishing Interests in Property from Dischargeable Debts; Pensions. In many cases, debtors file their bankruptcy petitions while divorce proceedings containing equitable distribution claims are pending or after an agreement or state court order has equitably distributed an asset titled in the debtor's name. Frequently, the asset involved is the debtor's interest in a pension. In such cases, the bankruptcy court must decide the fundamental question whether the debtor's obligations to the spouse or former spouse are no more than a right to payment, n76 and, therefore, potentially dischargeable as a debt under the Code, or whether the nondebtor former spouse has obtained a property interest in the asset itself. If the spouse obtained an ownership interest in the asset, no debt exists which may be discharged, and the spouse's rights will be unimpaired by the bankruptcy filing unless there is some basis for avoiding the transfer of the property interest to the spouse. In making the inquiry into the nature of the obligation, the bankruptcy court will necessarily examine state law. In many jurisdictions, the spouse will have obtained a separate ownership

interest in the pension. n77 The spouse's ownership interest may attach even if the equitable distribution proceedings have not been completed prior to the bankruptcy filing. n78 Some cases also refer to the state court proceedings as creating a constructive trust in which the debtor is the trustee with bare legal title and the spouse is the beneficiary whose beneficial interest in the asset is not part of the bankruptcy estate pursuant to section 541(d) of the Code. n79 If the court's conclusion is that the spouse does not have a property interest in the asset, the court must analyze whether the obligation is dischargeable based on the relevant factors under section 523(a)(5). n80

Status of Assigned Debts under Section 523(a)(5). A debt for alimony, maintenance, or support, although otherwise within the terms of the definition of domestic support obligation in section 101(14A), is excluded from the statutory definition and is therefore dischargeable under section 523(a)(5), if it has been assigned to a nongovernmental entity. However, if the debt was assigned voluntarily by the spouse, former spouse, child, or parent solely for the purpose of collection, the debt is a domestic support obligation and is not discharged pursuant to section 523(a)(5). n81 However, a debt does not become nondischargeable simply by virtue of a state court order directing the obligor to make payment directly to a third party. n82 Prior to the 2005 Act, section 523(a)(5) provided that debts assigned pursuant to section 408(a)(3) n83 of the Social Security Act n84 or any debt assigned to the federal government or to a state or a political subdivision of a state were not within the class of debts dischargeable based on their status as assigned debts. The nondischargeability of a debt in the nature of alimony or support which has been assigned to a governmental unit has been maintained in the definition of domestic support obligation in section 101(14A) and the incorporation of that term into the section 523(a)(5) discharge exception. n85

For a complete discussion of Code section 523, see Collier on Bankruptcy, ch. 523.

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n1 Pub. L. No. 109-8, § 211(2) (2005), effective in cases commenced on or after October 17, 2005.

n2 11 U.S.C. § 101(14A); see Collier on Bankruptcy, 101.14A.

n3 *In re Collis*, 184 Misc. 717, 53 N.Y.S.2d 316 (1945); see also *Norris v. Norris*, 324 F.2d 826 (9th Cir. 1963).

n4 H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 59 (2005), *reprinted in* Collier on Bankruptcy, App. Pt. 10(b).

n5 H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 16 (2005), *reprinted in in* Collier on Bankruptcy, App. Pt. 10(b).

n6 Former 11 U.S.C. § 523(a)(5) (2004), amended by Pub. L. No. 109-8, § 215(1) (2005), effective in cases commenced on or after October 17, 2005.

n7 H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 16 (2005), *reprinted in* Collier on Bankruptcy, App. Pt. 10(b).

n8 Except for those debts arising postpetition which are treated as if they arose prepetition when chapter 11, 12 or 13 cases are converted to chapter 7, *see* 11 U.S.C. § 348(d), the chapter 7 discharge applies to debts that arose before the commencement of the bankruptcy case. *See* 11 U.S.C. § 727(b).

n9 *See, e.g.,* 11 U.S.C. §§ 1112(p), 1129(a)(14), 1208(c)(10), 1225(a)(7), 1228(a), 1307(c)(11), 1325(a)(10), 1328(a).

n10 11 U.S.C. § 507(A)(1).

n11 11 U.S.C. § 522(c)(1) (referring to 11 U.S.C. § 523(a)(5)).

n12 11 U.S.C. § 547(c)(7).

n13 11 U.S.C. § 707(c)(3).

n14 11 U.S.C. § 1112(b)(4)(P).

n15 11 U.S.C. § 1208(c)(10).

n16 11 U.S.C. § 1307(c)(11).

n17 11 U.S.C. § 1325(b)(2)(A)(ii).

n18 Pub. L. No. 109-8 (2005).

n19 Former section 523(a)(15) was added to the Code in 1994 by Pub L. No. 103-394, § 304(e), *reprinted in Collier on Bankruptcy*, App. Pt. 9(a). *See Collier on Bankruptcy*, 523.21.

n20 *See Collier on Bankruptcy*, 523.02.

n21 11 U.S.C. § 1328(a).

n22 *See, e.g., 11 U.S.C. §§ 507(a)(1), 547(c)(7), 707(c)(3), 1112(p), 1129(a)(14), 1208(c)(10), 1225(a)(7), 1228(a), 1307(b)(11), 1325(a)(8), 1325(b)(2), 1328(a).*

n23 *See In re Jones*, 9 F.3d 878 (10th Cir. 1993); *In re Stacey*, 164 B.R. 210 (Bankr. D.N.H. 1994); *In re Peters*, 133 B.R. 291 (S.D.N.Y. 1991), *aff'd*, 964 F.2d 166 (2d Cir. 1992); *In re Booch*, 95 B.R. 852 (Bankr. N.D. Ga. 1988); *see also Mullally v. Carter*, 67 B.R. 535, 538 (N.D. Ill. 1986) (discussing historic policy against bankruptcy discharge of family financial obligations).

n24 *See H.R. Rep. No. 595, 95th Cong., 1st Sess. 363 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 77-79*

(1978).

n25 *In re Young*, 35 F.3d 499 (10th Cir. 1994); *In re Fitzgerald*, 9 F.3d 517, 30 C.B.C.2d 185 (6th Cir. 1993); *In re Sampson*, 997 F.2d 717, 29 C.B.C.2d 198 (10th Cir. 1993). Section 523(a)(5) is intended to overrule cases such as *In re Waller*, 494 F.2d 447 (6th Cir. 1974), which assumed that the law of the state in which the bankruptcy court sits is controlling on the question of whether a debt qualifies as alimony, maintenance or support so as to be nondischargeable.

n26 *In re Biggs*, 907 F.2d 503 (5th Cir. 1990); *In re Harrell*, 754 F.2d 902, 12 C.B.C.2d 340 (11th Cir. 1985); *Shaver v. Shaver*, 736 F.2d 1314 (9th Cir. 1984); *Melichar v. Ost*, 661 F.2d 300 (4th Cir. 1981).

n27 *Forsdick v. Turgeon*, 812 F.2d 801, 16 C.B.C.2d 452 (2d Cir. 1987); *In re Spong*, 661 F.2d 6, 5 C.B.C.2d 242 (2d Cir. 1981).

n28 11 U.S.C. § 101(14A)(C).

n29 Pub. L. No. 98-353 (1984), reprinted in *Collier on Bankruptcy*, App. Pt. 6(a); see also 130 Cong. Rec. S 6094 (daily ed. May 21, 1984) (remarks of Sen. Exon).

n30 *Compare Shine v. Shine*, 802 F.2d 583 (1st Cir. 1986) with *Lake County Dep't of Public Welfare v. Marino (In re Marino)*, 29 B.R. 797 (N.D. Ind. 1983); *In re Fenstermacher*, 8 C.B.C.2d 1294, 31 B.R. 77 (Bankr. D. Neb. 1983).

n31 *Leib v. Auerbach*, 10 N.J. Super. 391, 76 A.2d 726 (Co. Ct. N.J. 1950); *Wintrobe v. Connors*, 67 Ohio App. 106, 35 N.E.2d 1018 (1941); *Schwoll v. Meeks*, 76 Ohio App. 231, 63 N.E.2d 831 (1944).

n32 *Schellenberg v. Mullaney*, 112 A.D. 384, 98 N.Y.S. 432 (1906).

n33 *In re Meyers*, 12 F.2d 938 (W.D.N.Y. 1926). But see *In re Livengood*, 157 B.R. 678 (Bankr. D. Idaho 1993); *In re Beattie*, 28 C.B.C.2d 849, 150 B.R. 699 (Bankr. S.D. Ill. 1993).

n34 *In re Lo Grasso*, 23 F. Supp. 340 (W.D.N.Y. 1938); *Leman v. Locke*, 240 Mass. 551, 134 N.E. 343 (1922).

n35 *Wintrobe v. Connors*, 67 Ohio App. 106, 35 N.E.2d 1018 (1941). But see *In re Ozey*, 166 B.R. 169 (Bankr. N.D. Okla. 1994) (contract to pay children's college expenses nondischargeable).

n36 11 U.S.C. § 101(14A)(A)(i)(ii).

n37 Pub. L. No. 109-8, § 211(2) (2005), effective in cases commenced on or after October 17, 2005.

n38 *In re Tremblay*, 162 B.R. 60 (Bankr. D. Me. 1993); *Monsanto Industrial Chemicals, Inc. v. Harris*, 161 B.R. 385 (Bankr. E.D. Mich. 1993); *In re Glynn*, 138 B.R. 360 (Bankr. D. Conn. 1992).

n39 *Cain v. Isenhower (In re Cain)*, 29 B.R. 591, 596, quoting *Deeb v. Morris (In re Morris)*, 5 C.B.C.2d 371, 374, 14 B.R. 217, 219 (Bankr. D. Colo. 1981).

n40 *In re Spong*, 661 F.2d 6, 5 C.B.C.2d 242 (2d Cir. 1981). But see *In re Garcia*, 32 C.B.C.2d 1, 174 B.R. 529 (Bankr. W.D. Mo. 1994).

n41 *Strickland v. Shannon (In re Strickland)*, 90 F.3d 444 (11th Cir. 1996); *Joseph v. O'Toole (In re Joseph)*, 16 F.3d 86 (5th Cir. 1995); *In re Jones*, 9 F.3d 878, 30 C.B.C.2d 206 (10th Cir. 1993); *In re Catlow*, 663 F.2d 960 (9th Cir. 1981).

n42 *In re Miller*, 55 F.3d 1487, 33 C.B.C.2d 1044 (10th Cir.), cert. denied, 516 U.S. 916, 116 S. Ct. 305, 133 L. Ed. 2d 210 (1995); *In re Peters*, 964 F.2d 166 (2d Cir. 1992), aff'g 133 B.R. 291 (S.D.N.Y. 1991).

n43 *Hudson v. Raggio & Raggio, Inc. (In re Hudson)*, 107 F.3d 355, 37 C.B.C.2d 1109 (5th Cir. 1997); *In re Seibert*, 914 F.2d 102, 23 C.B.C.2d 1157 (7th Cir. 1990); *Smith v. Barbre (In re Barbre)*, 91 B.R. 846 (Bankr. S.D. Ill. 1988); *In re Booch*, 95 B.R. 852 (Bankr. N.D. Ga. 1988).

n44 *In re Visness*, 57 F.3d 775 (9th Cir. 1995), cert. denied, 516 U.S. 1099, 116 S. Ct. 828, 133 L. Ed. 2d 770 (1996); *In re Erfourth*, 126 B.R. 736 (Bankr. W.D. Mich. 1991) (cost of placing child in group home dischargeable); *In re Lutz*, 128 B.R. 244 (Bankr. W.D. Mo. 1991) (debt owed to debtor's sister for support of debtor's child dischargeable). See generally, Sommer & McGarity, *Collier Family Law and the Bankruptcy Code*, 6.03[3] (Matthew Bender).

n45 11 U.S.C. § 101(14A)(D).

n46 *Vickers v. Vickers (In re Vickers)*, 7 C.B.C.2d 849, 853, 24 B.R. 112, 116 (Bankr. M.D. Tenn. 1982).

n47 See *Collier on Bankruptcy*, 523.11[4].

n48 90 F.3d 444, 36 C.B.C.2d 718 (11th Cir. 1996).

n49 Pub. L. No. 103-394 (enacted on October 22, 1994), at § 304(e), reprinted in App. Pt. 9(a) *infra*, adding 11 U.S.C. § 523(a)(15), effective on the date of enactment, and not applicable to pending cases.

n50 Pub. L. No. 109-8, § 215(3) (2005), effective in cases commenced on or after October 17, 2005.

n51 See *Collier on Bankruptcy*, 523.11[1].

n52 *Friedkin v. Sternberg (In re Sternberg)*, 85 F.3d 1400 (9th Cir. 1996); *Yeates v. Yeates (In re Yeates)*,

807 F.2d 874 (10th Cir. 1986); *Shaver v. Shaver*, 736 F.2d 1314 (9th Cir. 1984).

n53 *In re Fitzgerald*, 9 F.3d 517, 30 C.B.C.2d 185 (6th Cir. 1993); *Davidson v. Davidson (In re Davidson)*, 947 F.2d 1294, 25 C.B.C.2d 1501 (5th Cir. 1991); *Gianakas v. Gianakas (In re Gianakas)*, 917 F.2d 759, 23 C.B.C.2d 1510 (3d Cir. 1990). For extensive discussion of the case law pertaining to obligations in the nature of alimony, maintenance or support under section 523(a)(5), *see generally*, Sommer & McGarity, Collier Family Law and the Bankruptcy Code, 6.04-6.06 (Matthew Bender).

n54 *Sylvester v. Sylvester*, 865 F.2d 1164 (10th Cir. 1989); *Goin v. Rives (In re Goin)*, 808 F.2d 1391 (10th Cir. 1987); *Benich v. Benich (In re Benich)*, 811 F.2d 943 (5th Cir. 1987); *Forsdick v. Turgeon*, 812 F.2d 801, 16 C.B.C.2d 452 (2d Cir. 1987).

n55 *Catron v. Catron (In re Catron)*, 164 B.R. 912 (E.D. Va. 1994).

n56 *Forsdick v. Turgeon*, 812 F.2d 801, 16 C.B.C.2d 452 (2d Cir. 1987); *Long v. West (In re Long)*, 794 F.2d 928 (4th Cir. 1986).

n57 *Sampson v. Sampson (In re Sampson)*, 997 F.2d 717 (10th Cir. 1993); *Tilley v. Jessee*, 789 F.2d 1074, 14 C.B.C.2d 1376 (4th Cir. 1986).

n58 *Carrigg v. Carrigg (In re Carrigg)*, 5 C.B.C.2d 446, 14 B.R. 658 (Bankr. D.S.C. 1981).

n59 *Dennis v. Dennis (In re Dennis)*, 25 F.3d 274, 31 C.B.C.2d 713 (5th Cir. 1994), *cert. denied*, 513 U.S. 1081, 115 S. Ct. 732, 130 L. Ed. 2d 636 (1995).

n60 *See Yeates v. Yeates (In re Yeates)*, 807 F.2d 874 (10th Cir. 1986); *Shaver v. Shaver*, 736 F.2d 1314 (9th Cir. 1984).

n61 715 F.2d 1103, 9 C.B.C.2d 290 (6th Cir. 1983).

n62 But see *In re Fitzgerald*, 9 F.3d 517 (6th Cir. 1993) (limiting *Calhoun* holding to obligations not designated as alimony or support).

n63 E.g., *Draper v. Draper*, 790 F.2d 52 (8th Cir. 1986); *In re Harrell*, 754 F.2d 902, 12 C.B.C.2d 340 (11th Cir. 1985).

n64 *Buccino v. Buccino*, 397 Pa. Super. 241, 580 A.2d 13 (Pa. Super. 1990); *Goin v. Rives (In re Goin)*, 808 F.2d 1391 (10th Cir. 1987); *Zaera v. Raff (In re Raff)*, 93 B.R. 41 (Bankr. S.D.N.Y. 1988).

n65 *Fitzgerald v. Fitzgerald (In re Fitzgerald)*, 9 F.3d 517, 30 C.B.C.2d 185 (6th Cir. 1993); *Sylvester v. Sylvester*, 865 F.2d 1164 (10th Cir. 1989); see also *In re Morel*, 983 F.2d 104 (8th Cir. 1992).

n66 *Sampson v. Sampson (In re Sampson)*, 997 F.2d 717 (10th Cir. 1993); *Singer v. Singer (In re Singer)*, 787 F.2d 1033, 14 C.B.C.2d 1386 (6th Cir. 1986).

n67 See *Forsdick v. Turgeon*, 812 F.2d 801, 16 C.B.C.2d 452 (2d Cir. 1987).

n68 See *Messnick v. Messnick (In re Messnick)*, 104 B.R. 89 (Bankr. E.D. Wis. 1989).

n69 *Pattie v. Pattie (In re Pattie)*, 112 B.R. 437 (Bankr. M.D. Fla. 1990). See generally *Brody v. Brody (In re Brody)*, 3 F.3d 35 (2d Cir. 1993).

n70 *Beiler v. Beiler*, 80 B.R. 63 (Bankr. E.D. Va. 1987); *Wadleigh v. Wadleigh (In re Wadleigh)*, 68 B.R. 499 (Bankr. D. Vt. 1986).

n71 *Sylvester v. Sylvester*, 865 F.2d 1164 (10th Cir. 1989).

n72 *In re Albin*, 591 F.2d 94 (9th Cir. 1979).

n73 *Tilley v. Jessee*, 789 F.2d 1074, 14 C.B.C.2d 1376 (4th Cir. 1986); see also *Beiler v. Beiler*, 80 B.R. 63 (Bankr. E.D. Va. 1987).

n74 *Robb-Fulton v. Robb (In re Robb)*, 23 F.3d 895, 30 C.B.C.2d 2061 (4th Cir. 1994); *In re Davidson*, 947 F.2d 1294, 25 C.B.C.2d 1501 (5th Cir. 1991).

n75 *Friedkin v. Sternberg (In re Sternberg)*, 85 F.3d 1400 (9th Cir. 1996), citing *Collier Family Law and the Bankruptcy Code*, 6.04[10] (Matthew Bender 1996).

n76 11 U.S.C. § 101(12); 11 U.S.C. § 101(5).

n77 *In re Chandler*, 805 F.2d 555 (5th Cir. 1986); *In re Teichman*, 774 F.2d 1395, 13 C.B.C.2d 1077 (9th Cir. 1985).

n78 *In re Bennett*, 175 B.R. 181 (Bankr. E.D. Pa. 1994).

n79 11 U.S.C. § 541(d). See *McCafferty v. McCafferty (In re McCafferty)*, 96 F.3d 192, 36 C.B.C.2d 1074 (6th Cir. 1996); *Bush v. Taylor*, 912 F.2d 989, 23 C.B.C.2d 1294 (8th Cir. 1990).

n80 See *Collier on Bankruptcy*, 523.11[6].

n81 See H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 59 (2005), reprinted in *Collier on Bankruptcy*, App.

Pt. 10(b).

n82 See *Collier on Bankruptcy*, 523.11[4].

n83 The cross-reference to the Social Security Act was changed from section 402(a)(26) to section 408(a)(3) by the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193.

n84 Section 2334(b) of title XXIII of the Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, approved August 13, 1981.

n85 H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 59 (2005), *reprinted in* *Collier on Bankruptcy*, App. Pt. 10(b).

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175 of 197 DOCUMENTS

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Collier on the Discharge Exception for Educational Loans

2008 Emerging Issues 966

Collier on the Discharge Exception for Educational Loans

By Collier

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SUMMARY: This Emerging Issues Analysis addresses issues pertaining to the discharge exception for educational loans in Section 523(a)(8), including discharge based on undue hardship, partial discharge, timing of the filing of a dischargeability complaint in Chapter 13 cases, postpetition interest on nondischargeable student loans in Chapter 13 cases, and Health Education Loans.

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ARTICLE: *Bankruptcy Code section 523(a)(8)* restricts the dischargeability of educational benefits or loans which were insured or guaranteed by a governmental unit or under any program funded by a governmental unit or nonprofit institution. In addition, as a result of the 2005 Act, the discharge of any education loan that is qualified for a tax deduction is similarly restricted. n1 The 2005 Act extended the nondischargeability of educational loan to some loans that are not insured or guaranteed by a governmental unit or under a program funded by a governmental unit or nonprofit institution. Typically, the participants in government insured or guaranteed educational loan programs (whether lenders or guarantors) grant credit to persons who might not qualify for credit under traditional credit standards, in order to foster the government's policy of promoting access to educational opportunities. n2

In delineating the boundaries of section 523(a)(8), courts have focused on two purposes of this exception to discharge:

preventing abuses of the educational loan system by restricting the ability to discharge a student loan shortly after a student's graduation, and

safeguarding the financial integrity of governmental entities and nonprofit institutions that participate in educational loan programs. n3

Based on these purposes, some courts have held that the liability of a non-student co-obligor of a guaranteed education loan (such as the student's parent) is not dischargeable under section 523(a)(8). n4 A loan made by a debtor's employer for the express purpose of repaying the debtor's educational debt is not itself a nondischargeable educational

loan. n5

To fall within the discharge exception, an obligation must meet the literal criteria of section 523(a)(8) and be either an "overpayment of an educational benefit" or a "loan." To constitute a "loan," the creditor must have actually transferred funds to the debtor or the parties must have entered into an agreement for the extension of credit. Thus, the mere fact that the school has permitted a student to attend classes despite the student's unilateral decision not to timely pay the tuition does not transform the student's obligation to pay the tuition into a loan subject to the section 523(a)(8) discharge exception. Courts will treat the debt as a loan only if there is a formal, express agreement between the student and the school, such as a written loan agreement or a promissory note. n6

Discharge Based on Undue Hardship. Section 523(a)(8) is the "hardship" provision, which allows the court to discharge an otherwise nondischargeable student loan if excepting the debt from discharge will impose an undue hardship on the debtor or the debtor's dependents. This exemption from the exception to discharge requires the bankruptcy judge to exercise discretion in determining whether payment of the debt will cause undue hardship on the debtor and his dependents, thus defeating the "fresh start" concept of the bankruptcy laws. There may well be circumstances that justify failure to repay a student loan, such as illness or incapacity. When the court finds that such circumstances exist, it may order the debt discharged. The Supreme Court has stated that section 523(a)(8) is "self-executing" and that "[u]nless the debtor affirmatively secures a hardship determination, the discharge order will not include a student loan debt." n7 In other words, student loan debt remains due until there is a determination that the loan is dischargeable. n8 There has been a wide range of judicial reaction to the undue hardship claims of debtors. The most widely used test for evaluating the dischargeability of a student loan under section 523(a)(8) states that the debt is dischargeable if three conditions are met:

- the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living if forced to repay the loans;
- there are indications that the state of affairs is likely to persist for a significant portion of the repayment period; and
- the debtor made good faith efforts to repay the loans. n9

In the first inquiry, the court will consider the debtor's income, living expenses and standard of living. A debtor is not expected to live in "abject poverty" in order to repay a student loan. n10 Accordingly, the federal poverty level is too strict a standard for measuring whether the debtor's standard of living is at a minimal level and should not be employed for that purpose. Nor is it appropriate for the court to go through a debtor's budget dollar-for-dollar in order to find every possible way to create or increase a surplus if the overall expense level and living standard remains minimal. n11 Rather, the court should examine the debtor's income and expenses in a manner that is sensitive to the particular circumstances of the case, taking into account the debtor's needs for care, including food, shelter, clothing, transportation medical treatment and a small source of recreation. n12

The second prong of the test, sometimes referred to as "the additional circumstances test," requires that the court make a predictive judgment as to the likelihood that the debtor's financial hardship will continue for a significant portion of the repayment period. There are two elements to the second prong. The first is whether the debtor's financial difficulties are "likely" to continue. Under this standard, a debtor must establish by a preponderance of the evidence that the debtor's financial situation is not likely to improve. The debtor is not required to prove with certainty that the financial situation will not improve and the court's determination must be based on a realistic, factual assessment of the debtor's financial prospects, not on unfounded optimism. n13 Nor is the debtor required to prove that the his or her financial distress will continue due to a serious illness, psychological problem, disability of the debtor or a dependent or some other exceptional circumstances. It is sufficient for the debtor to establish any circumstances that show that the inability to pay is likely to persist for a significant portion of the repayment period. n14 The court's judgment on this question necessarily must be based on a consideration of the debtor's education, work history, health and other relevant

circumstances. The second element of the second prong is that the financial difficulties must be likely to persist for a significant portion of the repayment period. There is little judicial discussion of the meaning of the term "significant portion of the repayment period," perhaps because courts are able to make judgments whether the factors causing a debtor's financial hardship are likely to persist indefinitely without the need for more precision. One court concluded that, for a 10-year loan, five years constituted a significant portion of the repayment period and evaluated the debtor's financial prospects within that time frame. n15

The good faith inquiry is guided by the understanding that "undue hardship" encompasses a notion that the debtor's bad financial condition and default should not have been caused by the debtor's own willfulness or negligence, but rather by factors beyond the debtor's control. n16 Therefore, if the debtor has not made payments on the loans because, through no fault of the debtor, he or she has never had the ability to pay, the good faith effort test is met. n17 One circumstance that some courts have considered is the potential availability, in certain cases, of an income-contingent repayment plan pursuant to which the monthly payment due on a student loan is dependent on the debtor's income and, after a 25-year repayment period, any remaining unpaid balance is canceled. n18 Creditors have argued that a debtor who has not applied for an income-contingent repayment plan cannot meet the good faith test. A more ambitious argument is that the existence of an option to repay based on the debtor's income establishes that there is no undue hardship and that, therefore, the student loan should not be discharged. n19 These arguments overstate the role that an income-contingent repayment plan should play in determining dischargeability. The U.S. Department of Education regulations provide that under an income-contingent repayment plan, a debtor is obliged to make some payment once the debtor's income exceeds the federal poverty level. n20 However, the federal poverty level is below a "minimal" standard of living. Therefore, the repayment program is based on a standard different from that found in section 523(a)(8) and cannot be determinative. n21 Courts must also be careful not to treat the enactment of the statute authorizing the U.S. Department of Education to accept an income-contingent repayment plan as an implied repeal of *section 523(a)(8) of the Bankruptcy Code*.

If there is a meaningful prospect for an improvement in the debtor's financial condition, an income-contingent repayment plan could provide relief to the debtor until the improved circumstances exist. However, if the debtor's prospects are not likely to improve, a mechanical finding that the existence of an income-contingent repayment precludes an undue hardship may prejudice the debtor. During the repayment program, which could last up to 25 years, interest continues to accrue on the debt. If, after the expiration of a lengthy repayment period, a large student loan is forgiven under the program, the debtor may incur a large tax debt due to taxable income arising from the debt forgiveness. Such a result would be inconsistent with the fresh start purposes of the Bankruptcy Code. Thus, the availability, by itself, of the income-contingent repayment plan should not preclude hardship discharge under section 523(a)(8). At most, its existence is one factor that may be considered by the court. n22

Despite the courts' best efforts to formulate objective criteria for evaluating undue hardship, the application of the articulated standards necessarily requires each court to apply its own intuitive sense of what is a "minimal" standard of living and what is "good faith." At bottom, the Bankruptcy Code requires bankruptcy courts to decide how much personal sacrifice society expects from individuals who accepted the benefits of guaranteed student loans but who have not obtained the financial rewards they had expected to receive as a result of their educational expenditures.

Partial Discharge. The plain language of section 523(a)(8) provides for the nondischargeability of any debt falling within its terms unless certain conditions exist. The statutory text appears absolute on its face; it does not provide that a debt is nondischargeable "to the extent" that repayment would impose an undue hardship on the debtor. Nonetheless, some courts have found the "all or nothing" approach to student loan dischargeability dictated by the plain language to be inconsistent with the purpose of the provision and have held that *section 105 of the Bankruptcy Code* n23 empowers the court to grant a discharge of that portion of the student loan obligation which would impose an undue hardship on the debtor. n24 Other courts have rejected the partial discharge doctrine as unauthorized by the statute. n25

Timing of Filing of Dischargeability Complaint in Chapter 13 Cases. In 1990, Congress amended section 1328(a) to incorporate the section 523(a)(8) discharge exception in chapter 13 cases. n26 Since a dischargeability

determination under section 523(a)(8) requires an examination of the debtor's current and future financial situation, the question arises as to whether the dischargeability determination may be made prior to the end of a chapter 13 case. This is not an issue which arises in chapter 7 cases. As one court has explained,

In a Chapter 7 case, the bankruptcy proceeding is short-lived and the debtor achieves a quick discharge of his unsecured, dischargeable debts. Thus, predicting whether the debtor's current inability to maintain a minimal standard of living will persist throughout a significant portion of the repayment period is based upon a known, current situation. Where an adversary proceeding seeking a discharge of student loan obligations is brought early in a Chapter 13 case, however, the question of whether the debtor will be unable to maintain a minimal standard of living throughout a significant portion of the repayment period must be premised upon a prediction of what the debtor's situation will be at the conclusion of the Chapter 13 plan which, as here, may extend up to five years. n27

Some courts have held that, in a chapter 13 case, a dischargeability determination is not ripe until the completion of the chapter 13. n28 Other courts have held that where circumstances exist that would permit the court to determine the debtor's future financial condition in advance of the conclusion of the chapter 13 case, a dischargeability determination under section 523(a)(8) may be made prior to the completion of the debtor's chapter 13 plan. n29

Postpetition Interest on Nondischargeable Student Loans in Chapter 13 Cases. Under section 502(b)(2) of the *Bankruptcy Code*, n30 unmatured interest on an unsecured claim is not allowable. Thus, the bankruptcy estate is not liable for postpetition interest on an unsecured claim. Since the Supreme Court's decision in *Bruning v. United States*, n31 it has been settled that the estate's freedom from liability does not relieve the debtor from personal liability for postpetition interest on a nondischargeable tax debt. n32 This principle applies to nondischargeable student loan debts in chapter 13 cases. Thus, unless the chapter 13 plan provides otherwise, n33 the debtor will remain liable for postpetition interest on a student loan claim which is nondischargeable under section 523(a)(8) after the conclusion of the chapter 13 case, even if the chapter 13 plan provided for full payment of the prepetition claim. n34

Repealed Seven-Year Rule; Consolidation Loans; Former § 523(a)(8)(A). Prior to October 7, 1998, section 523(a)(8) provided for the dischargeability of an educational loan or benefit if the debtor's repayment obligation "first became due more" than seven years (exclusive of any applicable suspension period) before the date of the filing of the petition. n35 Former section 523(a)(8)(A) reflected a legislative judgment that after a seven year repayment period has expired, the public policy concerns about potential abuse of the educational loan system and the risks to the system's fiscal integrity are outweighed by the fresh start policy of the Code. In 1998, Congress deleted section 523(a)(8)(A) from the Code, leaving "undue hardship" as the sole basis for discharging an educational loan or benefit. n36 The elimination of the "seven year rule" applies to all cases commenced after October 7, 1998. n37

Under former section 523(a)(8)(A), the term "first became due" was measured from the date the first installment payment on the loan fell due. n38 Further, any time period in which repayment of the student loan was "suspended" was disregarded in computing whether seven years elapsed between the date repayment first fell due and the commencement of the bankruptcy case. An improper deferment, such as an unrequested unemployment deferment or one that was not authorized by the applicable regulations, did not suspend the running of the seven year period. n39

It is not uncommon for a debtor to sign a single note that consolidates the series of smaller notes that were signed when the debtor was in school. In some cases, the debtor has signed the consolidation note some time after repayment fell due on the original notes. In such cases, some courts held that the seven-year period was measured from the execution of the consolidation note, not the earlier date on which the debtor's repayment obligation began. n40 This result was questionable because it effectively expanded the seven-year repayment period established by Congress for the dischargeability of student loans.

Health Education Loans; 42 U.S.C. § 292f(g) (HEAL); 42 U.S.C. § 254o(c)(3) (NHSC). Separate dischargeability rules apply to certain health educational loan programs. The most well known are loans provided under the Health Education Assistance Loan Act (HEAL). n41 HEAL provides in pertinent part:

(g) A debt which is a loan insured under the authority of this subpart may be released by a discharge in bankruptcy under any chapter of title 11, United States Code , only if such discharge is granted--

(1) after the expiration of the 5-year period beginning on the first date, as specified in subparagraphs (B) and (C) of section 731(a)(2) , when repayment of such loan is required;

(2) upon a finding by the Bankruptcy Court that the nondischarge of such debt would be unconscionable; and

(3) upon the condition that the Secretary shall not have waived the Secretary's right to apply subsection (f) to the borrower and the discharged debt.

The dischargeability of a HEAL loan under all chapters of the Code is controlled by 42 USCS § 292f(g), the more specific and later enacted statute, rather than section 523(a)(8). n42 The "unconscionability" standard for discharging HEAL loans is stricter than the "undue hardship" standard under section 523(a)(8). n43 However, in evaluating whether a debtor can establish that requiring repayment of the debt would be unconscionable, a court should consider the same factors used in determining whether a debt is dischargeable under the undue hardship standard. n44

The National Health Service Corps (NHSC) Scholarship Program awards students scholarships in return for a commitment to serve for two years in the Public Health Service or as a civilian member of the NHSC. If a student does not receive a degree, the amount of the scholarship must be repaid. The NHSC statute bars the discharge of NHSC repayment obligations in bankruptcy cases except in certain circumstances. n45

For a complete discussion of Code section 523, see Collier on Bankruptcy, ch. 523.

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Return to Text

n1 1. 11 U.S.C. § 523(a)(8)(B), as amended by Pub. L. No. 109-8, § 220 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. See *Santa Fe Medical Services, Inc. v. Segal (In re Segal)*, 57 F.3d 342, 33 C.B.C.2d 1496 (3d Cir. 1995).

n3

3. E.g., *In re Renshaw*, 222 F.3d 82 (2d Cir. 2000). However, the National Bankruptcy Review Commission concluded that the anecdotal concerns about abuse of the educational loan system are not supported by empirical evidence. National Bank. Rev. Comm'n, *Bankruptcy: The Next Twenty Years*, §1.4.5 (Oct. 20, 1997), cited in *In re Hornsby*, 144 F.3d 433, 40 C.B.C.2d 313 (6th Cir. 1998).

n4

4. *In re Pelkowski*, 990 F.2d 737, 28 C.B.C.2d 1023 (3d Cir. 1993).

n5

5. *Santa Fe Medical Services, Inc. v. Segal (In re Segal)*, 57 F.3d 342 (3d Cir. 1995).

n6

6. *In re Chambers*, 348 F.3d 650 (7th Cir. 2003); *Boston Univ. v. Mehta (In re Mehta)*, 310 F.3d 308 (3d Cir. 2002); *Cazenovia College v. Renshaw (In re Renshaw)*, 222 F.3d 82 (2d Cir. 2000).

n7

7. *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440, 124 S. Ct. 1905, 1912, 158 L. Ed. 2d 764, 51 C.B.C.2d 627 (2004).

n8

8. *Underwood v. United Student Aid Funds, Inc. (In re Underwood)*, 299 B.R. 471 (Bankr. S.D. Ohio 2003).

n9

9. *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987); *see also Educational Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302, 1309 (10th Cir. 2004) (adopting *Brunner* framework with qualification that it "must be applied such that debtors who truly cannot afford to repay their loans may have their loans discharged"); *Hemar Ins. Corp. of Am. v. Cox (In re Cox)*, 338 F.3d 1238 (11th Cir. 2003); *In re Pena*, 155 F.3d 1108, 40 C.B.C.2d 848 (9th Cir. 1998); *Pennsylvania Higher Educ. Assistance Agency v. Faish (In re Faish)*, 72 F.3d 298 (3d Cir. 1995); *Cheesman v. Tennessee Student Assistance Corp. (In re Cheesman)*, 25 F.3d 356 (6th Cir. 1994), *cert. denied*, 513 U.S. 1081, 115 S. Ct. 731, 130 L. Ed. 2d 634 (1995); *In re Roberson*, 999 F.2d 1132, 29 C.B.C.2d 561 (7th Cir. 1993); *cf. Long v. Educ. Credit Mgmt. Corp. (In re Long)*, 322 F.3d 549 (8th Cir. 2003) (adopting "less restrictive" totality of the circumstances test focusing on (1) the debtor's past, present and reasonably reliable future financial resources, (2) the reasonable, necessary living of expenses of the debtor and the debtor's dependents and (3) any other relevant facts and circumstances).

n10

10. *Pennsylvania Higher Educ. Assistance Agency v. Faish (In re Faish)*, 72 F.3d 298 (3d Cir. 1995).

n11

11. *Cline v. Illinois Student Loan Assistance Ass'n (In re Cline)*, 248 B.R. 347 (B.A.P. 8th Cir. 2000).

n12

12. See *Ivory v. United States (In re Ivory)*, 269 B.R. 890 (Bankr. N.D. Ala. 2001); *Salinas v. United Student Aid Funds, Inc. (In re Salinas)*, 258 B.R. 913 (Bankr. W.D. Wis. 2001).

n13

13. *Educational Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302 (10th Cir. 2004).

n14

14. *Nys v. Educational Credit Mgmt. Corp. (In re Nys)*, 308 B.R. 436, 444 (B.A.P. 9th Cir. 2004) ("The circumstances need be exceptional' only in the sense that they demonstrate insurmountable barriers to the debtor's financial recovery and ability to pay.").

n15

15. *Mayer v. Pennsylvania Higher Educ. Assistance Agency (In re Mayer)*, 198 B.R. 116 (Bankr. E.D. Pa. 1996).

n16

16. *Educational Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302 (10th Cir. 2004); *Pennsylvania Higher Educ. Assistance Agency v. Faish (In re Faish)*, 72 F.3d 298, 305, 34 C.B.C.2d 1312, 1324 (3d Cir. 1995) (citations omitted).

n17

17. *Alderete v. Educational Credit Mgmt. Corp. (In re Alderete)*, 308 B.R. 495 (B.A.P. 10th Cir. 2004); *Great Lakes Higher Education Corp. v. Brown (In re Brown)*, 239 B.R. 204 (S.D. Cal. 1999); *Clevenger v. Nebraska Student Loan Program (In re Clevenger)*, 212 B.R. 139 (Bankr. W.D. Mo. 1997).

n18

18. See 20 U.S.C. § 1087e(d)(1); 34 C.F.R. §§ 685.208-685.209 (William D. Ford Federal Direct Loan Program).

n19

19. See *Long v. Educ. Credit Mgmt. Corp. (In re Long)*, 292 B.R. 635 (B.A.P. 8th Cir. 2003).

n20

20. 34 C.F.R. § 685.209.

n21

21. *Alderete v. Educational Credit Management Corp. (In re Alderete)*, 308 B.R. 495 (B.A.P. 10th Cir. 2004) (little weight given to the debtor's failure to investigate eligibility for an income contingent repayment plan where evidence showed that, if eligible, the debtor could not have afforded the minimum program payments).

n22

22. *Ford v. Student Loan Guar. Found. of Ark. (In re Ford)*, 269 B.R. 673 (B.A.P. 8th Cir. 2001).

n23

23. 11 U.S.C. § 105.

n24

24. *E.g.*, *Saxman v. Educational Credit Management BJR Corp. (In re Saxman)*, 325 F.3d 1168 (9th Cir. 2003); *Tennessee Student Assistance Corp. v. Hornsby (In re Hornsby)*, 144 F.3d 433 (6th Cir. 1998); *see also Miller v. Pennsylvania Higher Educ. Assistance Agency (In re Miller)*, 377 F.3d 616 (6th Cir. 2004) (clarifying *Hornsby* and holding that the section 105 does not provide an independent basis for a partial discharge; the section 105 power to grant a partial discharge can only be made upon a showing of undue hardship under section 523(a)(8) as to the partial amount to be discharged).

n25

25. *E.g.*, *Salinas v. United Student Aid Funds, Inc. (In re Salinas)*, 258 B.R. 913 (Bankr. W.D. Wis. 2001); *Skaggs v. Great Lakes Higher Educ. Corp. (In re Skaggs)*, 196 B.R. 865 (Bankr. W.D. Okla. 1996).

n26

26. *See Collier on Bankruptcy*, 1328.02[3][d] (Matthew Bender).

n27

27. *Ekenasi v. Education Resources Institute (In re Ekenasi)*, 325 F.3d 541, 547 (4th Cir. 2003).

n28

28. *E.g.*, *Soler v. United States (In re Soler)*, 250 B.R. 694 (Bankr. D. Minn. 2000).

n29

29. *Ekenasi v. Education Resources Institute (In re Ekenasi)*, 325 F.3d 541, 547 (4th Cir. 2003); *see also Goranson v. Pennsylvania Higher Educ. Assistance Agency (In re Goranson)*, 183 B.R. 52 (Bankr. W.D.N.Y. 1995).

n30

30. 11 U.S.C. § 502(b)(2).

n31

31. 376 U.S. 358, 84 S. Ct. 906, 11 L. Ed. 2d 772 (1964).

n32

32. See *Collier on Bankruptcy*, 523.07[7] (Matthew Bender).

n33

33. *Great Lakes Higher Education Corporation v. Pardee (In re Pardee)*, 193 F.3d 1083 (9th Cir. 1999) (even if statute provides for nondischargeability of debt, the debt was discharged by the creditor's failure to challenge the plan during the bankruptcy proceedings); *Andersen v. UNIPAC-NEBHELP (In re Andersen)*, 179 F.3d 1253 (10th Cir. 1999) (same). But see *Banks v. Sallie Mae Servicing Corp. (In re Banks)*, 299 F.3d 296 (4th Cir. 2002) (confirmation order held not binding on creditor because dischargeability must be determined by adversary proceeding).

n34

34. *Kielisch v. Educational Credit Mgmt. Corp. (In re Kielisch)*, 258 F.3d 315 (4th Cir. 2001); *Leeper v. Pennsylvania Higher Educ. Assistance Agency (In re Leeper)*, 49 F.3d 98, 32 O.&G.R. 1833 (3d Cir. 1995).

n35

35. Section 523(a)(8)(A) originally required that an educational loan or benefit be due and owing for a five-year period before that debt could be discharged. The five-year period was increased to seven years in 1990. Pub. L. No. 101-647, § 3621(1) (1990).

n36

36. Higher Education Amendments of 1998, Pub. L. No. 105-244, § 971(a) (1998).

n37

37. Higher Education Amendments of 1998, Pub. L. No. 105-244, § 971(b) (1998).

n38

38. *Nunn v. State of Washington (In re Nunn)*, 788 F.2d 617, 14 C.B.C.2d 892 (9th Cir. 1986); see also *Woodcock v. Chemical Bank, NYSHESC (In re Woodcock)*, 45 F.3d 363, 32 C.B.C.2d 1341 (10th Cir. 1995), cert. denied, 516 U.S. 828, 116 S. Ct. 97, 133 L. Ed. 2d 52 (1995).

n39

39. *Connecticut Student Loan Found. v. Keenan (In re Keenan)*, 14 C.B.C.2d 1344, 53 B.R. 913 (Bankr. D. Conn. 1985).

n40

40. See, e.g., *Hiatt v. Indiana State Student Assistance Commission*, 36 F.3d 21 (7th Cir. 1994); *United States v. McGrath*, 143 B.R. 820 (D. Md. 1992); *In re Martin*, 137 B.R. 770 (Bankr. W.D. Mo. 1992).

n41

41. 42 U.S.C. § 292f(g).

n42

42. *United States v. Rice*, 182 B.R. 759 (N.D. Ohio 1994), aff'd, 78 F.3d 1144 (6th Cir. 1996); *Hines v. United States (In re Hines)*, 15 C.B.C.2d 959, 63 B.R. 731 (Bankr. D.S.D. 1986).

n43

43. *U.S. Dep't of Health & Human Servs. v. Smitley*, 347 F.3d 109 (4th Cir. 2003); *Rice v. United States (In re Rice)*, 78 F.3d 1144 (6th Cir. 1996); *In re Lawrence*, 32 C.B.C.2d 1903 (Bankr. S.D. Fla. 1995).

n44

44. *Rice v. United States (In re Rice)*, 78 F.3d 1144 (6th Cir. 1996); see also *U.S. Dep't of Health & Human Servs. v. Smitley*, 347 F.3d 109 (4th Cir. 2003) (considering, *inter alia*, the debtor's age, income, earning ability, health, educational background, dependents, standard of living, the likelihood that the debtor's situation will improve, the debtor's previous efforts to repay the loan).

n45

45. 42 U.S.C. § 254o(c)(3); see *United States v. Brown (In re Brown)*, 79 B.R. 789 (Bankr. N.D. Ill. 1987).

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176 of 197 DOCUMENTS

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Collier on the Definition of Claim Under the Bankruptcy Code

2008 Emerging Issues 968

Collier on the Definition of Claim Under the Bankruptcy Code

By Collier

November 16, 2007

SUMMARY: This Emerging Issues Analysis addresses issues pertaining to section 101(5) of the Code, including statutory obligations as claims, statutory administrative functions with respect to pension plans as claims, criminal restitution obligations as claims, rights against a debtors property constituting a claim, right to payment arising from breach of the equitable right to performance, and tort claims.

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ARTICLE: "Claim" is defined as any right to payment, whether or not reduced to judgment, liquidated, unliquidated, fixed, contingent, n1 matured, unmatured, disputed, n2 undisputed, legal, equitable, secured or unsecured. The effect of the definition is a significant departure from prior law. The Code defines the term "claim" much more broadly in section 101(5) than under previous law. Under Section 1 of the former Bankruptcy Act, "claim" was not defined. The term was only used with the concept of provability in Section 63 of the Act to limit the kinds of debts that were payable in a bankruptcy case. n3

The term "claim" is coextensive with the term "debt," according to the Supreme Court in *Pennsylvania Department of Public Welfare v. Davenport*. n4 Under the broad definition in the Code, "claim" may include a claim based on state law for breach of warranty, n5 subrogation as well as contribution and indemnity claims, n6 the claim for contribution of a codebtor ex-spouse who paid more than her proportionate share of joint debts n7 or an individual debtor's personal but contingent and unliquidated liability for trust fund taxes. n8 By fashioning a single definition of "claim" in the Code, Congress intended to adopt the broadest available definition of that term. n9 The Supreme Court has repeatedly reiterated this principle and has declined all invitations to exclude rights to payment from the definition of claim. n10

"Claim" may also include a cause of action or right to payment that has not yet accrued or become cognizable. n11 Neither the contingency of the debt nor the immaturity of the obligation affects whether a right to payment is a claim. n12 For example, in *In re Manville Forest Products*, n13 the Court of Appeals for the Second Circuit held that an obligation under a prepetition indemnification agreement was a prepetition debt discharged by confirmation of a chapter 11 plan even though the contingency against which the nondebtor party had been indemnified had not yet occurred when the bankruptcy petition was filed. A creditor's right to payment that arose from the earliest point in the

relationship between debtor and creditor is a claim. n14 A collective bargaining representative has a "right to payment" of unpaid wages of its members. n15 Equitable relief held against a debtor should be estimated as to its monetary value for proof of claim purposes. n16

However, the broad definition of claim is not boundless. The fact that an entity may have a claim in the future does not mean that the entity has a claim on the date of the petition. A person who might be injured in the future due to a manufacturing defect in a product made before bankruptcy does not have a prepetition claim if the person did not have a prepetition relationship with the debtor or the product. n17 A parent corporation's asserted interest in customer obligations it was to transfer under an operating agreement to its finance subsidiary, a chapter 11 debtor, was not a claim. n18 A claim is distinguishable from an ownership interest in the debtor, and the holder of an equity security, without more, is not the holder of a claim. n19 Retirement advances that may have to be repaid under certain contingencies have been found not to be "claims" where the obligation is dependent on the debtor's choice of future actions. n20 A *sue sponte* monetary sanctions award that was ordered postpetition in a lawsuit that was filed prepetition, in a case in which no party could have fairly contemplated such an award when the bankruptcy petition was filed, has also been found not to be a prepetition "claim." n21 Similarly, new or continuing postpetition acts in violation of a statute that the debtor had been violating before filing the petition can give rise to postpetition claims, separate from the prepetition claims based on prepetition violations. n22

Statutory Obligations as Claims; *Ohio v. Kovacs*. In *Ohio v. Kovacs*, n23 the United States Supreme Court, affirming the Court of Appeals for the Sixth Circuit, held that a state court judgment requiring the removal of hazardous waste from a dump site was a "claim" within the meaning of section 101 and, therefore, dischargeable under section 727. The Court, in a unanimous decision, rejected the State's arguments that because the breach was statutory it was not a liability on a claim, and that the breach of the debtor's obligation did not give rise to a right to payment within the meaning of subparagraph (B). "There is no indication in the statute that a right to performance cannot be claimed unless it arises from a contractual arrangement . It makes little sense to assert that because the cleanup order was entered to remedy a statutory violation, it cannot likewise constitute a claim for bankruptcy purposes." n24 The Court concluded that upon the debtor's default on the judgment, the State of Ohio's appointment of a receiver to obtain possession of the debtor's assets and to implement the site cleanup had reduced the judgment to a monetary obligation. n25

Most payment obligations to environmental regulatory agencies, even if contingent, are claims if they are based upon prepetition conduct. n26 A claim under federal and state environmental statutes generally arises upon the actual or threatened release of hazardous waste or when the conduct of a debtor which gives rise to the cause of action occurs. n27 However, when the state neither seeks money nor has a right to payment, but only exercises its right to force a debtor to comply with the debtor's continuing obligation under state law to dispose of hazardous waste, the state's demand that the debtor remedy the hazard is not a claim of the state. n28

If a claimant's right to payment arises from a statute that was enacted after the debtor's reorganization, the court will determine whether the right to payment constitutes a discharged claim on the basis of whether the claimant had an analogous right to payment under the law that was in existence at the time of the debtor's reorganization. n29 In the context of environmental cleanup claims, several courts have expressed concern that, although the triggering event for establishing liability (i.e., the actual or threatened release of hazardous substances) may have occurred prepetition, a party having the right to recover damages from the debtor for the cleanup costs relating to such environmental contamination may not know until many years after the debtor has emerged from bankruptcy that (1) a release occurred or (2) the debtor was liable for such cleanup. n30 As a result, many courts evaluating whether a claim for environmental cleanup costs constitutes a "claim" that was discharged in the debtor's bankruptcy case assess whether (1) the actual or threatened release occurred prepetition *and* (2) whether the claim was fairly contemplated. Evidence that a claim by a governmental agency was fairly contemplated during a debtor's bankruptcy case could include the following: knowledge by the parties of a site at which a debtor may be liable; listing of the site on the National Priorities List; notification by the Environmental Protection Agency of liability; commencement of investigation and cleanup activities; and incurrence by the governmental agency of cleanup costs. n31 In cases where a private party asserts an environmental claim against a debtor, relevant factors could include the following: whether the party was aware of

releases of hazardous substances at a site; whether the party contemplated future suit against the debtor; whether the parties considered the site an environmental risk prior to bankruptcy; whether visible signs of contamination existed; whether the party had the ability or responsibility to determine the site's condition because of a contractual relationship with the debtor (such as a lease) or otherwise; and whether the party knew of the use of the site. n32

Statutory Administrative Functions with Respect to Pension Plans as Claims. A debtor that sponsors a pension plan subject to the Employee Retirement Income Security Act of 1974 ("ERISA") n33 may have a variety of statutory obligations with respect to the plan and its participants and beneficiaries. For example, to the extent the debtor is the plan administrator n34 under a defined benefit pension plan, n35 section 4041 of ERISA 36 mandates a variety of obligations that must be fulfilled in order to complete a successful termination of the plan. These obligations include a duty to terminate the plan in accordance with ERISA section 4041, n37 to notify the Pension Benefit Guaranty Corporation after the filing of a bankruptcy, to notify all affected parties of the impending termination and to comply with various reporting requirements as to the net assets and liabilities of the plan. n38 Other duties imposed upon a plan administrator by ERISA, regardless of whether the ERISA plan is a defined benefit plan, include maintaining a fidelity bond with respect to the plan, n39 preparing annual reports n40 and issuing participant statements. n41 A plan administrator may have additional responsibilities under the Internal Revenue Code, such as maintaining the plan document in compliance with changing federal laws and regulations applicable to the plan, n42 and making minimum required distributions to certain participants and beneficiaries. n43

The issue raised in *In re Esco Manufacturing* n44 was whether ERISA termination obligations were "claims" that the trustee was obligated to resolve. In *Esco*, the chapter 7 trustee filed a notice with the bankruptcy court stating the debtor intended to abandon its pension plan. n45 The trustee argued that the plan was not property of the estate, and that even if it were later deemed to be so, it was of little value to the estate, and thus could be abandoned as burdensome under section 554(a) of the Bankruptcy Code. n46 The Pension Benefit Guaranty Corporation ("PBGC") n47 filed an objection, asserting that the trustee was prohibited from abandoning the debtor's statutory obligations to the pension plan under ERISA. n48 The bankruptcy court granted the trustee's motion, and the PBGC appealed. n49 The district court in *Esco* held that the ERISA termination obligations were "claims" that the trustee was obligated to resolve. n50 Initially, the Fifth Circuit affirmed, finding that the duties imposed by the Bankruptcy Code include the obligation to perform any termination obligations imposed by ERISA, and that by doing so a trustee is acting in the best interests of the bankruptcy estate. n51 However, on rehearing, the court's first opinion was withdrawn and a second opinion was issued. The second *Esco* opinion stated that the terms of the pension plan set up a committee as a plan administrator. n52 Based on this plan provision, the court concluded that the debtor was not the plan administrator, and thus never had the power to terminate the plan. n53 According to the court, the power to terminate the plan was vested in the "administrator," not the plan sponsor, under ERISA. n54 Therefore, the court found the bankruptcy trustee could not succeed to the power to terminate the plan. n55 The withdrawal of the first *Esco* opinion left it unclear whether its finding that ERISA termination obligations are "claims" that the trustee is obligated to resolve continues to apply in circumstances where the debtor is in fact the plan administrator under the terms of its pension plan.

In *CPT Holdings v. Industrial and Allied Union Employees Pension Plan*, n56 the Court of Appeals for the Sixth Circuit considered a chapter 11 debtor's withdrawal liability with respect to a union pension plan that it withdrew from after confirmation of its plan, which had assumed the collective bargaining agreement. The former debtor argued that it was liable only with respect to its postconfirmation membership in the plan and that any liability with respect to its prepetition membership was a claim that had been discharged in the chapter 11 case. Disagreeing with or distinguishing the decisions of several lower courts that had found withdrawal liability to be a dischargeable claim, n57 the court held that an employer's withdrawal liability does not exist until the employer actually withdraws from the plan, leaving the plan underfunded. Therefore, the court held, the withdrawal liability cannot be discharged unless the employer withdraws from the plan prior to confirmation. n58

In *In re New Center Hospital*, n59 an action was brought on behalf of a defined contribution retirement plan to

compel a court-appointed chapter 11 trustee to administer the plan. The trustee asserted that the duty to act as a plan administrator did not lie with the trustee, but rather with a court-appointed plan trustee. n60 The bankruptcy trustee argued that if he were to administer the plan, he would be required to act solely in the interest of the plan beneficiaries, which would be in conflict with the trustee's duty to the bankruptcy estate. n61 The *New Center Hospital* court compelled the bankruptcy trustee to administer (i.e., terminate) the retirement plan. In reaching its conclusion, the court found that under the plan at issue, the debtor was both the plan sponsor and the plan administrator. n62 The court, citing section 541 Code, stated that a bankruptcy trustee assumes the position of the debtor as to that debtor's many obligations, including statutory obligations relating to retirement plans. n63

Criminal Restitution Obligations as Claims; the *Davenport* Case. The Supreme Court again had occasion to address the definition of "claim" in *Pennsylvania Department of Public Welfare v. Davenport*, n64 in which the issue was whether a criminal restitution obligation was a claim. Despite *dictum* in its earlier decision in *Kelly v. Robinson* n65 expressing doubts that such obligations were claims, the Court, in a seven-to-two decision, held that such obligations were within the scope of the Code's definition of "claim." In reaching its decision, the Court first noted the expansive language of section 101, and the fact that it was modified only to reflect "a broad rather than restrictive view of the class of obligations that qualify as a claim' giving rise to a debt.'" n66 The Court also referred to the legislative history describing the definition of "claim" as the "broadest possible" and noted that the Code "contemplates that all legal obligations of the debtor will be able to be dealt with in a bankruptcy case." n67 The Supreme Court rejected the argument of the defendants in *Davenport* that a criminal restitution obligation did not arise out of a "traditional debtor-creditor relationship" because of its special purposes of punishment and rehabilitation. Although the purpose of the obligation was relevant to whether it was dischargeable under Code section 523(a)(7), n68 the Court stated that the language of section 101 made no reference to purpose, and the objectives of the state in imposing restitution were therefore irrelevant. n69 The Court also rejected the argument that restitution obligations were not claims because they were enforced differently from other obligations. Although neither the Probation Department nor the victim could enforce the obligation in civil proceedings in the *Davenport* case, the obligation was enforceable through other means, such as the threat of probation revocation and incarceration. The fact that the enforcement mechanisms available to the creditors were criminal rather than civil was held not to affect the character of the obligation as a right to payment. n70 Although only criminal enforcement mechanisms were available to enforce the Pennsylvania restitution order in *Davenport*, criminal restitution orders in other states may be enforced through civil proceedings. n71

The *Davenport* decision reinforces the statute's intended effect to define the scope of the term "claim" as broadly as possible, subject to the limitations on equitable remedies that are expressly stated in section 101. It can be expected that in light of *Davenport* the courts will rebuff virtually all attempts to characterize obligations as outside the scope of the definition due to "special" or unique characteristics of those obligations. Although Congress, in two separate acts, n72 amended Code section 1328(a) to make certain criminal restitution debts nondischargeable in chapter 13 cases, thus reversing the result in *Davenport*, it did nothing to change the definition of claim or to disturb the Supreme Court's holding regarding the scope of that definition. Therefore, the broad scope of the term "claim" described in *Davenport*, including obligations for criminal restitution, continues to be the law.

Rights Against Debtor's Property Constitute a Claim; *Johnson v. Home State Bank*. The Supreme Court addressed the definition of "claim" yet again in *Johnson v. Home State Bank*. n73 In that case, the Court held that when a debtor had discharged his personal liability on the notes underlying a mortgage, the mortgagee's right to receive the proceeds from the sale of the mortgaged property remained an enforceable monetary obligation, and therefore a right to payment within the definition of "claim." The discharge of the debtor's personal liability merely extinguished one mode of enforcing the claim through an *in personam* judgment; the fact that the claim could thereafter be enforced only by another mode--collecting from the debtor's property--was held to be immaterial. n74

After reviewing case law, legislative history, the Code definition of "claim," and the rule of construction concerning "claim against the debtor," the Court in *Johnson* confirmed that Congress had intended to adopt the broadest available

definition of "claim," and that a "right to payment," as "claim" is defined in section 101(5)(A), meant "nothing more or less than an enforceable obligation." Even after the debtor's personal liability had been discharged, the mortgage holder still retained a "right to payment" stemming from its right to the proceeds from the sale of the debtor's property. The Court noted that the rule of construction set forth in section 102(2) established that the phrase "claim against the debtor" includes a claim against the property of the debtor. n75

The Court in *Johnson* concluded that the issue was a straightforward one of statutory construction to be resolved by reference to the Code itself and to legislative history, which confirmed that the definition of "claim" includes an obligation enforceable only against a debtor's property. Finally, the Court rejected the bank's argument that Congress had intended to prohibit a debtor from utilizing serial filings to discharge such a debt, pointing out that when Congress intended to discourage certain types of serial filings, it did so explicitly. Considering the full range of Code provisions designed to protect chapter 13 creditors, and the intent of Congress that "claim" be construed broadly, the Court found it unlikely that Congress intended bankruptcy courts to police chapter 13 abuses through a limitation of the Code's definition of "claim."

Right to Payment Arising from Breach of Equitable Right to Performance. The definition of "claim" also includes breach of an equitable right to performance which gives rise to a right of payment. n76 The intended result is that a liquidation or estimation of a contingent right of payment for which there may be an alternative remedy makes the equitable claim dischargeable in bankruptcy. n77 For example, in some states, a judgment for specific performance may be satisfied by an alternative right to payment in the event performance is refused; in that event the creditor entitled to specific performance would then have a "claim" for the purpose of a case under title 11. In *Johnson v. Home State Bank*, n78 the Supreme Court held that this language encompassed the right of a mortgage holder to foreclose on property after the debtor had discharged his personal obligation on the underlying notes in an earlier chapter 7 case. A purchaser's down payment for a purchase that created a right to either performance or a remedy for breach of performance against the debtor constitutes a "claim" for purposes of this section. n79 Similarly, the Court of Appeals for the Third Circuit held in *In re Continental Airlines* n80 that employees' rights to reinstatement under a collective bargaining agreement could be reduced to monetary damages and therefore were "claims." A claim is a right to payment, or a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment; it is irrelevant whether the right is reduced to judgment, liquidated, fixed, matured, disputed, legal, equitable or secured. n81

On the other hand, rights to an equitable remedy for breach of performance with respect to which such breach does not give rise to a right to payment are not "claims" within the Code's contemplation, and would not therefore be dischargeable in bankruptcy, unless such obligations could be translated into a claim for damages if breached. n82 When there is no money damage alternative to state court ordered equitable remedies such as resulting trust, partition in kind, or deed reformation, they do not fit the definition of claim under section 101(5) and, therefore, are not subject to discharge under the Code. n83 For example, in *In re Ben Franklin Hotel Associates*, n84 the Court of Appeals for the Third Circuit held that an equitable demand for reinstatement of a partnership interest in a partnership owning unique commercial property could not be reduced to damages and therefore was not a claim. Most courts have concluded that a covenant not to compete, or at least the portion of such a contract giving a right to injunctive relief, is not a claim. n85 Courts have disagreed about whether injunctions requiring a debtor to clean up contaminated property constitute "claims." n86 So long as a monetary payment is not being sought, or monetary payment is viewed as a "suboptimal" remedy for the creditor, a growing number of courts will not classify a request for injunctive relief as a claim. n87

The definition of "claim" as it was originally proposed in H.R. 8200 was designed to give "claim" the broadest

interpretation, as the Code contemplated that all legal obligations of the debtor, no matter how remote or contingent, be able to be dealt with in the bankruptcy case. It permitted the court to give the broadest possible relief. n88 As enacted, however, section 101(5)(B) limits the definition of "claim" by excluding rights to an equitable remedy for a breach of performance with respect to which such a breach does not give rise to a right to payment. Such rights are not "claims" and are not, therefore, susceptible to discharge in bankruptcy. n89

Tort Claims are "Claims." Tort claims constitute claims, and thus are payable out of the estate, and constitute dischargeable debts. Under former Section 63, only limited types of tort claims were provable in a bankruptcy case, but if not provable would receive no distribution and be nondischargeable. Under the Code, the fact that the tort claim may be unliquidated or disputed does not mean that it is not a claim. As the Court of Appeals for the Federal Circuit held in *In re Cambridge Biotech Corporation*, n90 a claim for damages arising from patent infringement would be considered a type of tort within the definition of "claim."

For a complete discussion of Code section 101 of the Bankruptcy Code, see Collier on Bankruptcy, ch. 101.

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Return to Text

n1 1. See *In re La Bonte*, 5 C.B.C.2d 181, 13 B.R. 887 (Bankr. D. Kan. 1981) (guarantor of debtor's note held contingent claim).

n2

2. See *NCNB Fin. Servs., Inc. v. Shumate*, 55 B.R. 489 (Bankr. W.D. Va. 1985) (creditor's disputed right to payment on debtor's guarantee).

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3. H.R. Rep. No. 595, 95th Cong., 1st Sess. 309 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 21 (1978).

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4. 495 U.S. 552, 110 S. Ct. 2126, 109 L. Ed. 2d 588, 22 C.B.C.2d 1067 (1990).

n5

5. *Southeastern Sprinkler Co. v. Meyertech Corp. (In re Meyertech Corp.)*, 831 F.2d 410, 18 C.B.C.2d 34 (3d Cir. 1987).

n6

6. *In re Hemingway Transp.*, 954 F.2d 1, 26 C.B.C.2d 372 (1st Cir. 1992); *In re Erin Food Services, Inc.*, 980 F.2d 792 (1st Cir. 1992); *In re Charter Co.*, 862 F.2d 1500, 20 C.B.C.2d 915 (11th Cir. 1989); *Solow Bldg. Co., L.L.C. v. ATC Assocs.*, 175 F. Supp. 2d 465 (E.D.N.Y. 2001); *In re Eagle-Picher Indus., Inc.*, 164 B.R. 265 (S.D. Ohio 1994); *In re Cottonwood Canyon Land Co.*, 146 B.R. 992 (Bankr. D. Colo. 1992); *In re Kent Holland Die Casting & Plating*, 125 B.R. 493 (Bankr. W.D. Mich. 1992); *Acevedo v. Van Dorn Plastic Mach. v. Cut Rate Plastic Hanger*, 68 B.R. 495 (Bankr. E.D.N.Y. 1986). But see *In re Reading Co.*, 115 F.3d 1111 (3d Cir. 1997) (in Bankruptcy Act case, contribution claim not a claim where explicit statutory right to contribution not created until after consummation of reorganization); *In re M. Frenville Co.*, 744 F.2d 332 (3d Cir. 1984), *cert. denied*, 469 U.S. 1160, 105 S. Ct. 911, 83 L. Ed. 2d 925 (1985) (claim for indemnity accrued only when cause of action for indemnity accrued under state law).

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7. *In re Amburgey*, 68 B.R. 768 (Bankr. S.D. Ind. 1987).

n8

8. *In re Kilen*, 25 C.B.C.2d 326, 129 B.R. 538 (Bankr. N.D. Ill. 1991).

n9

9. See *In re Udell*, 18 F.3d 403, 30 C.B.C.2d 1192 (7th Cir. 1994).

n10

10. *FCC v. NextWave Personal Communications, Inc. (In re NextWave Personal Communications, Inc.)*, 537 U.S. 293, 123 S. Ct. 832, 154 L. Ed. 2d 863 (2003) (FCC's right to payment for broadband licenses was a claim even if obligation to pay was also a regulatory condition); *Johnson v. Home State Bank*, 501 U.S. 78, 83, 111 S. Ct. 2150, 115 L. Ed. 2d 66 (1991).

n11

11. *Watson v. Parker (In re Parker)*, 313 F.3d 1267 (10th Cir. 2002), cert. denied, 540 U.S. 965, 124 S. Ct. 429, 157 L. Ed. 2d 309 (2003) (claim arises when underlying conduct occurred, not when cause of action accrued); see *In re Cool Fuel, Inc.*, 210 F.3d 999 (9th Cir. 2000) (tax board had claim even though it had not, as of petition date, taken all steps necessary to bring a collection action); *McSherry v. TWA*, 81 F.3d 739 (8th Cir. 1996) (employee had claim for discrimination based on prepetition events even though she had not yet received a right to sue letter from the investigating agency); *In re Clinton Centrifuge, Inc.*, 81 B.R. 844 (Bankr. E.D. Pa. 1988); *In re Johns-Manville Corp.*, 14 C.B.C.2d 273, 57 B.R. 680 (Bankr. S.D.N.Y. 1986); see also *Kilbarr Corp. v. General Servs. Admin. Office (In re Remington Rand Corp.)*, 836 F.2d 825, 18 C.B.C.2d 367 (3d Cir. 1988) (claim deemed to arise when government has requisite knowledge of its right to payment based on breach of contract even though claim has not accrued under the Contract Disputes Act of 1978).

n12

12. *In re Oxford Management*, 4 F.3d 1329 (5th Cir. 1993) (commissions owed by debtor on rents to be collected in the future were claims); *In re Rosteck*, 899 F.2d 694 (7th Cir. 1990) (prepetition contract obligation for future condominium assessments was a prepetition claim); *Smith v. Smith (In re Smith)*, 81 B.R. 888 (Bankr. W.D. Mich. 1988).

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13. 209 F.3d 125 (2d Cir. 2000).

n14

14. *In re A.H. Robins Co.*, 63 B.R. 986 (Bankr. E.D. Va. 1986), aff'd sub nom. *Grady v. A.H. Robins Co. (In re A.H. Robins Co.)*, 839 F.2d 198, 18 C.B.C.2d 176 (4th Cir. 1988); see also *In re UNR Indus., Inc.*, 20 F.3d 766 (7th Cir. 1994), cert. denied, 513 U.S. 999, 115 S. Ct. 509, 130 L. Ed. 2d 416 (1994). Cf. *Epstein v. Official Comm. of Unsecured Creditors (In re Piper Aircraft Corp.)*, 58 F.3d 1573 (11th Cir. 1995) (prepetition conduct can give rise to claim only if there is relationship between identifiable claimant and that conduct; class of persons who at time of chapter 11 plan confirmation had no known injuries due to debtor's conduct did not have claims); *Lemelle v. Universal Mfg. Corp.*, 18 F.3d 1268, 30 C.B.C.2d 1830 (5th Cir. 1994) (holding that while the term "claim" is meant to be given a broad interpretation when determining which claims are discharged in a bankruptcy case, it is not so broad as to include claims relating to injuries and manifestations of injuries that occurred after the plan was confirmed when there was no evidence contemporary with the bankruptcy case from which the debtor could have identified and notified the victims of the case).

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15. *In re Altair Airlines, Inc.*, 727 F.2d 88, 10 C.B.C.2d 343 (3d Cir. 1984); see also *In re Berry Estates, Inc.*, 12 C.B.C.2d 1023, 49 B.R. 1002 (Bankr. S.D.N.Y. 1985) (N.Y. State Division of Housing and Community Renewal has claim for excess rents charged by debtor to its tenants).

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16. See *Goodman v. NLRB (In re Goodman)*, 18 C.B.C.2d 219, 81 B.R. 786 (Bankr. W.D.N.Y. 1988).

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17. *Epstein v. Official Comm. of Unsecured Creditors (In re Piper Aircraft Corp.)*, 58 F.3d 1573 (11th Cir. 1995); see also *Fogel v. Zell*, 221 F.3d 955 (7th Cir. 2000).

n18

18. *Storage Technology Corp. v. Storage Technology Fin. Corp. (In re Storage Technology Corp.)*, 55 B.R. 479 (Bankr. D. Colo. 1985).

n19

19. See *Carrieri v. Jobs.com, Inc.*, 301 B.R. 187 (N.D. Tex. 2003) (right to have debtor repurchase preferred stock was equity security, not claim).

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20. See *Mullen v. U.S.*, 696 F.2d 971, 7 C.B.C.2d 1074 (6th Cir. 1983); *New York City Employees' Retirement Sys. v. Villarie (In re Villarie)*, 648 F.2d 810, 4 C.B.C.2d 494 (2d Cir. 1981).

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21. *In re Water Valley Finishing, Inc.*, 139 F.3d 325 (2d Cir. 1998).

n22

22. *O'Loughlin v. County of Orange*, 229 F.3d 871 (9th Cir. 2000) (debtor's continued actions in violation of Americans with Disabilities Act could give rise to postpetition claims or damages not encompassed in debtor's discharge).

n23 23. 469 U.S. 274, 105 S. Ct. 705, 83 L. Ed. 2d 649, 11 C.B.C.2d 1067 (1985).

n24

24. 469 U.S. 274, 279, 105 S. Ct. 705, 708, 83 L. Ed. 2d 649, 656, 11 C.B.C.2d 1067, 1070.

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25. The state had the option of instituting contempt proceedings or a suit for environmental law violations against the debtor in *Kovacs* but failed to do so. 469 U.S. 274, 283, 105 S. Ct. 705, 710, 83 L. Ed. 2d 649, 658, 11 C.B.C.2d 1067, 1072 (1985); see also *United States v. Robinson (In re Robinson)*, 55 B.R. 355 (M.D. Fla. 1985), reversing without explanation *United States v. Robinson (In re Robinson)*, 12 C.B.C.2d 49, 46 B.R. 136 (Bankr. M.D. Fla. 1985) (bankruptcy court followed *Kovacs* despite the absence of a receiver and a *de facto* money judgment).

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26. *In re Chateaugay Corp.*, 944 F.2d 997 (2d Cir. 1991).

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27. *In re Chicago, Milwaukee, St. Paul and Pacific R.R. Co.*, 974 F.2d 775 (7th Cir. 1992) (Bankruptcy Act case); *In re Jensen*, 25 C.B.C.2d 214, 127 B.R. 27 (B.A.P. 9th Cir. 1991); *NCL Corp. v. Lone Star Bldg. Centers (Eastern) Inc.*, 144 B.R. 170 (S.D. Fla. 1992); *In re National Gypsum Co.*, 27 C.B.C.2d 199, 139 B.R. 397 (N.D. Tex. 1991); *In re Bicoastal Corp.*, 147 B.R. 258 (Bankr. M.D. Fla. 1992); *In re Cottonwood Canyon Land Co.*, 146 B.R. 992 (Bankr. D. Colo. 1992) (debtor became liable at the time of disposal); *Storage Technology Corp. v. Comite Pro Rescate de la Salud (In re Storage Technology Corp.)*, 117 B.R. 610 (Bankr. D. Colo. 1990) (nature of claim is defined when triggering act--here, gas emission--occurred); see *In re Chateaugay Corp.*, 944 F.2d 997, 25 C.B.C.2d 620 (2d Cir. 1991) (Environmental Protection Agency may have a claim under the Comprehensive Environmental Response, Compensation and Liability Act against the estate for prepetition acts that released or threatened the release of hazardous substances); *Norwesco Dev. Corp. v. Pennsylvania, Dep't of Env'tl. Resources (In re Norwesco Dev. Corp.)*, 16 C.B.C.2d 145, 68 B.R. 123 (Bankr. W.D. Pa. 1986) (holding that breach of a state court order requiring the chapter 11 debtor to build a permanent water system for the town

residents, although statutory, constitutes a claim for bankruptcy purposes). *But see In re Reading Co.*, 115 F.3d 1111 (3d Cir. 1997) (claim arises when all elements of claim under nonbankruptcy law have accrued unless contingent claim exists because of prepetition legal relationship between parties); *Al Tech Specialty Steel v. Allegheny Int'l (In re Allegheny Int'l)*, 126 B.R. 919 (W.D. Pa. 1991) (claim for cleaning up hazardous waste site arises when funds are expended for the cleanup and not when contamination occurs). *Cf. Chemetron Corp. v. Jones*, 72 F.3d 341, 34 C.B.C.2d 810 (3d Cir. 1995), *cert. denied*, 517 U.S. 1137, 116 S. Ct. 1424, 134 L. Ed. 2d 548 (1996) (implicitly accepting that claims by individuals for alleged injury from exposure to toxic chemicals as a result of time spent in area prior to bankruptcy case constituted prepetition claims).

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28. *In re Torwico Elecs., Inc.*, 8 F.3d 146, 30 C.B.C.2d 86 (3d Cir. 1993), *cert. denied*, 511 U.S. 1046, 114 S. Ct. 1576, 128 L. Ed. 2d 219 (1994).

n29

29. *CMC Heartland Partners v. Union Pacific R.R. (In re Chicago, Milwaukee, St. Paul and Pacific R.R. Co.)*, 78 F.2d 285 (7th Cir. 1996); *In re Penn Central Transp. Co.*, 944 F.2d 164 (3d Cir. 1991), *cert. denied*, 503 U.S. 906, 112 S. Ct. 1262, 117 L. Ed. 491 (1992) (because "legal relationship" giving rise to claim did not evolve until after the consummation date, retroactive environmental cleanup costs could be assessed against the reorganized company); *United States v. Serafini*, 135 B.R. 219 (M.D. Pa. 1991) (following *Penn Central's* binding precedent, court held that debt was not discharged because it was not provided for under the debtor's Chapter XI arrangement under the Bankruptcy Act); *In re The Duplan Corp.*, 209 B.R. 324 (Bankr. S.D.N.Y. 1997) (where CERCLA was enacted four years after petition date, parties' contribution claim under CERCLA for prepetition contamination was not a prepetition claim).

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30. *See California Dep't of Health Servs. v. Jensen*, 995 F.2d 925, 29 C.B.C.2d 101 (9th Cir. 1993); *In re Chicago, Milwaukee, St. Paul and Pacific R.R. Co.*, 974 F.2d 775 (7th Cir. 1992) (Bankruptcy Act case); *In re Chateaugay Corp.*, 944 F.2d 997, 25 C.B.C.2d 620 (2d Cir. 1991); *In re National Gypsum Co.*, 27 C.B.C.2d 199, 139 B.R. 397 (N.D. Tex. 1991).

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31. *In re National Gypsum Co.*, 27 C.B.C.2d 199, 139 B.R. 397 (N.D. Tex. 1992); *see also California Dep't of Health Servs. v. Jensen*, 995 F.2d 925, 29 C.B.C.2d 101 (9th Cir. 1993) (claim was fairly contemplated when the state agency (i) visited inactive site several weeks after the commencement of the debtors' bankruptcy cases and observed hazardous substances, (ii) knew a serious environmental hazard existed at the site, and (iii) notified the debtors of the condition); *In re Chicago, Milwaukee, St. Paul & Pacific R.R. Co.*, 974 F.2d 775 (7th Cir. 1992) (Bankruptcy Act case). *Compare United States v. Union Scrap Iron & Metal*, 123 B.R. 831 (Bankr. D.

Minn. 1990) (court declined to hold a prepetition claim discharged when the Environmental Protection Agency was not notified of the debtor's liability at the site and the debtor had not listed the liability in any schedule or disclosure statement in the bankruptcy).

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32. *AM Int'l, Inc. v. Datacard Corp.*, 106 F.3d 1342 (7th Cir. 1997) (where there had been no visible signs of contamination, soil testing, involvement by the Environmental Protection Agency, publicized spills, or reports of releases to the Environmental Protection Agency, and debtor did not even realize until after confirmation that it faced CERCLA liability, purchaser of debtor's contaminated property "did not have sufficient information to tie [the debtor] to environmental contamination before [the debtor's] bankruptcy was confirmed"); *NCL Corp. v. Lone Star Bldg. Centers (Eastern) Inc.*, 144 B.R. 170 (S.D. Fla. 1992) (contractual relationship between landlord and lessee, landlord's actual knowledge of site's potential condition, and landlord's ability to inspect the site rendered environmental cleanup claims fairly contemplated); *Texaco, Inc. v. Sanders (In re Texaco, Inc.)*, 182 B.R. 937 (Bankr. S.D.N.Y. 1995) (claims discharged where claimants had received either actual or constructive notice of the bar date, had contracts with the debtor, and knew of debtor's use of oil wells that allegedly had caused environmental contamination). Compare *Chemetron Corp. v. Jones*, 72 F.3d 341, 342 (3d Cir. 1995), *cert. denied*, 517 U.S. 1137, 116 S. Ct. 1424, 134 L. Ed. 2d 548 (1996) (remanding to the district court to determine whether claims by individuals alleging injury from exposure to toxic chemicals as a result of prepetition time spent in area could be brought four years after bar date under the excusable neglect standard).

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33. 29 U.S.C. §§ 1001 *et seq.*

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34. Under ERISA, "plan administrator" is a defined term for the fiduciary charged with administering the plan. The administrator is "the person specifically so designated by the terms of the plan." ERISA § 3(16)(A)(i), 29 U.S.C. § 1002(16)(A)(i). The statute distinguishes between plan sponsors and plan administrators, providing that the plan sponsor becomes the plan administrator only if the plan does not designate an administrator. ERISA § 3(16)(A)(ii), 29 U.S.C. § 1002(16)(A)(ii). "Plan sponsor" is a separate defined term for the employer who sets up an employee benefit plan. ERISA § 3(16)(B), 29 U.S.C. § 1002(16)(B).

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35. A "defined benefit pension plan" is a pension plan other than an individual account plan. ERISA § 3(35), 29 U.S.C. § 1002(35). Generally, a defined benefit pension plan is an employer-sponsored retirement plan that promises a specified benefit upon retirement (for example, a percentage of compensation for each year of service, a percentage of average annual compensation, or a fixed dollar amount per month).

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36. 29 U.S.C. § 1341.

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37. 29 U.S.C. § 1341.

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38. 29 U.S.C. § 1341.

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39. ERISA § 412, 29 U.S.C. § 1112.

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40. ERISA §§ 103-104; 29 U.S.C. §§ 10231024.

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41. ERISA § 105; 29 U.S.C. § 1025.

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42. See I.R.C. § 401(a); 26 U.S.C. § 401(a).

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43. I.R.C. § 401(a)(9); 26 USCS § 401(a)(9).

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44. 33 *F.3d* 509 (5th Cir. 1994).

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45. 33 *F.3d* 509, 510.

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46. 33 *F.3d* 509, 510.

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47. The PBGC is a wholly-owned United States government corporation established under section 4002 of ERISA, 29 U.S.C. § 1302, to administer the pension plan termination program created under Title IV of ERISA, 29 U.S.C. §§ 1301-1461.

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48. 33 *F.3d* 509, 510.

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49. 33 *F.3d* 509, 510.

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50. 33 *F.3d* 509, 510.

n51

51. 33 *F.3d* 509, 513.

n52

52. *In re Esco Mfg. Co.*, 50 *F.3d* 315, 316 (5th Cir. 1995).

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53. 50 *F.3d* 315, 316.

n54

54. 50 *F.3d* 315, 316.

n55

55. 50 *F.3d* 315, 316.

n56

56. 162 *F.3d* 405 (6th Cir. 1998).

n57

57. *In re Art Shirt Ltd., Inc.*, 93 B.R. 333 (E.D. Pa. 1988); *In re Pulaski Highway Express, Inc.*, 57 B.R. 502, 504-508 (Bankr. M.D. Tenn. 1986); *In re Silver Wheel Freightlines, Inc.*, 57 B.R. 476 (Bankr. D. Or. 1985).

n58

58. 162 *F.3d* 405, 409.

n59

59. 200 B.R. 592, 20 E.B.C. 1869 (E.D. Mich. 1996).

n60

60. 200 B.R. 592, 593.

n61

61. *Id.*

n62

62. *Id.*

n63

63. *Id.*

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64. 495 U.S. 552, 110 S. Ct. 2126, 109 L. Ed. 2d 588, 22 C.B.C.2d 1067 (1990).

n65

65. 479 U.S. 36, 107 S. Ct. 353, 93 L. Ed. 2d 216, 15 C.B.C.2d 890 (1986).

n66

66. 495 U.S. 552, 558, 110 S. Ct. 2126, 2130, 109 L. Ed. 2d 588, 596, 22 C.B.C.2d 1067, 1070.

n67

67. 495 U.S. 552, 558, 110 S. Ct. 2126, 2130, 109 L. Ed. 2d 588, 596, 22 C.B.C.2d 1067, 1070 (quoting H.R. Rep. No. 95-595, p. 309 (1977)); *see also In re Udell*, 18 F.3d 403, 30 C.B.C.2d 1192 (7th Cir. 1994).

n68

68. 11 U.S.C. § 523(a)(7).

n69

69. 495 U.S. 552, 559, 110 S. Ct. 2126, 2131, 109 L. Ed. 2d 588, 596, 22 C.B.C.2d 1067, 1071.

n70

70. 495 U.S. 552, 559, 110 S. Ct. 2126, 2131, 109 L. Ed. 2d 588, 597, 22 C.B.C.2d 1067, 1071.

n71

71. *See Newton v. Fred Haley Poultry Farm (In re Newton)*, 5 C.B.C.2d 1181, 15 B.R. 708 (Bankr. N.D. Ga. 1981).

n72

72. Section 1328(a) was amended to except from the chapter 13 discharge a debt "for restitution included in a sentence on the debtor's conviction of a crime" by both the Criminal Victim's Protection Act of 1990, Pub. L. No. 101-581, effective as to petitions filed on or after November 15, 1990, and the Crime Control Act of 1990, Pub. L. No. 101-647, effective as to petitions filed on or after November 29, 1990.

n73

73. 501 U.S. 78, 111 S. Ct. 2150, 115 L. Ed. 2d 66, 24 C.B.C.2d 1171 (1991).

n74

74. 501 U.S. 78, 84, 111 S. Ct. 2150, 2154, 115 L. Ed. 2d 66, 75, 24 C.B.C.2d 1171, 1176.

n75

75. 11 U.S.C. § 102(2) provides: "claim against the debtor" includes claim against property of the debtor."

n76

76. H.R. Rep. No. 595, 95th Cong., 1st Sess. 309 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 21 (1978).

n77

77. 124 Cong. Rec. H11,090 (daily ed. Sept. 28, 1978); S17,406 (daily ed. Oct. 6, 1978).

n78

78. 501 U.S. 78, 111 S. Ct. 2150, 115 L. Ed. 2d 66, 24 C.B.C.2d 1171 (1991).

n79

79. See *In re Cybermech Inc.*, 13 F.3d 818, 30 C.B.C.2d 696 (4th Cir. 1994) (debtor's later repudiation of contract gives purchaser right to pursue damages for breach of contract, which damages also constitute a "claim.").

n80

80. 125 F.3d 120 (3d Cir.), cert. denied, 522 U.S. 1014, 118 S. Ct. 599, 139 L. Ed. 2d 488 (1997).

n81

81. See *In re Aslan*, 65 B.R. 826 (Bankr. C.D. Cal. 1986) (chapter 11 trustee has power to reject land sale contract and discharge ensuing claim because contract had clause calling for money damage remedy as well as remedy of specific performance, and if a judgment can be converted into money damages it is a claim under the Code).

n82

82. *In re Chateaugay Corp.*, 944 F.2d 997 (2d Cir. 1991).

n83

83. *In re Davis*, 3 F.3d 113, 29 C.B.C.2d 1306 (5th Cir. 1993); see *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994) (state law remedy was both injunction and damages); *In re Roxse Homes*, 74 B.R. 810 (Bankr. D. Mass. 1987) (when the only remedy allowed by state law to enforce a judgment is a nonmonetary one, that judgment is not a claim in the context of the debtor's chapter 11 case).

n84

84. 186 F.3d 301 (3d Cir. 1999).

n85

85. *Kennedy v. Medicap Pharms., Inc.*, 267 F.3d 493 (6th Cir. 2001); *In re Udell*, 18 F.3d 403 (7th Cir. 1994). But see *Maids International, Inc. v. Ward (In re Ward)*, 194 B.R. 703, 712 (Bankr. D. Mass. 1996).

n86

86. Compare *In re Torwico Elecs., Inc.*, 8 F.3d 146, 30 C.B.C.2d 86 (3d Cir. 1993), cert. denied, 511 U.S. 1046, 114 S. Ct. 1576, 128 L. Ed. 2d 219 (1994) (state court order requiring a chapter 11 debtor to clean up contamination on property it no longer owned did not constitute a claim), with *In re Goodwin*, 163 B.R. 825 (Bankr. D. Idaho 1993) (noting that a state or federal environmental agency typically has the option of performing the cleanup itself and seeking to recover the cleanup costs from the debtor).

n87

87. *In re Torwico Elecs., Inc.*, 8 F.3d 146, 30 C.B.C.2d 86 (3d Cir. 1993), cert. denied, 511 U.S. 1046, 114 S. Ct. 1576, 128 L. Ed. 2d 219 (1994) (the ruling that cleanup order was not a claim was warranted, in the court's view, because the state was not seeking money from the debtor and, therefore, had no right to payment under the statutory authority asserted in the state's cleanup order, even though provisions of state law permitted the state to clean up the property and seek reimbursement from the debtor); *Sheerin v. Davis (In re Sheerin)*, 3 F.3d 113, 29 C.B.C.2d 1306 (5th Cir. 1993) (applying test outside the environmental context); *Industrial Salvage, Inc. v. Illinois (In re Industrial Salvage, Inc.)*, 196 B.R. 784 (Bankr. S.D. Ill. 1996) (because state had not sought money from the debtors as an alternative to performance of debtors' obligations to close landfills, obligation was not a claim; court later states, however, that the state did not have the ability under state law to effect the closure itself

and seek recovery from the debtor); *see also* *AM Int'l, Inc. v. Datacard Corp.*, 106 F.3d 1342 (7th Cir. 1997) (even though party could seek recovery of cleanup costs under CERCLA, order requiring reorganized debtor to clean up property under RCRA did not create claim because no alternative right to payment is recognized under RCRA). *Compare* *Durham Inland Wetlands & Watercourses Agency v. Jimmo (In re Jimmo)*, 204 B.R. 655 (Bankr. D. Conn. 1997) (because Injunction and Remediation Order provided that persons to be selected by the plaintiff restore the wetlands to their original condition, but the debtors were neither ordered nor permitted to do the work themselves and the debtors were ordered to reimburse the plaintiff for the cost of the work, the order constituted a claim).

n88

88. H.R. Rep. No. 595, 95th Cong., 1st Sess. 309 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 21 (1978).

n89

89.124 Cong. Rec. H11,090 (daily ed. Sept. 28, 1978); S17,406 (daily ed. Oct. 6, 1978).

n90

90.186 F.3d 1356 (Fed. Cir. 1999).

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177 of 197 DOCUMENTS

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Collier on the Definition of Family Farmer Under the Bankruptcy Code

2008 Emerging Issues 969

Collier on the Definition of Family Farmer Under the Bankruptcy Code

By Collier

November 16, 2007

SUMMARY: This Emerging Issues Analysis details the definition of a family farmer under Section 101(18) of the Bankruptcy Code, including the distinction between an individual family farmer and a corporate/partnership family farmer, the maximum indebtedness ceiling, the requirement that a debtor be engaged in farming, and the farm debt test and the farm income test.

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ARTICLE: Pursuant to *Bankruptcy Code section 101(18)*, the term "family farmer" means--

(A) individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed \$3,544,525 n1 and not less than 50 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for

(i) the taxable year preceding; or

(ii) each of the 2d and 3d taxable years preceding;

the taxable year in which the case concerning such individual or such individual and spouse was filed; or

(B) corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation, and

(i) more than 80 percent of the value of its assets consists of assets related to the farming operation;

(ii) its aggregate debts do not exceed \$3,544,525 n2 and not less than 50 percent of its aggregate noncontingent,

liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation), on the date the case is filed, arise out of the farming operation owned or operated by such corporation or such partnership; and

(iii) if such corporation issues stock, such stock is not publicly traded. n3

Use of Definition in the Code. The definition of family farmer was enacted as part of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 n4 along with the enactment of chapter 12 of the Code. The term "family farmer" is used in the definition of "family farmer with regular annual income," which is in turn used in section 109(f), which sets forth the eligibility requirements for filing for relief under chapter 12. n5

The Code contains definitions of both "farmer" and "family farmer" and the two terms should not be confused. The term "family farmer" is used to determine eligibility for filing for relief under chapter 12. The term "farmer" is used in sections 303(a), 1112(c) and 1307(e), which prohibit the filing of an involuntary case or an involuntary conversion to chapter 7 against a person who qualifies as a farmer. The two terms involve some overlap and the same person may fit both definitions or may qualify under one definition but not the other. Because of the overlap between the two definitions, many of the cases decided under the definition of farmer will be relevant to determining the definition of family farmer. n6 Another relevant definition is "family fisherman," which was enacted by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. n7 This definition was modeled on and closely tracks the definition of "family farmer." Accordingly, cases referring to comparable provisions in the definition of family fisherman will be relevant in interpreting provisions in the definition of family farmer.

Distinction Between Individual Family Farmer and Corporate/Partnership Family Farmer. The definition of family farmer is divided into two parts. The first applies to individuals, and the second applies to corporations and partnerships. Each sets up a different, though related, test for determining whether individuals, corporations and partnerships qualify as family farmers. Both have an aggregate indebtedness limitation of \$3,544,525, n8 and require the debtor to be engaged in a farming operation at the time that the case is commenced. If the case involves an individual, the farming operation must be owned and operated by such individual or by such individual and such individual's spouse. If the case involves a corporation or partnership, the entity must be engaged in a farming operation and the farming operation must be conducted by a family that owns, either alone or in conjunction with relatives, more than 50 percent of the stock of the entity. For both individuals and entities, there is a further requirement that not less than 50 percent of the debtor's noncontingent, liquidated debts at the commencement of the case, other than debts for a dwelling used as a principal residence, must arise out of the debtor's farming operation. An individual debtor must fulfill one additional test. The individual debtor must have received from his or her farming operation at least 50 percent of such individual's gross income during the taxable year preceding the year in which the petition was filed or during each of the second and third taxable years preceding the year in which the petition was filed.

Maximum Indebtedness Ceiling. In order for either an individual debtor or a corporate or partnership debtor to qualify as a family farmer, the debtor cannot have aggregate debts in excess of \$3,544,525. When chapter 12 was originally enacted in 1986, the debt limit was \$1,500,000. This limit was raised to \$3,237,000 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. n9 Cases decided before the effective date of the 2005 Act will refer to the former debt ceiling of \$1,500,000. The word "aggregate" is used in the definition of family farmer without qualification, in contrast to section 109(e) which sets forth the eligibility requirements for chapter 13. The indebtedness limitation in that section refers to "noncontingent, liquidated" debts. The lack of any qualification also stands in contrast to later language in the definition which uses the phrase "noncontingent, liquidated" to qualify the term "aggregate debts." The logical inference from this choice of language is that Congress explicitly intended that all of a person's debts be used in calculating the indebtedness ceiling. n10 This would certainly include government farm program indebtedness if the debtor's obligation under the program is styled as a loan. n11

If the validity of a debt is disputed, the court should make a preliminary determination with regard to the validity of the debt. If it is *prima facie* valid, it should be counted even though the debtor may have defenses to payment or rights

of offset. n12 The date on which the aggregate indebtedness limitation is to be calculated is the date of commencement of the case. n13 Debts that have been forgiven or satisfied prior to filing should not be included. In determining the amount of the debtor's outstanding debts, the debtor's schedules should be accorded *prima facie* validity. n14

Debtor Must Be Engaged in Farming. A second element that is common to both the definition of an individual family farmer and of a corporate or partnership family farmer is that the debtor must be engaged in a farming operation at the time the case is commenced. n15 This requirement stands in contrast to the definition of farmer, which does not require that the debtor continue to be engaged in farming. n16 If a person has ceased farming, even if that person has been a lifelong farmer, that person would not meet the definition of family farmer. n17 If the cessation is only temporary, however, due to financial setbacks, and the debtor intends to resume farming in connection with the debtor's chapter 12 case, the debtor may nonetheless be held to be engaged in a farming operation. n18

Farm Debt Test. A third requirement common to the definitions of an individual family farmer and a corporate or partnership family farmer is that not less than 50 percent of the debtor's noncontingent, liquidated debts at the commencement of the case, other than debts for a dwelling used as a principal residence, must arise out of the debtor's farming operation. When chapter 12 was originally enacted in 1986, the percentage applicable under the farm debt test was 80 percent. The percentage was reduced to 50 percent by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. n19 Cases decided before the effective date of the 2005 amendments will refer to the 80 percent requirement applicable at the time. Application of the farm debt requirement makes it necessary for the court to determine whether each of the debtor's debts "arises out of" a farming operation. n20 It is not enough, however, that the debt merely arise out of a farming operation. The debt must arise out of a farming operation in which the debtor plays a part. In one case, the Court of Appeals for the Eighth Circuit held that a guarantee of another person's farm loan would not be considered farm debt unless the guarantor could demonstrate an ownership interest or an operational involvement in the farming operation. n21

Farm Income Test. To qualify as a family farmer, an individual family farmer must fulfill a "farm income" test that is not applicable to a corporation or partnership desiring to qualify as a family farmer. To satisfy the farm income test, an individual must have received at least 50 percent of such individual's gross income from the individual's farming operation during the taxable year immediately preceding the taxable year in which the petition was filed or during each of the second and third years preceding the taxable year in which the petition was filed. n22 When chapter 12 was originally enacted in 1986, the farm income test was measured only during the taxable year immediately preceding the taxable year in which the petition was filed. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 expanded eligibility to also include individuals who could not meet the farm income test during the immediately preceding year but who could meet the test for both of the two prior years. n23 The result is that a farmer who ceased farming during the year before filing bankruptcy could still qualify for chapter 12 if the farmer met the farm income requirement during the two years before the farmer ceased farming. It should be noted, however, that at the time the petition is filed a family farmer must be "engaged in a farming operation." If a person ceased farming but has not resumed farming, the changes to the farm income requirement will not create eligibility. Determining whether the farm income test has been fulfilled requires the court to first determine the amount of the debtor's gross income during the relevant tax year and then to determine the portion of that income attributable to the debtor's farming operation. n24 Some courts have used the Internal Revenue Code definition of gross income to calculate the amount of the debtor's gross income, although this approach has not been universally followed. n25 In analyzing whether income can be considered farm-related, there is no statute such as the Internal Revenue Code to look to for guidance and a decision must be made on a case-by-case basis. Proceeds received from government farm programs have typically been considered farm income. n26 Income received from joint venture or sharecropping arrangements has also been considered farm income. n27 Proceeds from sale of real property have been held to be non-farm income when the debtor had not farmed the land that was sold. n28 Wages are not generally considered farm income, although an exception might be made for wages received by a person from a wholly-owned corporation. n29 Income received from sale of farm equipment has generally been held to be farm income. n30

There is a split of authority, however, with regard to income from rental of farmland. Some cases have held that

rental income should not be considered farm income because the lessor does not bear the traditional risk of farming. n31 Others have held that the issue must be decided on a case-by-case basis in light of all relevant circumstances. n32 An important Eighth Circuit decision rejects this latter line of cases and stresses that the proper characterization of income received by a debtor must focus on the relationship between the income and a farming operation of the debtor. n33 If income is to be considered farm income, the debtor must be involved to some extent in the farming operation that gives rise to the income. Where the income consists of cash rent, the debtor must demonstrate that the debtor "had some significant degree of engagement in, played some significant operational role in, or had an ownership interest in the crop production" taking place on the rented farmland. n34

For a complete discussion of Code section 101, *see* Collier on Bankruptcy, ch. 101.

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n1 1. For cases commenced before April 1, 2007, the dollar amount was \$3,237,000.

n2

2. For cases commenced before April 1, 2007, the dollar amount was \$3,237,000.

n3

3. *11 U.S.C. § 101(18).*

n4

4. Pub. L. No. 99-554 (1986), *reprinted in* Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender).

n5

5. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1007(b) (2005) amended section 109(f) to change "family farmer with regular annual income" to "family farmer or family fisherman with regular annual income."

n6

6. See *In re Wagner*, 808 F.2d 542, 16 C.B.C.2d 28 (7th Cir. 1986); *Armstrong v. Corn Belt Bank (In re Armstrong)*, 812 F.2d 1024, 16 C.B.C.2d 238 (7th Cir. 1986).

n7

7. 11 U.S.C. § 101(19A), added by Pub. L. No. 109-8, § 1007(a)(2) (2005).

n8

8. For cases commenced before April 1, 2007, the dollar amount was \$3,237,000.

n9

9. Pub. L. No. 109-8, § 1004 (2005). That Act also made the amount subject to the three-year adjustments specified in section 104(b). For cases commenced on or after April 1, 2007, the dollar amount is \$3,544,525.

n10

10. See *Quintana v. Internal Revenue Service (In re Quintana)*, 107 B.R. 234 (B.A.P. 9th Cir. 1989); *In re Vaughan*, 100 B.R. 423 (Bankr. S.D. Ill. 1989); *In re Carpenter*, 79 B.R. 316 (Bankr. S.D. Ohio 1987); see also *Lindsey, Stephenson & Lindsey v. Federal Dep. Ins. Corp. (In re Lindsey, Stephenson & Lindsey)*, 995 F.2d 626 (5th Cir. 1993) (nonrecourse debts included in calculation of debt limit).

n11

11. *In re Carpenter*, 79 B.R. 316 (Bankr. S.D. Ohio 1987); *In re Stedman*, 72 B.R. 49 (Bankr. D.N.D. 1987) (full face amount of a debt owed to the Farm Credit System, including the equity portion of the loan, must be included within the debtor's aggregate indebtedness).

n12

12. *Quintana v. Internal Revenue Service (In re Quintana)*, 107 B.R. 234 (B.A.P. 9th Cir. 1989); *In re Cross Timbers Ranch*, 151 B.R. 923 (Bankr. W.D. Mo. 1993); *In re Vaughn*, 100 B.R. 423 (Bankr. S.D. Ill. 1989). But see *In re Budde*, 79 B.R. 35 (Bankr. Colo. 1987). In *Budde*, the debtor disputed the amount of interest claimed by a creditor. The amount of the disputed interest was critical in determining whether the debtor's debts

exceeded the maximum. The court denied the creditor's motion to dismiss on the grounds that the court had insufficient evidence from which to make a determination. The court held, however, that dismissal was without prejudice to the creditor's submitting new evidence and raising the issue again at the confirmation hearing.

n13

13. *In re Cross Timbers Ranch*, 151 B.R. 923 (Bankr. W.D. Mo. 1993); *In re Orr*, 16 C.B.C.2d 640, 642 n.4, 71 B.R. 639, 641 n.4 (Bankr. E.D.N.C. 1987).

n14

14. In *In re Labig*, 74 B.R. 507 (Bankr. S.D. Ohio 1987), the court held that the schedules create a rebuttable presumption with regard to the amount of the debtor's indebtedness but that a creditor may overcome the presumption by introducing evidence controverting the schedules. If a creditor does so, the burden of proof on the amount of the debt belongs to the debtor. *But see In re LLL Farms*, 22 C.B.C.2d 1182, 111 B.R. 1016 (Bankr. M.D. Ga. 1990), where the court held that three sisters who equally owned a farm that was bought for their father and operated by one of their sons were eligible for relief under chapter 12, even though they held outside jobs and none lived on the farm or personally operated it. A debtor who elects not to plant a crop and to rent his land on a cash basis, but who can provide clear and convincing evidence that such act is based on sound business judgment that such drastic steps are necessary in order to save the farming business, has met the burden of proving that he is a "family farmer." *In re Hettinger*, 20 C.B.C.2d 1466, 95 B.R. 110 (Bankr. E.D. Mo. 1989).

n15

15. The term "farming operation" is defined in 11 U.S.C. § 101(21).

n16

16. 11 U.S.C. § 101(20); see *Potmesil v. Alexandria Prod. Credit Ass'n*, 11 C.B.C.2d 953, 42 B.R. 731 (W.D. La. 1984).

n17

17. See *In re Buckingham*, 197 B.R. 97 (Bankr. D. Mont. 1996) (farmers who had ceased farming but intended to lease out farm to third parties for grazing land not engaged in a farming operation); *In re Tart*, 16 C.B.C. 2d 1278, 73 B.R. 78 (Bankr. E.D.N.Y. 1987) (farmers who had become disabled and could no longer continue farming not engaged in a farming operation); *In re Haschke*, 77 B.R. 223 (Bankr. D. Neb. 1987) (debtors who had leased out farmland, sold their farm equipment, and taken nonfarm jobs not engaged in farming operation despite retaining interest in stored crops).

n18

18. Compare *Otoe County Nat'l Bank v. Easton* (*In re Easton*), 883 F.2d 630, 634 (8th Cir. 1989) (renting out farmland, by itself, does not constitute being engaged in a farming operation; the debtor must be directly involved in the production of crops or the raising of livestock), with *In re Mikkelsen Farms, Inc.*, 16 C.B.C.2d 1247, 74 B.R. 280 (Bankr. D. Or. 1987) (noting that five factors can be considered relevant in determining whether debtors who had leased out their farmland could be considered engaged in a farming operation: (1) whether the debtor remains physically present on the farm, (2) whether the debtor owns traditional farm assets, (3) whether leasing land is a form of "scaling down" the debtor's farming business, (4) the form of the lease between the debtor and the lessee (i.e., is the lease a crop share lease in which the lessor bears some of the risk of the farming venture), and (5) whether the debtor intended to continue its own investment of assets and labor to produce crops or livestock in the future). See also *Cottonport Bank v. Dichiara*, 193 B.R. 798 (W.D. La. 1996) (debtors who held full time non-farming jobs were held to be "engaged in a farming operation" where they continued some farming on a reduced basis); *In re Koppes*, 2000 Bankr. LEXIS 1898 (Bankr. N.D. Iowa Jan. 5, 2000) (debtors who ceased farming not engaged in farming operation); *In re Fogle*, 87 B.R. 493 (Bankr. N.D. Ohio 1988) (debtor who had sold his farm equipment but not his farmland, and who testified that he intended to continue in farming through a joint venture, was considered to be engaged in farming).

n19

19. Pub. L. No. 109-8, § 1004 (2005), effective in cases commenced on or after October 17, 2005.

n20

20. Compare *In re Douglass*, 77 B.R. 714 (Bankr. W.D. Mo. 1987) (debt secured by mortgage on service station considered farm debt because loan proceeds used in debtor's farming operation), with *In re Kan Corp.*, 101 B.R. 726 (Bankr. W.D. Okla. 1988) (loan secured by the debtor's farmland did not constitute farm debt because proceeds of loan had been used to refinance an existing loan used to acquire a beer distributorship). See also *In re McSwine Creek Farms, Inc.*, 276 B.R. 461 (Bankr. N.D. Miss. 2000) (debt encumbering property transferred to the debtor on the eve of filing by an insider not counted for debt calculation where property excluded from the debtor's estate); *In re Roberts*, 78 B.R. 536 (Bankr. C.D. Ill. 1987) (inheritance taxes assessed in connection with death of the debtor's mother arose out of a farming operation because they were related to the debtor's acquisition of farm); *In re Rinker*, 17 C.B.C.2d 488, 75 B.R. 65 (Bankr. S.D. Iowa 1987) (debt arising out of lawsuit settlement is farm debt because lawsuit dispute was over acquisition of farmland).

n21

21. *Otoe County Nat'l Bank v. Easton* (*In re Easton*), 883 F.2d 630 (8th Cir. 1989).

n22

22. The test will be applied based on taxable years even if the case was filed late in a calendar year. *In re Fogle*, 87 B.R. 493 (Bankr. N.D. Ohio 1988) (using 1986 tax year for case filed December 31, 1987); *In re Shepherd*, 17 C.B.C.2d 92, 75 B.R. 501 (Bankr. N.D. Ohio 1987) (using 1985 tax year for case filed December 31, 1986).

n23

23. Pub. L. No. 109-8, § 1004 (2005), effective in cases commenced on or after October 17, 2005.

n24

24. The farm income test is to be determined at the outset of the case based on facts. *See In re Grey*, 145 B.R. 86 (Bankr. D. Kan. 1992) (rejecting the debtor's argument that if pending lawsuit against Commodity Credit Corporation was successful, the debtor could amend its income tax return and meet the farm income requirement).

n25

25. *See In re Wagner*, 808 F.2d 542, 16 C.B.C.2d 28 (7th Cir. 1986) (applying Internal Revenue Code definition of gross income in a case decided under identical language in the definition of farmer). *Accord In re Vernon*, 101 B.R. 87 (Bankr. E.D. Mo. 1989); *Shamblin v. Dutton (In re Dutton)*, 18 C.B.C.2d 1323, 86 B.R. 651 (Bankr. D. Colo. 1988); *In re Fogle*, 87 B.R. 493 (Bankr. N.D. Ohio 1988); *In re Bergmann*, 78 B.R. 911 (Bankr. S.D. Ill. 1987); *In re Etheridge*, 68 B.R. 235 (Bankr. C.D. Ill. 1986) (considering definition of farmer). *But see In re Rott*, 73 B.R. 366 (Bankr. D.N.D. 1987) (holding that Internal Revenue Code definition of gross income would not be considered binding); *In re Faber*, 78 B.R. 934, 935 (Bankr. S.D. Iowa 1987) (stating in dictum that Internal Revenue Code definition would be applied except where doing so would lead to a result "absurdly irreconcilable" with overall purpose of chapter 12); *In re Snider*, 99 B.R. 374 (Bankr. S.D. Ohio 1989) (same); *see also In re Lamb*, 209 B.R. 759 (Bankr. M.D. Ga. 1997) (using Internal Revenue Code definition of gross income and holding that gross income includes distributive share of partnership income).

n26

26. *In re Jessen*, 82 B.R. 490 (Bankr. S.D. Iowa 1988); *In re Shepherd*, 17 C.B.C.2d 92, 97, 75 B.R. 501, 504 (Bankr. N.D. Ohio 1987); *In re Welch*, 16 C.B.C.2d 1431, 74 B.R. 401 (Bankr. S.D. Ohio 1987).

n27

27. *In re Martin*, 78 B.R. 593 (Bankr. D. Mont. 1987); *In re Welch*, 16 C.B.C.2d 1431, 74 B.R. 401 (Bankr. S.D. Ohio 1987).

n28

28. *Integra Bank v. Ross (In re Ross)*, 270 B.R. 710 (Bankr. S.D. Ill. 2001); *In re Sohrakoff*, 85 B.R. 848 (Bankr. E.D. Cal. 1988); *Aud v. Van Fossan (In re Van Fossan)*, 18 C.B.C.2d 65, 82 B.R. 77 (Bankr. W.D. Ark. 1987) *But see In re Bircher*, 241 B.R. 11 (Bankr. S.D. Iowa 1999) (capital gain from farmland held to be farm income).

n29

29. *See Shamblin v. Dutton (In re Dutton)*, 18 C.B.C.2d 1323, 86 B.R. 651 (Bankr. D. Colo. 1988) (work done on another person's farm not considered to be farm income); *In re Schafroth*, 18 C.B.C.2d 149, 81 B.R. 509 (Bankr. S.D. Iowa 1987) (wages from family corporation held to be farm income); *In re Hampton*, 100 B.R. 535 (Bankr. D. Or. 1987) (contra); *In re Pierce*, 175 B.R. 153 (Bankr. D. Conn. 1994) (payment to debtor for managing farming business received from a partnership in which the debtor was a partner considered farm income).

n30

30. *See Armstrong v. Corn Belt Bank (In re Armstrong)*, 812 F.2d 1024, 16 C.B.C.2d 238 (7th Cir. 1987) (holding, in case considering identical language in definition of farmer, that proceeds of sale of farm equipment constitutes farm income); *In re Barnett*, 162 B.R. 535 (Bankr. W.D. Mo. 1993) (same); *In re Haschke*, 77 B.R. 223 (Bankr. D. Neb. 1987) (proceeds from sale of farm equipment are farm income even though debtors had sold all of their farm equipment and debtors were no longer engaged in farming; the court, however, held that the debtors were not eligible for chapter 12 because of the fact that they were no longer engaged in farming); *In re Shepherd*, 17 C.B.C.2d 92, 75 B.R. 501 (Bankr. N.D. Ohio 1987) (farm equipment sale proceeds are farm income even though the debtor sold all of the debtor's equipment). *But see In re Burke*, 18 C.B.C.2d 141, 81 B.R. 971 (Bankr. S.D. Iowa 1987) (noting that proceeds from sale of farm equipment would not be considered farm income if the sale involved all the debtor's farm equipment and the debtor did not intend to continue farming).

n31

31. *See Armstrong v. Corn Belt Bank (In re Armstrong)*, 812 F.2d 1024, 16 C.B.C.2d 238 (7th Cir. 1987) (holding, in a case considering identical language in the definition of farmer, that lease income is not farm income when the rent is paid in cash and up front because the lessor does not bear the traditional risks of farming); *In re Krueger*, 104 B.R. 223 (Bankr. D. Neb. 1988) (cash rent from pasture lease not farm income because the landlord bore no risk); *In re Haschke*, 77 B.R. 223 (Bankr. D. Neb. 1987) (cash rent is not farm income when the debtors are no longer engaged in farming and no longer owned any farm equipment); *In re Seabloom*, 78 B.R. 543 (Bankr. C.D. Ill. 1987) (cash rent does not constitute farm income despite fact that the

rent was not payable until after harvest and debtors had indicated an intent to resume farming the land).

n32

32. This approach was suggested by the dissenting opinion in *Armstrong v. Corn Belt Bank (In re Armstrong)*, 812 F.2d 1024 (7th Cir. 1987). See *In re Coulston*, 98 B.R. 280 (Bankr. E.D. Mich. 1989) (cash rent is farm income where debtor compelled to rent out farmland due to financial difficulties and where debtor continued a related farming operation); *In re Lamb*, 209 B.R. 759 (Bankr. M.D. Ga. 1997) (same). Cases employing this approach in the Eighth Circuit have been disapproved by the *Easton* decision, though it is possible that application of the *Easton* approach may have led to the same outcome. See, e.g., *In re Vernon*, 101 B.R. 87 (Bankr. E.D. Mo. 1989) (cash rent is farm income where lease terminable at will and entered into to save farm); *In re Hettinger*, 20 C.B.C.2d 1466, 95 B.R. 110 (Bankr. E.D. Mo. 1989) (cash rent is farm income where debtors were lifelong farmers and used lease income to pay debts secured by their farm); *In re Jessen*, 82 B.R. 490 (Bankr. S.D. Iowa 1988) (cash rent considered farm income when debtors, who had been farming for over twenty years, were forced to cease farming due to financial difficulties, even though debtors apparently leased all of their land and sold all of their farm equipment); *In re Burke*, 18 C.B.C.2d 141, 81 B.R. 971 (Bankr. S.D. Iowa 1987) (crop share rent from debtors' wholly owned corporation considered farm income); *In re Rott*, 17 C.B.C.2d 381, 73 B.R. 366 (Bankr. D.N.D. 1987) (cash rent from debtor's son considered farm income when the farming operations of debtor and son were related and rent would not have been payable had the son's crop failed).

n33

33. *Otoe County Nat'l Bank v. Easton (In re Easton)*, 883 F.2d 630 (8th Cir. 1989). Still another approach was taken in *In re Creviston*, 157 B.R. 380 (Bankr. S.D. Ohio 1993), which contains an additional list of factors to be considered in analyzing this issue.

n34

34. 883 F.2d 630, 636.

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Collier on the Definition of "Family Fisherman" Under the Bankruptcy Code

2008 Emerging Issues 970

Collier on the Definition of "Family Fisherman" Under the Bankruptcy Code

By Collier

November 16, 2007

SUMMARY: This Emerging Issues Analysis details the definition of "family fisherman" and "family fisherman with a regular income" under Section 101 of the Bankruptcy Code, including issues pertaining to individual versus corporate or partnership family fishermen, maximum aggregate debt, and the requirement that a debtor be engaged in a commercial fishing operation.

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ARTICLE: Family Fisherman. Pursuant to *Bankruptcy Code section 101.19A*, the term "family fisherman" means--

(A) an individual or individual and spouse engaged in a commercial fishing operation--

(i) whose aggregate debts do not exceed \$1,642,500 n1 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse, unless such debt arises out of a commercial fishing operation), on the date the case is filed, arise out of a commercial fishing operation owned or operated by such individual or such individual and spouse; and

(ii) who receive from such commercial fishing operation more than 50 percent of such individual's or such individual's and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed; or

(B) a corporation or partnership--

(i) in which more than 50 percent of the outstanding stock or equity is held by--

(I) 1 family that conducts the commercial fishing operation; or

(II) 1 family and the relatives of the members of such family, and such family or such relatives conduct the commercial fishing operation; and

(ii) (I) more than 80 percent of the value of its assets consists of assets related to the commercial fishing operation;

(II) its aggregate debts do not exceed \$1,642,500ⁿ² and not less than 80 percent of its aggregate noncontingent, liquidated debts (excluding a debt for 1 dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a commercial fishing operation), on the date the case is filed, arise out of a commercial fishing operation owned or operated by such corporation or such partnership; and

(III) if such corporation issues stock, such stock is not publicly traded.

The definition of "family fisherman" was enacted by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 as part of the provisions expanding the scope of chapter 12 to include family fishermen.ⁿ³ The term "family fisherman" is used in the definition of "family fisherman with regular annual income," which is itself used in section 109(f), which sets forth the eligibility requirements for filing a case under chapter 12.

Individual vs. Corporate or Partnership Family Fishermen. The definition of family fisherman is divided into two parts. The first part applies to individuals and the second part applies to corporations and partnerships. Each part sets up a slightly different test for determining whether an individual, a corporation, or a partnership will qualify as a family fisherman. Both parts have an aggregate indebtedness limitation of \$1,642,500ⁿ⁴ and require the debtor to be engaged in a commercial fishing operation at the time the case is commenced. Both also require that not less than 50 percent of the debtor's noncontingent, liquidated debts at the commencement of the case, other than debts for a dwelling used as a principal residence, must arise out of the debtor's commercial fishing operation. An individual debtor must fulfill one additional requirement. The individual must have received from his or her fishing operation at least 50 percent of such individual's gross income from the individual's commercial fishing operation during the taxable year immediately preceding the taxable year in which the petition was filed or during each of the second and third years preceding the taxable year in which the petition was filed. The definition of family fisherman was modeled on and closely tracks the definition of family farmer. Accordingly, cases referring to comparable provisions in the definition of family farmer will be relevant in interpreting provisions in the definition of family fisherman.

Maximum Aggregate Debt. For a debtor to qualify as a family fisherman, a debtor cannot have aggregate debts in excess of \$1,642,500. This debt limit is equally applicable to both individual debtors and debtors that are corporations or partnerships. For some reason, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 set the debt ceiling for family fishermen at \$1,500,000 at the same time that it raised the debt ceiling for family farmers from \$1,500,000 to \$3,237,000.ⁿ⁵ This was probably an inadvertent error but nonetheless will constitute the debt limit until changed by congressional action. The word "aggregate" is used in the definition of family fisherman without qualification, in contrast to section 109(e), which sets forth the eligibility requirements for chapter 13. The indebtedness limitation in that section refers to "noncontingent, liquidated" debts. The lack of any qualification also stands in contrast to later language in the definition which uses the phrase "noncontingent, liquidated" to qualify the term "aggregate debts." The logical inference from this choice of language is that Congress explicitly intended that all of a person's debts be used in calculating the indebtedness ceiling. If the validity of a debt is disputed, the court should make a preliminary determination with regard to the validity of the debt. If it is *prima facie* valid, it should be counted even if the debtor may have defenses to payment or right of offset. The date on which the aggregate indebtedness limitation is to be calculated is the date of commencement of the case. Debts that have been forgiven or satisfied prior to filing should not be included. In determining the amount of the debtor's outstanding debts, the debtor's schedules should be accorded *prima facie* validity.

Engaged in Commerical Fishing Operation. A second element that is common to both the definition of an individual commercial fisherman and a corporate or partnership commercial fisherman is that the debtor must be engaged in a commercial fishing operation.ⁿ⁶ If the case involves an individual, the commercial fishing operation

must be owned and operated by such individual or by such individual and such individual's spouse. If the case involves a corporation or partnership, the entity must be engaged in a commercial fishing operation and the commercial fishing operation must be conducted by a family that owns, either alone or in conjunction with relatives, more than 50 percent of the stock of the entity. The "engaged in a commercial fishing operation" language is phrased in the present tense. If a person has ceased fishing operations, even if the person was a lifelong commercial fisherman, that person would not meet the definition of family fisherman. If the cessation is only temporary, however, due to financial setbacks, and the debtor intends to resume commercial fishing in connection with the debtor's chapter 12 case, the debtor may nonetheless be held to engaged in a commercial fishing operation.

A requirement common to both individuals and corporations and partnerships is that not less than 50 percent of the debtor's contingent, liquidated debts at the commencement of the case, other than debts for a dwelling used as a principal residence, arise out of the debtor's commercial fishing operation. This requirement makes it necessary for the court to determine whether each of the debtor's debts "arise out of" a commercial fishing operation. n7

Family Fisherman with Regular Annual Income. The term "family fisherman with regular annual income" means a family fisherman whose annual income is sufficiently stable and regular to enable such family fisherman to make payments under a plan under chapter 12 of title 11. The definition of "family fisherman with regular annual income" was enacted by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 as part of the provisions expanding the scope of chapter 12 to include family fishermen. n8 The term is used in section 109(f) with respect to eligibility for relief under chapter 12 of the Code. n9

Analyses of the term "family farmer with regular annual income" are equally applicable to family fishermen. However, while the "regular annual income" requirement has rarely been an impediment to chapter 12 relief with regard to family farmers, perhaps the same will not be true with regard to family fishermen. If the income of a family fisherman is so erratic or unstable as not to be considered regular, a court might find that the family fisherman does not qualify for chapter 12 relief. It is more likely, however, that a court will find the family fisherman to be eligible and consider the stability of the family fisherman's income in the context of whether the chapter 12 plan is feasible.

For a complete discussion of Code section 101, see Collier on Bankruptcy, ch. 101.

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n1 1. For cases commenced before April 1, 2007, the dollar amount was \$1,500,000.

n2

2. For cases commenced before April 1, 2007, the dollar amount was \$1,500,000.

n3

3. Pub. L. No. 109-8, § 1007(a)(2), (c) (2005).

n4

4. For cases commenced before April 1, 2007, the dollar amount was \$1,500,000.

n5

5. Both debt ceilings are subject to the three-year adjustment provided for in section 104(b). For cases commenced on or after April 1, 2007, the dollar amounts are \$3,544,525 and \$1,642,500 for family farmers and family fishermen, respectively.

n6

6. 11 U.S.C. § 101(7A), added by Pub. L. No. 109-8, § 1007(a)(1) (2005).

n7

7. There are numerous cases considering the same issue in the context of the definition of family farmer. See *Collier on Bankruptcy*, 101.18 (Matthew Bender).

n8

8. Pub. L. No. 109-8, § 1007(a)(2), (c) (2005).

n9

9. See *Collier on Bankruptcy*, ch. 109 (Matthew Bender).

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Collier on the Definition of "Insolvent" Under the Bankruptcy Code

2008 Emerging Issues 971

Collier on the Definition of "Insolvent" Under the Bankruptcy Code

By Collier

November 16, 2007

SUMMARY: Under the Bankruptcy Code, there is no requirement that a debtor be insolvent to obtain relief under title 11. Section 109(d) states only a person that may be a debtor under chapter 7 may be a debtor under chapter 11. This Emerging Issues Analysis discusses the definition of insolvent under the Code, including issues pertaining to what property is included, municipal insolvency, community property states, fair valuation of property, and debts.

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ARTICLE: The term insolvent means--

(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of--

- (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
- (ii) property that may be exempted from property of the estate under section 522 of this title;

(B) with reference to a partnership, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation--

- (i) all of such partnership's property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and
- (ii) the sum of the excess of the value of each general partner's nonpartnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner's nonpartnership debts; and

(C) with reference to a municipality, financial condition such that the municipality is--

- (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or

(ii) unable to pay its debts as they become due. n1

Under the Code, there is no requirement that a debtor be insolvent to obtain relief under title 11. Section 109(d) states only a person that may be a debtor under chapter 7 may be a debtor under chapter 11. No requirement of insolvency is enunciated for filing under either chapter. In an involuntary case, a debtor need only be unable to pay its debts as such debts become due. n2 This represents a significant departure from the Act concerning the grounds for involuntary bankruptcy which required balance sheet insolvency n3 and an act of bankruptcy. n4

The term insolvent has particular applicability under the Code in the context of avoidance actions. It is relevant in ascertaining whether a transfer is preferential for purposes of avoiding the transfer or substituting the trustee in lieu of the transferee, n5 for finding that a transfer that was made or an obligation that was incurred was constructively fraudulent, n6 and for determining whether a judicial lien can be either set aside or made available for the estate. n7

The definition of insolvent as found under the Act was applicable to persons--a term having a specific meaning in section 1(23) of the Act, rather than entities as it appears under the Code. Entity is specifically defined under the Code in section 101(15) and encompasses the term person within it. In addition, an estate, trust, governmental unit, and a United States Trustee are entities. The Code, however, further differentiates between an entity other than a partnership and a municipality (subparagraph (A)), a partnership (subparagraph B), and a municipality (subparagraph C). A slightly varying test of insolvency is to be applied in each.

In the case of an entity other than a partnership and a municipality, the test is whether the debts of such entity are greater than its assets, at a fair valuation, exclusive of property exempted under section 522 or fraudulently transferred. The standard of insolvency for a partnership is modified with respect to the liability of a general partner for the partnership debts. Property fraudulently transferred is also excluded in computation of a partnerships financial condition. However, the sum of the excess of the value of each general partners separate property, exclusive of exempt property and fraudulently transferred property, over such partners separate debts is also excluded. The standard of insolvency for a municipality is that the municipalitys financial condition is such that it is generally not paying its debts as they become due unless those debts are the subject of a *bona fide* dispute, or the municipality is unable to pay its debts as they become due. n8 In order to be found insolvent for purposes of chapter 9 eligibility, a municipality must prove that it will be unable to pay its debts as they become due in the current fiscal year, or, based on an adopted budget, in the next fiscal year. In determining whether the municipality is insolvent, a court should apply a prospective analysis with respect to the debtors ability to pay its debts and should examine the debtors cash flow, not the debtors projected budget deficits. n9

Property to Be Included. The composition of the assets side of the statutory assets-and-liabilities test of insolvency is circumscribed by the formula the sum of (in the case of an entity other than a partnership or municipality) such entitys property, exclusive of property transferred, concealed, or removed with intent to hinder, delay, or defraud such entitys creditors and property that may be exempted from property of the estate under [section 522 of title 11]. The Code, like the Act, fails to give a specific definition of the breadth of the meaning in which the word property is used. It has been held to denote something subject to ownership, transfer, or exclusive possession or enjoyment, which may be brought within the dominion of a court through some recognized process. n10 Simply stated, property signifies something which is considered an asset by business practice. n11 Under the Code, property covers not only property rights in real estate and chattels but also choses-in-action n12 and other incorporeal rights of various types such as contract rights, tort claims, interest in patents, patent rights, copyrights and trademarks, and applications therefor, memberships in trade organizations, n13 as well as licenses, franchises and permits under the state and federal regulatory statutes, even where the transfer requires certain approvals. n14 Under the Act, the single express exclusion which the statutory definition of insolvency specified, related to property conveyed or concealed by the debtor with the intent to defraud, hinder or delay his creditors. The Act thus denied the debtor and, correspondingly, a creditor who has received a preference, the benefit of adding such property to the assets side of the comparison test. Section 1(19) of the

Act was written in terms first specifying active conduct on the part of the debtor and then enunciating passive conduct as within the exclusion, (i.e., permitted to be concealed). Substantively, the Code reaches the same result. The wording of the Code is objective, e.g., exclusive of property transferred, concealed or removed. Presumably, this phrase would include the active and the passive conduct specifically set forth in the Act. The prohibition extends no further than the actual interest transferred. When the fraudulent transfer consists of the giving of a mortgage, the debtor is still allowed to include the value of its remaining interest in the land or of the equity of redemption within its assets. n15 But where the transfer is outright, no such privilege exists, and it does not matter that the transfer was meant to be merely temporary or subject to a trust for the benefit of a fraudulent grantor. n16

The mental state required by the exclusionary clause in section 101(32) is the actual intent to hinder, delay or defraud creditors, that is, only conduct that would render the transfer avoidable under section 548(a)(1)(A). n17 The statute contains no analogous exclusion with respect to property which has been the object of a preferential transfer, and no special regulation is needed. This is because a preferential transfer satisfies an antecedent debt of the debtor, and therefore, does not diminish the estate. There is no reason to doubt that property which has been conveyed for the purpose of a preferential transfer, to the extent of such conveyance, thereafter has ceased to form a part of the debtors estate inasmuch as at common law such transaction is valid against the other creditors. Thus, it cannot be counted as property of the debtor in determining solvency at the time of *subsequent* occurrences. n18 On the other hand, the property so transferred must be counted among the debtors assets when solvency *at the time of such transfer* itself is to be decided. n19 Section 1(19) of the Act failed to exclude property that was exempt under state law, and therefore, such assets were typically valued in determining the question of the alleged bankrupts insolvency. Under the Code, however, such exemption is made express in the section 101(32) definition of insolvency, and is repeated in section 522, which states that such property may be exempted from an insolvency computation. Section 522(b)(2)(A) in turn, states that an individual debtor may exempt from property of the estate either:

any property that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of the filing of the petition .

While the word property is used in the definition in a broad sense and does not require that the assets involved are either subject to the reach of creditors or freely available to be used for the payment of the debtors debts, n20 it is obvious that interests which are subject to creditors remedies must necessarily be considered for inclusion in the balance sheet test. n21 In particular, property which is subject to a valid and subsistent lien by judgment, attachment, garnishment, execution or supplementary proceedings against the debtor may *to that extent* still be counted as property, although the debtor has parted with its ownership at the critical date. n22 On the other hand, the mere fact that interests may be reached by creditors process does not necessarily signify that those interests possess actual value under the valuation standards of the definition. Thus, it has been held that the debtors right to income from a trust fund, although at least in part subject to garnishee execution under the controlling local law, has nevertheless no sale value of substance, where such right is contingent on the debtors survival and applicable state law denies enforcement of a voluntary assignment of such interest and, in addition, prohibits insurance without the debtors consent. n23 Analogous considerations apply, of course, with even greater cogency to assets which, because of their contingent or otherwise intangible nature, are withdrawn from the local collection proceedings, but still possess commercial transferability, and thus convertibility into cash. n24 Such interests, which include rights of subrogation, contribution or reimbursement, rights to funds, good will of business, expectancies and contingent interests in the corpus of a testamentary trust, must also be valued for inclusion within the asset side of the balance sheet test. n25 Of course, value that is speculative or remote will not be attributed to the property in question. n26 For example, attempts to allocate a separate pecuniary value to the good will of a financially distressed business have not met with tangible success. n27 The definition of insolvent is modified to account for the liability of a general partner for the partnerships debts. n28 Partnership property, exclusive of property transferred, concealed or removed with the intent to hinder, delay or defraud the partnership creditors, and the surplus value of each general partners property, exclusive of exemptions, n29 will be included as partnership assets.

Municipal Insolvency. The definition of insolvent in section 101(32) was amended in 1988 by Pub. L. No. 100-597. n30 The Act added the words and a municipality in subparagraph (A) after the word partnership, and added subparagraph (C), which provides that

[insolvent means] with reference to a municipality, financial condition such that the municipality is--(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due. n31

In order to be found insolvent for purposes of chapter 9 eligibility, a municipality must prove that it will be unable to pay its debts as they become due in the current fiscal year, or, based on an adopted budget, in the next fiscal year. In determining whether the municipality is insolvent, a court should apply a prospective analysis with respect to the debtors ability to pay its debts and should examine the debtors cash flow, not the debtors projected budget deficits. n32

Community Property States. Separate and special consideration must be given to the operation of section 101(32) in the community property states. Unfortunately, the divergences among the different community property regimes and recent amendments to various community property laws n33 make the subject complex. The fundamental complexities stem from the fact that the statutory formula for insolvency, referring to the aggregate of the debtors property as well as the debts, is ill-suited to the intricate blending of assets and liabilities attendant to the community property systems. Because creditors of both spouses may satisfy their claims from community property, it should have been made clear that the test for insolvency takes all such claims into account. n34 While the Code does avoid the problem of cutting off the right of the nondebtor spouses creditors to reach community property in the estate, n35 nothing was done to integrate this same policy consideration into the definition of insolvency. Further difficulties derive from the legislative technique which makes the criteria of insolvency separate from, but not wholly independent of, the equally troublesome questions of what assets pass to the trustee (section 541) n36 and of what debts are affected by a discharge (section 524). n37 Therefore, a sensible interpretation of section 101(32) requires due regard for the ramifications flowing from these related matters.

The situation in California may serve as an example for one approach. Statutory language and judicial interpretation have established in California that the marital community is not regarded as a separate entity, but rather, there are only debts of the husband and debts of the wife. n38 Under California law, all community property, as well as the separate property of the contracting spouse, is obligated for the contracts of either spouse made after marriage and prior to legal separation. n39 This is consistent with the concept that management and control resides in both spouses. n40 The separate property and earnings during marriage of one spouse are exempt from liability for debts of the other spouse which were contracted before marriage. n41 Broader liability is imposed where debts are incurred for necessities of life. Creditors providing such necessities are entitled to resort to both the community property and to the separate property of each spouse. n42 With respect to tort claims, a distinction is made between torts committed while performing an activity beneficial to the marital community and those committed under other circumstances. In the former instance, the liability must be satisfied first from the community property and then from the separate property of the spouse who committed the tort. In the latter, the separate property of the tortfeasor must be exhausted before the community property is liable. n43 As a result of section 541(a)(2) of the Code, a petition by one spouse passes not only that spouses separate property to the estate but also the whole of the community property, n44 with the possible exception of a community property business solely managed by the nondebtor. This composition of the estate dictates that creditors of both spouses share in its distribution, n45 and affects the discharge granted to the debtor. n46 The determination of the solvency or insolvency of either spouse under the California community property system should proceed on the basis of the framework outlined above. Accordingly, in determining the solvency of a spouse, the assets which are to be counted consist of a debtors entire separate estate and all of the community property, except exempt property and a community property business under the sole management and control of the nondebtor if, under state law, creditors of the spouse may not reach this asset, n47 but including possible rights of repayment from the nondebtors separate property. n48 The debts which must be balanced against these assets are the debts of the debtor and such debts of the nondebtor spouse as are entitled to satisfaction from community property, n49 with due regard to marshaling of the nondebtors creditors claims against assets of the nondebtor spouse which do not pass to the estate.

n50 Analogous considerations apply to the determination of solvency or insolvency in the other community property states. In each case, reference should be made to applicable state law and to the provisions of sections 541(a)(2) and 101(7) of the Code. n51

Fair Valuation of Property. The Code definition of insolvency is essentially a balance sheet test. A debtor is insolvent when its liabilities exceed its assets. n52 Insolvency is determined by whether assets exceed liabilities, and not, except in the case of a municipality, whether the debtor was able to pay its debts as they became due. n53 The application of an assets-and-liabilities test requires of necessity a valuation of the property involved. This may be a difficult task, however, because value is not a natural or fixed quality, but will vary according to the purposes and policies which dictate the determinative judgments and the processes by which it is ascertained. n54 The statute describes the controlling standard of valuation with one brief phrase: at a *fair* valuation. But the meaning and effect of this term in concrete cases generates a formidable and, on the surface, not always consistent stream of adjudications.

Valuation, in general, will signify the reasonable estimate of what can be realized from the assets by converting them into, or reducing them to cash, under carefully guarded if not idealized conditions. Fair valuation is not the same as reasonably equivalent value. It is necessary to look at market value, and not distress value, to reach a fair valuation. n55

On the one hand, the statutory definition does not imply that a person can only be deemed solvent at a particular time when the amount which creditors would be able to actually obtain at the time is sufficient to pay all debts then existing. n56 Otherwise, the controlling test would possess greater stringency than the one applicable under the traditional equity concept of insolvency, a result which the framers of the clause definitely intended to obviate. Rather, the underlying policy requires disregard of, and allowances for, unavoidable sacrifices or other adverse effects caused by the particular distress of the debtor. n57 Accordingly, saleable value and fair value are not synonymous. n58 In particular, the latter test ordinarily is not met by reliance on the sum which could be realized at a foreclosure, execution or receivership sale. n59 Nor is it satisfied by equating it with the price which the debtor could obtain if he or she were forced to *instantly* dispose of the assets in question. Conversely, compliance with the appropriate standard likewise does not require the taking into account of the sum which could be realized only through retail sale of certain articles in the slow process of trade, n60 or through collection from debtors without property by patient and persistent effort, n61 or through a protracted search for a buyer who because of a special use for a particular item or other special circumstances is willing to pay an extraordinary price. n62 Couching the mandates of fair valuation in positive terms it can be said that they direct the estimate of what can be realized out of the assets within a reasonable time n63 either through collection or sale at the regular market value, n64 conceiving the latter as the amount which could be obtained for the property in question within such period by a capable and diligent effort n65 from an interested buyer who is willing to purchase under the ordinary selling conditions. n66

Of course, unless there is a current market for the property in question there is much of opinion that enters into the estimate. n67 The courts have identified and utilized different methods of valuation suitable to various types of assets. Thus, notes or accounts receivable are not appraised at their face value but on the basis of prospect at the critical date n68 of their collectibility within a reasonable time, depending on the solvency of the obligors, n69 the presence or absence of a serious dispute over their validity n70 or the availability of other defenses. Stocks, bonds and other securities having a readily ascertained price in a normally active market should be valued at the applicable quotations for the pertinent date; but if the market is sluggish or exceptionally depressed, or if there is no regular market for the type of securities involved, they may still be counted at par or with particularized deductions so long as interest payments are not in arrears and principal and interest are amply secured. n71 Merchandise inventories are to be valued with due regard for the age and condition of the stock, the season of the year, and the general state of the trade. n72 Acquisition costs or book values are not tantamount to fair value n73 but may furnish an adequate measure thereof under the particular conditions of a case. n74 Moreover, in a number of instances, the courts have permitted resort to prior inventories and book values, at least as a starting point for the process of valuation, especially where such approach was the only feasible one under the circumstances and the results were not particularly critical. n75 Subsequent inventories and appraisals may be interpolated to a prior date, if such procedure appears to be reliable and

the most promising avenue. n76 Real estate and other tangible fixed assets have been appraised at their fair selling price by consideration of a variety of factors. Ordinarily the issue calls for expert opinion, n77 but such judgment may be formed on the basis of widely varying elements covering not only physical characteristics such as location, n78 type of business for which the premises are designed or suited, n79 or age and condition, n80 but also original costs n81 and past and prospective earnings n82 or other pertinent factors. n83 Intangible assets in the nature of franchises which are considered transferable and have an independent commercial value, such as business licenses and patents, are to be appraised with due regard for the competitive or technological advantage which they secure in the light of the state of the trade or industry. Assets of singular character, such as earned credits for completed work under construction contracts, n84 or future or other conditional interests n85 are appraised in view of the particular circumstances.

One of the most vexing problems in the valuation of the assets of a business enterprise as of a specified date is the question whether, and under what conditions, it should be treated as a going concern requiring appraisal of its property as an active unit rather than on an item-by-item basis. Fair value, in the case of a going concern, is determined by the fair market price of the debtors assets that could be obtained if sold in a prudent manner within a reasonable period of time. n86 There is overwhelming authority to the effect that normally such valuation must be made from the vantage of a going concern and that subsequent dismemberment or impossibility to dispose of plant, equipment, inventory, etc., as an entirety should not enter into the picture. n87 Indeed, it has been held that the court should use fair market going concern price unless a business is on its deathbed, n88 in which case a liquidating value should be used. n89 Where the enterprise was already defunct at the critical date a non-going concern value has been applied by the courts. n90 Where the going concern value is the appropriate standard, the appraisal must take into account the additional value element which flows from the combination of the various assets to an economic unit. Closely allied to the matter under discussion is the further question of whether, and under what conditions, good will constitutes an independent item to be included in the aggregate of the debtors property. The courts have quickly discounted fantastic claims of such assets n91 and generally exhibited a great reluctance to accept good will as a separate asset, particularly where the enterprise was already in a seriously distressed condition. n92

Debts. The term debt contained in the definition of insolvent must be construed in light of the meaning ascribed to it under section 101(12). The pertinent discussion should be consulted. n93 The statutory definition specifies that a debt means liability on a claim. Because claims may be contingent, n94 contingent liabilities must be included in the computation of total indebtedness. Accordingly, liability as surety, guarantor, or endorser of commercial paper must be counted, n95 with appropriate allowances under assets for possible rights of subrogation or reimbursement from the principal, or contribution from cosureties or coendorsers. In some instances, the question of the inclusion of a particular item among the liabilities of the debtor will depend upon whether or not it constitutes a valid debt under applicable state or federal law. Although the court may have to determine the existence and amount of the claim, no finding of balance sheet insolvency is required for debtor relief under title 11. All that is necessary is that the debtor is unable to meet its debts as they mature.

For a complete discussion of Code section 101, see Collier on Bankruptcy, ch. 101.

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n1 1. 11 U.S.C. § 101(32).

n2

2. H.R. Rep. No. 595, 95th Cong., 1st Sess. 323-24 (1977). *See* S. Rep. No. 989, 95th Cong., 2d Sess. 34 (1978). *See also* 11 U.S.C. § 303(h).

n3

3. In *Finn v. Meighan*, 325 U.S. 300, 65 S. Ct. 1147, 89 L. Ed. 1624 (1945), Justice Douglas defined insolvency under the Bankruptcy Act as an insufficiency of assets at a fair valuation to pay the debts. *See also Dabney v. Chase Natl Bank of the City of New York*, 98 F. Supp. 807 (S.D.N.Y. 1951), *revd in part on other grounds*, 196 F.2d 668 (2d Cir. 1952), *reversed after retrial*, 201 F.2d 635 (2d Cir. 1952).

n4

4. H.R. Rep. No. 595, 95th Cong., 1st Sess. 323-324 (1977); *see* S. Rep. No. 989, 95th Cong., 2d Sess. 34 (1978).

n5

5. 11 U.S.C. § 547.

n6

6. 11 U.S.C. § 548.

n7

7. 11 U.S.C. § 545.

n8

8. *See Collier on Bankruptcy*, 101.32 (Matthew Bender).

n9

9. *In re City of Bridgeport*, 25 C.B.C.2d 269, 129 B.R. 332 (Bankr. D. Conn. 1991).

n10

10. *See Gleason v. Thaw*, 236 U.S. 558, 35 S. Ct. 287, 59 L. Ed. 717 (1915).

n11

11. The willingness of the debtors principal stockholder to advance funds to the debtor is not an asset which can be included in a balance sheet computation. *In re Sponsor Realty Corp.*, 48 F. Supp. 735, 739 (S.D.N.Y. 1943). An oral agreement of creditors of the debtor to exchange their notes for stock, however, was held a binding subscription agreement under California Law and includable as an asset. *Hoppe v. Rittenhouse*, 279 F.2d 3 (9th Cir. 1960); *see also Penn v. Grant*, 244 F.2d 309 (9th Cir. 1957), *cert. denied*, 355 U.S. 837, 78 S. Ct. 58, 2 L. Ed. 2d 47 (1957) (pending usury suit of debtor against finance company was inchoate and uncertain in character and amount and therefore had no appreciable value); *Mossler Acceptance Co. v. Martin*, 322 F.2d 183 (5th Cir. 1963) (estate of tenant at will is not susceptible of assignment as an asset in determining issue of debtors insolvency).

n12

12. 11 U.S.C. § 522.

n13

13. *Sparhawk v. Yerkes*, 142 U.S. 1, 12 S. Ct. 104, 35 L. Ed. 915 (1891); *Page v. Edmunds*, 187 U.S. 596, 23 S. Ct. 200, 47 L. Ed. 318 (1903); *Chicago Bd. of Trade v. Johnson*, 264 U.S. 1, 44 S. Ct. 232, 68 L. Ed. 533 (1923).

n14

14. *Friederich v. Dockery*, 209 F.2d 677 (8th Cir. 1954); *Barutha v. Prentice*, 189 F.2d 29 (7th Cir. 1951); *In re Rainbo Express*, 179 F.2d 1 (7th Cir. 1950).

n15

15. *Warner Coal Corp. v. Costanzo Transp. Co.*, 144 F.2d 589 (4th Cir. 1944); *Acme Food Co. v. Meier*, 153 F. 74 (6th Cir. 1907); *Lansing Boiler & Engine Works v. Ryerson & Sons*, 128 F. 701 (6th Cir. 1904).

n16

16. *Brickell v. Bond Realty Corp.*, 36 F.2d 865 (5th Cir. 1930); *In re Hughes*, 183 F. 872 (S.D.N.Y. 1910).

n17

17. Section 548(a)(1)(A) was formerly designated as 548(a)(1) before amendment by the Religious Liberty and Charitable Donation Protection Act of 1998, Pub. L. No. 105-183, effective for cases pending or commenced on or after June 19, 1998.

n18

18. *In re Doscher*, 120 F. 408 (E.D.N.Y. 1902), seemingly contains language opposed to the statement in the text. But closer analysis reveals that the court merely decided that in the case of a preferential mortgage or pledge the value of the hypothecated property so far as it exceeds the secured debt cannot be excluded from the computation of the debtors assets in determining his solvency at a subsequent date. The debt, of course, will likewise not be an outstanding item in the balance sheet test under such circumstances.

n19

19. *In re Utrecht Coal Co.*, 63 F.2d 745 (2d Cir. 1933); see also *In re Doscher*, 120 F. 408 (E.D.N.Y. 1902).

n20

20. *Lasswell & Stein-Block & Co.*, 93 F.2d 322, 323 (5th Cir. 1937).

n21

21. *Syracuse Engineering Co. v. Haight*, 97 F.2d 573 (2d Cir. 1938).

n22

22. 1 Collier on Bankruptcy, 1.19[2] (Matthew Bender 14th ed. 1974).

n23

23. *Syracuse Engineering Co. v. Haight*, 110 F.2d 468 (2d Cir. 1940), noted in 39 Mich. L. Rev. 813 (1941).

n24

24. See statements to that effect in *In re Studebaker Corp.*, 9 F. Supp. 426, 427 (D. Ind. 1935).

n25

25. *In re Xonics Photochem., Inc.*, 841 F.2d 198, 18 C.B.C.2d 711 (7th Cir. 1988).

n26

26. See *In re Bloch*, 109 F. 790 (2d Cir. 1901) (prospective profits on foreign goods ordered but not paid for or delivered, but which may arise if orders from domestic customers materialize, were not properly capable of valuation); *In re Sponser Realty Corp.*, 47 F. Supp. 735, 738 (S.D.N.Y. 1943) (willingness of debtors principal stockholder to advance funds to meet debtors requirements is not asset that can be included in balance sheet computation).

n27

27. See, e.g., *Fifth Natl Bank of the City of New York v. Lyttle*, 250 F. 361 (2d Cir.), cert. denied, 247 U.S. 506, 38 S. Ct. 427, 62 L. Ed. 1240 (1918) (no value to good will of insolvent company); Fair Valuation of Property, 1 Collier on Bankruptcy, 1.19[3], nn. 44, 45 (Matthew Bender 14th ed. 1974).

n28

28 H.R. Rep. No. 595, 95th Cong., 1st Sess. 312 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 25 (1978).

n29

29. *11 U.S.C. § 522.*

n30

30. An Act to Amend the Bankruptcy Law to Provide for Special Revenue Bonds, and for Other Purposes, Pub. L. No. 100-597.

n31

31. Pub. L. No. 100-597 (1988) deleted from section 109(c)(3) the phrase or unable to meet such entity's debts as such debts mature.

n32

32. *In re City of Bridgeport*, 25 C.B.C.2d 269, 129 B.R. 332 (Bankr. D. Conn. 1991).

n33

33. For a discussion of the amendments to certain states community property laws, see Pedlar, *The Implications of the New Community Property Laws for Creditors Remedies and Bankruptcy*, 63 Cal. L. Rev. 1610 (1975); Pedlar, *Community Property and the Bankruptcy Reform Act of 1978*, 11 St. Marys L.J. 349 (1979).

n34

34. See Pedlar, *The Implications of the New Community Property Laws for Creditors Remedies and Bankruptcy*, 63 Cal. L. Rev. 1610 (1975); Pedlar, *Community Property and the Bankruptcy Reform Act of 1978*, 11 St. Marys L.J. 349 (1979).

n35

35. See *Collier on Bankruptcy* 101.07 and *Collier on Bankruptcy* 726.04726.05 (Matthew Bender).

n36

36. *See Collier on Bankruptcy* 541.13 (Matthew Bender).

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37. *See Collier on Bankruptcy* 524.02 (Matthew Bender).

n38

38. *See Collier on Bankruptcy* 541.13 (Matthew Bender).

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39. Cal. Civ. Code §5120.110(a).

n40

40. *See Van Maren v. Johnson*, 15 Cal. 308, 311 (1860).

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41. Cal. Civ. Code §5120.110(b).

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42. Cal. Civ. Code § 5120.140(b).

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43. Cal. Civ. Code § 5122(b).

n44

44. See *Collier on Bankruptcy* 541.13 (Matthew Bender).

n45

45. See *Collier on Bankruptcy* 101.07 and *Collier on Bankruptcy* 726.05 (Matthew Bender).

n46

46. See *Collier on Bankruptcy* 524.01 (Matthew Bender).

n47

47. See *Collier on Bankruptcy* 541.13 (Matthew Bender).

n48

48. This claim would clearly be property of the estate under section 541(a)(2).

n49

49. See *Collier on Bankruptcy* 101.07. One would total the claims against the debtor and the community claims against either spouse.

n50

50. Marshaling assets is an equitable doctrine requiring that a debtors assets be applied to protect a creditor or other person having an interest in only a portion of the assets. In the community property context, the doctrine would require the creditors of one spouse to utilize separate property for the satisfaction of their claims to enable the creditors of the other spouse to utilize the community property for payment of their debts. This doctrine is invoked only when to do so does not prejudice other creditors rights.

n51

51. See the discussion of the law of each community property state contained in *Collier on Bankruptcy* 101.07 and *Collier on Bankruptcy* 541.13 (Matthew Bender).

n52

52. *Torgenrud v. Benson (In re Wolcott)*, 194 B.R. 477, 487 (Bankr. D. Mont. 1996).

n53

53. *In re Durso Supermarkets, Inc.*, 193 B.R. 682, 701 (Bankr. S.D.N.Y. 1996).

n54

54. *Dabney v. Chase Natl Bank of the City of New York*, 98 F. Supp. 807 (S.D.N.Y. 1951), reversed in part, 196 F.2d 668 (2d Cir. 1952); see *Penn v. Grant*, 244 F.2d 309 (9th Cir. 1957), cert. denied, 355 U.S. 837, 78 S. Ct. 58, 2 L. Ed. 2d 47 (1957).

n55

55. *In re Durso Supermarkets, Inc.*, 193 B.R. 682, 701 (Bankr. S.D.N.Y. 1996); see *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757, 1761, 128 L. Ed. 2d 556 (1994).

n56

56. The proposition stated in the test was first established in the early leading case of *Duncan v. Landis*, 106 F. 839 (3d Cir. 1901).

n57

57. See *Pirie v. Chicago Title & Trust Co.*, 182 U.S. 438, 21 S. Ct. 906, 45 L. Ed. 1171 (1901).

n58

58. *In re Crystal Ice & Fuel Co.*, 283 F. 1007, 1009 (D. Mont. 1922).

n59

59. *Grandison v. National Bank of Commerce*, 231 F. 800 (2d Cir. 1916), *cert. denied*, 242 U.S. 644, 37 S. Ct. 213, 61 L. Ed. 542 (1916); *In re Marine Iron Works*, 159 F. 753 (E.D.N.Y. 1908); *Rutland County Natl Bank v. Graves*, 156 F. 168 (D. Vt. 1907); *In re Hines*, 144 F. 142 (D. Or. 1906); *Chicago Title & Trust Co. v. Roebling Sons Co.*, 107 F. 71 (D. Ill. 1901).

n60

60. *Stern v. Paper*, 183 F. 228, 231 (D.N.D. 1910), *affd*, 198 F. 642 (8th Cir. 1912); *Matthews v. Concrete Engineering Co.*, 228 Iowa 493, 497, 292 N.W. 64, 66 (1940).

n61

61. *In re Coddington*, 118 F. 281, 282 (D. Pa. 1902); *Irving Trust Co. v. Manufacturers Trust Co.*, 6 F. Supp. 185 (S.D.N.Y. 1934).

n62

62. *In re Hines*, 144 F. 142 (D. Or. 1906); *see also In re Ouellette*, 98 F. Supp. 941, 943 (S.D. Me. 1951).

n63

63. In *In re Studebaker Corp.*, 9 F. Supp. 426, 427 (D. Ind. 1935), the court stated:

A person or corporation is insolvent when he or it is unable to pay debts and this inability to pay debts is not temporary, through lack of assets convertible in a reasonable time, not necessarily at forced sale, but nevertheless within a reasonable period . If the assets will not sell on the market within a reasonable time for enough to liquidate debts insolvency exists.

n64

64. *In re Hines*, 144 F. 142, 143 (D. Or. 1906) (I can conceive of no better or surer standard by which to arrive at fair valuation than the market value; that is what the property will probably bring, or is worth in the general market, where everybody buys.).

n65

65. *In re Sedalia Farmers Coop. Packing and Produce Co.*, 268 F. 818 (7th Cir. 1920); *Stern v. Paper*, 183 F. 228 (D.N.D. 1910), *affd*, 198 F. 642 (8th Cir. 1912); *In re Ouellette*, 98 F. Supp. 941, 943 (D. Me. 1950).

n66

66. *In re Kobre*, 224 F. 106, 117 (E.D.N.Y. 1915).

n67

67. *In re Hines*, 144 F. 142, 143 (D. Or. 1906).

n68

68. Although the value depends on the prospect of their collectibility, as it exists at the critical date, courts sometimes have relied on hindsight gained from the success or failure of subsequent efforts to collect exerted by either the debtor or the trustee in bankruptcy, especially in cases involving preferences. *See Matthews v. Concrete Engineering Co.*, 228 Iowa 493, 292 N.W. 64 (1940).

n69

69. Where the note or account is undisputed but its collectibility is doubtful, the courts have tried to determine whether or not it can be collected within a reasonable time, often by inquiry into the obligors resources or reliance on witnesses experienced in similar businesses or acquainted with the debtors transactions. *In re Coddington*, 118 F. 281 (D. Pa. 1902); *In re Rome Planning Mill*, 99 F. 937 (N.D.N.Y. 1900).

n70

70. The existence of a serious dispute over the validity of a note or account has induced the court to either appraise it under a heavy discount or to disregard it in toto in the valuation process, presumably in order to avoid the necessity of going into collateral issues. The former approach was taken in *Grandison v. National Bank of Commerce*, 231 F. 800 (2d Cir. 1916), *affg* 220 F. 981 (N.D.N.Y. 1915); *In re International Mercantile Agency*, 127 F. 173 (S.D.N.Y. 1922). The second category is represented by *Houghton Wool Co.*, 249 F. 434 (1st Cir. 1918); *In re Cooper*, 12 F.2d 485 (D. Mass. 1926); *First Natl Bank v. Wyoming Valley Ice Co.*, 136 F. 466 (D. Pa. 1905); *cf. In re Commonwealth Lumber Co.*, 223 F. 667 (D. Wash. 1915), relating to uncertainty of a contest.

n71

71. *In re Cleveland Discount Co.*, 9 F.2d 97 (D. Ohio 1924); *In re Kobre*, 224 F. 106 (E.D.N.Y. 1915).

n72

72. *Stern v. Paper*, 183 F. 228 (D.N.D. 1910), *affd*, 198 F. 642 (8th Cir. 1912); *In re Hines*, 144 F. 142 (D. Or. 1906); *In re Ouellette*, 98 F. Supp. 941 (D. Me. 1951).

n73

73. *Dunlavey v. Uhlmeier (In re Uhlmeier)*, 67 B.R. 977 (Bankr. D. Ariz. 1986) (insolvency is determined by a balance sheet test; the debtor is insolvent if the sum of debts is greater than assets at fair valuation. It is not necessary to examine the debtors financial statements to make that determination).

n74

74. *Inter-State Natl Bank of Kansas City v. Luther*, 221 F.2d 382, 391 (10th Cir. 1955) (book value of stored grain); *Updike v. Oakland Motor Car Co.*, 53 F.2d 369 (2d Cir. 1931); *In re Hines*, 144 F. 142 (D. Or. 1906); *In re Ouellette*, 98 F. Supp. 941 (D. Me. 1951) (acquisition cost of hardware store inventory).

n75

75. *Farmers State Bank v. Freeman*, 249 F. 579 (8th Cir. 1918); *In re Iron Clad Mfg. Co.*, 197 F. 280 (2d Cir. 1912); *In re Electron Chem. Co.*, 208 F. 954 (D.W. Mo. 1913); *Brown v. Streicher*, 177 F. 473 (D.R.I. 1910); *In re McMurtrey & Smith*, 142 F. 853 (D. Tex. 1905); *see also Bogen & Trummel v. Protter*, 129 F. 533 (6th Cir. 1904), involving the determination of solvency or insolvency of a retail merchant at a date some time subsequent to a fire in his store. The court held that in order to ascertain the amount of his insurance claims for loss of part of his stock in trade it was necessary to have the last inventory taken before the fire, with the books showing the purchases and sales since, or, in their absence, to resort to any other evidence. Full credence was given to the book values of inventory.

n76

76. *Rosenberg v. Semple*, 257 F. 72 (3d Cir. 1919); *accord Stern v. Paper*, 183 F. 228 (D.N.D. 1910), *affd*, 198 F. 642 (8th Cir. 1912); *In re Docker-Foster Co.*, 123 F. 190 (D. Pa. 1903). *But cf. Rosenman v. Coppard*, 228 F. 114 (6th Cir. 1915), holding that an appraisement, made ex parte in the course of bankruptcy proceedings, in itself does not constitute competent evidence of insolvency in an action to recover a preference.

n77

77. Current appraisals of the debtors assets afford a more accurate determination of the debtors insolvency than can be had solely by the balance sheet test. *American Insulator Co. v. Marsh Plastics (In re American Insulator Co.)*, 60 B.R. 752 (Bankr. E.D. Pa. 1986).

n78

78. *Stitzer Hotel Co. v. Beyer*, 55 F.2d 620 (3d Cir. 1932); *In re Kobre*, 224 F. 106 (E.D.N.Y. 1915).

n79

79. In cases involving hotel property it has been held that fair valuation is the value of the assets as an entirety taken in their relationship to the business of the hotel as a going concern. Special attention is due to the particular location of the hotel property and its competitive position relative to other hotels in regard to design, construction and modernization. *Meyer v. Dolan*, 145 F.2d 880 (2d Cir. 1944); *Stitzer Hotel Co. v. Beyer*, 55 F.2d 620 (3d Cir. 1932).

n80

80. *Meyer v. Dolan*, 145 F.2d 880 (2d Cir. 1944); *In re Brown Comml. Car Co.*, 227 F. 387 (7th Cir. 1915).

n81

81. Although it is recognized that neither acquisition costs nor book values of real property and buildings are determinative of their fair value, courts have attributed evidentiary value to the original construction or acquisition costs either without or with adjustments, see *In re Brown Comml. Car Co.*, 227 F. 387 (7th Cir. 1915); *In re Klein*, 197 F. 241 (6th Cir. 1912) (hotel equipment); *In re Hines*, 144 F. 142 (D. Or. 1906); *In re Rogers Milling Co.*, 102 F. 687 (D. Ark. 1900).

n82

82. *Doyle Dry Goods Co. v. Lewis*, 5 F.2d 918 (8th Cir. 1925); see also *Meyer v. Dolan*, 145 F.2d 880 (2d Cir. 1944); *Dabney v. Chase Natl Bank of the City of New York*, 98 F. Supp. 807 (S.D.N.Y. 1951), rev'd in part on other grounds, 196 F.2d 668 (2d Cir. 1952); *In re Gibson Hotels*, 24 F. Supp. 859 (D. W.Va. 1938).

n83

83. Amounts realized at subsequent sheriffs and bankruptcy sales are usually not particularly significant, *Liberty Natl Bank v. Foltz*, 25 F.2d 295 (6th Cir. 1928). Upon occasion, courts have attached some evidentiary force to such figures, especially for the purpose of deflating over valuation, see *Rosenberg v. Semple*, 257 F. 72 (3d Cir. 1919); *Huttig Mfg. Co. v. Edwards*, 160 F. 619 (8th Cir. 1908); *In re Mayo Contracting Co.*, 157 F. 469 (D. Mass. 1907).

n84

84. *Tumarkin v. Gally*, 127 F. Supp. 94 (S.D.N.Y. 1954).

n85

85. For purposes of the insolvency test, if there is a contingent asset or contingent liability, that asset or liability must be reduced to its present, or expected value. *In re Xonics Photochem., Inc.*, 841 F.2d 198, 18 C.B.C.2d 711 (7th Cir. 1988); *Syracuse Engineering Co. v. Haight*, 110 F.2d 468 (2d Cir. 1940) (future interest); *Warner Coal Corp. v. Costanzo Transp. Co.*, 144 F.2d 589 (4th Cir. 1944) (nonassignable leasehold and qualified title to machinery).

n86

86. *In re Roblin Indus., Inc.*, 78 F.3d 30, 35 (2d Cir. 1996).

n87

87. *Meyer v. Dolan*, 145 F.2d 880 (2d Cir. 1944) (concurring opinion); *In re Nathanson Bros. Co.*, 64 F.2d 912 (6th Cir. 1941); *In re Bucyrus Road Mach. Co.*, 10 F.2d 333 (6th Cir. 1926); *In re Klein, Dougherty v. First Natl Bank of Ohio*, 197 F. 241 (6th Cir. 1912); *Chicago Motor Vehicle Co. v. American Oak Leather Co.*, 141 F. 518 (7th Cir. 1905); *J.W. Butler Paper Co. v. Goembel*, 143 F. 295 (7th Cir. 1905).

n88

88. *Schwinn Bicycle Comm. v. AFS Cycle & Co., Ltd.*, 192 B.R. 477, 486 (Bankr. N.D. Ill. 1996), quoting *Utility Stationery Stores, Inc. v. Southworth Co.*, 12 B.R. 170, 176 (Bankr. N.D. Ill. 1981).

n89

89. *In re Taxman Clothing Co., Inc.*, 905 F.2d 166, 170 (7th Cir. 1990).

n90

90. *In re Brown Comml. Car Co.*, 227 F. 387 (7th Cir. 1915); *In re Jones Co.*, 268 F. 818 (7th Cir. 1920) (It cannot be accepted, as a general rule, that in every situation the debtor must inevitably be regarded as going concern even if at the time of giving the alleged preference he was financially dead or mortally wounded.).

n91

91. *See, e.g., Farmers State Bank v. Freeman*, 249 F. 579 (8th Cir. 1918).

n92

92. *See, e.g., Wofford Oil Co. v. Hatcher*, 73 F.2d 335 (5th Cir. 1934); *Updike v. Oakland Motor Car Co.*, 53 F.2d 369 (2d Cir. 1931); *Everette v. Warfield Mining Co.*, 37 F.2d 328 (4th Cir. 1930); *Fifth Natl Bank of the City of New York v. Lyttle*, 250 F. 361 (2d Cir. 1918); *see also In re Doscher*, 120 F. 408 (E.D.N.Y. 1902); *Davenport v. Lines*, 72 Conn. 118, 44 Atl. 17 (1905).

n93

93. *See Collier on Bankruptcy*, 101.12 (Matthew Bender).

n94

94. 11 U.S.C. § 101(5). For purposes of the insolvency test, if there is a contingent asset or contingent liability, that asset or liability must be reduced to its present, or expected value. *In re Xonics Photochem., Inc.*, 841 F.2d 198, 18 C.B.C.2d 711 (7th Cir. 1988).

n95

95. *Syracuse Engineering Co. v. Haight*, 97 F.2d 573 (2d Cir. 1938); *Updike v. Oakland Motor Car Co.*, 53 F.2d 369 (2d Cir. 1931); *Wingert v. Hagerstown Bank*, 41 F.2d 660 (4th Cir. 1930); *Huttig Mfg. Co. v. Edwards*, 160 F. 619 (8th Cir. 1908); *In re Bowers*, 215 F. 617 (D. Ga. 1914).

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Collier on the Definition of "Small Business Debtor" Under the Bankruptcy Code

2008 Emerging Issues 972

Collier on the Definition of "Small Business Debtor" Under the Bankruptcy Code

By Collier

November 16, 2007

SUMMARY: This Emerging Issues Analysis discusses the definition of a small business debtor under section 101(51C) of the Bankruptcy Code.

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ARTICLE: Under *11 U.S.C. § 101(51C)*, small business means a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debt as of the date of the petition does not exceed \$2,000,000. n1 The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 repealed the definition of small business, n2 and the definition is not effective in cases commenced on or after October 17, 2005. n3

The definition of small business was added by the Bankruptcy Reform Act of 1994. n4 Section *11 U.S.C. § 101(51C)* was added as part of a process to expedite small business reorganization under chapter 11. n5 The definition of a small business does not restrict the availability of the small business amendments to a person who at the time of the filing of the petition is presently engaged in commercial or business activities and who expects to continue in those same activities under a plan of reorganization. That person may have incurred \$2,000,000 in liquidated secured and unsecured debts that arose from business activities before the date of the filing of the case, but as of the petition date may have discontinued those business activities. There is nothing in the legislative history to suggest that in this latter instance, the small business amendments should not apply to that person. n6

For a complete discussion of Code section 101, see Collier on Bankruptcy, ch. 101.

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n1 1. *11 U.S.C. § 101(51C)*.

n2

2. Pub. L. No. 109-8, § 432(a) (2005).

n3

3. Pub. L. No. 109-8, § 1501 (2005).

n4

4. Pub. L. No. 103-394 (1994), *reprinted in* Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender).

n5

5. Section-by-Section Description of H.R. 5116, 140 Cong. Rec. H10,768 (daily ed. Oct. 4, 1994).

n6

6. *But cf. 11 U.S.C. § 101(18)(A)*, defining family farmer. By way of contrast, relief under chapter 12 is not available to an individual or an individual and his or her spouse who had been engaged in a farming operations, but by implication discontinued or materially reduced his or her or their farming operation so that less than 50% of gross income is received from that operation for the taxable year that precedes the taxable year during which the case was filed. Thus, if Congress intended to exclude from the small business amendments those businesses that are not operating as of the date of the petition, it could have done so as it did with the family farmer amendments.

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Bankruptcy Abuse Prevention & Consumer Protection Act of 2005

2008 Emerging Issues 973

Collier on Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Business Bankruptcy

By Collier

November 16, 2007

SUMMARY: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ended seven years of congressional silence on bankruptcy laws. Changes affecting business debtors were made to the administrative and operating rules governing chapter 11 debtors, including some changes designed to streamline the chapter 11 process. This Emerging Issues Analysis addresses these issues.

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ARTICLE: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 n1 ended seven years of congressional silence on bankruptcy laws. n2 With origins in the report of the National Bankruptcy Review Commission issued in October 1997, n3 the legislation contains some of the sharpest diversions from provisions and policies found in the 1978 Reform Act. Although concerns sparked by historically high consumer filings were the principal impetus behind the 2005 amendments, the legislation also significantly affected business bankruptcies. Changes affecting business debtors were made to the administrative and operating rules governing chapter 11 debtors, including some changes designed to streamline the chapter 11 process. n4 In addition, although some changes--such as amendments to avoiding powers--technically affect all debtors, their principal impact will be on business debtors.

Avoiding Powers. Several changes were made to the avoiding powers. The 2005 amendments made minor changes to section 545, modifying it to clarify that it does not apply to federal tax liens, n5 and changes to the venue provisions for avoiding power actions, generally making it more difficult for an estate to sue in the home district to recover small preferences. n6 Section 546 was amended to expand greatly the reclamation rights of unpaid vendors; the time limits for making a reclamation demand were expanded to 45 days, n7 and a new priority was created for vendors who supply goods within 20 days before the commencement of the case. n8 Section 547Section 547Section 547, dealing with preferences, was changed in several ways. First, the effects of the DePrizio decision were finally sorted out, and thus it is now clear that a transfer that benefits an insider will not render vulnerable a transfer to a connected non-insider creditor. n9 Second, the ordinary course of business test was softened in favor of creditors by allowing the defense if the creditor can establish either that the transfer was made according to ordinary business terms or that it was made in the ordinary course of the debtor's and the transferee's business; previously, both had to be shown. n10 Smaller transfers of less than \$5,000 were shielded by an explicit defense in business cases, n11 and the grace period for

perfecting a security interest was extended from 10 to 30 days. n12 Section 548 Section 548s one-year lookback period was extended to two years, but only for cases commenced after April 20, 2006. n13 An additional ground for finding a constructive fraudulent transfer was added: for cases filed on or after October 17, 2005, if a transfer or obligation is made for less than reasonably equivalent value to or for the benefit of an insider and made under an employment contract outside the ordinary course of business, then it may be set aside under section 548 regardless of whether the debtor was solvent at the time of the transaction. n14 Finally, Congress added a new subsection (e), which gives the estate 10 years to look back and set aside actually fraudulent transfers made to a self-settled trust or similar device. n15

Executory Contracts. The 2005 amendments made several changes to the way in which executory contracts are treated in bankruptcy. Overruling some prior decisions to the contrary, the amendments modified section 365 to permit the assumption of an unexpired lease of real property in which there is a nonmonetary default without the need to cure that default if that default is impossible to cure--such as would arise if an executory contract requires continuous insurance coverage and the debtor has a gap in coverage. n16 More important, section 365(d) was changed to extend to 120 days the time in which the estate has to assume or reject an unexpired lease of nonresidential real property, and to cap the total amount of extensions of such time at 210 days, unless the landlord consents to a further extension. n17 Finally, Congress placed limits on administrative claims arising from the rejection of a previously assumed nonresidential real property lease--specifically, two years worth of rent and other lease obligations. n18

Committee Duties and Powers. Chapter 11 committees were also affected by the 2005 amendments. Congress clarified a bankruptcy courts right to require the United States trustees to change the membership of an existing chapter 11 committee in order to ensure adequate representation of creditors and equity security holders. n19 Further changes increased the duty of committees to solicit and receive comments from their constituents, and to provide wider access to information the committee obtains. n20

Health Care, Privacy Rights and Employee Benefits. Congress added several protections related to health and privacy issues. The post of ombudsman was created to monitor sales of personal information under section 363 and to monitor the progress of health care bankruptcies. n21 Congress also added a direct prohibition on the release of the names of minor children. n22 Finally, studies were ordered to ensure the privacy of tax-related information debtors are required to disclose. n23 Employees also received changes to their status. Congress more than doubled the priority for wages and contributions to employee benefit plans, increasing it to \$10,000. n24 The practice of giving existing management severance and retention bonuses as administrative claims was curtailed. n25

Procedure and Standard for Dismissal for Chapter 11 Cases. The provisions related to the conversion or dismissal of a chapter 11 case, or for the appointment of a chapter 11 trustee, were changed in three ways. First, Congress expanded the number of grounds of cause for such actions from 10 to 16. n26 Second, Congress limited the amount of discretion given to a court to consider the best interest of creditors and the estate. n27 Third, the time frame in which such a motion must be heard was circumscribed; a court must hear the motion within 30 days and must decide it within 15 days after hearing it. n28 In addition, Congress made clear that the same grounds and procedure sufficient to convert or dismiss a chapter 11 case will apply to the appointment of a chapter 11 trustee. n29

Single Asset Debtors. The 2005 amendments removed the debt limit for single asset debtors. n30 Further, the relief from stay provisions related to single asset debtors were modified to allow debtors to make adequate protection payments from cash collateral and to require only nondefault contract rates of interest with respect to any interim interest payments. n31

Small Business Cases. The 2005 amendments radically reformed small business cases. Small business treatment is no longer optional; it is now mandatory for chapter 11 business debtors with less than \$2,190,000 in non-insider debt and which do not have active creditors' committees. n32 Once classified as a small business debtor, the debtor is subject to increased reporting and informational requirements, n33 and accelerated time frames to propose and to confirm a plan. n34 In addition, in a measure to deter serial filers, any small business debtor that files again within two years of dismissal or plan confirmation (or any entity that acquires all or substantially all of a small business debtors

assets out of a bankruptcy) will not automatically receive the benefit of the automatic stay, but will be able to seek to have it imposed for cause shown. n35

Chapter 11 for Individuals. The 2005 amendments singled out individual chapter 11 debtors for different treatment. First, the 2005 amendments provide that, unlike previous treatment in chapter 11 and the current treatment in chapter 7, postpetition earnings from services will be part of the individuals chapter 11 estate. n36 In addition, an amount equal to five years worth of such earnings will have to be committed to the debtor's chapter 11 plan n37 and that plan will, in addition to all other requirements, be subject to the disposable income test borrowed from chapter 13. n38 Finally, the discharge for an individual in chapter 11 normally will be moved from the time of confirmation to the time that all plan payments are completed. n39

For an overview of consumer and business bankruptcy changes by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, see Collier on Bankruptcy, ch. 1 (Matthew Bender).

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n1 1. Pub. L. No. 109-8 (2005). With certain specified exceptions, the acts provisions are effective in cases commenced on or after October 17, 2005.

n2

2. For a detailed account of the tumultuous legislative reform initiative that culminated in the 2005 amendments, see Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 *Am. Bankr. L.J.* 485 (2005).

n3

3. National Bankruptcy Review Commn, *Bankruptcy: The Next Twenty Years* (Oct. 20, 1997), *reprinted in* Collier on Bankruptcy, App. Pt. 44 (Matthew Bender).

n4

4. For example, several provisions of the Code were changed to accommodate prepackaged chapter 11 plans. See 11 *U.S.C.* §§ 341(e) (allowing the United States trustee to dispense with calling a first meeting of creditors), 11 *USCS* § 1125(g) (validating postpetition vote solicitation in accordance with applicable nonbankruptcy law but without a court-approved disclosure statement if the person was solicited prepetition in accordance with applicable nonbankruptcy law).

n5

5. *11 U.S.C. § 545(2)*.

n6

6. *28 U.S.C. § 1409(b)*.

n7

7. *11 U.S.C. § 546(c)*.

n8

8. *11 U.S.C. § 503(b)(9)*.

n9

9. *See 11 U.S.C. § 547(i)*, added by Pub. L. No. 109-8, § 1213(a)(2) (2005), effective in any case pending on, or commenced on or after, October 17, 2005.

n10

10. *11 U.S.C. § 547(c)(2)*, as amended by Pub. L. No. 109-8, § 409(1) (2005), effective in cases commenced on or after October 17, 2005.

n11

11. *11 U.S.C. § 547(c)(9)*, added by Pub. L. No. 109-8, § 409(3) (2005), effective in cases commenced on or after October 17, 2005.

n12

12. *11 U.S.C. § 547(e)(2)*, as amended by Pub. L. No. 109-8, § 403 (2005), effective in cases commenced on or after October 17, 2005.

n13

13. Pub. L. No. 109-8, §§ 1402(1), 1406(b)(2) (2005).

n14

14. *11 U.S.C. § 548(a)(1)(B)(i)(IV)*, added by Pub. L. No. 109-8, § 1402(3)(C) (2005), effective in cases commenced on or after April 20, 2005.

n15

15. *11 U.S.C. § 548(e)*, added by Pub. L. No. 109-8, § 1402(4) (2005), effective in cases commenced on or after April 20, 2005.

n16

16. *11 U.S.C. § 365(b)(1)(A)*.

n17

17. *11 U.S.C. § 365(d)(4)*.

n18

18. *11 U.S.C. § 503(b)(7)*.

n19

19. *11 U.S.C. § 1102(a)(4)*.

n20

20. *11 U.S.C. § 1102(b)(3)*.

n21

21. The post of consumer privacy ombudsman is created by new section 332 of the Code, *see* Pub. L. No. 109-8, § 232 (2005), and enforced through the amendments to section 363(b)(1), *see id.* § 231(a). The post of patient care ombudsman is created in new section 333. *See* Pub. L. No. 109-8, § 1104(a) (2005), effective in cases commenced on or after October 17, 2005.

n22

22. *11 U.S.C. § 112*.

n23

23. Pub. L. No. 109-8, § 315(c) (2005).

n24

24. *11 U.S.C. § 507(a)(4)(5)*, as amended by Pub. L. No. 109-8, § 1402(2) (2005), effective in cases commenced on or after April 20, 2005.

n25

25. *11 U.S.C. § 503(c)*, added by Pub. L. No. 109-8, § 331 (2005), effective in cases commenced on or after October 17, 2005.

n26

26. *11 U.S.C. § 1112(b)(4)*.

n27

27. *11 U.S.C. § 1112(b)(1)*, in which may was changed to shall, with certain limited exceptions.

n28

28. *11 U.S.C. § 1112(b)(3)*.

n29

29. *11 U.S.C. § 1104(a)(3)*, added by Pub. L. No. 109-8, § 442(b)(3) (2005), effective in cases commenced on or after October 17, 2005.

n30

30. *See 11 U.S.C. § 101(51B)*, as amended by Pub. L. No. 109-8, § 1201(5) (2005).

n31

31. *11 U.S.C. § 362(d)(3)*, as amended by Pub. L. No. 109-8, § 444 (2005), effective in cases commenced on or after October 17, 2005.

n32

32. The opt-in language previously found in section 1121(e) was deleted by the amendments. *See* Pub. L. No. 109-8, § 437 (2005) (codified at *11 U.S.C. § 1121(e)*). The definition of small business debtor is found at *11 U.S.C. § 101(51D)*. For cases commenced before April 1, 2007, the debt limit is \$2 million.

n33

33. *See 11 U.S.C. §§ 308, 1116*.

n34

34. *See 11 U.S.C. §§ 1121(e), 1129(e)*.

n35

35. 11 U.S.C. § 362(n).

n36

36. 11 U.S.C. § 1115, added by Pub. L. No. 109-8, § 321(a) (2005), effective in cases commenced on or after October 17, 2005.

n37

37. 11 U.S.C. § 1123(a)(8).

n38

38. 11 U.S.C. § 1129(a)(15).

n39

39. 11 U.S.C. § 1141(d)(5).

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Collier on Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

2008 Emerging Issues 974

Collier on Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Consumer Bankruptcy

By Collier

November 16, 2007

SUMMARY: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ended seven years of congressional silence on bankruptcy laws. With origins in the report of the National Bankruptcy Review Commission issued in October 1997, the legislation contains some of the sharpest diversions from provisions and policies found in the 1978 Reform Act. This Emerging Issues Analysis addresses issues pertaining to consumer bankruptcy.

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ARTICLE: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 n1 ended seven years of congressional silence on bankruptcy laws. n2 With origins in the report of the National Bankruptcy Review Commission issued in October 1997, n3 the legislation contains some of the sharpest diversions from provisions and policies found in the 1978 Reform Act. Sparked by concern over historically high consumer filings, which were the principal impetus behind the 2005 amendments, the primary focus of the 2005 amendments was consumer bankruptcy. However, the legislation also significantly affected business bankruptcies.

In the early 1990s, when bankruptcy filings topped 1 million, members of Congress began to introduce bills designed to shift the focus in consumer bankruptcies. No longer was the relief afforded by chapter 7 to be available to all. Instead, Congress experimented with various forms of means testing, whereby a consumer's ability to pay a certain portion of his or her debts was assessed, and if a sufficiently high amount of those debts could be paid out of future income, chapter 7 relief would be denied. The changes were adopted in 2005, along with a host of other changes to consumer bankruptcy, including requiring credit counseling as a prerequisite to filing and financial education as a condition to a discharge. Many other changes were implemented, including changes to the availability of relief to serial filers, changes to the ways in which creditors are to receive notices and a change in the scope of chapter 13 relief. When added to changes in priorities for domestic support obligations, and to exemptions, the changes wrought by the 2005 amendments are the most extensive since the adoption of the 1978 Code.

Eligibility; Consumer Credit Counseling and Briefing. Under the 1978 Code, eligibility to file for bankruptcy had never been questioned or conditioned for regular individuals. The 2005 amendments, however, imposed a requirement of obtaining credit counseling within six months of filing for all individuals. n4 The counseling agency

must be approved by the Executive Office for United States Trustees, n5 but may be in individual or group settings, by telephone or over the Internet. n6 The debtor must file evidence of credit counseling with the petition, n7 unless there are exigent circumstances preventing the debtor from obtaining the counseling during the five-day period immediately preceding the filing, n8 in which case the debtor must file a certification listing the exigent circumstances that precluded the obtaining of credit counseling during such five-day period. There are some exemptions, but not many, from this requirement. n9

Ability to Dismiss Chapter 7 Cases for Abuse: Means Testing. The centerpiece of the consumer bankruptcy amendments was the institution of means testing in all chapter 7 cases. Its significance can be measured by the fact that the pre-2005 version of section 707(b) contained the following sentence: There shall be a presumption in favor of granting the relief requested by the debtor. The 2005 amendments deleted that sentence. n10 The elimination of the presumption in favor of the debtor was one of the smallest changes to section 707(b). The 2005 amendments substantially revised the entire section, in large part to implement means testing through specifying sufficient grounds to dismiss a chapter 7 case. Specifically, if the means test is satisfied--in the sense that the debtor has the requisite means to provide for creditors--then there is presumed abuse and the court may dismiss the debtor's chapter 7 case, or the debtor has to attempt to convert to chapter 13. n11 In concept, the means test found in section 707(b) is simple. Its theory is that if debtors can afford to pay creditors something between \$6,000 and \$10,000 over five years, they should. But as with the rest of life, the devil is in the details, and Congress has packed a lot of details into the means test. In understanding the means test, it is important to recognize first that Congress used common terms such as income and expenses, but did not equate them to what debtors actually earn and spend. Rather, the section defines them by several artificial constructs designed to remove discretion.

With a high level of generality, the means test can be summarized as follows:

First, take the debtors current monthly income, a new defined term; n12

Second, subtract from that monthly income the following:

- living expenses, as calculated under certain IRS collection standards; and
- projected payments on actual secured debt, including repayment of arrears, over five years; and
- projected payments on actual priority debt, such as tax debt or domestic support obligations;
- Other and sundry expenses specified in section 707(b), such as additional expenses for education, charitable contributions, health insurance, home energy costs and projected chapter 13 administrative expenses;

Third, multiply the difference by 60. There is presumed to be abuse if the product so obtained is greater than:

- the greater of \$6,000 or 25 percent of the debtor's nonpriority unsecured debt; or
- \$10,000.

If a motion to dismiss the case is filed and the court finds abuse because of the presumption is not rebutted, the court may dismiss or, with the debtors consent convert, the case.

In addition, the debtor may attempt to show special circumstances in an effort to rebut any presumption of abuse. n13

The complete means test may not need to be calculated in all cases; in particular, the Advisory Committee on Bankruptcy Rules has promulgated a form that does not require calculation of the means test if annualized current monthly income is below the applicable median family income. n14 The Executive Office for United States Trustees maintains a Web site with much of the information necessary for the means test calculations, such as state medians and

links to the Internal Revenue Service's National and Local Living Expense Standards. n15

Filing Obligations and Sanctions for Failure to Comply with Such Rules. The 2005 amendments also corrected what Congress viewed as a separate type of abuse: noncompliance by debtors with the rules requiring the provision of information. In this regard, Congress expanded the list of required filings from the previous schedules and statements to include copies of all payment advices or other evidence of payment received within 60 days before the date of filing from any employer. n16 In addition, the schedules have been revised to take into account other requirements, such as a statement of itemized monthly net income and a statement of any reasonably anticipated increase in income or expenditures during the year following the filing. n17 The sanction for noncompliance with the filing requirements is severe. Unless there is a valid request for an extension, or unless the court orders otherwise, the debtor's case is automatically dismissed on the 46th day after filing if any of the above requirements are not complete, n18 and any creditor may request an order confirming the dismissal. n19

Scope of Automatic Stay. The 2005 amendments have not changed the scope of the automatic stay, but they have changed the applicable exceptions. n20 Initially, the exceptions granted to holders of domestic support obligations have expanded. n21 More leeway is given to holders of such claims to seek to withhold privileges, such as professional licenses and driver's licenses, until payments are current, n22 and to request the interception of tax refunds made to the debtor to satisfy unpaid domestic support obligations. n23 Also exempted are repayments of loans taken out against retirement assets, n24 and, in some cases, the rights of landlords to evict nonpaying tenants if the landlord has obtained, prepetition, a judgment of possession for the leased premises. n25 Congress also amended section 362 to deal with the problem of serial filers. Generally speaking, if a debtor has had a case dismissed within 12 months of the filing of a new case, the stay in the new case will last only 30 days; if the debtor has had two cases dismissed within that same 12-month period, the new case will not generate a stay at all. n26 Debtors may seek to extend or impose the stay in such cases, but face fairly specific requirements to show that the latest filing was made in good faith. n27 Limited provisions for imposing an *in rem* order exempting certain property from the stay in a future case were added, subject to the creditor's showing that the filings were part of a scheme to hinder, delay and defraud creditors. n28 Finally, Congress linked relief from the stay to the debtors actions with respect to his or her statement of intention filed under section 521. If a chapter 7 debtor does not file a statement of intention within 30 days of the cases filing, or does not timely act on any stated intention to surrender or redeem collateral or leased goods, or reaffirm a secured debt (or assume a lease of personal property), within 30 days of the first date set for the meeting of creditors under section 341 of the Code, then the stay terminates as to the collateral or as to the leased property. n29

Exemptions. The 2005 amendments made two major changes in exemptions. First, they federalized the exempt status of retirement assets, providing an exemption for such assets to the extent that they are held in a fund or account that is exempt from taxation under various provisions of the Internal Revenue Code, including IRAs and section 401(k) plans. n30 Second, the 2005 amendments made significant changes to the treatment of homestead exemptions to the extent that federal law permits a debtor to claim a state-law based homestead. In a move to discourage moving to states with high exemptions, Congress extended the residency requirement for using a states exemption to 730 days; debtors who do not meet that requirement are relegated to the laws of the state in which they were resident for the better part of the 180 days preceding the 730-day period. n31 Third, Congress reduced the homestead exemption available to debtors on a dollar-for-dollar basis to the extent that, within the 10 years preceding filing, a debtor's equity in his or her homestead was attributable to transfers of otherwise nonexempt property that were made with the intent to hinder, delay or defraud a creditor. n32 Fourth, Congress capped the exemption at \$125,000 in two situations: when the debtor has not owned the homestead for at least 1215 days preceding the date of the filing (with an exception that allows tacking of ownership for certain in-state transfers); n33 and when the debtor is liable to a creditor for securities fraud or because of the commission of a criminal act, intentional tort or wilful or reckless conduct that caused serious physical injury or death within five years of the debtor's filing. n34

Redemption and Reaffirmation. Before the 2005 amendments, courts had been mixed about whether they would allow a lease or secured obligations to ride through a consumer's bankruptcy; that is, whether the debtor, without formally reaffirming or redeeming the collateral or the lease could continue to use them, shielded by the automatic stay.

The 2005 amendments addressed this situation by linking relief from the stay with respect to specific property to a debtor's filing, and performance under, his or her statement of intention with respect to that property, n35 and by making part of the debtor's basic duties the relinquishment of possession of property in which another has an interest if the debtor does not redeem the property, or does not reaffirm the debt related to it. n36 In addition, the valuation standard for redemption was confirmed as replacement value, and the statute was clarified to provide that redemptions have to be made in a lump sum. n37 Reaffirmation practice was changed to require standardized language in the reaffirmation agreements. n38

Scope of Chapter 13. The 2005 amendments significantly cut back the scope of the chapter 13 discharge; whereas fraud and certain defalcations were dischargeable before 2005, under the amendments they are no longer dischargeable. n39 In addition, for debtors whose income is calculated to be above their state's applicable median, upon objection by the chapter 13 trustee or an unsecured creditor, their plans will have to include at least five years worth of disposable income, n40 and the amount of reasonably necessary expenses used to calculate disposable income will be taken from the test used in section 707(b) presumptive abuse cases. n41 The mechanics of how and when debtors file, confirm and make payments under their plans were also changed, n42 as were the requirements with respect to the ongoing provision of information, such as income tax returns, to the chapter 13 trustee. n43

Discharge and the Requirement of Financial Education. While the 2005 amendments did not change the scope of discharge in chapter 7, they did provide for an extension of time--six years to eight years--that a debtor must wait to obtain a second chapter 7 discharge. n44 With respect to chapter 13, the 2005 amendments put in place similar waiting periods--a chapter 13 discharge cannot issue for four years after the filing of a case in which the debtor received a discharge under chapter 7, 11 or 12, n45 or for two years after the filing of a case in which a discharge was entered under chapter 13. n46 The 2005 amendments also introduced a new concept: financial education. Discharges in chapters 7 and 13 normally will not be granted until the debtor certifies that he or she took a course in financial education from an instructor approved by the United States trustee. n47

Treatment of Domestic Support Obligations. Congress greatly enhanced the protection given to holders of claims related to domestic support obligations. The nub of these protections is a new definition of a domestic support obligation. n48 Congress used this new definition to expand the exemptions available from the automatic stay n49 and the scope of nondischargeable support obligations. n50 It also required debtors to be current on all postpetition domestic support obligations as a condition of confirming contested chapter 11 and chapter 13 plan.

For an overview of consumer and business bankruptcy changes by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, see Collier on Bankruptcy, ch. 1 (Matthew Bender).

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[Return to Text](#)

n1 1. Pub. L. No. 109-8 (2005). With certain specified exceptions, the acts provisions are effective in cases commenced on or after October 17, 2005.

n2

2. For a detailed account of the tumultuous legislative reform initiative that culminated in the 2005 amendments, see Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 *Am. Bankr. L.J.* 485.

n3

3. National Bankruptcy Review Comm'n, *Bankruptcy: The Next Twenty Years* (Oct. 20, 1997).

n4

4. 11 *U.S.C. § 109(h)*.

n5

5. 11 *U.S.C. § 111*. In districts in which the United States trustee system does not operate, these duties are fulfilled by the bankruptcy administrator.

n6

6. 11 *U.S.C. § 109(h)(1)*.

n7

7. *Fed. R. Bankr. P. 1007(c)*.

n8

8. 11 *U.S.C. § 109(h)(3)*.

n9

9. Exemptions exist for those unable to complete the requirements due to disability, incapacity or due to active military service in a combat zone, 11 *U.S.C. § 109(h)(4)*, and in those districts in which the United States

trustee (or bankruptcy administrator) certifies that there is insufficient availability of credit counseling, *11 U.S.C. § 109(h)(2)*. Because the counseling can be performed by telephone or over the Internet, however, no district has been the subject of a determination that credit counseling is unavailable.

n10

10. Pub. L. No. 109-8, § 102(a)(2)(B)(ii) (2005).

n11

11. *11 U.S.C. § 707(b)(2)(A)(B)*.

n12

12. Current monthly income is defined in *11 U.S.C. § 101(10A)*, added by Pub. L. No. 109-8, § 102(b) (2005).

n13

13. *11 U.S.C. § 707(b)(2)(B)*. The statute lists a serious medical condition or a call to active military status as possible examples of special circumstances.

n14

14. See Official Form 22A. For definition of median family income, see *11 U.S.C. § 101(39A)*.

n15

15. These expenses are collected and published at the United States trustee's Web site: <http://www.usdoj.gov/ust>.

n16

16. *11 U.S.C. § 521(a)(1)(B)(iv)*.

n17

17. 11 U.S.C. § 521(a)(1)(B)(vi).

n18

18. 11 U.S.C. § 521(i)(1).

n19

19. 11 U.S.C. § 521(i)(2).

n20

20. For a discussion of the exceptions to the stay, see *Collier on Bankruptcy*, 362.05 (Matthew Bender).

n21

21. See 11 U.S.C. § 362(b)(2).

n22

22. 11 U.S.C. § 362(b)(2)(D).

n23

23. 11 U.S.C. § 362(b)(2)(F).

n24

24. 11 U.S.C. § 362(b)(19).

n25

25. *11 U.S.C. § 362(b)(22).*

n26

26. *See 11 U.S.C. § 362(c)(3)(4).*

n27

27. *Id.*

n28

28. *11 U.S.C. §§ 362(d)(4), 362(b)(20).*

n29

29. *11 U.S.C. § 362(h)(1)* (incorporating the time limits set forth in section *11 U.S.C. § 521(a)(2)*).

n30

30. *11 U.S.C. §§ 522(b)(3)(C), 522(b)(12).* With respect to regular and Roth IRAs, this amount is subject to a \$1 million cap; however, this cap does not include any amounts rolled over into such IRAs from other tax-favored accounts, and may be increased if the interests of justice so require. *11 U.S.C. § 522(n).*

n31

31. *11 U.S.C. § 522(b)(2).* If application of these residency rules render[s] the debtor ineligible for any exemption, the debtor may elect to use the exemptions found in section 522(d). *11 U.S.C. § 11 U.S.C. § 522(b)(3).*

n32

32. *11 U.S.C. § 522(o).*

n33

33. *11 U.S.C. § 522(p).*

n34

34. *11 U.S.C. § 522(q).*

n35

35. *11 U.S.C. § 362(h)(1)* (incorporating the time limits set forth in section *11 U.S.C. § 521(a)(2)*).

n36

36. *11 U.S.C. § 521(a)(6).*

n37

37. *11 U.S.C. § 722.*

n38

38. *See 11 U.S.C. § 524(k).*

n39

39. *11 U.S.C. § 1328(a)*, as amended by Pub. L. No. 109-8 , § 314(b) (2005), effective in cases commenced on or after October 17, 2005.

n40

40. *11 U.S.C. § 1325(b)(4).*

n41

41. *11 U.S.C. § 1325(b)(3).*

n42

42. *11 U.S.C. § 1326(a).*

n43

43. *See 11 U.S.C. § 521(f).*

n44

44. *11 U.S.C. § 727(a)(8).*

n45

45. *11 U.S.C. § 1328(f)(1).*

n46

46. *11 U.S.C. § 1328(f)(2).*

n47

47. *11 U.S.C. §§ 727(a)(11), 11 U.S.C. § 1328(g).*

n48

48. 11 U.S.C. § 101(14A).

n49

49. 11 U.S.C. § 362(b)(2).

n50

50. 11 U.S.C. § 523(a)(5).

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183 of 197 DOCUMENTS

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Collier on the Appointment of a Patient Care Ombudsman

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Collier on the Appointment of a Patient Care Ombudsman

By Collier

November 16, 2007

SUMMARY: Section 1104 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act) added section 333 to the Bankruptcy Code. Section 333 contains specific provisions regarding the appointment of a patient care ombudsman within 30 days after the commencement of any health care business bankruptcy case. This Emerging Issues Analysis addresses issues pertaining to the appointment of a patient care ombudsman under the Code.

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ARTICLE: Section 1104 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act) n1 added *section 333 to the Bankruptcy Code*. Section 333 contains specific provisions regarding the appointment of a patient care ombudsman within 30 days after the commencement of any health care business bankruptcy case. This ombudsman is, apparently, to serve as a patient advocate--one who can speak for the consumers of the health care businessss services who might have different interests then those of the health care businessss creditors n2--monitoring the quality of patient care, representing the interests of patients and reporting to the bankruptcy court every 60 days on the status of patient care in the debtors health care business.

The appointment of an ombudsman is mandatory unless the court finds that the appointment is not necessary for the protection of patients under the specific facts of the case. n3 Yet, the bankruptcy court has no inherent mechanism to determine whether facts exist that would argue against the appointment of an ombudsman. Thus, the bankruptcy court presumably will appoint an ombudsman unless, before the appointment, the debtor or another party in interest files a timely motion requesting a determination that the appointment is not necessary. Any hearing on the motion should be an evidentiary hearing because the bankruptcy court could not, without specific evidence, decide that the facts do not warrant the appointment of an ombudsman. Facts that warrant a decision not to appoint an ombudsman could include that the facilitys patient care is of high quality, that the debtor has adequate financial strength to maintain high-quality patient care, that the facility already has an internal ombudsman program in operation or that the situation at the facility is adequately monitored already by federal, state, local or professional association programs so that the ombudsman would be redundant.

Section 333(a)(1) uses the term for the protection of the patientsⁿ⁴ so that the determination of the bankruptcy court not to appoint an ombudsman must be tied to a decision that the patients are otherwise adequately protected. Section 333 leaves unsaid from what the patient is being protected; presumably, because the section refers to patient care, the protection being provided by section 333 is from the poor medical care because of the disruption caused by the bankruptcy filing, the business's overall financial problems or the transfer of a patient from a closing facility.

Qualifications; non-long term care facility. If the court orders the appointment of an ombudsman other than for a long-term care facility, the United States Trustee appoints the ombudsman.ⁿ⁵ Although the section specifies that the ombudsman must be disinterested,ⁿ⁶ it otherwise does not address the qualifications necessary to serve as an ombudsman. The ombudsman should have to be a person having expertise related to the type of services that the subject health care business provides and is capable of performing the tasks required of the ombudsman. For example, if the debtor were a hospital, rendering an opinion on the quality of patient care might well require a doctor or a hospital administrator, or an organization with such persons as part of the team working on the case to serve as the ombudsman.

Qualifications; long term care facility. If the debtor is a health care business that provides long-term care,ⁿ⁷ then the United States Trustee may appoint the State Long-Term Care Ombudsmanⁿ⁸ from the state in which the case is pending to serve as the ombudsman under section 333.ⁿ⁹ It is unclear how this would work in a practical sense, because the State Long-Term Care Ombudsman program has different responsibilities than section 333 imposes on its ombudsman. The responsibilities of the State Long-Term Care Ombudsman are set out in applicable state statutes. Those responsibilities are, in virtually every state, different from the role of the bankruptcy ombudsman, and there may well be a tension in the execution of the two roles by a single individual or entity. For example, in a bankruptcy case the ombudsman is required to be proactive in evaluating patient care and reporting on it to the bankruptcy court. In contrast, the State Long-Term Care Ombudsman programs are generally designed to advocate for patients and their families by investigating complaints and assisting patients and their families in resolving disputes with long-term care facilities. State ombudsmen are neither trained nor expected to conduct comprehensive reviews of facility programs or care, or to evaluate the quality of patient care in the absence of specific complaints or issues. Further, some state statutes limit the authority of the State Long-Term Care Ombudsman to its older or elderly citizens.ⁿ¹⁰ Finally, in most states the Long-Term Care Ombudsmen's offices are primarily staffed with volunteers, some with little formal training in health care industry practices. If a long-term care facility in a bankruptcy case in such states provides services to patients who do not fall within the responsibilities of the State Long-Term Care Ombudsman, or if such state ombudsmen's staff is not competent to perform the responsibilities of the bankruptcy ombudsman, the bankruptcy court should not appoint the State Long-Term Care Ombudsman to serve as the ombudsman under section 333. At a minimum, the State Long-Term Care Ombudsman would have to be able to accept a position supplementary to that held under state law, which could be inconsistent with applicable nonbankruptcy law or regulations.

Another tension with the appointment of the State Long-Term Care Ombudsman to serve as the ombudsman under section 333 is that the section expressly states that the United States trustee can only appoint a single person as the ombudsman.ⁿ¹¹ Because person is defined in the Bankruptcy Code as including partnerships and corporations,ⁿ¹² a corporation could be appointed and have representatives inspect facilities in multiple states. More likely a person from an organization, as is the practice with examiners, will be appointed, and that person will retain professionals to assist in the discharge of his or her responsibilities. However, the authority of the State Long-Term Care Ombudsman is limited to the state that appointed the ombudsman, and the appointing state may be reluctant to have the energies and resources of the State Long-Term Care Ombudsman focused, even in part, on facilities outside the state's borders. Thus, if appointed in the bankruptcy of a multistate health care business, the State Long-Term Care Ombudsman would likely not be able to discharge the bankruptcy-court imposed duties outside of the ombudsmen's home state.

If the United States trustee does not appoint a State Long-Term Care Ombudsman, the bankruptcy court is directed to notify the appropriate State Long-Term Care Ombudsman of the name and address of the person who has been appointed. This notification may well be nothing more than service of the order appointing the ombudsman.

Duties of the Ombudsman. The duties of the ombudsman are (1) to monitor the quality of patient care and (2) to

represent the interests of the patients of the health care business. n13 These responsibilities are broad. Thus, section 333 provides wide authority for the ombudsman to review the operations of a health care business. The latter duty is broad enough to allow the ombudsman to review virtually every business decision a health care business debtor makes, so long as the ombudsman can articulate an interest of the patients in the outcome of the decision. Certainly the scope is broad enough that the ombudsman will be able to review and comment on decisions such as the closure of any facility, the sale of any portion of the facility and the increase or decrease in the scope of any services rendered by a health care business to its patients.

Confidentiality of Patient Information. The obligation to monitor the quality of patient care provided to patients of the debtor includes an express authorization allowing the ombudsman to interview patients and physicians. n14 However, such an authorization does not, by itself, allow the ombudsman to review confidential patient records or information. In fact, section 333 expressly provides that the ombudsman may not review confidential patient records unless the bankruptcy court approves such review in advance and imposes restrictions on the ombudsman to protect the confidentiality of such records. n15 State law and doctor-patient privilege will certainly be implicated. The ombudsman also may be required to comply with the federal Health Insurance Portability and Accountability Act of 1996 (HIPAA), n16 which sets a national standard for privacy of protected health information (PHI), in any format, including paper, electronic and even oral. If HIPAA applies to the debtors patient records, the ombudsman would have to comply with HIPAA's requirements before obtaining any information.

If the United States trustee appoints the State Long-Term Care Ombudsman, that ombudsmans access to patient records remains whatever it is under applicable nonbankruptcy law. n17 In some states, the ombudsmans access is quite limited absent patient consent; for example, numerous states appear to require patient consent prior to review of the patients records. In states with such laws, the State Long-Term Care Ombudsman has access to records only if the patient or the patients legal representative signs a valid authorization and release, or in some cases, in an emergency or pursuant to court order. n18

The Ombudsmans Reporting Obligations. The ombudsman is required to report to the bankruptcy court every 60 days after the appointment regarding the quality of patient care provided to patients of the debtor. n19 The report can be submitted in writing or presented orally at a hearing, but either means of reporting must be noticed to interested parties. The initial report on the quality of patient care of a health care business of significant size could be voluminous and costly. Subsequent reports would likely be limited to reporting only changes in patient care occurring after the previous report. Section 333 does not address immunity from prosecution for acts of the ombudsman. Thus, if the ombudsman issues a report critical of the quality of care provided by the debtor health care business and the report is publicized and results in destruction of the debtors business, the ombudsman may be liable to the estate for any errors in the report. Moreover, because such report would have to be mindful of the limits of patient confidentiality, the report may have to be vague as to the details of issues related to any specific patients care.

If the ombudsman determines that the quality of patient care provided to patients of the debtor is declining significantly or is otherwise being materially compromised, the ombudsman is directed to file either a motion or a written report, again with appropriate notice to parties in interest immediately upon making such determination. n20 If the ombudsman provides notice to interested parties, that notice should be of the filing of the motion or written report, rather than of the ombudsmans reaching the conclusion that such a report or motion is required, which is what the strict language of section 333 seems to require. Bankruptcy courts should expect that the ombudsman will, upon determining that the quality of patient care is declining significantly or is otherwise materially compromised, promptly file a motion or written report and immediately give notice of the filing to interested parties. While section 333's reference to a report in such circumstances is unremarkable, its language gives no guidance as to what relief a motion would be authorized to seek, e.g., the appointment of a trustee, an order compelling the debtor to take some specific action to remedy the situation or conversion of the case to chapter 7 from chapter 11.

Compensation for the Ombudsman. The 2005 Act provides that compensation for the ombudsman is at the expense of the estate. n21 The Act provides that the ombudsman may be awarded reasonable compensation for actual,

necessary services rendered by the ombudsman and by any paraprofessional employed by the ombudsman. n22 Section 333 does not expressly state that the ombudsman can retain counsel or professionals to assist in the discharge of the ombudsmans duties, but if the ombudsman decides to file motions in accordance with the statute, or becomes involved in an evidentiary hearing defending a determination that the quality of health care is declining, representation by an attorney would be necessary and such counsel fees should be paid by the estate as a necessary expense of the ombudsman. If the health care business is large or complicated, the ombudsman could be expected to retain professionals to assist in the discharge of the ombudsmans duties.

Compensation for the ombudsman should be analogous to compensation for examiners and the their professionals, except for one difference that results from the revisions to the Bankruptcy Code and may well be a drafting error. Section 330(a)(3) provides that in determining the amount of reasonable compensation to be awarded to an examiner, trustee or professional person, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including, generally, time, rates, whether the services were necessary, whether the services were performed in a reasonable amount of time and whether the compensation is reasonable. n23 The omission of ombudsmen from section 330 should not be construed as removing their compensation from the bankruptcy courts oversight under these factors. Another apparent omission from the necessary revisions to the Bankruptcy Code related to the ombudsmans compensation can be found in section 331, which permits trustees, examiners and professional persons to receive interim compensation during a bankruptcy case. n24 There is no logical reason why an ombudsman appointed under section 333 should not be entitled to interim compensation in the same manner as an examiner, and it is likely this omission is merely an oversight rather than an intentional omission by the 2005 Act.

The plain language of section 330 suggests that the estate could be liable to reimburse the State Long-Term Care Ombudsmans office for the work done by that person when serving as the estates ombudsman. Applicable state ethics laws, however, may prohibit such payments. These laws generally prohibit any state employee, officer or official from taking private funds for fulfilling their governmental duties. n25 However, payments may, in some circumstances, be made to the state directly to reimburse it for the fees and expenses incurred by the State Long-Term Care Ombudsman while fulfilling the ombudsman duties under section 333. Alternatively, states may simply not require reimbursement for such expenses.

For a complete discussion of Code section 333, see Collier on Bankruptcy, ch. 333.

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[Return to Text](#)

n1 1. Pub. L. No. 109-8, § 1104(a)(1) (2005), effective in cases commenced on or after October 17, 2005.

n2

2. Bankruptcy Reform Act of 1999, 145 Cong. Rec. S14,052-14,057, 14,059, 106th Cong. (1st Session,

1999) (remarks of Senator Leahy on prior Senate bill with similar provisions: [This] amendment establishes an ombudsman to provide a voice for all health care patients, making sure that judges are well aware of all the facts in balancing the interests between the creditor and the patients.").

n3

3. 11 U.S.C. § 333(a)(2)(A).

n4

4. *Id.*

n5

5. 11 U.S.C. § 333(a)(2)(A).

n6

6. *Id.*

n7

7. Long-term care is defined as a range of medical and/or social services designed to help people who have disabilities or chronic care needs. Services may be short- or long-term and may be provided in a person's home, in the community, or in residential facilities (e.g., nursing homes or assisted living facilities)." <http://aspe.hhs.gov/daltcp/diction.shtml#LTC>.

n8

8. A State Long-Term Care Ombudsman is defined under the Older Americans Act as an individual designated by a state or a substate unit responsible for investigating and resolving complaints made by or for older people in long-term care facilities. Also responsible for monitoring federal and state policies that relate to long-term care facilities, for providing information to the public about the problems of older people in facilities, and for training volunteers to help in the ombudsman program." <http://aspe.hhs.gov/daltcp/diction.shtml#LTC>. The long-term care ombudsman program is authorized by title III of the Older Americans Act, Pub. L. No. 106 501. In 1978, Congress amended the Older Americans Act to include a requirement that each state develop a Long-term Care Ombudsman Program. There are approximately 53 State Long-Term Care Ombudsman

Programs which have additional statewide networks of almost 600 regional and local programs. A good source of information on these programs is the National Long Term Care Ombudsman Resource Center, whose Web site is at <http://www.ltombudsman.org/default.cfm>. That Web site also contains information on The National Association of State Long-term Care Ombudsman Programs and the National Association of Local Long Term Care Ombudsmen.

n9

9. 11 U.S.C. § 333(a)(2)(B).

n10

10. *See, e.g.*, Ala. Stat. § 44.21.200-240.

n11

11. 11 U.S.C. § 333(a)(2)(A) (If the court orders the appointment of an ombudsman the United States shall appoint 1 disinterested person to serve as such ombudsman.").

n12

12. 11 U.S.C. § 101(41).

n13

13. 11 U.S.C. § 333(a)(1).

n14

14. *Id.*

n15

15. 11 U.S.C. § 333(c)(1).

n16

16. Pub. L. No. 104-191 (1996). To be a covered entity under HIPAA, a health care provider must engage in HIPAA electronic transactions, e.g., health care claims. HIPAA allows a covered entity (or a trustee standing in the shoes of the covered entity) to disclose PHI without patient authorization for health care operations, which is broadly defined to include, among other things, business management and general administrative of the entity." *See 45 C.F.R. § 164.501*. There is no guidance on this point, but arguably the transfer of patient records to the ombudsman in bankruptcy is part of health care operations. This position makes sense from a policy standpoint, since allowing the transfer would ensure availability of the records with the overall goal of protecting the patient's interests, although the ombudsman would have to become a covered entity under HIPAA, and would, therefore, be bound by HIPAA to protect the confidentiality of the PHI.

n17

17. *11 U.S.C. § 333(c)(2)*.

n18

18. See, e.g., Ala. Code §§ 22-5A-1 through 22-5A-7.

n19

19. *11 U.S.C. § 333(b)(2)*.

n20

20. *11 U.S.C. § 333(b)(3)*.

n21

21. *11 U.S.C. § 330(a)(1)*.

n22

22. 11 U.S.C. § 330(a)(1)(A).

n23

23. 11 U.S.C. § 330(a)(3).

n24

24. 11 U.S.C. § 331.

n25

25. *See, e.g.*, Ohio Rev. Code Ann. § 102.04.

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184 of 197 DOCUMENTS

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Collier on Disposal of Patient Records

2008 Emerging Issues 976

Collier on Disposal of Patient Records

By Collier

November 16, 2007

SUMMARY: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act) added section 351 to the Bankruptcy Code. Section 351 contains specific provisions for the disposal of patient records in a bankruptcy case. In the health care industry, patients records are vitally important documents. This Emerging Issues Analysis addresses issues pertaining to the disposal of patient records under section 351 of the Code.

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ARTICLE: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act) n1 added *section 351 to the Bankruptcy Code*. Section 351 contains specific provisions for the disposal of patient records in a bankruptcy case. In the health care industry, patients records are vitally important documents. Patient records can contain a patients entire medical history and information crucial to future care, including allergies to certain antibiotics, such as penicillin. Thus, loss or destruction of a patients records can have a devastating impact on a persons ability to obtain the best, or even appropriate, medical treatment in a particular situation. In order to manage the myriad patient-related records, providers of medical services, including doctors and hospitals, rely on traditional paper files, but with increasing frequency also rely on sophisticated electronic medical records or computer based systems. Applicable nonbankruptcy law and regulations require that these records be handled with the utmost confidentiality, and frequently require the storage of such records for long periods. n2

Section 351 of the Bankruptcy Code addresses a perceived need by providing specific requirements for the disposal of patient records that apply only if, in the bankruptcy case of a health care business, the trustee n3 has insufficient funds to pay for the storage of patient records in the manner required under applicable federal or state law. n4 Essentially, this section provides a uniform mechanism for the trustee to dispose of the records under certain circumstances, preempting applicable nonbankruptcy laws, and thereby protects trustees from potential liability under federal and state laws controlling the disposition of patient records. n5

The Scope of Patient Records. The application of section 351 is dependent on the definition of three terms: patient, patient records, and health care business. These terms were added to the Bankruptcy Code as part of the 2005 Act, so their exact scope remains subject to future judicial interpretation. However, even a cursory review of these

definitions reveals imprecise language that will likely lead to confusion and litigation in the application of this section. For example, the definition of patient records appears to be written to include health care business records not related to patients at all. n6 The definition of patient includes anyone who receives services from a health care business, but those services do not have to relate to health care. n7 Although the exact scope of what is a health care business remains untested in the courts, at least one proponent of prior similar legislation thought it extended to any institution holding medical records, n8 which could include a records storage facility.

On its face, the definition of patient records includes a variety of documents unrelated to the patients medical treatments, including financial and billing records. If courts apply the definition literally, it might confuse health care business debtors because the industry has its own widely accepted definition of patient records, and health care businesses must comply with state laws that contain their own definitions of patient records. For example, the Guidelines for Defining the Health Record for Legal Purposes, created by the American Health Information Management Association (AHIMA), n9 divide health records into four categories and draw a distinction between legal-medical records, patient-identifiable source data (such as a videotape of a doctor-patient encounter), administrative records and information derived from any of those (such as statistical evaluations of a population that do not identify individual patients). On the other hand, California state law defines patient records as

any records in any form or medium maintained by, or in the custody or control of, a health care provider relating to the health history, diagnosis, or condition of a patient, or relating to treatment provided or proposed to be provided to the patient Patient records does not include information given in confidence to a health care provider by a person other than another health care provider or the patient, and that material may be removed from any records prior to inspection or copying Patient records does not include information contained in aggregate form, such as indices, registers, or logs. n10

Thus, if the purpose of the legislation is to ensure that a patients medical records are not disposed of in violation of confidentiality requirements and to the detriment of continuity of medical care, section 351 is too broadly written. It will, therefore, increase the costs associated with closing a facility, because it creates a costly and cumbersome mechanism for the disposition of records which is beyond the intent of the Congress.

Procedure for the Disposition of Patient Records. Section 351 provides a detailed procedure to be followed in order for the trustee to obtain authorization to destroy patient records. Generally, it requires the trustee to publish notice of the intended disposition of the records in newspapers, give written notice directly to patients and their insurance providers and, if the records are not claimed within a year, give notice to an agency of the federal government requesting that it accept the patient records or, if the agency will not accept delivery of the records, of the trustees intent to destroy the patient records. If, after this process is completed, the records remain unclaimed, section 351 explains how the trustee is to destroy the records. Section 351 should not apply when the health care business is sold to another health care business, unless the purchaser refuses to include the patient records in the assets being purchased. If the health care business is sold to a non-health care business, or the purchaser does not purchase the patient records as part of the acquired assets, section 351 would apply.

Notice of the intended disposition must be published notice in at least one appropriate newspaper. n11 Presumably an appropriate newspaper would depend on the geographical scope of the health care business; a national newspaper would be required for a national business, while local newspapers would suffice for health care businesses operating in more limited geographical areas. Section 351 requires only a single publication. The notice must explain that patient records that are not claimed by the patient or insurer within 365 days of the publication of the notice will be destroyed. n12 This notice is not completely accurate, because, as described below, at the end of the 365 days the trustee must still give notice to appropriate federal agencies and wait for a response before the trustee can actually destroy the records. The notice must also explain that an insurance provider can claim the records as well, if applicable nonbankruptcy law permits the insurance provider to do so. n13 However, in providing this notice and, if necessary, responding to the

insurance providers demand for the patient records to be turned over to it, the trustee must be cognizant of the potential application of the federal Health Insurance Portability and Accountability Act of 1996 (HIPAA),ⁿ¹⁴ which sets a national standard for privacy of protected health information (PHI), in any format, including paper, electronic and even oral. The general rule is that a HIPAA-covered entity should only disclose the minimum information necessary to the insurance provider. This requirement will have to be satisfied before the trustee can release the patient records to the insurance provider under HIPAA. Other than notice of the need to claim the records or have them destroyed, section 351 offers no details on what must be included in the notice to describe the patient records. For most debtors, publishing a patient list may be prohibitively expensive and time-consuming. Additionally, publishing a patient privacy list may infringe on patient privacy rights.

Within 180 days of the publication of the notice, the trustee is required to mail a notice to the patients of the health care business, at the most recent known address of that patient, or a family member or contact person for that patient, notifying the patient of the estates possession of patient records and of its intent to destroy them absent someone coming forward to claim the records.ⁿ¹⁵ The trustee is also required to mail the same notice to the patients appropriate insurance carrier.ⁿ¹⁶ While this is not overly burdensome for many debtors, in the case of a large health care business it may result in thousands of notices and a significant burden on the debtors staff to identify patients treated many years before commencement of the bankruptcy case. Because section 351 uses the term most recent known address,ⁿ¹⁷ the trustee should not be required to do any independent research to find addresses for former patients in response to returned mail. Section 351 does not discuss giving notice to state agencies, although many states have laws requiring notice from health care businesses when they are disposing of patient records.ⁿ¹⁸ Trustees should be cognizant of such requirements and comply with them.ⁿ¹⁹ Nothing in section 351 seems to preempt state laws on this issue.

If the patient records are not claimed within 365 days of the publication notice, the trustee is required to mail a written request, by certified mail, to each appropriate federal agency to request permission from that agency to deposit the patient records with that agency.ⁿ²⁰ The text of section 351 indicates that the trustee must wait until the 365-day period has expired before sending the request to the federal agency. Yet, the section does not create any requirement that a federal agency accept patient records tendered by the trustee, and does not provide any guidance to the trustee as to which federal agencies would be appropriate. The Centers for Medicare and Medicaid Services may be a logical agency to contact. Section 351 does not indicate how long the trustee should give the federal agency to make a decision. Presumably, the appropriate time to wait for a response will be a reasonable one, as determined by the trustee. If the estate is operating on a severely limited budget, the reasonable time available to the trustee to wait for a decision may be equally limited.

Interestingly, although some states allow a health care business to deposit patient records with the appropriate state department when the business closes,ⁿ²¹ section 351 only refers to federal agencies. Thus, section 351 could be read to foreclose the trustees option of transferring the patient records to a state agency rather than destroying them. A more reasonable reading of section 351, however, is that it does not preempt that option. Rather, if the applicable state law allows the trustee to transfer the patient records to the state for storage, the cost to the estate should be minimal, and the likelihood will be low that the estate will not have sufficient funds to comply. Therefore, section 351 will not be invoked because the trustee will have sufficient funds to pay for storage of the records in the manner required under applicable Federal or State law. Thus, a viable alternative to invoking section 351 in some states may be for the trustee to dispose of patient records by delivering them to the appropriate state agency under applicable state law.

If the patient records are not claimed by a patient or an insurance provider, or accepted by a federal agency, the trustee shall destroy the records.ⁿ²² If the records are written, shredding or burning the records is required.ⁿ²³ If the records are magnetic, optical or other electronic records, the trustee must destroy those records by a means so that those records cannot be retrieved.ⁿ²⁴

Cost of Record Storage or Disposal. In order to apply section 351, the trustee must show that the estate does not have a sufficient amount of funds to pay for the storage of patient records in the manner required under applicable federal or state law.ⁿ²⁵ Because the storage time required may be lengthy, the costs of storing even modest amounts of

records can be high. To determine whether the estate has sufficient funds, the trustee must first calculate the cost of storing the estate's patient records. These costs can include labor, storage boxes, transportation costs, storage and retrieval costs for the required retention period.

The trustee must then decide the priority to which payment of the storage fees is entitled. Section 351 does not address this issue. The most reasonable view is that storage fees should be considered an administrative cost, as an actual, necessary cost of preserving the estate under section 503(b)(1)(A).ⁿ²⁶ This argument is bolstered by the application of 28 U.S.C. § 959, which requires debtors to comply with applicable state law when operating in bankruptcy.ⁿ²⁷ If state law requires the trustee to store the patient records postpetition, presumably compliance with that law is an actual and necessary expense of preserving the estate.ⁿ²⁸ This status would require the trustee to pay the storage costs *pari passu* with other costs of preserving the estate, and ahead of all other types of administrative expenses, including professional fees.

Section 351 is silent on whether the trustee is to seek bankruptcy court review and approval of the determination that section 351 can be invoked. However, a prudent trustee is likely to file a motion seeking approval of the determination to invoke section 351 and the form of the proposed notice. Notice of this motion should be served, at a minimum, on appropriate federal and state agencies.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended section 503 to allow as an administrative expense the costs and expenses incurred in disposing of patient records in accordance with section 351 by a trustee or a federal, state or municipal government, but only if that disposal was part of the actual, necessary costs and expenses of closing a healthcare business.ⁿ²⁹ This change was necessary to respond to rulings that suggested that if governmental entities or trustees incurred costs in closing a health care business, such costs, because they were incurred in the act of closing the facility, were not entitled to treatment as a expense of the administrative of the estate.ⁿ³⁰ Section 503 as amended does not apply to the disposal of patient records if the health care business does not close.

For a complete discussion of Code section 351, see Collier on Bankruptcy, ch. 351

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ⁿ¹ 1. Pub. L. No. 109-8, § 1102(a) (2005), effective in cases commenced on or after October 17, 2005.

ⁿ²

2. See Nancy A. Peterman, *Intensive Care: Protecting Patients Rights in Health Care Bankruptcies*, 17 Am. Bankr. Inst. J. 10, at 10 & n.3 (1998). Medicare regulations generally require that providers of Medicare services keep their records for at least five years from the date of settlement of the claim against Medicare for payment. For example, hospital medical records must be maintained for at least five years. 42 U.S.C. § 1395cc(a)(1)(I)(ii)(2005); 42 C.F.R. § 482.24(b)(1)(2005). California statutes require that certain providers of health services, if they cease operations, preserve records for a minimum of seven years after the discharge of the patient, except that records of minors must be maintained for at least one year after the minor reaches the age of 18, and in any event for no less than seven years, which can require storage for 25 years. See Cal. Health &

Safety Code § 123145(a). Massachusetts requires retention of certain medical records for 30 years. *See* Mass. Ann. Laws ch. 111, § 70. Minnesota requires certain medical records to be retained permanently. *See* Minn. Stat. §§ 145.30, 145.32, 147.091.

n3

3. Although section 351 expressly refers only to a trustee, it applies equally to a debtor in possession. A debtor in possession has all the rights and powers, and performs all the duties and functions of a trustee, unless the Bankruptcy Code expressly states otherwise. *See* 11 U.S.C. § 1107(a).

n4

4. 11 U.S.C. § 351.

n5

5. *See, e.g.*, Cal. Health & Safety Code § 123145(b) (The department or any person injured as a result of the licensee's abandonment of health records may bring an action in a proper court for the amount of damage suffered as a result thereof. In the event that the licensee is a corporation or partnership that is dissolved, the person injured may take action against that corporation's or partnership's principal officers of record at the time of dissolution.).

n6

6. 11 U.S.C. § 101(40B).

n7

7. 11 USC § 101(40A).

n8

8. *Bankruptcy Reform Act of 1999*, 145 Cong. Rec. S. 14052-07, 14059, 106th Cong. (1st Session, 1999) (remarks of Senator Leahy on prior Senate bill with similar provisions).

n9

9. See AHIMAs Web site at
http://library.ahima.org/xpedio/groups/public/documents/ahima/pub_bokl_009223.html

n10

10. Cal Health & Safety Code § 123105(d).

n11

11. 11 U.S.C. § 351(1)(A).

n12

12. *Id.*

n13

13. *Id.*

n14

14. Pub. L. No. 104-191 (1996). HIPAA applies to health care providers, facilities or clearinghouses if they conduct HIPAA electronic transactions as defined in 45 C.F.R. § 160-103 (2005) (e.g., submitting health care claims). Medicare requires entities with more than 25 full-time employees to bill electronically, so HIPAA applies to all but small health care businesses. HIPAA allows a covered entity (or a trustee standing in the shoes of the covered entity) to disclose PHI without patient authorization for health care operations, which is broadly defined to include business management and general administration of the entity. *See 45 C.F.R. § 164.501.* There is no guidance on this point, but arguably transfer of patient records in bankruptcy is part of health care operations. This position makes sense from a policy standpoint, since allowing the transfer would ensure availability of the records, and the insurer, who would also be a covered entity under HIPAA, would be bound by HIPAA to protect the confidentiality of the PHI.

n15

15. 11 U.S.C. § 351(1)(B).

n16

16. *Id.*

n17

17. *Id.*

n18

18. See AHIMA Practice Brief, *Protecting Patient Information after a Facility Closure*, Exhibit 1, available at www.ahima.org (providing a state-by-state list of laws, regulations or guidelines pertaining to facility closure and disposition of patient records).

n19

19. See 28 U.S.C. § 959(b).

n20

20. 11 U.S.C. § 351(2).

n21

21. See Nancy A. Peterman, *Intensive Care: Protecting Patients Rights in Health Care Bankruptcies*, 17 Am. Bankr. Inst. J. 10, at 10 n.4 (1998); see also, e.g., Miss. Code Ann. § 41-9-79 (directing that, if no other hospital in the vicinity is willing to accept and retain the medical records, they are to be delivered to the state licensing agency); Tenn. Code Ann. § 68-11-308 (providing that if a hospital closes it must surrender its records to the Tennessee Department of Health); Wyo. Stat. Ann. § 9-2-408 (requiring that when publicly funded hospitals or nursing homes cease to operate, records are transferred to the state archives).

n22

22. 11 U.S.C. § 351(3).

n23

23. 11 U.S.C. § 351(3)(B).

n24

24. *Id.*

n25

25. 11 U.S.C. § 351.

n26

26. 11 U.S.C. § 503(b)(1)(A).

n27

27. 28 U.S.C. § 959(b) provides that a trustee shall manage and operate the property in his possession according to the requirements of the valid laws of the State in which such property is situated . *See, e.g., MidAtlantic Natl Bank v. New Jersey Dept of Env'tl. Protection*, 474 U.S. 494, 505, 106 S. Ct. 755, 761, 88 L. Ed. 2d 859, 859 (1986).

n28

28. *See, e.g., Reading Co. v. Brown*, 391 U.S. 471, 483-84, 88 S. Ct. 1759, 1766, 20 L. Ed. 2d 751, 758 (1968) (administrative expenses include those ordinarily incident to operation of a business, and not [solely] costs without which rehabilitation would be impossible).

n29

29. 11 U.S.C. § 503(b)(8)(A).

n30

30. See *In re Allen Care Centers, Inc.*, 163 B.R. 180, 183-89 (Bankr. D. Or. 1994), *affd*, 175 B.R. 397, 399-400 (D. Or. 1994). In *Allen Care Centers*, the debtor decided to shut down one of its three nursing homes, and the state assumed responsibility for the facility during its shutdown and transfer of its patients. It then sought payment of its costs as an administrative expense. The bankruptcy court denied its request, rejecting its argument that expenses incurred by a governmental entity in assuring the public health and safety upon liquidation of Chapter 7 estate property would be entitled to an administrative priority.

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Limitations on Automatic Stay Under Subsections 362(c)(3) and (4) of the Code

2008 Emerging Issues 977

Collier on Limitations on Automatic Stay Under Subsections 362(c)(3) and (4) of the Code

By Collier

November 16, 2007

SUMMARY: For debtors who have had prior bankruptcy filings dismissed within one year of a current filing, subsections 362(c)(3) and 362(c)(4) set some limits on the duration and effect of the automatic stay. This Emerging Issues Analysis discusses issues pertaining to the limitations on the automatic stay under 362(c)(3) and (4), including a prior dismissed case within a year of filing, and two or more dismissed cases within a year of filing.

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ARTICLE: For debtors who have had prior bankruptcy filings dismissed within one year of a current filing, subsections 362(c)(3) and 362(c)(4) set some limits on the duration and effect of the automatic stay. Section 362(c)(3) limits the duration of the automatic stay in a case filed by a debtor who has had a prior case dismissed within the year. Section 362(c)(4) prevents the automatic stay from taking effect in a case filed by a debtor who has had two or more prior cases dismissed within the year.

Prior Dismissed Case Within Year of Filing; § 362(c)(3). Section 362(c)(3) limits the duration of the automatic stay in a case filed by a debtor who has had a prior case dismissed within the year. n1 If a single or joint case is filed by or against an individual debtor under chapter 7, 11 or 13, and the debtor has had a prior single or joint case that was pending within the preceding one-year period and was dismissed, the automatic stay provided under section 362(a) with respect to any action taken in relation to a debt or property securing such debt, or to any lease, expires with respect to the debtor on the 30th day after the filing of the later case.

There are certain limitations arising from the express wording of subsection 362(c)(3). First, the stay terminates under this provision only with respect to the debtor. As in other provisions in section 362, Congress sought in subsection 362(c)(3) to distinguish between actions taken against property of the debtor and property of the estate. n2 This intent to limit the stay termination to actions against the debtor is made abundantly clear when the language in subsection (c)(3) is compared to the much broader scope of the parallel stay termination provision in subsection 362(c)(4) n3 for a debtor who has had two dismissed cases within the prior year, particularly since both provisions were enacted at the same time as part of the 2005 amendments. n4 Thus, if there has been a stay termination based on the operation of subsection (c)(3) in a case filed within a year of a prior dismissal, the automatic stay provided under

section 362(a) continues to apply in that case as to actions taken against property of the estate, but not as to actions against the debtor or property of the debtor that is not property of the estate. n5 Second, as a result of the absence in the 2005 amendments of any express or implied limitation on section 1301, subsection 362(c)(3) does not prevent the application of the codebtor stay in a chapter 13 case. Thus, the stay provided under section 1301 applies irrespective of subsection 362(c)(3) as to any consumer debt of the debtor with respect to actions taken against a codebtor on the debt. Third, the stay limitation under subsection 362(c)(3) does not apply in a case filed under chapter 11 or 13 following the dismissal of a prior chapter 7 case under section 707(b). Finally, the stay limitation does not apply in a case brought by a family farmer under chapter 12.

The pending but dismissed language in subsection (c)(3) has caused one court to consider when a case is no longer pending in the not uncommon situation where the clerk of the court does not complete the administrative function of closing a case until sometime after an order of dismissal. In *In re Moore*, n6 the debtor's previous case was dismissed prior to the one-year period, but the case remained open after dismissal and was eventually closed by the court during the one-year period. To determine whether subsection (c)(3) applied, the court referred to the definition of pending found in *Black's Law Dictionary*, which defines the word as remaining undecided: awaiting decision. n7 This definition, the court noted, suggests that a case is no longer pending after dismissal; once the case has been dismissed, there is nothing undecided remaining. n8 In addition, since the word pending is also used in section 109(g), the court referred to decisions that have counted the 180-day period in that section from the date of dismissal of the prior case, not the date the case is closed. n9 The court in *Moore* therefore concluded that the case dismissal date, rather than the closing date, is controlling for purposes of applying subsection (c)(3).

In a further parsing of the statutory language, the court in *In re Paschal* n10 sought to determine the type of actions which are no longer stayed if subsection (c)(3) is applicable, based on the phrase with respect to any action taken. By comparing Congress's varying use of the word act n11 and action n12 in section 362, the court concluded that Congress must have intended a different and more limited meaning for the words action taken. Thus, the court held that subsection (c)(3) terminates the automatic stay only as to creditors who have taken a specific action against the debtor, which must be some formal judicial, administrative or similar undertaking. n13 In addition, since the word taken is used, which the *Paschal* court construed as meaning an action in the past, the court found that the creditor's formal action which is stayed under subsection (c)(3) must occur before the filing of the petition. n14

Section 362(c)(3)(B) provides that upon motion of a party in interest, and after notice and hearing completed within the 30-day period before the expiration of the stay, the court may continue the automatic stay if such party demonstrates that the later case has been filed in good faith as to the creditors stayed by the filing. In determining whether the case has been filed in good faith, the court shall consider whether the presumption set out in section 362(c)(3)(C) that the case was not filed in good faith is applicable, and, if so, whether the moving party has rebutted the presumption with clear and convincing evidence to the contrary. Section 362(c)(3)(C)(i) provides that the later case is presumed to be filed not in good faith, as to all creditors in the case, if:

-- more than one previous case under chapter 7, 11 or 13 filed by or against the debtor was pending within the preceding one-year period;

-- the prior chapter 7, 11 or 13 case was dismissed within the preceding one-year period after the debtor failed to (a) file or amend without substantial excuse the petition or any required documents, (b) provide adequate protection ordered by the court, or (c) perform the terms of a confirmed plan; or

-- there has not been a substantial change in the debtor's financial or personal affairs since the dismissal of the prior case, or there has not been any other reason to conclude that the later case will be concluded either with a discharge if it is a chapter 7 case or with a confirmed plan that will be fully performed if it is a chapter 11 or 13 case.

The presumption under this subsection arising due to a prior dismissal following the debtor's failure to file or amend the petition or other required documents is applicable only if the debtor's actions are without substantial excuse.

n15 This provision states that mere inadvertence or negligence on the part of the debtor shall not be a substantial excuse, unless the dismissal was caused by the negligence of the debtor's attorney. In addition, section 362(c)(3)(C)(ii) provides that the later case is presumed to be filed in bad faith as to any creditor who sought relief from the automatic stay in the prior case of the debtor and the stay relief motion was, at the time of dismissal of the prior case, pending before the court or resolved with an order terminating, conditioning or limiting the stay. The presumption created by section 362(c)(3)(C), however, does not apply if the prior case is dismissed because the debtor has entered into a debt repayment plan. Section 362(i) provides that if a case filed under chapter 7, 11, or 13 is dismissed due to the creation of a debt repayment plan, any subsequent case shall not be presumed to have been filed by the debtor with a lack of good faith. n16 Unlike the prepetition credit counseling requirement for individual debtors found in section 109(h), or the claim reduction provision found in section 502(k), section 362(i) does not require that the debt repayment plan be proposed or negotiated by an approved nonprofit budgeting and credit counseling agency. n17 This provision also does not require that the debt repayment plan be successfully completed by the debtor.

Two or More Dismissed Cases Within Year of Filing; § 362(c)(4). Section 362(c)(4) prevents the automatic stay from taking effect in a case filed by a debtor who has had two or more prior cases dismissed within the year. n18 If a single or joint case is filed by or against an individual debtor under any chapter of title 11, and the debtor has had two or more single or joint prior cases that were pending within the preceding one-year period and were dismissed, the automatic stay provided under § 362(a) shall not go into effect upon the filing of the later case. For this stay limitation to apply, at least two prior cases filed under any chapter must have been pending and subsequently dismissed during the one-year period. In contrast with section 362(c)(3), and due to an apparent drafting error, this subsection applies to cases other than a case refiled under section 707(b). The meaning of this phrase is unclear since cases are not filed under section 707(b). It was likely intended to provide, as under section 362(c)(3), that the subsection's stay limitation does not apply in a case filed under a chapter other than chapter 7 following the dismissal of a prior chapter 7 case under section 707(b).

In practice, section 362(c)(4) operates much as a stay exception does under section 362(b), in that it prevents the stay from taking effect upon the commencement of the case. However, unlike the stay exceptions in section 362(b), there is an explicit substantive right and statutory procedure contained within the subsection for a party in interest to seek the imposition of the stay, without the need to invoke the court's injunctive power under section 105. Section 362(c)(4)(B) provides that upon motion of a party in interest filed within 30 days after the filing of the later case, and after notice and hearing, the court may order the automatic stay to take effect as to any or all creditors, subject to conditions or limitations that the court may impose, if such party demonstrates that the later case has been filed in good faith as to the creditors to be stayed by the filing. A stay imposed under section 362(c)(4)(B) shall be effective on the date such an order is entered.

As under section 362(c)(3), a presumption that a case was not filed in good faith may arise under this subsection, subject to rebuttal by clear and convincing evidence to the contrary. Section 362(c)(4)(D) lists the criteria under which the presumption arises, and these criteria are similar to those set out in section 362(c)(3)(C). n19 Section 362(c)(4)(D)(i) states that the later case is presumed to be filed not in good faith, as to all creditors in the case, if:

-- two or more previous cases filed by or against the debtor under any chapter of title 11 were pending within the preceding one-year period;

-- a previous case was dismissed within the preceding one-year period after the debtor failed to (a) file or amend without substantial excuse the petition or any required documents, (b) provide adequate protection ordered by the court, or (c) perform the terms of a confirmed plan; or

-- there has not been a substantial change in the debtor's financial or personal affairs since the dismissal of the prior case, or there has not been any other reason to conclude that the later case will not be concluded either with a discharge if it is a chapter 7 case or with a confirmed plan that will be fully performed if it is a chapter 11 or 13 case. n20

The presumption under this subsection arising if a previous case is dismissed due to the debtor's failure to file or amend the petition or other required documents is applicable only if the debtor's actions are without substantial excuse. n21 This provision states that mere inadvertence or negligence on the part of the debtor shall not be a substantial excuse, unless the dismissal was caused by the negligence of the debtor's attorney. In addition, section 362(c)(4)(D)(ii) provides that the later case is presumed to be filed in bad faith as to any creditor who sought relief from the automatic stay in a previous case of the debtor and the stay relief motion was, at the time of dismissal of such previous case, pending before the court or resolved with an order terminating, conditioning or limiting of the stay.

For a complete discussion of Code section 362, see Collier on Bankruptcy, ch. 362 (Matthew Bender).

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[Return to Text](#)

n1 1. 11 U.S.C. § 362(c)(3), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n2

2. See, e.g., 11 U.S.C. § 362(a)(1) (against the debtor), 11 U.S.C. § 362(a)(2) (against the debtor or against property of the estate), 11 U.S.C. § 362(a)(3) (property of the estate or of property from the estate), 11 U.S.C. § 362(a)(4) (against property of the estate), 11 U.S.C. § 362(a)(5) (against property of the debtor), 11 U.S.C. § 362(a)(6) (against the debtor).

n3

3. 11 U.S.C. § 362(c)(4)(i), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n4

4. See *In re Moon*, 339 B.R. 668, 671 (Bankr. N.D. Ohio 2006) (Had the drafters of this provision intended that the whole of the automatic stay would terminate, they could have easily just referenced § 362(a) as they did in § 362(c)(4)(A) (the stay under subsection (a) shall not go into effect upon the filing of the later case).).

n5

5. *In re Jones*, 339 B.R. 360 (Bankr. E.D.N.C. 2006); *In re Johnson*, 335 B.R. 805 (Bankr. W.D. Tenn.2006).
But see *In re Jupiter*, 344 B.R. 754 (Bankr. D.S.C. 2006).

n6

6. *In re Moore*, 337 B.R. 79 (Bankr. E.D.N.C. 2005).

n7

7. 337 B.R. 79, 81 (citing Black's Law Dictionary 1169 (8th ed. 2004)).

n8

8. *Id.*

n9

9. *Id.* (citing *In re Carty*, 149 B.R. 601 (B.A.P. 9th Cir. 1993); *In re Richardson*, 217 B.R. 479 (Bankr. M.D. La. 1998)).

n10

10. 337 B.R. 274 (Bankr. E.D.N.C. 2006).

n11

11. See, e.g., 11 U.S.C. § 362(a)(3), (a)(4), (a)(5), (a)(6), (c)(1), (c)(2).

n12

12. See, e.g., 11 U.S.C. §§ 362(b)(1), (b)(2)(A), (b)(4), (b)(14), (b)(16), (b)(25)(A)(B), (c)(3)(C)(ii).

n13

13. 337 B.R. 274 , 280.

n14

14. *Id.*

n15

15. 11 U.S.C. § 362(c)(3)(C)(i)(II)(aa), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n16

16. 11 U.S.C. § 362(i), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n17

17. See 11 U.S.C. § 111, added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n18

18. 11 U.S.C. § 362(c)(4), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

n19

19. See 11 U.S.C. § 362(c)(3)(C).

n20

20. In contrast with section 11 U.S.C. § 362(c)(3)(C)(i)(III), and due to an apparent drafting error, the word

not was added to section 11 U.S.C. § 362(c)(4)(D)(i)(III), creating a double negative that affects the meaning of the provision, and produces a result likely not intended by Congress.

n21

21. 11 U.S.C. § 362(c)(4)(D)(i)(II), added by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

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186 of 197 DOCUMENTS

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Succession of Trustee to Rights to Unsecured Creditor under Section 544(b)

2008 Emerging Issues 979

Collier on Succession of Trustee to Rights to Unsecured Creditor under Section 544(b)

By Collier

November 16, 2007

SUMMARY: Bankruptcy Code subsection 544(b) gives the trustee the right to avoid any transfer of the debtor or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under the Bankruptcy Code or by a creditor holding an unsecured claim for reimbursement or contribution that is not allowable only because of section 502(e) of the Code.

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ARTICLE: Bankruptcy Code subsection 544(b) gives the trustee the right to avoid any transfer of the debtor or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under the Bankruptcy Code or by a creditor holding an unsecured claim for reimbursement or contribution that is not allowable only because of section 502(e) of the Code. Excluded from this avoidance power are charitable contributions n1 to qualified religious or charitable entities or organizations to the same extent that they would be excluded from avoidance were the action brought under section 548. n2 The burden is on the trustee seeking to take advantage of this provision to demonstrate the existence of an actual creditor with a viable cause of action against the debtor which is not time barred or otherwise invalid. n3

Need for an Actual Creditor. Under section 544(b), the trustee succeeds to the rights of an unsecured creditor in existence at the commencement of the case who may void the transfer under applicable law. n4 The unsecured creditor need not exist at the time the action is filed; n5 so long as the trustee pleads the existence of a creditor who could have avoided the transfer, n6 the trustee need not identify a specific creditor by name. n7 If there are no creditors against whom the transfer is voidable under the applicable law, the trustee is powerless to act under section 544(b). n8 Thus, if a state can invoke the defense of sovereign immunity against a debtors creditor, the trustee may not pursue an alleged fraudulent transfer made to the state. n9 It is not necessary, however, that there be more than one such creditor. n10 Nor is it requisite that the creditor whose rights the trustee seeks to assert has reduced its claim against the debtor to a judgment, or has issued execution and had it returned unsatisfied as long as the creditor is unsecured. n11

The creditor whose rights the trustee invokes must be one holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title. The requirement found in former

Section 70e, the predecessor of section 544(b), that the creditor whose rights are being relied upon by the trustee be the holder of a provable claim, has been eliminated from this section, as has the entire concept of provability been eliminated from the Code. n12 It is not necessary that the creditor be just a simple contract creditor or a general creditor. The trustee may assert the rights of a judgment creditor where the judgment has not given rise to a lien. n13 The drafters of section 544(b) made it clear that this section overrules those cases that hold [former] Section 70e gives the trustee the rights of secured creditors. n14 A debtor may use the section 544(b) powers after confirmation even though all of the unsecured creditors have been paid. n15

State Law. Although federal law provides the trustee with the rights of an actual unsecured creditor, the extent of the rights is determined entirely by the applicable state or local law. n16 Under section 544(b) the trustee may exercise the rights of creditors under state fraudulent transfer law, n17 or preferential transfer laws. n18 However, the trustee may not pursue every action that may be brought by a debtors creditors. For example, a trustee may not recover treble damages and attorney fees if a voidable transfer violates state criminal law. n19 The trustee may also use the right of any existing creditor to avoid a bulk transfer in violation of state law. n20 The applicable state law limitations period applies to actions brought under section 544(b). n21 The trustee is, as previously noted, also subject to the statute of limitations of section 546(b) of the Code. n22 Thus, the trustee must bring a section 544 action within the applicable state law limitation period, plus any extension provided by section 108 of the Code, but is also subject to the section 546 limitation period. Moreover, if state fraudulent transfer law allows attorneys fees to be awarded to the prevailing party in an avoidance action, a successful defendant may claim its attorneys fees from the bankruptcy estate as an administrative expense. n23

Trustee Subject to Defenses. The general rule is that section 544(b) confers upon the trustee no greater rights of avoidance than the creditor would have if it were asserting invalidity on its own behalf. n24 Consequently, if the creditor is deemed estopped to recover upon a claim, or is barred from recovery because of the running of a statute of limitations prior to the commencement of the case, the trustee is likewise estopped or barred. n25 The general viewpoint has been stated in *Davis v. Willey*, n26 in which the court declared:

It is well established that the effect of this section is to clothe the trustee with no new or additional right in the premises over that possessed by a creditor, but simply puts him in the shoes of the latter, and subject to the same limitations and disabilities that would have beset the creditor in the prosecution of the action on his own behalf; and the rights of the parties are to be determined, not by any provision of the [former] Bankruptcy Act, but by the applicable principles of the common law, or the laws of the state in which the right of action may arise. In other words, the [former] Bankruptcy Act merely permits the trustee the rights which the creditor could assert but for the pendency of the bankruptcy [case], and if, for any reason arising under the laws of the state the action could not be maintained by the creditor, the same disability will bar the trustee. n27

Thus, an election by the creditor prior to commencement of the case to treat the transfer as valid, n28 or an admission in a proceeding prior to commencement of the case with respect to the validity of an obligation, n29 have been held to estop the creditor and in turn the trustee claiming in the creditors stead from asserting any rights under the predecessor of section 544(b). Similarly, a trustee in a proceeding to set aside a fraudulent transfer may be barred by the states three-year statute of limitations where it appears that the creditor acquired knowledge of the facts showing the fraud more than three years before the petition was filed. n30 This will generally be fatal to the trustees chances if that creditor is the only creditor who may have rights of avoidance, but if there are many such creditors asserting the rights of other creditors, of course, the estoppel or the barring of one will not affect the trustees right to proceed. So, also, estoppel not be ruinous where a single creditor appears in two capacities, and the estoppel runs against only one of these. For example, where a secured creditor against whom an estoppel might be invoked in that capacity had renounced the security and claimed as a general creditor, the basis for the estoppel was cut away, and a trustee asserting the

creditors rights was not denied recovery on that ground. n31 In no event will the waiver or admission after the commencement of the case by the debtor create an estoppel that may be used against the trustee under section 544(b). n32 Similarly, a judgment against the debtor will not bar the trustee from pursuing any remedy against a transfer that would still be available to a creditor holding an unsecured claim that is allowable. n33 Even if there is time under state law to assert the claim, the trustee is subject to the limitations period in section 546 applicable to the commencement of avoidance actions generally. n34

Assignee of Creditor. The fact that the creditor whose rights are invoked is an assignee or successor in interest of the original creditor against whom a transfer was invalid will not bar the trustees action, so long as the assignee has an allowable claim and succeeds to the assignors rights of avoidance under state law. n35

Extent to Which Transfer May Be Avoided. As under *Moore v. Bay*, n36 the entire transfer is avoided to the extent necessary to benefit the estate. n37 As a result, all creditors holding unsecured claims share in the recovery, not merely those creditors whose rights are asserted. n38 Before the enactment of the Bankruptcy Code of 1978, the decision in *Moore v. Bay*, written by Justice Oliver Wendell Holmes, Jr., was one of the most controversial in the entire field of bankruptcy law. Interpreting Section 70e of the former Bankruptcy Act, the predecessor to section 544(b), the decision allowed the trustee to avoid a transfer entirely without regard to the size of the claim of the creditor whose rights and powers the trustee was asserting, with the recovery to be retained for the benefit of the entire estate. Accordingly, under *Moore v. Bay*, the right of the trustee to recover is dependent upon just one creditor with a cause of action and not dependent at all upon the size of that creditors claim against the debtor. In other words, an entire transfer can be set aside even though the creditors claim is nominal n39 and even though the avoidance may provide more funds than necessary to pay the creditors and the administrative expenses of the case. n40 Moreover, the recovery of the trustee is for the benefit of all creditors including those who had no right to avoid the transfer.

As a result of the Report of the Commission on the Bankruptcy Laws of the United States n41 a Commission Bill was introduced n42 in which § 4-604(b) overruled *Moore v. Bay*. An opposing bill, n43 introduced by the National Conference of Bankruptcy Judges, retained the rule of *Moore v. Bay*. These bills and succeeding bills were the subject of considerable debate during the following three years, much of it focusing on *Moore v. Bay*. The National Bankruptcy Conference said:

We endorse the proposal of the Commission that the recovery of the trustee should be limited to the amount which the particular creditor whose rights are asserted could have recovered. This conclusion is based on the proposition that it is unfair to permit a trustee to set aside a large transaction involving substantial sums when under state law the creditor whose claim is being asserted by the trustee could have recovered from the transferee no more than the amount of his claim. As to the question of whether the recovery should be for the benefit of the estate rather than for the benefit solely of the particular creditor whose rights are being asserted, the NBC recommends that the recovery should be for the benefit of all creditors. n44

The Bankruptcy Code when enacted was silent with regard to the rule of *Moore v. Bay*. However, the Committee Reports state that the intention was to retain the rule of that case. n45

For a complete discussion of Code section 544, see Collier on Bankruptcy, ch. 544.

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[Return to Text](#)

n1 1. The term charitable contribution is defined in section 548(d)(3). *See Collier on Bankruptcy*, 548.05[6][b].

n2

2. Section 548 was amended by the Religious Liberty and Charitable Donation Protection Act of 1998, Pub. L. No. 105-183 (1998), to add section 548(d)(3) in order to exclude charitable contributions from bankruptcy avoidance powers of a trustee under both sections 548 and 544(b). In general, the amendments establish a safe harbor from both sections 548 and 544(b) for aggregate contributions of up to 15 percent of the debtor's gross income. An even greater amount may be excluded from the trustee's avoidance power if that amount is consistent with the debtor's practice of making charitable contributions. The Act was held to be constitutional in *Miller v. Grace Fellowship, Inc. (In re Witt)*, 231 B.R. 92, 92-99 (Bankr. N.D. Okla. 1999).

n3

3. *In re 9281 Shore Road Owners Corp.*, 187 B.R. 837 (E.D.N.Y. 1995); *Tabas v. Gigi Advertising Partnership (In re Kaufman & Roberts, Inc.)*, 188 B.R. 309 (Bankr. S.D. Fla. 1995); *In re International Loan Network, Inc.*, 160 B.R. 1 (Bankr. D. Colo. 1993).

n4

4. *In re Turner*, 78 B.R. 166 (Bankr. M.D. Tenn. 1987). The existing actual unsecured creditor holding an allowable unsecured claim who could avoid the transfers at issue has been called the golden creditor. *Turner v. Phoenix Fin., LLC (In re Imageset, Inc.)*, 299 B.R. 709, 715 (Bankr. D. Me. 2003). The Seventh Circuit has twice stated that the trustee need not identify a specific creditor so long as the unsecured creditor exists. *Leibowitz v. Parkway Bank & Trust Co. (In re Image Worldwide, Inc.)*, 139 F.3d 574, 577 (7th Cir. 1998); *In re Leonard*, 125 F.3d 543, 544 (7th Cir. 1997). The unsecured creditor need not exist at the time the action is filed.

n5

5. *Stalnaker v. DLC, Ltd. (In re DLC, Ltd.)*, 295 B.R. 593 (B.A.P. 8th Cir. 2003).

n6

6. *Leibowitz v. Parkway Bank & Trust Co. (In re Image Worldwide, Inc.)*, 139 F.3d 574, 577 (7th Cir. 1988); *In re Leonard*, 125 F.3d 543, 544 (7th Cir. 1997); *Freeland v. Enodis Corp. (In re Consol. Indus. Corp.)*, 2006 U.S. Dist. LEXIS 79620, at *20 (N.D. Ind. Oct. 31, 2006) (a trustee need not identify the specific creditor that creates standing under 11 U.S.C. § 544(b) so long as he shows that at least one creditor exists).

n7

7. *Giuliano v. U.S. Nursing Corp. (In re Lexington Healthcare Group, Inc.)*, 339 B.R. 570, 576 (Bankr. D. Del. 2006); *Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.)*, 35 C.B.C.2d 1345, 195 B.R. 971, 980 (Bankr. D. Mass. 1996).

n8

8. *Heffron v. Duggins*, 115 F.2d 519 (9th Cir. 1940); *Bumgardner v. Simms*, 151 B.R. 978, 983 (Bankr. S.D. Fla. 1993); *Weibolt Stores Inc. v. Shottenstein*, 20 C.B.C.2d 776, 94 B.R. 488, 506 (Bankr. N.D. Ill. 1988). Bankruptcy courts differ as to whether the trustee succeeds to state avoidance powers where the state law limits such avoidance powers to receivers and assignees. Compare *Dubis v. B.W. Supply (In re Delta Group)*, 300 B.R. 918 (Bankr. E.D. Wis. 2003) (the trustee does not succeed to state avoidance powers limited to an assignee or a receiver even though creditors exist), with *Copter, Inc. v. Gladwin Leasing, Inc.*, 725 F.2d 37, 9 C.B.C.2d 1155 (3d Cir. 1984) (the trustee will not succeed to state avoidance powers where there is no existing assignee for the benefit of creditors), and with *Zimmerman v. Fren Corp. (In re Kenval Marketing Corp.)*, 69 B.R. 922, 930 (Bankr. E.D. Pa. 1987) (where there are no creditors, the trustee will succeed to the avoidance powers of an existing assignee for creditors).

n9

9. *Grubbs Constr. Co. v. Florida Dep't of Revenue (In re Grubbs Constr. Co.)*, 321 B.R. 346 (Bankr. M.D. Fla. 2005) (even though the state instrumentality by filing a proof of claim had waived sovereign immunity).

n10

10. *United Const. Co. v. Milam (In re Diamond Block Asphalt Corp.)*, 124 F.2d 670 (6th Cir.), cert. denied, 317 U.S. 642, 63 S. Ct. 33, 87 L. Ed. 517 (1942); *First Presbyterian Church v. Rabbitt*, 118 F.2d 732 (9th Cir. 1940).

n11

11. See, e.g., *Adler v. Hill*, 981 F.2d 1474 (5th Cir. 1993); *In re Baumgartner*, 55 F.2d 1041, 1046 (7th Cir. 1931) (An execution returned unsatisfied is not a prerequisite to the right of action of the trustee; but in the

exercise of that right he may file a bill to avoid any transfer by the debtor of his property, which any creditor might have avoided had not bankruptcy intervened.); *Barr v. Roderick*, 11 F.2d 984 (9th Cir. 1925).

n12

12. See 11 U.S.C. § 502(c).

n13

13. See, e.g., *Adler v. Hill*, 981 F.2d 1474 (5th Cir. 1993); *In re Morris*, 204 F. 770 (2d Cir. 1913); *Macken v. Gass*, 23 F. Supp. 320 (W.D.N.Y. 1938). If the judgment of the creditor gives rise to a lien, however, the trustee is not subrogated to the rights inhering in the security, unless the lien arose within the appropriate time period and otherwise is subject to attack under section 547. See *Collier on Bankruptcy*, 547.01.

n14

14. See Analysis of H.R. 8200, H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 370 (1977), reprinted in *Collier on Bankruptcy*, App. Pt. 4(d)(i); Analysis of S. 2266, S. Rep. 95-989, 95th Cong., 2d Sess. 85 (1978), reprinted in *Collier on Bankruptcy*, App. Pt. 4(e)(i).

n15

15. *In re Acequia, Inc.* 34 F.3d 800, 808, 31 C.B.C.2d 1197 (9th Cir. 1994); *Stalnaker v. DLC, Ltd. (In re DLC, Ltd.)*, 295 B.R. 593 (B.A.P. 8th Cir. 2003), *aff'd*, 376 F.3d 819 (8th Cir. 2004).

n16

16. *Havee v. Belk*, 775 F.2d 1209 (4th Cir. 1985). Section 544 may allow the trustee to reach back to transfers made more than one year before the bankruptcy filing, because the statute of limitations from the state or applicable non-bankruptcy law applies. *In re Estate of Graven*, 64 F.3d 453, 456 at n.5 (8th Cir. 1995); see also *In re Levine*, 134 F.3d 1046 (11th Cir. 1998) holding that a trustee's action to avoid a transfer of nonexempt assets to exempt annuities was governed by the two year Florida fraudulent transfer limitation and not the 30 day limitation on objection to exemptions in Rule 4003. In *Brock v. Draper (In re Draper)*, 56 C.B.C.2d 42, 355 B.R. 607, 610 (Bankr. E.D. Ky. 2006), the court allowed a trustee to set aside a fraudulent transfer made fourteen months before the commencement of the case noting that under Kentucky Revised Statute § 378.020 a fraudulent transfer action is not barred until five years from the time the cause of action accrued or ten years from the time the fraud was perpetrated. See also *Ackerman v. Ventimiglia (In re Ventimiglia)*, 362 B.R. 71, 80 (Bankr. E.D.N.Y. 2007) (setting aside under state law a fraudulent transfer made more than six years before the commencement of the case).

n17

17. *E.g., Butler v. Nationsbank, N.A.*, 58 F.3d 1022 (4th Cir. 1995) (applying North Carolina fraudulent conveyance law); *In re Jones*, 184 B.R. 377 (Bankr. D.N.M. 1995) (applying New Mexico law); *In re McFarland*, 170 B.R. 613 (Bankr. S.D. Ohio 1994) (applying Ohio law and finding actual intent to hinder creditors).

n18

18. Four states have preferential transfer statutes which may be available to the trustee. Ohio's law (Ohio Rev. Code § 1313.56) has a reach-back period of 6 or 10 years. *Cf. Buckley, The Use of Ohio's Preference Law in Bankruptcy: An Alternative to Section 547 With a Longer Reach Back Period*, 20 Cap. Univ. L. Rev. 863, 894 (1991). Both Kentucky (Ky. Rev. Stat. Ann. §§ 378.060, 378.070) and New Mexico (N.M. Stat. Ann. §§ 56-9-1, 56-9-2) have six-month reach-back periods. However, a Kentucky court has held that under section 546 of the Code the trustee has two years to bring an action under section 544(b). *Castlen v. Ohio Valley Nat'l Bank (In re Wilson)*, 106 B.R. 125 (Bankr. W.D. Ky. 1989). The Maryland preference law (Md. Com. Code Ann. § 15-101) has a reach-back period coextensive with federal law.

n19

19. *Kleven v. Stewart (In re Myers)*, 320 B.R. 667 (Bankr. N.D. Ind. 2005) (in addition, 11 U.S.C. § 550(a) limits the trustee's recovery to either the property transferred or the value of such property.)

n20

20. *In re Verco Indus.*, 704 F.2d 1134, 8 C.B.C.2d 554 (9th Cir. 1983).

n21

21. *In re Luis Elec. Contracting Corp.*, 149 B.R. 751 (Bankr. E.D.N.Y. 1992) (applying New York's six year limitations period for fraudulent transfers).

n22

22. *See Collier on Bankruptcy*, 544.02; *cf. In re Commercial W. Fin. Corp.*, 761 F.2d 1329, 12 C.B.C.2d 1177 (9th Cir. 1985).

n23

23. *Krommenhoek v. A-Mark Precious Metals, Inc. et al. (In re Bybee)*, 945 F.2d 309, 316 (9th Cir. 1991) (awarding attorney's fees); *In re Good Taste, Inc.*, 317 B.R. 112, 120-21 (Bankr. D. Alaska 2004) (allowing defendant's attorney's fees as an administrative expense).

n24

24. See *Heffron v. Duggins*, 115 F.2d 519 (9th Cir. 1940); *Grubbs Constr. Co. v. Florida Dep't of Revenue (In re Grubbs Constr. Co.)*, 321 B.R. 346 (Bankr. M.D. Fla. 2005) (although the state waived sovereign immunity by filing a proof of claim, the state could assert sovereign immunity against any creditor and so the trustee was barred from claiming under the rights of a creditor); *In re Luis Elec. Contracting Corp.*, 149 B.R. 751 (Bankr. E.D.N.Y. 1992); *In re Lyons*, 130 B.R. 272 (Bankr. N.D. Ill. 1991). So in *United States v. Field (In re Abatement Environmental Resources, Inc.)*, 2003 U.S. Dist. LEXIS 11989 (D. Md. May 27, 2003), the trustee was unable to recover tax payments made by the debtor to IRS because Maryland's voluntary payment doctrine afforded immunity to taxing authorities.

n25

25. See, e.g., *Harris v. Huff (In re Huff)*, 160 B.R. 256 (Bankr. M.D. Ga. 1993); see also *McKey v. McKean*, 384 Ill. 112, 51 N.E.2d 189 (1943), where an action to avoid a conveyance to the debtor's wife on the ground of its alleged fraud on creditors, brought nearly four years after recordation of the conveyance, was held barred by laches. See 11 U.S.C. § 546(a).

n26

26. 263 F. 588 (N.D. Cal. 1920), *aff'd*, 273 F. 397 (9th Cir. 1921).

n27

27. 263 F. 588, 589 (citing *Collier on Bankruptcy* (10th ed.), 1042 (f) & (g)); *Manning v. Evans*, 156 F. 106, 19 Am. B.R. 217 (D.C. N.J. 1907); *In re Mullen*, 101 F. 413, 4 Am. B.R. 224 (D.C. Mass. 1900); *Holbrook v. International Trust Co.*, 220 Mass. 150, 33 Am. B.R. 808, 107 N.E. 665 (1915).

n28

28. *Lane v. Eggleston* 284 F. 743 (5th Cir. 1922); *Durrett v. Harris*, 148 Ark. 4, 228 S.W. 386 (1921).

n29

29. *Smith v. Litton*, 167 Va. 263 (1936). This case represents one of the preliminary skirmishes in the series of legal maneuvers that culminated in the well known case of *Pepper v. Litton*, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939). The Supreme Court held that although the trustee was estopped to challenge Litton's judgment in an independent proceeding for avoidance (*Smith v. Litton*, 167 Va. 263 (1936)), the bankruptcy court when later presented with the judgment claim for allowance was entitled to look behind the judgment in order to determine the essential validity of the claim with respect to fraud or collusion.

n30

30. *Heffron v. Duggins*, 115 F.2d 519 (9th Cir. 1940). Under the California law the burden of proof that the fraud was not discovered until within such time as would save the creditor's right of action is upon the trustee.

n31

31. *Buffum v. Peter Barceloux Co.*, 289 U.S. 227, 234, 53 S. Ct., 539, 542, 77 L. Ed. 1140, 1145 (1933).

n32

32. *See Craddick v. Cotta Gear Co.*, 306 Ill. App. 459 (1940).

n33

33. *See, e.g., Saper v. Long*, 121 F. Supp. 65 (S.D.N.Y. 1954) (*res judicata* and collateral estoppel rejected as defenses to suit brought by trustee under predecessors to sections 544(b), 547 and 548); *see also In re Hill*, 981 F.2d 1474 (5th Cir. 1993).

n34

34. *Viscount Air Servs., Inc. v. Cole (In re Viscount Air Servs., Inc.)*, 232 B.R. 416, 432 (Bankr. D. Ariz. 1998).

n35

35. See, e.g., *Macken v. Gass*, 23 F. Supp. 320 (W.D.N.Y. 1938); *Barr v. Roderick*, 11 F.2d 984 (N.D. Cal. 1925); *In re Putnam Props., Ltd. P'ship*, 134 B.R. 477 (Bankr. D. Conn. 1991). An assignee for the benefit of creditors, however, is not such a creditor. *In re Komfo Prod. Corp.*, 247 F. Supp. 229 (E.D. Pa. 1965) (citing *Treatise*); see 550.02 *infra*, on trustee's right to recover transferred property.

n36

36. 284 U.S. 4, 52 S. Ct. 3, 76 L. Ed. 133 (1931).

n37

37. In a chapter 11 case where the avoidance would provide more funds than necessary to pay not only the creditors but also the administrative expenses of the case, the court in *Coleman v. Community Trust Bank (In re Coleman)*, 426 F.3d 719, 726-27 (4th Cir. 2005), nevertheless held that deeds of trust could be voided in their entirety, finding that the words for the benefit of the estate in section 550(a) of the Code did not limit the section 544 avoidance power.

n38

38. *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 18 C.B.C.2d 711 (7th Cir. 1988). *In re Galbreath*, 207 B.R. 309, 316 (Bankr. M.D. Ga. 1997).

n39

39. *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800, 809-10 (9th Cir. 1994) (As several courts have noted, under section 544(b) [a] transaction that is avoidable by a single, actual unsecured creditor may be avoided in its entirety, regardless of the size of the creditor's claim.) (quoting *Harris v. Huff (In re Huff)*, 160 B.R. 256, 261 (Bankr. M.D. Ga. 1993)); see also *Abramson v. Boedeker*, 379 F.2d 741, 748 n.16 (5th Cir. 1967), cert. denied, 389 U.S. 1006, 88 S. Ct 563, 19 L. Ed 2d 602 (1967) (If the transfer is avoidable at all by any creditor, it is avoidable in full for all creditors regardless of the dollar amount of the prevailing claim.).

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40. *Coleman v. Community Trust Bank (In re Coleman)*, 426 F.3d 719, 726-27 (4th Cir. 2005).

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41. House Doc. 93-137, Part II, 93d Cong, 1st Sess., July 1973.

n42

42. H.R. 31, 94th Cong., 1st Sess., January 14, 1975.

n43

43. The Judges Bill, H.R. 32, 94th Cong., 1st Sess., January 14, 1975.

n44

44. Statement of Leon S. Forman on Behalf of the National Bankruptcy Conference, Hearings before the Subcommittee on Civil and Constitutional Rights of the Committee on the Judiciary, House of Representatives, 94th Cong., 2d Sess. March 19, 1976, Serial No.27, Part 3, p. 1839.

n45

45. H. Rep. No. 95-595, 95th Cong., 1st Sess. 370 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 85 (1978).

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187 of 197 DOCUMENTS

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Collier on Limitation of Avoiding Powers Based on Sellers Right of Reclamation

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Collier on Limitation of Avoiding Powers Based on Sellers Right of Reclamation

By Collier

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SUMMARY: Bankruptcy Code section 546(c) defines a sellers right to reclamation under the Bankruptcy Code. This section states the trustees rights and powers under sections 544(a), 545, 547 and 549 of the Bankruptcy Code are subject to the sellers right to reclaim goods sold to the debtor in the ordinary course of the sellers business if the debtor received such goods while insolvent and within 45 days before the start of the debtors bankruptcy case.

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ARTICLE: Overview and Application. *Bankruptcy Code section 546(c)* defines a sellers right to reclamation under the Bankruptcy Code. n1 This section states that the trustees rights and powers under sections 544(a), n2 545, n3 547 n4 and 549 n5 of the Bankruptcy Code are subject to the sellers right to reclaim goods sold to the debtor in the ordinary course of the sellers business if the debtor received such goods while insolvent and within 45 days before the commencement of the debtors bankruptcy case. n6 To effectuate reclamation under section 546(c), the seller must make written demand for reclamation of the goods not later than 20 days after the date of commencement of the bankruptcy case. n7 If a seller fails to provide notice within this prescribed time limit, the seller may nevertheless assert a right to an administrative expense under *section 503(b)(9) of the Bankruptcy Code*. n8

The avoiding powers expressly set forth in section 546(c) are subject to the sellers right of reclamation which is, in turn, subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof. n9 The trustee may defeat *a right* to reclamation under other avoidance sections, e.g., state fraudulent transfer law n10 or fraudulent transfer law in *section 548 of the Bankruptcy Code*. n11

Section 546(c) applies only to reclamation; it in no way precludes a sellers right to pursue other nonbankruptcy remedies, such as the right to stop goods in transit. n12 Of course, these remedies are not protected under section 546(c) and may be subject to avoidance by the trustee as well as the automatic stay of section 362(a).

Operation of Section 546(c). Section 546(c) is the exclusive reclamation remedy in bankruptcy. Once a

bankruptcy case has been commenced, a seller may exercise reclamation rights only if the requirements of section 546(c) are met. n13 The seller has the burden to prove all elements of its right to reclamation by a fair preponderance of the evidence. n14

One significant issue stemming from the 2005 amendments to section 546(c) is whether the statute now contains a new federal right of reclamation or whether the statute continues to incorporate state law reclamation rights and practices. In *In re Dana Corp.*, n15 the court expressly held that amended 546(c) does not create a new federal right of reclamation. The court's conclusion was based on several considerations, including: (1) section 546(c)'s placement in the Bankruptcy Code under the heading limitation on avoiding powers, which implies the section provides for an exception rather than an independent fount of rights; (2) the failure of section 546(c) to create a coherent comprehensive federal scheme for reclamation that precisely defines the contours of the right and any defenses to the right; (3) Congress's failure to include in the 2005 Acts legislative history any discussion of an intent to effect a major change to pre-2005 practices; (4) the fact that a new federal right would arguably lead to the absurd result of allowing a seller to reclaim goods that have already been sold to consumers or to other good faith purchasers; and (5) the general principle that the filing of a bankruptcy petition, by itself, should not function to enhance the rights of one set of creditors at the expense of other creditors.

While Congress did not provide specific discussion of its intent in the 2005 Acts legislative history, it is unclear what purpose could be served by deleting the phrase any statutory or common law before the word right and replacing it with the definite article the other than uncoupling state law reclamation rights from the bankruptcy process. Moreover, amended section 546(c) does unquestionably provide *some* detail about the extent of reclamation rights in bankruptcy, such as the expanded 45- and 20-day periods. Additionally, one could argue that, if section 546(c) *does* create a federal right of reclamation, it remains appropriate to reference state law reclamation principles, as well as the case law applying those principles, in order to fill in any gaps in the statute pursuant to the Supreme Court's teaching in *United States v. Kimbell Foods*. n16

Requirements for Right to Reclamation under Section 546(c).

Goods Must Be Sold in Ordinary Course of Sellers Business. Section 546(c) establishes the reclamation rights of sellers who sell goods in the ordinary course of [their] business. n17 Courts generally apply the definition of the word goods contained in the Uniform Commercial Code n18 in determining the application of section 546(c). n19

Debtor Must Have Been Insolvent When Goods Were Received. Section 546(c) protects a seller's reclamation rights only if the debtor was insolvent when it received the goods. n20 An entity, other than a municipality, is insolvent under the Bankruptcy Code if its liabilities exceed its assets at a fair valuation. n21 As in section 546(c), section 2-702(2) of the Uniform Commercial Code requires that the debtor be insolvent when it receives the goods to be reclaimed and the seller must discover such insolvency after delivery of the goods. An insolvent person under the Uniform Commercial Code is one who either has ceased to pay his [or her] debts in the ordinary course of business *or* cannot pay his [or her] debts as they become due *or* is insolvent within the meaning of the federal bankruptcy law. n22 This definition incorporates the definition of insolvent under the Bankruptcy Code, n23 but also provides alternative grounds for a finding of insolvency based on the debtor's payment of debts. Proof of insolvency based solely on these alternative grounds is not sufficient to meet the insolvency requirement in section 546(c), which requires proof of insolvency based on the Bankruptcy Code definition. n24

Debtor Must Have Received Goods Within 45-Day Period Before Bankruptcy Case Commenced. Section 546(c) provides that the debtor must have received the goods within 45 days before the date of the commencement of the debtor's bankruptcy case. n25 The 45-day period should be calculated in accordance with *Rule 9006(a) of the Federal*

Rules of Bankruptcy Procedure. n26

Timely Written Demand Requirement. The seller must act promptly to protect its interests by making a timely written demand for reclamation. n27 This demand is mandatory and may not be altered under equitable principles. n28 Demand must be made by the seller, as opposed to third parties, such as a warehouseman or bailee of the seller, n29 and must be clear on its face that the seller is seeking to reclaim goods. n30 Under section 546(c)(1), written demand must be made either (1) not later than 45 days after the date of the debtors receipt of the goods, n31 or (2) not later than 20 days after the petition date, if the 45-day period expires after the petition date. n32 Since a sellers right to reclamation only covers goods received by the debtor within 45 days of the commencement of the debtors case, the phrases not later than 45 days after the date of receipt of such goods by the debtor in section 546(c)(1)(A) and if the 45-day period expires after the commencement of the case in section 546(c)(1)(B) appear to be meaningless. Using with Rule 9006 to compute the time periods within which the debtor must receive the goods and the seller must assert its reclamation right, the 45-day period referenced in section 546(c)(1)(B) expires on or after the petition date in every instance.

Notwithstanding the one limited instance in which the sellers right to assert reclamation technically expires on the petition date, section 546(c)(1) should be read in every instance to give the seller 20 days after the petition date to assert its reclamation right. If, for example, the debtor receives goods on April 1, and the debtor files bankruptcy on May 15 (which is 44 days after the debtors receipt of the goods computed under *Rule 9006 of the Federal Rules of Bankruptcy Procedure*), the seller has 45 days within which to assert its reclamation right. Using Rule 9006, the date on which the buyer receives the goods is not counted in computing the period within which the seller must act, so the sellers 45-day clock to make written demand for reclamation starts running the following day and expires one day after the date the debtor files its petition, thereby triggering the not later than 20 days after the date of commencement of the case limitation. If, for example, the debtor receives goods on March 31 (one day earlier), and the debtor files bankruptcy on May 15 (which is 45 days after the debtors receipt of the goods computed under *Rule 9006 of the Federal Rules of Bankruptcy Procedure*), the sellers right to assert reclamation lapses on the petition date. Section 546(c)(1) should not be read, however, to require the seller to assert its reclamation right on the date the debtor files bankruptcy. Such a reading would defeat one of the purposes of section 546(c)(1) to give a seller a reasonable period of time within which to assert its reclamation right n33 and would, at a minimum, be impractical because the seller likely will not have notice of the debtors bankruptcy filing. The better and more logical reading is to give the seller, whose shipped goods have been received at any time within 45 days of the petition date, 20 days after the petition date to assert its reclamation right under section 546(c)(1). n34 In determining the date by which written demand must be made, one must first determine the day on which the debtor received the goods. n35 That day is not included in calculating the demand period. n36 If the last day of the demand period is a Saturday, Sunday or legal holiday, the time period should run until the end of the next day that is not a Saturday, Sunday or legal holiday. n37 Demand is effective upon mailing. n38

Date of Receipt of Goods. Determining the date of the debtors receipt of goods is important in analyzing several elements of section 546(c). The seller must show that the debtor was insolvent on the date goods were received. n39 In addition, the time period for written demand set forth in section 546(c)(1)(A) runs from the date of the debtors receipt of goods. n40 Courts generally rely on the definition of the word receipt set forth in section 2-103 of the Uniform Commercial Code to determine the date the goods were received by the debtor for purposes of section 546(c). n41 Section 2-103 of the Uniform Commercial Code defines receipt of goods as taking physical possession of them. n42

Goods Must Be in Debtors Possession and Identifiable. The seller must establish that the goods to be reclaimed are in the debtors possession when reclamation was sought, n43 and the goods must be identifiable. n44 The seller may not reclaim raw goods if they have been converted into a finished product. n45

Reclamation Rights Subject to Prior Rights of Secured Creditors. Section 546(c)(1) provides in relevant part that

subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 544(a), 545, 547 and 549 are subject to the right of a seller of goods to reclaim such goods under certain circumstances. n46 It is not clear what the phrase subject to prior rights of a holder of a security interest modifies--i.e., whether it modifies the trustees avoidance powers or the sellers reclamation rights. Using prior versions of section 546(c)(1) as a guide, this provision appears intended to state that the sellers reclamation rights remain subject to the secured creditors rights as well. n47 A sellers reclamation rights may, for example, be subject to the rights of a creditor with a floating lien on the debtors inventory. n48 Yet it remains unclear precisely what subject to means.

In the case of a secured creditor, the sellers right to reclaim is subordinated to the secured creditors claim. Thus, the seller may be given possession of the goods, but the seller must pay the secured creditor the value of its lien prior to obtaining possession. Several courts have held that the secured creditors lien may arise from either a pre- or postpetition transaction, and may encompass both pre- and postpetition collateral. n49 In courts that apply the broad prior lien defense, the existence, as of the time of reclamation, of liens on the goods to be reclaimed functionally renders otherwise valid reclamation claims valueless if the amount of the liens exceeds the value of the goods. n50 Alternatively, if the goods are not returned to the seller, the seller may seek alternative remedies. n51 The seller may seek an administrative expense claim for certain amounts under section 503(b)(9). n52 A reclaiming seller whose right is subject to that of a secured creditor may not invoke the equitable principle of marshalling or a similar principle to require a senior secured creditor to look to assets in which the seller has no interest. n53

Operation of Section 546(c)(2). Section 546(c)(2) provides that [i]f a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9). n54 Section 503(b)(9), in turn, provides that [a]fter notice and a hearing, there shall be allowed, administrative expenses, including the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtors business. n55 Thus, if the seller fails to satisfy the notice and timing requirements of section 546(c)(1), the seller may nonetheless seek recovery of the value of any goods the debtor received in the 20 days before the debtors bankruptcy case was commenced. In addition to the 20-day window, the seller must show that the goods received by the debtor were sold by the seller to the debtor in the ordinary course of the *debtors* business. n56 Unlike section 546(c)(1), however, there is no requirement under section 546(c)(2) or 503(b)(9) that the debtor be insolvent when it received the goods from the seller. n57 Moreover, based on the construction and wording of sections 546(c)(2) and 503(b)(9), a sellers right to assert an administrative expense priority claim does not appear to be subject to the rights and claims of secured creditors, n58 nor does the seller appear to need an independent right to reclamation.

Right to Reclaim Proceeds. Section 546(c) applies to reclamation of goods, but not to proceeds of the goods. n59

Procedure for Reclamation under Section 546(c). Sellers may assert reclamation rights by commencing an adversary proceeding. n60 Service of the sellers complaint on the trustee will constitute written demand required under section 546(c)(1). n61 However, a separate written demand can preserve the reclamation right prior to commencement of an action to enforce it. At least one court has held that the burden is on the seller to pursue its claim after demand by filing a motion or adversary proceeding. n62

For a complete discussion of Code section 546, see Collier on Bankruptcy, ch. 546.

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n1 1. Under section 1227 of the 2005 Act, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, Congress deleted the phrase any statutory or common law from the sentence in section 546(c) that previously provided as follows: Except as provided in subsection (d) of this section, the rights and powers of a trustee are subject to any statutory or common law right of a seller of goods that has sold goods to the debtor to reclaim such goods . This alteration in the language of section 546(c) suggests that a seller's reclamation rights in bankruptcy may now be derived exclusively from *section 546(c) of the Bankruptcy Code* and not from any nonbankruptcy statutory provision or common law, such as Article 9 of the Uniform Commercial Code. *See In re Dana Corp., 2007 Bankr. LEXIS 1466* (Bankr. S.D.N.Y. Apr. 19, 2007) (analyzing and rejecting the contention that amended section 546(c) creates a new federal right of reclamation); *Davis v. Par Wholesale Auto, Inc. (In re Tucker)*, 329 B.R. 291, 298 n.8 (Bankr. D. Ariz. 2005) (discussing this possibility).

n2

2. 11 U.S.C. § 544(a) (trustee's powers as lien creditor and as successor to certain creditors and purchasers); *see* Collier on Bankruptcy, ch. 544. This limitation applies only to the trustee's rights under subsection (a) of section 544. The trustee's rights and powers as successor to creditors under paragraph (b) of that section are not limited by this provision.

n3

3. 11 U.S.C. § 545 (power to avoid statutory liens); *see* Collier on Bankruptcy, ch. 545.

n4

4. 11 U.S.C. § 547 (power to avoid preferential transfers); *see* Collier on Bankruptcy, ch. 547.

n5

5. 11 U.S.C. § 549 (power to avoid postpetition transfers); *see* Collier on Bankruptcy, ch. 549.

n6

6. 11 U.S.C. § 546(c).

n7

7. 11 U.S.C. § 546(c)(1)(B). The 2005 Act substantively amended *section 546(c) of the Bankruptcy Code* with respect to reclamation rights. Pub. L. No. 109-8, § 1227 (2005), effective in cases commenced on or after October 17, 2005.

n8

8. *See 11 U.S.C. § 503(b)(9)*. The 2005 Act amended *section 503(b) of the Bankruptcy Code* to provide that the value of any goods sold to the debtor in the ordinary course of the debtor's business and received by a debtor not later than within 20 days prior to the commencement of the bankruptcy case is an allowed administrative expense. Pub. L. No. 109-8, § 1227(b) (2005), effective in cases commenced on or after October 17, 2005.

n9

9. This latter restriction was codified by the 2005 Act, Pub. L. No. 109-8, § 1227 (2005), effective in cases commenced on or after October 17, 2005.

n10

10. 11 U.S.C. § 544(b); *see Collier on Bankruptcy*, ch. 544. 0

n11

11. 11 U.S.C. § 548; *see Collier on Bankruptcy*, ch. 548.

n12

12. *See, e.g., National Sugar Refining Co. v. C. Czarnikow, Inc. (In re National Sugar Refining Co.)*, 27 B.R. 565 (S.D.N.Y. 1983); *In re Fabric Buys*, 9 C.B.C.2d 995, 34 B.R. 471 (Bankr. S.D.N.Y. 1983); *see also Montello Oil Corp. v. Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc.)*, 740 F.2d 220, 225, 11 C.B.C.2d 28, 34 (3d Cir. 1984) (right to stop goods in transit is different right); *Mayer Pollack Steel Corp. v. London Salvage & Trade Co. (In re Mayer Pollack Steel Corp.)*, 157 B.R. 952 (Bankr. E.D. Pa. 1993) (same).

n13

13. Initially, there was some confusion about the exclusive nature of section 546(c). Some commentators

stated that section 546(c) was not an exclusive remedy, but rather provided a safe harbor for a seller whose reclamation rights were otherwise avoidable. Thus, although the seller was not precluded from asserting reclamation rights solely under state law, if the seller did not comply with the procedures set forth in section 546(c), its right to reclamation was subject to avoidance. However, almost every court that has addressed this issue has rejected this view, holding section 546(c) to be an exclusive remedy in bankruptcy. *See, e.g., Oakland Gin Co. v. Marlow (In re Julien Co.)*, 44 F.3d 426, 32 C.B.C.2d 1437 (6th Cir. 1995); *Flav-O-Rich, Inc. v. Rawson Food Serv., Inc. (In re Rawson Food Serv., Inc.)*, 846 F.2d 1343 (11th Cir. 1988); *In re MGS Mktg.*, 22 C.B.C.2d 1258, 111 B.R. 264 (B.A.P. 9th Cir. 1990); *Hitachi Denshi Am., Ltd. v. Rozel Indus., Inc. (In re Rozel Indus., Inc.)*, 74 B.R. 643 (Bankr. N.D. Ill. 1987) (collecting cases); *In re Flagstaff Foodservice Corp.*, 56 B.R. 899 (Bankr. S.D.N.Y. 1986).

Under earlier versions of section 546(c), the seller must have had a right to reclamation under nonbankruptcy law to assert such a right under section 546(c). *See 11 U.S.C. § 546(c)*. However, the 2005 Act deleted the phrase any statutory or common law, thereby arguably abrogating and replacing the seller's right to reclamation under nonbankruptcy law with the right arguably granted under section 546(c). *See Pub. L. No. 109-8, § 1227 (2005)*, effective in cases commenced on or after October 17, 2005; *Davis v. Par Wholesale Auto, Inc. (In re Tucker)*, 329 B.R. 291, 298 n.8 (Bankr. D. Ariz. 2005). *But see In re Dana Corp.*, 2007 Bankr. LEXIS 1466 (Bankr. S.D.N.Y. Apr. 19, 2007) (analyzing and rejecting the contention that amended section 546(c) creates a new federal right of reclamation).

n14

14. *See, e.g., Flav-O-Rich, Inc. v. Rawson Food Serv., Inc. (In re Rawson Food Serv., Inc.)*, 846 F.2d 1343 (11th Cir. 1988); *In re Adventist Living Ctrs., Inc.*, 171 B.R. 310 (N.D. Ill. 1994), *aff'd*, 52 F.3d 159 (7th Cir. 1995).

n15

15. 2007 Bankr. LEXIS 1466 (Bankr. S.D.N.Y. Apr. 19, 2007).

n16

16. 440 U.S. 715, 99 S. Ct. 1448, 59 L. Ed. 2d 711, 20 C.B.C.2d 1 (1979).

n17

17. 11 U.S.C. § 546(c).

n18

18. U.C.C. § 2-105(1). Section 2-105(1) states that [g]oods means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action. *Id.* Goods also includes the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty (Section 2-107). *Id.*

n19

19. *See In re GIC Government Sec.*, 64 B.R. 161 (Bankr. M.D. Fla. 1986) (court applied U.C.C. definition of goods).

n20

20. 11 U.S.C. § 546(c).

n21

21. 11 U.S.C. § 101(32). In the case of municipalities, section 101 defines insolvent as generally not paying debts as they become due or unable to pay debts as they become due. *See Collier on Bankruptcy*, ch. 101. In addition, exempt assets and assets that have been transferred, concealed or removed with intent to hinder, delay or defraud creditors are not considered in determining whether insolvency exists. *Id.*

n22

22. U.C.C. § 1-201(23) (emphasis added).

n23

23. 11 U.S.C. § 101(32); *see Collier on Bankruptcy*, ch. 101.

n24

24. *See, e.g., Oakland Gin Co. v. Marlow (In re Julien Co.)*, 44 F.3d 426, 431-32, 32 C.B.C.2d 1437, 1444-1446 (6th Cir. 1995); *In re Video King of Ill., Inc.*, 100 B.R. 1008 (Bankr. N.D. Ill. 1989); *Lawrence Pharm. Inc. v. Best Buy Drugs, Inc. (In re Best Buy Drugs, Inc.)*, 89 B.R. 997 (Bankr. S.D. Fla. 1988); *Pike Tool & Grinding v. Storage Tech. Corp. (In re Storage Tech. Corp.)*, 48 B.R. 862 (Bankr. D. Colo. 1985); *But see Ambico, Inc. v. AIC Photo, Inc. (In re AIC Photo, Inc.)*, 14 C.B.C.2d 95, 57 B.R. 56 (Bankr. E.D.N.Y. 1985)

(strongly criticizing limiting definition of insolvent to *section 101 of Bankruptcy Code* and applying definition found in U.C.C. § 1-201(23)).

n25

25. *See 11 U.S.C. § 546(c)*. The 2005 Act added the 45-day receipt of goods requirement. *See* Pub. L. No. 109-8, § 1227 (2005), effective in cases commenced on or after October 17, 2005.

n26

26. *See* Collier on Bankruptcy, ch. 9006.

n27

27. *11 U.S.C. § 546(c)(1); cf. U.C.C. § 2-702(2)* (demand, but not written demand, is required).

n28

28. *See In re Lockwood Enters., Inc.*, 54 B.R. 829 (Bankr. S.D.N.Y. 1985) (debtor's failure to list creditor in bankruptcy schedules, so that creditor did not receive notice of pending chapter 11 case, provided no basis for court to extend reclamation demand time period; equitable ground arising from conduct of parties cannot supersede statutory mandate).

n29

29. *Oakland Gin Co. v. Marlow (In re Julien Co.)*, 44 F.3d 426, 432 n.4, 32 C.B.C.2d 1437, 1445 n.4 (6th Cir. 1995).

n30

30. *Montello Oil Corp. v. Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc.)*, 740 F.2d 220, 11 C.B.C.2d 28 (3d Cir. 1984).

n31

31. 11 U.S.C. § 546(c)(1)(A).

n32

32. 11 U.S.C. § 546(c)(1)(B).

n33

33. See Pub. L. No. 109-8, § 1227 (2005), effective in cases commenced on or after October 17, 2005.

n34

34. Such a reading also comports with similarly worded provisions of the Bankruptcy Code. The language in section 546 that the debtor must have received the goods within 45 days is slightly different from the language in other sections of the Bankruptcy Code. Section 547, for example, provides that the trustee may avoid any transfer of an interest of the debtor in property made on or within 90 days before the date of the filing of the petition. The absence or omission of the word on in section 546(c)(1) is not explained in the legislative history or commentary to the 2005 amendments.

n35

35. See *Collier on Bankruptcy*, 546.04[2][b][iv].

n36

36. *Fed. R. Bankr. P. 9006(a)*.

n37

37. *Fed. R. Bankr. P. 9006(a)*; see *In re Dixie Enters., Inc.*, 22 B.R. 855 (Bankr. S.D. Ohio 1982).

n38

38. See *Montello Oil Corp. v. Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc.)*, 740 F.2d 220, 225, 11

C.B.C.2d 28, 34 (3d Cir. 1984); In re Bill's Dollar Stores, Inc., 164 B.R. 471 (Bankr. D. Del. 1994); *In re Flagstaff Foodservice Corp.*, 56 B.R. 899 (Bankr. S.D.N.Y. 1986).

n39

39. 11 U.S.C. § 546(c); see *Flav-O-Rich, Inc. v. Rawson Food Serv., Inc. (In re Rawson Food Serv., Inc.)*, 846 F.2d 1343 (11th Cir. 1988); *United States v. Westside Bank*, 732 F.2d 1258 (5th Cir. 1984); *Allstate Fabricators Corp. v. Flagstaff Foodservice Corp. (In re Flagstaff Foodservice Corp.)*, 56 B.R. 899 (Bankr. S.D.N.Y. 1986). But see *Eagle Indus. Truck Mfg., Inc. v. Continental Airlines, Inc. (In re Continental Airlines, Inc.)*, 125 B.R. 415 (Bankr. D. Del. 1991) (insolvency at time of delivery); *In re Penthouse Travelers of Aripeka, Inc.*, 120 B.R. 226 (Bankr. M.D. Fla. 1990) (same); *In re Video King of Ill., Inc.*, 100 B.R. 1008 (Bankr. N.D. Ill. 1989) (same).

n40

40. 11 U.S.C. § 546(c)(1)(A).

n41

41. See *Montello Oil Corp. v. Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc.)*, 740 F.2d 220, 11 C.B.C.2d 28 (3d Cir. 1984) (applying U.C.C. definition); *In re Bill's Dollar Stores, Inc.*, 164 B.R. 471 (Bankr. D. Del. 1994) (goods that arrived at debtor's yard but were left in truck were received when they arrived, not when unpacked); *Aventura Sportswear, Ltd. v. Maloney Enter. (In re Maloney Enter.)*, 37 B.R. 290 (Bankr. E.D. Ky. 1983) (receipt of goods occurs when debtor takes actual, physical possession of them, not when they are delivered to carrier).

n42

42. U.C.C. § 2-103(1)(c).

n43

43. See *In re Adventist Living Ctrs., Inc.* 52 F.3d 159, 162 (7th Cir. 1995) (supplied goods were perishable foodstuffs); *Pester Refining Co. v. Ethyl Corp. (In re Pester Refining Co.)*, 964 F.2d 842, 26 C.B.C.2d 1663 (8th Cir. 1992) (citing *Griffin Retreading Co. v. Oliver Rubber Co. (In re Griffin Retreading Co.)*, 795 F.2d 676 (8th Cir. 1986)); *Flav-O-Rich, Inc. v. Rawson Food Serv., Inc. (In re Rawson Food Serv., Inc.)*, 846 F.2d 1343 (11th Cir. 1988) (collecting cases); *Collingwood Grain, Inc. v. Coast Trading Co. (In re Coast Trading Co.)*, 744 F.2d 686, 692, 11 C.B.C.2d 790, 796 (9th Cir. 1984); *Graphic Prods. Corp. v. WWF Paper Corp. (In re Graphic Prods. Corp.)*, 32 C.B.C.2d 879, 176 B.R. 65 (Bankr. S.D. Fla. 1994).

n44

44. See, e.g., *Archer Daniels Midland Co. v. Charter Int'l Oil Co.*, 60 B.R. 854 (M.D. Fla. 1986); *Eagle Indus. Truck Mfg., Inc. v. Continental Airlines, Inc. (In re Continental Airlines, Inc.)*, 125 B.R. 415 (Bankr. D. Del. 1991); *In re Penthouse Travelers of Aripeka, Inc.*, 120 B.R. 226 (Bankr. M.D. Fla. 1990); *McCain Foods, Inc. v. Flagstaff Foodservice Co. (In re Flagstaff Foodservice Co.)*, 9 C.B.C.2d 9, 14 B.R. 462 (Bankr. S.D.N.Y. 1981).

n45

45. See *Bethlehem Steel Corp. v. Wheeling-Pittsburgh Steel Corp. (In re Wheeling-Pittsburgh Steel Corp.)*, 74 B.R. 656 (Bankr. W.D. Pa. 1987).

n46

46. 11 U.S.C. § 546(c)(1).

n47

47. Prior to the 2005 amendments, section 546(c)(1) provided that a seller needed reclamation rights under applicable nonbankruptcy law to establish a right to reclamation under section 546(c). Under nonbankruptcy law, mainly the applicable provisions of the Uniform Commercial Code, a seller's reclamation rights were subject to the rights of a secured creditor. The 2005 amendments deleted the reference to the trustee's avoidance powers being subject to any statutory or common law right of a seller of goods to reclaim such goods. Pub. L. No. 109-8, § 1227 (2005), effective in cases commenced on or after October 17, 2005. Given the tendency to protect the rights of properly perfected, prior secured creditors throughout other provisions in the 2005 Act, however, the same intent likely applies to section 546(c)(1). Regardless, the 2005 amendments to section 546(c)(1) foreclose the prior minority position that an Article 9 security interest cannot be senior to a reclamation right. See, e.g., *In re Reliable Drug Stores, Inc.*, 70 F.3d 948, 949 (7th Cir. 1995) (suggesting that an Article 9 secured creditor may not qualify as a good faith purchaser under Article 2, and thus may not have priority under section 2-702(2) of the Uniform Commercial Code).

n48

48. See, e.g., *Pester Refining Co. v. Ethyl Corp. (In re Pester Refining Co.)*, 964 F.2d 842, 26 C.B.C.2d 1663 (8th Cir. 1992) (citing cases); *McLouth Steel Prods. Corp. v. Quaker Chem. Co. (In re McLouth Prods. Corp.)*, 213 B.R. 978, 989 (E.D. Mich. 1997); *Lavonia Mfg. Co. v. Emery Corp.*, 52 B.R. 944 (E.D. Pa. 1985); *Sandoz Pharm. Corp. v. Blinn Wholesale Drug Co. (In re Blinn Wholesale Drug Co.)*, 164 B.R. 440 (Bankr. E.D.N.Y. 1994); *United States Trust Co. v. Raritan River Steel Co. (In re American Spring Bed Mfg. Co.)*, 153

B.R. 365 (Bankr. D. Mass. 1993); Isaly Klondike Co. v. Sunstate Dairy & Food Prods. Co. (In re Sunstate Dairy & Food Prods. Co.), 145 B.R. 341 (Bankr. M.D. Fla. 1992); In re Diversified Food Serv. Distrib., Inc., 130 B.R. 427 (Bankr. S.D.N.Y. 1991). But see In re Reliable Drug Stores, Inc., 70 F.3d 948 (7th Cir. 1995) (acknowledging *Pester* and other cases, but, without deciding issue, recognizing views of legal scholars who disagree with view that secured creditor is equivalent of good faith purchaser).

n49

49. See, e.g., *Auto Auction Assocs. of Mont., Inc. v. Incredible Auto Sales LLC (In re Incredible Auto Sales LLC)*, 2007 Bankr. LEXIS 1024 (Bankr. D. Mont. Mar. 26, 2007) (looking to state law to determine the rights of a secured creditor and concluding that the creditor's liens on pre- and postpetition inventory trumped another creditor's reclamation rights); *Simon & Schuster, Inc. v. Advanced Mktg. Servs. (In re Advanced Mktg. Servs.)*, 360 B.R. 421 (Bankr. D. Del. 2007) (holding that the express language of amended section 546(c)(1) makes clear that a seller's reclamation rights may be subordinate to both pre- and postpetition liens on a debtor's inventory).

n50

50. See, e.g., *In re Dana Corp.*, 2007 Bankr. LEXIS 1466 (Bankr. S.D.N.Y. Apr. 19, 2007) (describing and applying the so-called Prior Lien Defense); *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003) (holding that a secured lender's prior floating lien on inventory rendered reclamation claims valueless). But see *In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003) (concluding that the establishment of a postpetition DIP facility released prepetition liens on certain goods, and thus had no impact on the value of rights to reclaim those goods).

n51

51. 11 U.S.C. § 546(c)(2); see also 11 U.S.C. §§ 503(b)(9), 507(a)(2); Collier on Bankruptcy, ch. 503 and Collier on Bankruptcy, ch. 507.

n52

52. 11 U.S.C. § 503(b)(9).

n53

53. *Galey & Lord, Inc. v. Arley Corp. (In re Arlco, Inc.)*, 42 C.B.C.2d 1539, 239 B.R. 261, 274-77 (Bankr. S.D.N.Y. 1999).

n54

54. 11 U.S.C. § 546(c)(2). The 2005 amendments revised section 546(c)(2) substantially. Pub. L. No. 109-8, § 1227 (2005), effective in cases commenced on or after October 17, 2005. Section 546(c)(2) previously provided that the bankruptcy court had discretion to deny the seller reclamation. If the court did so, however, it was required to protect the seller either by granting it an administrative expense priority claim or by securing the seller's claim with a lien. These alternative remedies under section 546(c)(2) were only available if the seller satisfied the other reclamation requirements under section 546(c).

n55

55. 11 U.S.C. § 503(b)(9). New subsection (9) of section 503(b) was added by the 2005 Act, Pub. L. No. 109-8, § 1227(b) (2005), effective in cases commenced on or after October 17, 2005.

n56

56. 11 U.S.C. § 503(b)(9).

n57

57. 11 U.S.C. §§ 546(c)(2), 503(b)(9).

n58

58. 11 U.S.C. § 546(c)(2). Section 546(c)(2), unlike section 546(c)(1), is not modified by the terms subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof. *Compare* 11 U.S.C. § 546(c)(2), with 11 U.S.C. § 546(c)(1).

n59

59. See, e.g., *In re MGS Mktg.*, 22 C.B.C.2d 1258, 111 B.R. 264 (B.A.P. 9th Cir. 1990); *Monfort, Inc. v. Kunkel (In re Morken)*, 182 B.R. 1007 (Bankr. D. Minn. 1995); *In re Diversified Food Serv. Distrib., Inc.*, 130 B.R. 427 (Bankr. S.D.N.Y. 1991); *Action Indus., Inc. v. Dixie Enters., Inc.*, 22 B.R. 855 (Bankr. S.D. Ohio 1982); see also *Collingwood Grain, Inc. v. Coast Trading Co. (In re Coast Trading Co.)*, 744 F.2d 686, 11 C.B.C.2d 790 (9th Cir. 1984) (discussing right to proceeds under U.C.C. § 2-702(2) and collecting cases); *McCain Foods, Inc. v. Flagstaff Foodservice Corp. (In re Flagstaff Foodservice Corp.)*, 9 C.B.C.2d 9, 14 B.R. 462 (Bankr.

S.D.N.Y. 1981) (recognizing that proceeds are not subject to reclamation under U.C.C. § 2-702(2)).

n60

60. *Fed. R. Bankr. P. 7001(1)*; see *In re Realty Southwest Assocs.*, 140 B.R. 360 (Bankr. S.D.N.Y. 1992); *In re Summit Airlines, Inc.*, 94 B.R. 367 (Bankr. E.D. Pa. 1988), *aff'd*, 102 B.R. 32 (E.D. Pa. 1989).

n61

61. See discussion in *Collier on Bankruptcy*, 546.04[2][b][iii].

n62

62. *McLouth Steel Prods. Corp. v. Quaker Chem. Co. (In re McLouth Prods. Corp.)*, 213 B.R. 978, 987 (E.D. Mich. 1997).

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188 of 197 DOCUMENTS

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Collier on Exemption for Avoidance of Contemporaneous Exchanges

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Collier on Exemption for Avoidance of Contemporaneous Exchanges

By Collier

November 16, 2007

SUMMARY: This Emerging Issues Analysis details the exemption for avoidance of contemporary exchanges under section 547(c)(1) of the Bankruptcy Code, including issues such as the requirement that the parties have the requisite intent that the transaction is substantially contemporaneous; the requirement that the exchange is, in fact, contemporaneous; and when payment to a creditor may be exempt from avoidance as a preference.

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ARTICLE: Section 547(c)(1) provides:

The trustee may not avoid under this section a transfer--

(1) to the extent such transfer was--

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange[.]

Thus, under section 547(c)(1) a transfer that would otherwise be considered preferential is insulated from attack by the trustee if (1) the preference defendant extended new value to the debtor, n1 (2) both the defendant and the debtor intended the new value and reciprocal transfer by the debtor to be contemporaneous and (3) the exchange was in fact contemporaneous. n2

The purpose of the contemporaneous exchange exception, like that of the other section 547(c) exceptions, is to encourage creditors to continue to deal with troubled debtors without fear that they will have to disgorge payments received for value given. If creditors continue to deal with a troubled debtor, it is possible that bankruptcy will be avoided altogether. n3 Section 547(c)(1) protects transfers only to the extent that the creditor can show that the value given to the creditor equals the value the debtor received. Thus, if the debtor transfers \$50,000 to the creditor in exchange for the release of a lien of \$30,000, the difference of \$20,000 is not protected from avoidance under the

contemporaneous exchange exception. n4

Creditors have often argued that the protections of the contemporaneous exchange exception could extend to creditors who fail to meet the 30-day perfection rule under the enabling loan exception in section 547(c)(3). n5 Enabling lenders who do not timely perfect their security interests have claimed that their loan to the debtor and the perfection of the security interest were nevertheless substantially contemporaneous. n6 Although earlier bankruptcy court decisions often permitted these creditors to utilize section 547(c)(1), n7 the better rule holds that section 547(c)(1) is not available to creditors who fail to meet the time requirement of section 547(c)(3). n8 The sparse legislative history of section 547(c)(1) shows that it was meant to protect exchanges of property that might be considered credit transactions when the transactions were contemporaneous transfers. n9

Parties to Transaction Must Have Requisite Intent. The requirement that subsection 547(c)(1)(A) the parties *intend* the transaction to be substantially contemporaneous codifies the judicially created rule established by *National City Bank v. Hotchkiss*. n10 There, defendant bank made an unsecured loan in the morning. Upon learning later that same day that the borrower was having financial difficulties, it requested and immediately received security for the loan. Although only a few hours had passed from the time of the loan to the time the security interest was given, the transaction was found to be preferential. n11 Transactions that appear at first glance to be a contemporaneous exchange for new value will not be so considered under subsection 547(c)(1)(A) absent a showing that the parties actually intended the exchange to be contemporaneous. For example, a vendor who conditions continued deliveries to the buyer on the buyers payment of old invoices will not be protected by section 547(c)(1) from attack by the buyer's trustee, even though the buyer's payment to the vendor and the vendors transfer of property to the buyer occurred contemporaneously. n12

Courts have held that a transaction concededly intended to be a contemporaneous exchange for new value is not, in fact, contemporaneous if the debtor purchased goods within the preference period with a check that is subsequently dishonored. For example, in *Goger v. Cudahy Foods Co. (In re Standard Food Services, Inc.)*, n13 the seller, upon receiving a check for goods delivered that was dishonored, warned the buyer that no further deliveries would occur until full payment for the prior delivery was received. The debtor replaced the dishonored check with a cashiers check, which was delivered 11 days after the debtors receipt of goods. Despite the parties obvious intent to effect a cash transaction, the court rejected the sellers argument that the transaction was substantially contemporaneous, and thus not a voidable preference, holding that when the check bounced, the transaction became a credit transaction. n14

Exchange Must in Fact Be Contemporaneous. Under subsection 547(c)(1)(B), the exchange of new value between the debtor and the defendant must *in fact* be substantially contemporaneous. n15 This subsection preserves the rule of *Dean v. Davis*. n16 There, the Supreme Court held that a transfer was not preferential if both parties to the transfer intended to make a secured loan, but the mortgage on the debtors real property securing the loan was not signed and recorded until one week after the loan was made. There was no preference because the concept of [p]reference implies paying or securing a pre-existing debt of the person preferred. The mortgage was given to secure [the creditor] for a substantially contemporary advance. n17 Intention that an exchange be contemporaneous is not relevant to a courts determination whether the exchange is in fact contemporaneous. n18

New Value May Be Paid by Third Party. Payment to a creditor may be exempt from avoidance as a preference if the debtor receives contemporaneous new value from a party other than the creditor. For example, in *Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc. (On re Fuel Oil Supply & Terminaling, Inc.)*, n19 a creditor released letters of credit upon receipt of payment from the debtor. The bank that had issued the letters of credit then released its collateral to the debtor. The Court of Appeals for the Fifth Circuit held that the payment to the creditor was exempt from preference avoidance because the three-party transaction was a contemporaneous exchange for new value. The courts decision is correct because the payment did not diminish the debtors estate. If the payment had not occurred, the creditor would have drawn down on the letter of credit and the bank would have been reimbursed through liquidation of

its collateral. On the facts presented, payment to the creditor did not diminish the debtors estate because the bank was fully secured. If the bank had not been fully secured, however, the debtors payment to the creditor might have been preferential. n20

For a complete discussion of Code section 547, see Collier on Bankruptcy, ch. 547.

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n1 1. New value is defined in 11 U.S.C. § 547(a)(2). See *Collier on Bankruptcy*, 547.02[2]. Release of a valid materialmens lien constitutes a transfer of new value, even when the property on which the lien formerly existed ultimately proves valueless to the estate. See *Stevenson v. Leisure Guide of Am., Inc. (In re Shelton Harrison Chevrolet, Inc.)*, 202 F.3d 834 (6th Cir. 2000) (a Manufacturers Statement of Origin delivered to the purchaser of a new vehicle more than a week after the purchaser pays for the vehicle did not itself have new value); *Harrison v. Brent Towing Co. (In re H&S Transp. Co.)*, 939 F.2d 355, 360 (6th Cir. 1991) (chapter 11 trustee could not recover payments made to fuel suppliers by debtor as preference, as payments made by debtor to fuel supplier were in exchange for new value, in that payments were made in order to purchase new fuel during the preference period); *In re Kumar Bavishi & Assocs.*, 906 F.2d 942 (3d Cir. 1990) (prepetition payments of antecedent debts owed by debtor partnership to limited partners in exchange for limited partners guarantee of loan to debtor constituted transfers for new value when debtor partnership would not have been able to secure the loan without the guarantees); *Energy Coop., Inc. v. SOCAP Intl, Ltd. (In re Energy Coop., Inc.)*, 832 F.2d 997, 1003, 17 C.B.C.2d 1215, 1222 (7th Cir. 1987) (a release from contractual obligations and continued credibility and goodwill is not new value, and court agreed with trustee that the release and goodwill do not fall within § 547(a)(2)s definition of new value. To hold otherwise would be inconsistent with the contemporaneous exchange exceptions purpose.); cf. *Tyler v. Swiss American Securities, Inc. (In re Lewellyn & Co., Inc.)*, 929 F.2d 424, 427 (8th Cir. 1991) (The parties intended the transfer of Safeguard shares to be a contemporaneous exchange for new value, that the exchange was in fact contemporaneous, and that the \$8 million in cash stock purchases SASI made for Lewellyn constituted new value for the Safeguard shares.); *Gulf Oil Corp. v. Fuel Oil Supply & Terminating, Inc.*, 837 F.2d 224 (5th Cir. 1988) (payment from debtor to beneficiary of letter of credit may constitute a contemporaneous exchange for new value, when issuer of letter of credit consequently reduced its encumbrances on property of debtor); *Kenan v. Fort Worth Pipe Co. (In re Rodman, Inc.)*, 792 F.2d 125, 14 C.B.C.2d 1230 (10th Cir. 1986) (bankruptcy court erred in undertaking valuation of property at time of adversary proceeding since no such valuation requirement could be gleaned from the statute or its legislative history). But see *Cimmaron Oil Co. v. Cameron Consultants, Inc.*, 71 B.R. 1005, 1009 (N.D. Tex. 1987) ([F]orgoing the right to perfect a lien is not the exchanging of new value [because such] waiver does not fit within the definition of new value as set forth by Congress.).

n2 2. See *Ray v. Security Mut. Fin. Corp. (In re Arnett)*, 731 F.2d 358, 362 (6th Cir. 1984); see also *Pine*

Top Ins. Co. v. Bank of Am. Natl Trust & Savings Assn, 969 F.2d 321 (7th Cir. 1992) (involving state preference statute relating to insolvent insurers; transfer of collateral to creditor two to three weeks after standby letter of credit was issued was substantially contemporaneous when both debtor-purchaser and bank-issuer intended letter of credit to be secured, and delay in transfer of collateral was reasonable under the circumstances).

n3 3. See *Jones Truck Lines, Inc. v. Central States, S.E. and S.W. Areas Pension Funds (In re Jones Truck Lines, Inc.)*, 130 F.3d 323, 326 (8th Cir. 1997) (Contemporaneous new value exchanges are not preferential because they encourage creditors to deal with troubled debtors and because other creditors are not adversely affected if the debtor's estate receives new value.). Purchase money lenders may use only section 547(c)(3) as a defense, not section 547(c)(1). See *In re Dorholt, Inc.*, 224 F.3d 871, 873 (8th Cir. 2000) ([A] transaction is not a preferential transfer, even if made on the eve of bankruptcy, if creditor provides new value in exchange for debtor's contemporaneous transfer. Other creditors are not adversely affected by such an exchange because the debtor's estate has received new value. Moreover, this exception encourages creditors to continue dealing with a troubled company, which may allow the company to escape bankruptcy altogether.).

n4

4. See *Lowrey v. U.P.G., Inc. (In re Robinson Bros. Drilling, Inc.)*, 877 F.2d 32, 21 C.B.C.2d 403 (10th Cir. 1989); *Florida, Inc. v. American Airlines, Inc. (In re Jet Florida Sys., Inc.)*, 861 F.2d 1555, 1558-59, 20 C.B.C.2d 33, 37 (11th Cir. 1988) (Section 547(c)(1) protects transfers only to the extent the transfer was a contemporaneous exchange for new value. [A] creditor seeking [its] protection must prove with specificity the new value given to the debtor.).

n5

5. The number of days allowed for perfecting an enabling loan under section 547(c)(3) was extended from 20 days to 30 days by the 2005 amendments. Pub. L. No. 109-8, § 1222 (2005), effective in cases commenced on or after October 17, 2005.

n6

6. See *Pine Top Ins. Co. v. Bank of Am. Natl Trust and Savings Assn*, 969 F.2d 321, 328 (7th Cir. 1992) (federal court decision applying state preference statute relating to insolvent insurers. Contemporaneity is a flexible concept which requires a case-by-case inquiry into all relevant circumstances, (e.g., length of delay, reason for delay, nature of the transaction, intentions of the parties, possible risk of fraud) surrounding an allegedly preferential transfer; a two to three week delay in transfer of collateral in connection with issuance of secured standby letter of credit was substantially contemporaneous). But see *Ray v. Security Mut. Fin. Corp. (In re Arnett)*, 731 F.2d 358, 362 (6th Cir. 1984) (to fall under this exception, the exchange must in fact be substantially contemporaneous; 33 days held not to be contemporaneous).

n7

7. See *Jahn v. First Tenn. Bank of Chattanooga (In re Burnette)* 14 B.R. 795 (Bankr. E.D. Tenn. 1981) (holding the two sections not mutually exclusive and 11 U.S.C. § 547(c)(3) only one type of contemporaneous exchange); see also *General Motors Acceptance Corp. v. Martella (In re Martella)*, 22 B.R. 649 (Bankr. D. Colo. 1982) (applying 11 U.S.C. § 547(c)(1) to enabling loan perfected after 10 days).

n8

8. *Wachovia Bank and Trust Co. v. Bringle (In re Holder)*, 892 F.3d 29, 31 (4th Cir. 1989) (section 547(c)(1) does not apply to purchase-money security transactions perfected more than 10 days after the debtor receives possession of the collateral); *Union Bank & Trust Co., Erie v. Baker (In re Tressler)*, 771 F.2d 791, 794 (3d Cir. 1985) (contemporaneous exchange exception may not be used to prevent the avoidance of a purchase-money security interest perfected beyond the 10-day period permitted in section 547(c)(3)); *Gower v. Ford Motor Credit Co. (In re Davis)*, 734 F.2d 604, 607 (11th Cir. 1984) (If 547(c)(1) applied to all such cases, the ten day grace period would serve as little more than an evidentiary presumption.). But see *Jahn v. First Tenn. Bank of Chattanooga (In re Burnette)*, 14 B.R. 795 (Bankr. E.D. Tenn. 1981) (holding the two sections not mutually exclusive and 11 U.S.C. § 547(c)(3) only one type of contemporaneous exchange); see also *General Motors Acceptance Corp. v. Martella (In re Martella)*, 22 B.R. 649 (Bankr. D. Colo. 1982) (applying 11 U.S.C. § 547(c)(1) to enabling loan perfected after 10 days).

The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994, effective in cases commenced on or after the date of enactment), reprinted in *Collier on Bankruptcy*, App. Pt. 9(a), changed the perfection period to 20 days, the intention of Congress being to conform bankruptcy law to the practice in most states. See *Collier on Bankruptcy*, 547.LH.

n9

9. H.R. Rep. No. 595, 95th Cong., 1st Sess. 177, 373 (1977); The [contemporaneous exchange] exception is a simple one, excepting a transfer that is really not on account of an antecedent debt No doubt a purchase by the debtor of goods or services with a check, if deemed to be on credit by state law, would be insulated by this exception. Though strictly speaking the transaction may be a credit transaction because the seller does not receive payment until the check is cleared through the debtor's bank, it is generally considered and intended to be a contemporaneous transaction, and assuming the check is promptly deposited and cleared, is in fact substantially contemporaneous. See Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 *Vand. L. Rev.* 713, 759-67 (1985). The 2005 amendments lengthen from 20 to 30 days the period of protection for an enabling loan. . Pub. L. No. 109-8, § 1222 (2005), effective in cases commenced on or after October 17, 2005.

n10

10. 231 U.S. 50, 34 S. Ct. 20, 58 L. Ed. 115 (1913).

n11

11. *National City Bank of N.Y. v. Hotchkiss*, 231 U.S. 50, 34 S. Ct. 20, 58 L. Ed. 115, 120 (1913). But see *Dean v. Davis*, 242 U.S. 438, 37 S. Ct. 130, 61 L. Ed. 419 (1917).

n12

12. See, e.g., *McClendon v. Cal-Wood Door (In re Wadsworth Bldg. Components, Inc.)*, 711 F.2d 122, 8 C.B.C.2d 1166 (9th Cir. 1983). In *Wadsworth*, the seller shipped goods to the buyer on credit, and subsequently received the buyers check for the full amount owing, which was dishonored. Based on the buyer's assurances that the check would be paid in full, the seller shipped additional goods to the debtor. The previously dishonored check was paid upon redeposit, but the seller was never paid for the last shipment. The buyer's bankruptcy trustee recovered as preferential the amount paid the seller for the earlier shipment. The court held that the parties intended the check to be payment for pre-existing debt rather than a contemporaneous exchange of new value by the seller. The court rejected defendant's contention that the debtor's payment was at least partially for the extension of new credit, and therefore satisfied the new value requirement. See also *Tyler v. Swiss American Securities, Inc. (In re Lewellyn & Co., Inc.)*, 929 F.2d 424, 427 (8th Cir. 1991) (The existence of intent, contemporaneousness, and new value are questions of fact.); *In re Lee and Ota*, 33 C.B.C.2d 1360, 179 B.R. 149 (B.A.P. 9th Cir. 1995) (contemporaneous exchange defense unavailable when initial check is dishonored by bank); *Remes v. Acme Carton Corp. (In re Fasano Harriss Pie Co.)*, 43 B.R. 871 (Bankr. W.D. Mich. 1984); *Thompson v. McMaster (In re Fritz-Mair Mfg. Co.)*, 16 B.R. 417, 420 (Bankr. N.D. Tex. 1982) (parties intended transfer of title to be contemporaneous exchange although consideration for transfer was paid in advance).

n13

13. 723 F.2d 820 (11th Cir. 1984).

n14

14. *Goger v. Cudahy Foods Co. (In re Standard Food Servs., Inc.)* 723 F.2d 820, 821 (11th Cir. 1984). The court recognized that checks should be considered contemporaneous exchanges. The court, however, quoted the following additional portions of the legislative history to support its view that the customary rules regarding checks did not obtain when the check was dishonored: Contrary to the language contained in the House report, payment of a check is equivalent to a cash payment *unless the check is dishonored*. Payment is to be considered to be made when the check is delivered for purposes of 11 U.S.C. § 547(c)(1) and (2). 124 Cong. Rec. H11,097 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17,414 (daily ed. Oct. 6, 1978). For a discussion of when a transfer is deemed made for purposes of section 547 if payment is by check, see *Collier on Bankruptcy*, 547.05[4]; see also *Endo Steel, Inc. v. Janas (In re JWJ Contracting Co., Inc.)*, 371 F.3d 1079 (9th Cir. 2004) (because Endo had given JWJ an unconditional release of the bond claim in exchange for what turned out to be a dishonored check, the subsequent payment that replaced the dishonored check was given in exchange for what had become an unsecured debt, and did not result in a contemporaneous exchange for new value); *Hall-Mark Elecs. Corp. v. Sims (In re Lee)*, 179 B.R. 149, 163 (B.A.P. 9th Cir. 1995) (A contemporaneous exchange defense cannot involve a dishonored check. Dishonor changes the nature of the transaction from one intended for a

contemporaneous cash exchange to a credit transaction (citations omitted)).

n15

15. *In re Dorholt, Inc.*, 224 F.3d 871, 873 (8th Cir. 2000) (transfer of nonpurchase-money security interest may be substantially contemporaneous, even if security interest is not perfected within 10 days; modifier substantial makes clear that contemporaneity is a flexible concept which requires a case-by-case inquiry into all relevant circumstances); *Pine Top Ins. Co. v. Bank of America National Trust & Savings Assn*, 969 F.2d 321, 328 (7th Cir. 1992) (contemporaneity is a flexible concept which requires a case-by-case inquiry into all relevant circumstances (e.g., length of delay, reason for delay, nature of the transaction, intentions of the parties, possible risk of fraud) surrounding an allegedly preferential transfer; two-to-three week delay in transfer of collateral in connection with issuance of secured standby letter of credit was substantially contemporaneous); *Ray v. Security Mut. Fin. Corp. (In re Arnett)*, 731 F.2d 358, 362 (6th Cir. 1984) (to fall under this exception the exchange must in fact be substantially contemporaneous; 33 days held not to be contemporaneous); *Telecash Indus., Inc. v. Universal Assets (In re Telecash Indus., Inc.)*, 104 B.R. 401, 404 (Bankr. D. Utah 1989) (issue of contemporaneous exchange is one of fact; contemporaneous exchange not precluded as a matter of law when defendant perfected security interest more than 10 days after loan transaction, despite section 547(e)(2)); *Gropper v. Samuel Kunstler Textiles, Inc. (In re Fabric Buys of Jericho, Inc.)*, 22 B.R. 1013, 1016 (Bankr. S.D.N.Y. 1982) (over 90 days; not contemporaneous); *Jahn v. First Tenn. Bank of Chattanooga (In re Burnette)*, 14 B.R. 795 (Bankr. E.D. Tenn. 1981) (20 days contemporaneous); *In re Hall*, 14 B.R. 186, 188 (Bankr. S.D. Fla. 1981) (90 days not contemporaneous); *Steinberg v. Natl Bank & Trust Co. (In re Independence Land Title Corp.)*, 9 B.R. 394, 396 (Bankr. N.D. Ill. 1981) (two months not contemporaneous); *Brown v. Callaway Bank (In re Meritt)*, 7 B.R. 876, 880 (Bankr. W.D. Mo. 1980) (eight months not contemporaneous).

n16

16. *Dean v. Davis*, 242 U.S. 438, 37 S. Ct. 130, 61 L. Ed. 419 (1917).

n17

17. 242 U.S. 438, 443, 37 S. Ct. 130, 131, 61 L. Ed. 419, 421.

n18

18. *See, e.g., Butz v. Pingel (In re Pingel)*, 17 B.R. 236, 238 (Bankr. S.D. Ohio 1982) (perfection of transfer nine days before bankruptcy petition, but over one year after parties intended the transfer to occur, held not to be contemporaneous in fact).

n19

19. 837 F.2d 224, 331, 18 C.B.C.2d 462, 470 (5th Cir. 1988) (We hold that under these circumstances, new value received by a debtor need not be provided by the creditor to whom the transfer was made but may be provided by the fully secured third party.).

n20

20. *Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc. (In re Fuel Oil Supply & Terminaling, Inc.)*, 837 F.2d 224, 228, 18 C.B.C.2d 462, 468 (5th Cir. 1988); see *In re Powerine Oil Co.*, 59 F.3d 969, 972-74, 33 C.B.C.2d 1778, 1782 (9th Cir. 1995) (payment voidable to the extent letter of credit reimbursement obligation unsecured; also rejected rule of reason defense that creditor should have no preference liability because it allowed letter of credit to expire in reliance on the receipt of payment); Resnick, *From the Bankruptcy Courts: Expiration of Letter of Credit After Payment Leaves Creditor Vulnerable to Preference Risk*, 28 U.C.C. L.J. 414 (1996) (issuer's contingent reimbursement claim may become unsecured and letter of credit may expire when underlying debt is repaid without providing for recourse against issuer in event creditor is required to disgorge payment as preferential).

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189 of 197 DOCUMENTS

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Prepetition Credit Counseling Eligibility Requirement Under the Bankr. Code

2008 Emerging Issues 918

Collier on the Prepetition Credit Counseling Eligibility Requirement Under the Bankruptcy Code

By Collier

November 12, 2007

SUMMARY: Bankruptcy Code section 109(h)(1) provides that an individual may not be a debtor under any chapter unless the individual has, within the 180 days before the petition date, received an individual or group briefing that outlined credit counseling opportunities and assisted the individual in performing a related budget analysis. This Emerging Issues Analysis addresses the issues relating to the prepetition credit counseling requirement.

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ARTICLE: Prepetition Briefing for Individual Debtors. Bankruptcy Code section 109(h)(1), added by the 2005 amendments to the Bankruptcy Code, n1 provides that an individual may not be a debtor under any chapter unless the individual has, within the 180 days before the petition date, received an individual or group briefing that outlined credit counseling opportunities and assisted the individual in performing a related budget analysis. The briefing must have been provided by a nonprofit budget and credit counseling agency approved by the United States trustee or, if the case is in North Carolina or Alabama, by the bankruptcy administrator pursuant to new Code section 111, also enacted in 2005. n2

The requirement applies to all individual debtors, n3 regardless of their financial circumstances and their ability to pay their debts. It applies to debtors who are proposing a chapter 13 repayment plan paying all or most of their debts, and even to debtors who have unsuccessfully attempted a credit counseling repayment plans in the past. And it applies to individual debtors who have solely business debts.

The new provision does not further elaborate on what the briefing must entail or its contents. Nor does it clarify exactly to what the budget analysis is related. Is it related to credit counseling or to the briefing generally? Such questions may be answered by standards that will probably be developed under section 111 for approval of nonprofit budget and credit counseling agencies. It is clear that the briefing may be provided over the telephone or on the Internet, n4 which would make it much more convenient for debtors who might otherwise have to travel to a distant agency, incurring travel expenses and possible loss of employment income.

Although a few courts have held to the contrary, n5 the better view is that the credit counseling briefing may occur on the same day as the bankruptcy petition is filed, as long as it occurs before the petition is filed. n6 The word date in section 109(h) should be read to connote a day and time. There is no indication in any of the legislative history that

Congress intended to require debtors to wait until the day after they received the briefing before they filed their petitions.

A corresponding amendment added to section 521(b) requires an individual debtor to file with the court a certificate from the nonprofit budget and credit counseling agency that provided a briefing to the debtor describing the services the debtor received. n7 The debtor must also file a copy of any debt management plan developed under section 109(h). n8 However, section 109(h) does not require the development of a debt management plan. The requirement that a debtor file a certificate from the counseling agency provides a mechanism for the court and the parties to verify the debtor's eligibility for relief. In light of the timing requirement, the certificate will have to state the date on which the briefing was provided to the debtor.

Interim Bankruptcy Rule 1007(c), prepared by the Advisory Committee on Bankruptcy Rules and adopted as a local rule in each district, provides that the certificate must be filed within 15 days after the petition unless the court orders otherwise. Exhibit D to the Voluntary Petition, Official Form 1, requires the debtor to state whether the debtor has received the credit counseling briefing and, if so, whether the certificate is being filed with the petition. n9 Alternatively, the debtor may state on the Exhibit that the debtor is seeking a deferral for exigent circumstances under section 109(h)(3) n10 or an exemption from the requirement under section 109(h)(4). n11

Courts have differed about the consequences when the credit counseling requirements are not met. Some courts have held that a case need not be dismissed. n12 These courts have weighed the circumstances of individual cases and concluded that sections 707(a) and 1307(a) grant discretion to courts when there are grounds for dismissal. Other courts have stricken petitions when the debtor failed to obtain the prepetition briefing. n13 In any event, because eligibility for relief is not jurisdictional, n14 it should be clear that the automatic stay is brought into effect by the petition. n15

Districts in Which Services Not Available. The requirement of a prepetition briefing does not apply if the United States trustee or bankruptcy administrator determines that the approved nonprofit budget and credit counseling agencies for the district are not reasonably able to provide adequate services for all potential debtors who would need them. n16 If such a determination is made, it must be reviewed no later than one year thereafter and no less frequently than annually after that. n17 In addition, a nonprofit budget and credit counseling agency may be disapproved at any time, which conceivably could lead to a determination that adequate services are not available.

The United States trustee or bankruptcy administrator will have to decide whether adequate services are available if the only services available to some debtors are over the telephone or on the Internet. Not all debtors have access to the Internet and some debtors do not have a telephone or are unable to use a telephone due to hearing problems. Debtors in this situation may also find it difficult or impossible to travel to a distant agency due to the expense involved or for other reasons. Lack of services in a language the debtor can speak should be another reason for finding that services are unavailable, at least for debtors in that situation. n18 It may be that agencies in some parts of a district could become overwhelmed by the demand for services and unable to provide them to all who request them. It is not clear whether a determination can be made that services are reasonably available in some parts of a district but not others.

Although section 521(b) contains no exception for debtors who reside in districts in which services have been found not to be reasonably available, because such debtors are not required to obtain a briefing they should not have to file a certificate showing they received one.

Emergency Bankruptcy Petitions. Section 109(h)(3)(A) creates a limited exception to the prepetition counseling requirement for debtors who must file a bankruptcy case very quickly to forestall imminent harm. Such a debtor must submit to the court a certification that describes the exigent circumstances that merit a waiver of the requirement and states that the debtor requested credit counseling services from an approved agency but was unable to obtain the services during the five-day period beginning on the date the debtor made the request. The inability to obtain services may be caused by the counseling agency not having services available, but it might also be caused by the debtor's inability to travel, or a temporary illness or disability. A debtor's incarceration as a prisoner, for example, may make it

impossible for the debtor to gain access to services. n19 The certification must also be satisfactory to the court. If the debtor files such a certification, the debtor may defer the counseling until after the petition is filed.

The language of this provision is somewhat unclear. It appears to require the debtor to have made a request for services to one approved agency. It also states that the debtor must have been unable to obtain the services referred to in section 109(h)(1) within five days after the request. This language could be read to mean that a debtor who had to file a petition one day after the request was made to forestall harm such as a foreclosure, repossession, or utility shutoff, but who could obtain services in three days, would not be able to obtain a waiver of the counseling requirement and would not be eligible to file a petition. In view of the obvious intent to protect debtors facing just that sort of harm, a better reading would be to construe services referred to in paragraph (1) to mean prepetition counseling services, which such a debtor would not have been able to obtain. In any event, if services are available over the Internet and by telephone, there will rarely be a situation in which a debtor cannot obtain the necessary briefing within hours of seeking it, so this issue may be primarily academic.

The requirement that the certification be satisfactory to the court raises another potential issue. Once the debtor has filed the petition and certification, what will happen if the certification is not satisfactory? Must the petition be dismissed? It is unclear whether the court can permit the debtor, who by the time of the determination may have obtained counseling postpetition, to continue with the case. Because eligibility requirements are not jurisdictional, n20 they may be waivable by the court if the debtor made the unsatisfactory certification in good faith, and certainly should not apply if no entity moves to dismiss the case. Again, such situations may occur only rarely, because a court would have little reason to find a good faith certification to be unsatisfactory.

If the debtor is exempted from the prepetition counseling requirement under this provision, the debtor must still obtain the briefing after the petition is filed. Section 109(h)(3)(B) provides that the exemption for such a debtor expires when the debtor obtains a postpetition briefing, but in no event later than 30 days after the petition, unless the court, for cause, allows the debtor an additional 15 days. Such cause might include, for example, a temporary illness or disability.

Permanent Exemption from Prepetition Counseling Requirement. In very limited circumstances a debtor may be completely exempted from the prepetition counseling requirement of section 109(h)(1), even if adequate services are available in the debtor's judicial district. Section 109(h)(4) provides that the debtor need not obtain the briefing if the court finds, after notice and a hearing, that the debtor is unable to meet the requirement because of incapacity, disability, or active military duty in a combat zone.

The provision goes on to define incapacity as impaired by reason of mental illness or mental deficiency so that [the debtor] is incapable of realizing and making rational decisions with respect to financial responsibilities and disability as so physically impaired as to be unable, after reasonable effort, to be unable to participate in an in person, telephone, or Internet briefing . By excepting such individuals from the requirement, section 109(h) avoids the absurd situation in which a debtor would be required to obtain a briefing even if suffering from Alzheimer's disease or some other disability that would make the briefing meaningless or even impossible. n21 Thus, for example, the briefing requirement has been waived for debtors who were deaf or so dependent on multiple medications that they could not participate meaningfully in a briefing. n22

Unless, a determination of disability or incapacity can be made before the bankruptcy case is filed, which may not be possible since there would not yet be a case in which the court could make a ruling, the court's determination on this issue must be made after the petition is filed. This likelihood again raises the issue of whether the case must be dismissed if the court denies the request for an exemption. Because such requests will be relatively infrequent, and because they will probably be uncontested in almost all cases, this situation may be extremely rare. In such cases, especially in view of the serious consequences of dismissal, n23 the court should find a way to allow a good faith case

to proceed despite this nonjurisdictional defect.

For a complete discussion of Code section 109, *see* Collier on Bankruptcy, ch. 109 (Matthew Bender).

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n1 1. Pub. L. No. 109-8, § 106(a) (2005), effective in cases commenced on or after October 17, 2005.

n2

2. *11 U.S.C. § 111*; *see* Collier on Bankruptcy, ch. 111 (Matthew Bender).

n3

3. For a discussion of involuntary debtors, *see Collier on Bankruptcy*, 303.02[8] (Matthew Bender).

n4

4. *11 U.S.C. § 109(h)(1)*.

n5

5. *E.g., In re Cole*, 347 B.R. 70 (Bankr. E.D. Tenn. 2006).

n6

6. *First Shore Fed. Sav. & Loan Ass'n v. Hudson (In re Hudson)*, 352 B.R. 391 (Bankr. D. Md. 2006); *In re Warren*, 339 B.R. 475 (Bankr. E.D. Ark. 2006).

n7

7. 11 U.S.C. § 521(b)(1), added by Pub. L. No. 109-8, § 106(d)(2) (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 521 (Matthew Bender).

n8

8. 11 U.S.C. § 521(b)(2), added by Pub. L. No. 109-8, § 106(d)(2) (2005), effective in cases commenced on or after October 17, 2005; see Collier on Bankruptcy, ch. 521 (Matthew Bender).

n9

9. Official Form 1.

n10

10. See Emergency Bankruptcy Petitions *infra*.

n11

11. See Permanent Exemption from Prepetition Counseling Requirement *infra*.

n12

12. *In re Manalad*, (Bankr. C.D. Cal. 2007) (collecting cases regarding whether such petitions must be dismissed); *In re Bricksin*, 346 B.R. 497 (Bankr. N.D. Cal. 2006); *In re Hess*, 347 B.R. 489 (Bankr. D. Vt. 2006).

n13

13. *E.g.*, *In re Thompson*, 344 B.R. 899 (Bankr. S.D. Ind. 2006); *In re Elmendorf*, 345 B.R. 486 (Bankr. S.D.N.Y.), appeal dismissed, 2006 U.S. Dist. LEXIS 81591 (S.D.N.Y. 2006).

n14

14. See Collier on Bankruptcy, 109.01[2] (Matthew Bender).

n15

15. *In re Thompson*, 344 B.R. 899 (Bankr. S.D. Ind. 2006). But see *In re Elmendorf*, 345 B.R. 486 (Bankr. S.D.N.Y.), appeal dismissed, 2006 U.S. Dist. LEXIS 81591 (S.D.N.Y. 2006).

n16

16. 11 U.S.C. § 109(h)(2)(A), added by Pub. L. No. 109-8, § 106(a) (2005), effective in cases commenced on or after October 17, 2005.

n17

17. 11 U.S.C. § 109(h)(2)(B), added by Pub. L. No. 109-8, § 106(a) (2005), effective in cases commenced on or after October 17, 2005.

n18

18. *In re Petit-Louis*, 344 B.R. 696 (Bankr. S.D. Fla. 2006).

n19

19. *In re Star*, 341 B.R. 830 (Bankr. E.D. Va. 2006).

n20

20. See *Collier on Bankruptcy*, 109.01[2] (Matthew Bender).

n21

21. A debtor who is disabled or incapacitated may still be eligible for relief. A petition may be filed on behalf of an infant or incompetent by a representative or next friend. *Fed. R. Bankr. P. 1004.1*. If the debtor is an infant, the debtor will still have to obtain credit counseling, unless the debtor is deemed mentally deficient.

n22

22. *In re Tulper*, 345 B.R. 322 (Bankr. D. Colo. 2006); see also *In re Hall*, 347 B.R. 532 (Bankr. N.D. W. Va. 2006) (waiving postpetition education requirement due to limited mental capacity of elderly debtor).

n23

23. See e.g., 11 U.S.C. § 362(c)(3).

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190 of 197 DOCUMENTS

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Collier on "Public Access to Papers" Under the Bankruptcy Code

2008 Emerging Issues 919

Collier on "Public Access to Papers" Under the Bankruptcy Code

By Collier

November 12, 2007

SUMMARY: This Emerging Issues Analysis details the right to public access to papers and dockets under Section 107(a), examines the mandatory exceptions to the right of access under Section 107(b), and discusses the courts broad general discretion to protect an individual with respect to information filed in a paper with the court under Section 107(c).

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ARTICLE: *Section 107(a) of the Bankruptcy Code* codifies the general right of the public to inspect and copy judicial records, which are to be available for examination at reasonable times without charge. n1

Section 107(b) contains exceptions to this general rule. On request of a party in interest, the court must protect an entity with respect to confidential commercial information or with respect to scandalous or defamatory matter. n2 The court must also protect an entity with respect to disclosure of such items on its own motion.

Section 107(c), added by the 2005 amendments to the Bankruptcy Code, n3 gives the court broader discretion to protect for cause any information in a paper filed or to be filed in a title 11 case. It provides for exceptions permitting governmental units, the United States trustee, a bankruptcy administrator, a trustee or an auditor serving under section 586(f) of title 28 to have access to such material.

Public Access to Papers and Dockets; 11 U.S.C. § 107(a)

Bankruptcy Code section 107(a) is derived from former Rule 508 of the Federal Rules of Bankruptcy Procedure. It codifies the public's general right under common law to inspect and copy public documents, including judicial records. As the Supreme Court recognized in *Nixon v. Warner Communications, Inc.*, n4 the basis for this right to access is not a proprietary interest in the information but, rather, the public's interest in monitoring the workings of the judicial system. n5 The existence of such rights has been called fundamental to a democratic state. n6 Section 107(a) provides that, subject to exceptions in section 107 and section 112, all papers filed in a case under title 11 and the dockets of a bankruptcy court are public records and open to examination by an entity at reasonable times without charge.

Definition of Docket, Entity, Paper and Filed. The

term docket is not defined in the Bankruptcy Code. *Federal Rule of Bankruptcy Procedure 5003(a)* requires the clerk of the court to keep a docket in each case and that the clerk shall enter thereon each judgment, order, and activity in the case. n7 Rule 5003(b) requires the court to also keep a claims register, which is sometimes colloquially called the claims docket. n8 Clearly, the claims register is a type of docket that must be open to examination by the public. Indeed, the legislative history states that the term docket in section 107 includes the claims docket, the proceedings docket and all papers filed in a case. n9 There is no indication in the history of Rule 5003 that its drafters intended that the listing of claims not be encompassed within the public access provisions of section 107 and, in any event, the rules could not narrow the applicability of the Code's provisions.

The term entity, as it is defined in section 101, is given its broadest interpretation, to include persons, estates, trusts, governmental units and the United States trustee. n10

The term paper includes documents that are filed electronically pursuant to *Federal Rule of Bankruptcy Procedure 5005(a)(2)*. n11 Thus, if documents are filed electronically pursuant to that rule, the clerk must establish a mechanism to permit the public to view those documents at reasonable times and at no charge in the clerk's office.

In considering the scope of section 107, it is important to keep the definitions and the language of the section in mind. Section 107 does not extend to papers that are not filed in a case, such as pretrial discovery material and other materials that are not filed, n12 or the documents an examiner may review in making a report to the court. n13 Other statutes or rules may apply to disclosure of such information, but section 107 does not. n14

In addition, under *Federal Rule of Bankruptcy Procedure 1007(f)*, certain information is submitted to the clerk rather than filed in order to protect the debtor's privacy. n15 That rule requires an individual debtor to submit, rather than file, a verified statement that sets out the debtor's Social Security number or that the debtor does not have a Social Security number. As the Advisory Committee Note makes clear, the purpose of this procedure is to prevent the Social Security number from becoming a part of the filed papers that are in the case file available to the general public. n16

Relation to Federal Rule of Bankruptcy Procedure 2013.

The purposes of section 107 are further carried out by *Federal Rule of Bankruptcy Procedure 2013*. That rule requires the clerk of the court to create and maintain a separate public record listing fees awarded by the court to trustees, attorneys, accountants, appraisers, auctioneers and other professionals employed by trustees, as well as fees awarded to examiners. n17

This record must be kept chronologically and, like records within the scope of section 107, must be open to the public without charge. n18 At the close of each year, the clerk must prepare a summary of the record listing the total fees awarded to each individual or firm during the year. n19

Mandatory Exceptions to the Right of Access

The common law right of access to public documents is not absolute, and confidentiality may be warranted if access is sought for an improper purpose. n20 Section 107(b) follows former Bankruptcy Rule 918 in recognizing exceptions to the right of access. If a party in interest so requests, the bankruptcy court shall (1) protect an entity with respect to a trade secret or confidential research, development, or commercial information; or (2) protect a person with respect to scandalous or defamatory matter contained in a paper filed in a case under this title. Section 107(b) also explicitly authorizes the court on its own motion to protect such information. n21

Federal Rule of Bankruptcy Procedure 1007(j) and Rule 9018 set forth the procedures for application of section 107. n22 Rule 1007(j) requires a motion to be filed by the party seeking to have the court direct the impounding of a list of creditors or of equity security holders. The movant must show cause for the impoundment, and upon a showing of cause the court may refuse to permit inspection by any entity, or permit only limited inspection on terms prescribed by the court.

Rule 9018 permits the court, on motion or on its own initiative, to make any order that justice requires:

- . to protect the estate or any entity with respect to a trade secret, or confidential research, development or commercial information;
- . to protect any entity against scandalous or defamatory matter contained in any paper filed in any case; or
- . to protect governmental matters that are made confidential by statute or regulation.

Federal Rule of Civil Procedure 26(c), made applicable to adversary proceedings in bankruptcy by *Federal Rule of Bankruptcy Procedure 7026* and to contested matters by *Federal Rule of Bankruptcy Procedure 9014*, also authorizes the issuance of a protective order with respect to discovery for good cause shown." n23

Application of the Exceptions. Any limitation on the public's

right of access, however, must be viewed as an extraordinary measure that is warranted only under rare circumstances. n24

Trade Secrets, Confidential Research or Commercial Information. The first exception requires a party seeking to limit access to show something more than simply a desire for confidentiality or a prior agreement to keep information confidential. Thus, the court in *In re Itel Corp.* n25 did not apply the commercial information exception of section 107(b)(1) to a list of debenture holders where the debtor feared the list would be used by investors to identify and purchase the debtor's debentures at depressed prices. The court denied impoundment of the creditor list under both section 107(b)(1) and Rule 1007(j). Quoting extensively from a case decided under the predecessor to Rule 1007(j), the *Itel* court noted that impoundment was too drastic a step when the objections to dissemination were general and to the effect that the reorganization would run more smoothly without outside interference. n26 Similarly, in *In re Bell & Beckwith*, n27 the court held that a generalized fear that some of the debtor's securities business customers might not want their transactions disclosed was insufficient to overcome the strong policy in favor of disclosing the creditors who were to receive distributions in the case.

In *In re Nunn*, n28 however, the debtor's customer list, which the court found to be the debtor's sole asset, was found to warrant protection under section 107(b)(1). The *Nunn* court specifically distinguished the case from *Itel*, emphasizing that dissemination of the debtor's customer list would clearly have an adverse effect on the debtor. The court in *In re Frontier Group, LLC* n29 came to a similar conclusion, ordering that a list of creditors be sealed because it named some or all of the physicians contracting with the debtor referral agency and was the debtor's primary asset. In *In re Global Crossing Ltd.*, n30 the court invoked section 107, as well as *Federal Rule of Bankruptcy Procedure 9018*, to protect confidential commercial information that could have been used to prejudice the ability of the debtor to sell assets for the benefit of unsecured creditors.

In *In re Orion Pictures Corp.*, n31 the Court of Appeals for the Second Circuit held that information need not be both commercial information and a trade secret to be protected, since section 107 is written in the alternative. The court also held that the good cause standard of *Federal Rule of Civil Procedure 26(c)* was not applicable, although it did not state a specific alternative test.

Scandalous or Defamatory Matter. The second exception has also been construed narrowly, in light of the general public policy that court records should be open for public inspection. Mere embarrassment, or harm to reputation based on non-scandalous, non-defamatory information disclosed is not sufficient cause to restrict public access. n32 Section 107(b)(2), by its terms, applies only to scandalous or defamatory information; the dissemination of merely prejudicial material cannot be enjoined under the provision. n33

The meaning of scandalous or defamatory was discussed at length by the Court of Appeals for the First Circuit in *Gitto v. Worcester Telegram & Gazette Corp. (In re Gitto Global Corp.)*. n34 The court held that the party seeking protection need not prove in every case that the material in question is false, but that there must be a showing that it is material that would cause a reasonable person to have a less favorable opinion of the party and that either (1) the material is untrue or (2) the material is potentially untrue and irrelevant or included within a bankruptcy filing for an improper end.

Whether Exception Applies Is a Question of Fact. Whether or not specific information will warrant the bankruptcy court's protection is a question of fact to be determined according to the judicial guidelines established for the particular jurisdiction. For example, in *In re Halkin*, n35 the court held that before a restriction on the public's First Amendment right to know may be imposed the harm posed by dissemination must be substantial and serious; the restraining order must be narrowly drawn and precise; and there must be no alternative means of protecting the public interest which intrudes less directly on expression. n36

These criteria were later recognized by the Court of Appeals for the Sixth Circuit in *Krause v. Rhodes*. n37 Other courts, without establishing an explicit set of criteria, have generally emphasized the same considerations, namely the seriousness of the harm threatened by dissemination n38 and the lack of a less drastic safeguard. n39

Once the court has determined that the information involved fits within the parameters of section 107(b), it must still decide on the appropriate action. The language of the section provides that the court shall protect the party filing a request, requiring that some protective steps be taken, n40 but does not say how such protection is to be granted. Filing a document under seal, in and of itself, does not prevent the public from having the right of access, and if a motion is made to unseal the document, the court could not avoid deciding whether it should remain under seal merely by ordering the document stricken. n41

Ultimately, the decision under section 107 is closely bound to the factual findings about the nature and seriousness of the threatened harm. The decision regarding what type of protection to give is committed to the discretion of the bankruptcy court, and should be reversed only for an abuse of discretion. n42

Request Must Be Made by a Party in Interest. Protection is mandatory when requested by a party in interest, a term left undefined by the Code. It seems clear that a creditor is a party in interest and therefore is entitled to request protection from the court, even if the creditor's claim is not formally filed or formally allowed in the case. n43 The debtor, of course, is a party in interest within the meaning of the phrase n44 but a debtor owing money to the estate has been held not to come within the meaning of the term. n45 Nor is a non-creditor a party in interest when it seeks access to the debtor's papers for use in a suit against a company associated with the debtor, even though the non-creditor agreed to pay the estate a percentage of any recovery made in the suit. n46 It has been said, though, that a person using what would have been an allowable claim as a setoff to a debt owed to the estate is sufficiently interested to demand the right granted to such parties. n47

Such protection in the case of potentially scandalous or defamatory matter contained in a paper filed in a case under title 11 extends only to a person. Section 101 defines person to include an individual, partnership and corporation but does not include a governmental unit, except under certain circumstances for purposes of section 1102. n48 Protection with respect to a trade secret or confidential research, development, or commercial information extends to an entity.

Pursuant to section 101, entity includes person, estate, trust, governmental unit and United States trustee. n49

Discretionary Protection of Information for Cause

Obtaining Protection. Section 107(c), added by the 2005 amendments to the Bankruptcy Code, n50 gives the court broad discretion to protect an individual with respect to any information, including identifying information, in a paper filed or to be filed with the court to the extent that the court finds that disclosure of the information would create an undue risk of identity theft or unlawful injury to the individual or the individual's property.

The types of information that can be protected by the court are unlimited. Although section 107(c)(1)(A) refers to means of identification, as defined in *section 1028(d) of title 18, United States Code*, n51 section 107(c)(1)(B) refers to any other information contained in a paper that is filed or to be filed. For example, a court can enter an order permitting a victim of domestic violence to keep her address and other identifying information confidential, perhaps by excusing the individual from having to include such information in the papers filed. There are strong arguments that the debtor's Social Security number should never be disclosed in a public record, arguments bolstered by policies already adopted by the courts to protect debtors' social security numbers from disclosure. n52 This would require either barring disclosure of or redacting social security numbers from tax returns or transcripts filed with the court pursuant to section 521. n53 In light of the many other confidential matters that may be revealed in such documents, and the general policy of protecting confidentiality of tax returns, the Judicial Conference should use the authority it is given under section 315(c) of the 2005 legislation n54 to prohibit the disclosure of any tax returns or transcripts that are filed, except for cause. However, individual courts may also protect confidential tax information by entering general orders protecting such information in all cases under section 107(c).

Unlike section 107(b), section 107(c) requires a showing of cause. It does not require a request to the court; although most orders under the section will be initiated in that manner, the court can act *sua sponte*. There is also no requirement that a request be made by a party in interest. However, the protection of the subsection extends only to individuals, n55 and only to prevent injury to the person or property of individuals.

As with section 107(b), the method of protection is determined by the bankruptcy court. A court may enter an order, for example, that a document need not be filed, that a document be redacted, that the document be submitted to the clerk, but not filed, as is the practice with the Statement of Social Security Number required by *Federal Rule of Bankruptcy Procedure 1007(f)*, or that a document be provided to certain parties who are prohibited from disclosing it to others.

Access for Governmental Units. Section 107(c)(2) provides that an entity acting under the police and regulatory powers of a domestic governmental unit n56 may be provided access to documents that are protected under section 107(c)(1). Such access, which is not further defined, must be granted upon an *ex parte* application of the entity, but only if the entity demonstrates cause. However, if the protection granted under section 107(c)(1) was to excuse the filing of the paper, the court may not be able to later grant access to it.

Access to United States Trustee, Bankruptcy Administrator, Trustee or Auditor. A broad exception to section 107(c)(1) is created for United States trustees, bankruptcy administrators, n57 trustees and auditors appointed under *section 586(f) of title 28, United States Code*. These individuals involved in administration of bankruptcy cases are given full access to all information in papers filed or submitted in bankruptcy cases. However, they are not permitted to disclose any information that has been specifically protected by the court. Thus, they may have some difficulty in using some of the information that they acquire through their broader access to the extent such use might require disclosure in a pleading or to another entity. Presumably, they may request that the court amend its order protecting the information to permit limited disclosure if such disclosure does not create any danger of the harms that the original protection was

intended to prevent.

For a complete discussion of Code section 107, *see* Collier on Bankruptcy, ch. 107 (Matthew Bender).

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Return to Text

n1 1 *See* Public Access to Papers and Dockets *infra*.

n2

2 *See* Mandatory Exceptions to the Right of Access *infra*.

n3

3 Pub. L. No. 109-8, § 234(a) (2005), effective in cases commenced on or after October 17, 2005.

n4

4 435 U.S. 589, 597-98, 98 S. Ct. 1306, 1312, 55 L. Ed. 2d 570, 580 (1978).

n5

5 *See also In re Continental Illinois Securities Litig.*, 732 F.2d 1302, 1308 (7th Cir. 1984).

n6

6 *In re Inslaw, Inc.*, 51 B.R. 298 (Bankr. D.D.C. 1985) (citing numerous cases).

n7

7 *See Collier on Bankruptcy, 5003.01* (Matthew Bender).

n8

8 *See Collier on Bankruptcy, 5003.02* (Matthew Bender).

n9

9 H.R. Rep. No. 595, 95th Cong., 1st Sess. 317-318 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 30 (1978).

n10

10 *See Collier on Bankruptcy, ch. 101* (Matthew Bender).

n11

11 Fed. R. Bankr. P. 5005(a)(2), as amended by the 2006 amendments to the Federal Rules of Bankruptcy Procedure, effective December 1, 2006. *See Collier on Bankruptcy, 5005.02* (Matthew Bender).

n12

12 *In re Handy Andy Home Improvement Centers, Inc.*, 199 B.R. 376 (Bankr. N.D. Ill. 1996) (finding section 107 inapplicable but granting protection under *Fed. R. Bankr. P. 9018*, which is broader).

n13

13 *101 B.R. 92 (Bankr. E.D. Mo. 1989)*.

n14

14 *E.g., Fed. R. Civ. P. 26(c)*, incorporated in *Fed. R. Bankr. P. 7026*; *Fed. R. Bankr. P. 9018*.

n15

15 Fed. R. Bankr. P. 1007(f), as amended by the 2003 amendments to the Federal Rules of Bankruptcy Procedure.

n16

16 2003 Advisory Committee Note to *Fed. R. Bankr. P. 1007(c) & (f)*.

n17

17 Fed. R. Bankr. P. 2013(a); see *Collier on Bankruptcy*, 2013.04 (Matthew Bender).

n18

18 Fed. R. Bankr. P. 2013(a); see *Collier on Bankruptcy*, 2013.04 (Matthew Bender).

n19

19 Fed. R. Bankr. P. 2013(b); see *Collier on Bankruptcy*, 2013.04 (Matthew Bender).

n20

20 See *Nixon v. Warner Communications*, 435 U.S. 589, 597-98, 98 S. Ct. 1306, 1312, 55 L. Ed. 2d 570, 580 (1978).

n21

21 See *In re Itel Corp.*, 6 C.B.C.2d 942, 17 B.R. 942 (B.A.P. 9th Cir. 1982).

n22

22 See (Collier on Bankruptcy, ch. 1007 and ch. 9018 (Matthew Bender).

n23

23 See 6 *Moore's Federal Practice*, §§ 26.10126.105 (Matthew Bender 3d ed.).

n24

24 See *In re Analytical Sys., Inc.*, 83 B.R. 833, 835 (Bankr. N.D. Ga. 1987); *In re Epic Assocs. V*, 13 C.B.C.2d 952, 954, 54 B.R. 445, 448 (Bankr. E.D. Va. 1985); see also *In re Buppelmann*, 269 B.R. 341 (Bankr. M.D. Pa. 2001) (expungement of bankruptcy petition filed fraudulently without debtor's authority denied because expungement reserved for rarest of circumstances).

n25

25 6 C.B.C.2d 4, 17 B.R. 942 (B.A.P. 9th Cir. 1982).

n26

26 6 C.B.C.2d 4, 10, 17 B.R. 942, 946 (quoting *Delatour v. Meredith*, 144 F.2d 594 (2d Cir. 1944)); see also *In re Epic Assocs. V*, 13 C.B.C.2d 952, 955, 54 B.R. 445, 449 (Bankr. E.D. Va. 1985); *In re Reliable Investors, Corp.*, 11 C.B.C.2d 1103, 1105, 44 B.R. 904, 906 (Bankr. W.D. Wis. 1984).

n27 27 44 B.R. 661 (Bankr. N.D. Ohio 1984).

n28

28 12 C.B.C.2d 1158, 1161, 49 B.R. 963, 965 (Bankr. E.D. Va. 1985).

n29

29 256 B.R. 771 (Bankr. E.D. Tenn. 2000).

n30

30 *In re Global Crossing Ltd.*, 295 B.R. 720 (Bankr. S.D.N.Y. 2003) (citing *In re Farmland Industries*, 290 B.R. 364 (Bankr. W.D. Mo. 2003)).

n31

31 21 F.3d 24 (2d Cir. 1994).

n32

32 *In re Analytical Sys., Inc.*, 83 B.R. 833 (Bankr. N.D. Ga. 1987); see also *In re Continental Airlines*, 150 B.R. 334 (D. Del. 1993) (sealing of the fee examiner's report was abuse of discretion when it did not contain defamatory material).

n33

33 See *In re Hemple*, 295 B.R. 200 (Bankr. D. Vt. 2003) (denying request to seal settlement documents based upon generalized desire of parties for confidentiality and allowing parties to present more specific reasons); *In re MUMA Servs.*, 279 B.R. 478 (Bankr. D. Del. 2002) (court should not seal documents simply because of a party's agreement to keep information confidential); *In re Whitener*, 14 C.B.C.2d 395, 398, 57 B.R. 707, 709 (Bankr. E.D. Va. 1986).

n34

34 422 F.3d 1, 54 C.B.C.2d 1308 (1st Cir. 2005).

n35

35 598 F.2d 176 (D.C. Cir. 1979).

n36

36 598 F.2d 176, 191-92.

n37

37 671 F.2d 212, 219 (6th Cir. 1982); see also *In re De Lorean Motor Co.*, 8 C.B.C.2d 1089, 1091, 31 B.R. 53, 55 (Bankr. E.D. Mich. 1983).

n38

38 See, e.g., *In re Epic Assocs. V*, 13 C.B.C.2d 952, 54 B.R. 445 (Bankr. E.D. Va. 1985).

n39

39 See *In re Whitener*, 14 C.B.C.2d 395, 399, 57 B.R. 707, 710 (Bankr. E.D. Va. 1986) (debtor who discharged his debts in a chapter 7 case but then voluntarily proceeded to satisfy all prepetition obligations was not entitled to have record of his bankruptcy expunged; court instead issued order declaring bankruptcy petition null and void); *In re Nunn*, 12 C.B.C.2d 1158, 49 B.R. 963 (Bankr. E.D. Va. 1985).

n40

40 *Gitto v. Worcester Telegram & Gazette Corp. (In re Gitto Gloval Corp.)*, 422 F.3d 1, 54 C.B.C.2d 1308 (1st Cir. 2005); *In re Global Crossing Ltd.*, 295 B.R. 720 (Bankr. S.D.N.Y. 2003); *In re Frontier Group, LLC*, 256 B.R. 771 (Bankr. E.D. Tenn. 2000).

n41

41 See *Copley Press, Inc. v. Peregrine Sys. (In re Peregrine Sys.)*, 311 B.R. 679 (D. Del. 2004).

n42

42 *In re Orion Pictures Corp.*, 21 F.3d 24 (2d Cir. 1994).

n43

43 See *In re Epic Assocs. V*, 13 C.B.C.2d 952, 54 B.R. 445 (Bankr. E.D. Va. 1985); *In re Nunn*, 12 C.B.C.2d 1158, 49 B.R. 963 (Bankr. E.D. Va. 1985).

n44

44 See *In re Itel Corp.*, 6 C.B.C.2d 4, 17 B.R. 942 (B.A.P. 9th Cir. 1982); *In re Whitener*, 14 C.B.C.2d 395, 57 B.R. 707 (Bankr. E.D. Va. 1986).

n45

45 See *In re Sully & Co.*, 152 F. 619 (2d Cir. 1907).

n46

46 See *In re Transatlantic & Pac. Corp.*, 216 F. Supp. 546 (S.D.N.Y. 1963).

n47

47 *In re Waters-Colver Co.*, 212 F. 761 (E.D.N.Y. 1914).

n48

48 See Collier on Bankruptcy, ch. 101 (Matthew Bender).

n49

49 See Collier on Bankruptcy, ch. 101 (Matthew Bender). United States trustee was added to the definition of entity by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554. The amendment became effective in a judicial district when a United States trustee was appointed in that district. Except for the districts in Alabama and North Carolina, all districts now have United States trustees.

n50

50 Pub. L. No. 109-8, § 234(a) (2005), effective in cases commenced on or after October 17, 2005.

n51

51 *See 18 U.S.C. § 1028(d)* for definition of means of identification.

n52

52 *See, e.g., Fed. R. Bankr. P. 1005* (requiring only last four digits of debtor's social security number in caption of petition); 2003 Advisory Committee Note to *Fed. R. Bankr. P. 1005*; *Collier on Bankruptcy*, 1005.01 (Matthew Bender).

n53

53 *11 U.S.C. § 521(f)*, added by Pub. L. No. 109-8, § 315(b) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, ch. 521 (Matthew Bender).

n54

54 Pub. L. No. 109-8, § 315(c) (2005), requires the Judicial Conference to establish procedures to protect confidentiality of tax information by October 17, 2005. Section 315(c) specifically provides that the procedures for safeguarding the confidentiality of tax information shall include restrictions on creditor access to tax information that is required to be provided under [section 521(a)(1)].

n55

55 Individual is not defined in section 101, but the term implicitly excludes partnerships and corporations, which are listed, along with individuals, in the definition of person in section 101.

n56

56 Governmental unit is defined in section 101; *see Collier on Bankruptcy*, ch. 101 (Matthew Bender).

n57

57 The bankruptcy administrator is a court official who, in districts that do not have a United States trustee, performs the duties performed by the United States trustee. *See Collier on Bankruptcy*, 6.33[1] (Matthew Bender).

ABOUT THE AUTHOR(S):

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191 of 197 DOCUMENTS

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Collier on the Constitutionality of Bankruptcy Code Section 106

2008 Emerging Issues 920

Collier on the Constitutionality of Bankruptcy Code Section 106

By Collier

November 12, 2007

SUMMARY: The Supreme Court decided *Central Virginia Community College v. Katz*, Congress and most courts, including the Supreme Court itself, had assumed that a valid congressional abrogation of sovereign immunity was required in order for bankruptcy proceedings to be brought against states or their agencies without their waiver or consent. Section 106(a) was enacted to accomplish that abrogation for states and all other governmental units.

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ARTICLE: *Section 106(a) of the Bankruptcy Code* clearly expresses the congressional intent to abrogate the sovereign immunity of federal, state, local and foreign governmental units with respect to certain enumerated sections of the Bankruptcy Code. n1 Until the Supreme Court decided *Central Virginia Community College v. Katz*, n2 Congress and most courts, including the Supreme Court itself, had assumed that a valid congressional abrogation of sovereign immunity was required in order for bankruptcy proceedings to be brought against states or their agencies without their waiver or consent. Section 106(a) was enacted to accomplish that abrogation for states and all other governmental units. Prior to the *Katz* decision, however, much litigation ensued over whether Congress had the constitutional authority under the Bankruptcy Clause to abrogate the states' Eleventh Amendment immunity. Similar constitutional questions were raised concerning subsections 106(b) and (c), which permit counterclaims and setoffs against state (and other) governmental units that have claims against bankruptcy estates. The following sections highlight the constitutional issues that were raised concerning the application of section 106 to state governments and how those issues were resolved by *Katz*.

Seminole Tribe v. Florida

The 1996 decision of the Supreme Court in *Seminole Tribe v. Florida* n3 was widely interpreted as rendering section 106(a) unconstitutional as applied to the states. In that nonbankruptcy case, the Court held, in a five-to-four decision, that Congress lacks the power under the Indian Commerce Clause in Article I of the U.S. Constitution to override the Eleventh Amendment and subject unconsenting states to suits in federal court for violations of federally created rights. In so holding, the Court overruled *Pennsylvania v. Union Gas Co.*, n4 a plurality decision finding that the Interstate Commerce Clause granted Congress the power to abrogate state sovereign immunity. The *Union Gas*

decision had been the only Supreme Court decision holding that Congress may abrogate sovereign immunity pursuant to its Article I powers. n5 In overruling *Union Gas*, the Court continued to recognize, however, that Congress does have the power to abrogate state sovereign immunity when it acts pursuant to section 5 of the Fourteenth Amendment. n6

Although the ruling in *Seminole Tribe* did not directly address Congress's power under the Bankruptcy Clause in Article I, section 8, clause 4 of the Constitution, the decision held that state sovereignty under the Eleventh Amendment overrides congressional power under Article I of the Constitution. According to the Supreme Court, even when the Constitution vests in Congress complete law-making authority over a particular area, the Eleventh Amendment prevents congressional authorization of suits by private parties against unconsenting States. The Eleventh Amendment restricts the judicial power under Article III, and Article I cannot be used to circumvent the constitutional limitations placed upon federal jurisdiction. n7

The federal statute at issue in *Seminole Tribe* was the Indian Gaming Regulatory Act (the IGRA"), enacted by Congress pursuant to the Indian Commerce Clause in Article I of the Constitution. The IGRA imposes a duty on state governments to negotiate in good faith with Indian tribes that seek to engage in gaming activities. Under the IGRA, a tribe may sue a state in federal court in order to compel observance of that duty. The Seminole Tribe sued the State of Florida and its governor in Florida district court, alleging that they violated the IGRA by refusing to engage in any negotiations. The defendants moved to dismiss the complaint on the ground that the suit violated Florida's sovereign immunity. The district court denied the motion, n8 but the Court of Appeals for the Eleventh Circuit reversed the district court's decision. n9

The Supreme Court rejected the Tribe's contention that because the IGRA authorizes only prospective injunctive relief, rather than monetary damages, the Eleventh Amendment did not bar the suit. The Court concluded that the type of relief sought by a plaintiff suing a state is irrelevant to the question of a state's sovereign immunity. n10

After the overruling of *Union Gas*, it appeared that there were only two circumstances in which an individual could sue a state. First, Congress could authorize such a suit in the exercise of its power under section 5 of the Fourteenth Amendment. Second, a state could waive its sovereign immunity by consenting to suit. n11 In two recent decisions, however, the Supreme Court has held that Congress has greater authority to subject states to suits in connection with bankruptcy cases than it has with regard to most other areas of substantive federal law. First it held that if a court renders a decision affecting state interests in an *in rem* proceeding, the state may be bound despite its lack of consent because the proceeding is not viewed as a suit against the state to which sovereign immunity applies. n12 Then, the Supreme Court held more broadly that the states surrendered their immunity from suit by agreeing to the Bankruptcy Clause of the Constitution. In ratifying that provision, the States acquiesced in a subordination of whatever sovereign immunity they might otherwise have asserted in proceedings necessary to effectuate the *in rem* jurisdiction of the bankruptcy courts." n13

Section 106(a); Constitutional Doubts Raised by *Seminole Tribe* and Resolved by *Katz*

The dissenting opinion of Justice Stevens in *Seminole Tribe* described the consequences of the Court's decision as follows:

The majority's opinion does not simply preclude Congress from establishing the rather curious statutory scheme under which Indian tribes may seek the aid of a federal court to secure a State's good-faith negotiations over gaming regulations. Rather, it prevents Congress from providing a federal forum for a broad range of actions against States, from those sounding in copyright and patent law, to those concerning bankruptcy, environmental law, and the regulation of our vast national economy. n14

Justice Stevens was thus concerned that the majority's conclusion that the Eleventh Amendment shields states from being sued under federal law in federal court would mean that persons harmed by state violations of bankruptcy law would be without a remedy.

The majority opinion responded to Justice Stevens's concern by labeling his conclusion as exaggerated in both substance and significance. According to the majority, as a substantive matter, there exist several other means available to individuals to ensure that a state is complying with federal law. First, the federal government can bring suit in a federal court against a state; second, an individual can bring suit against a state officer under the doctrine of *Ex parte Young*; n15 and third, the Supreme Court is empowered to review questions of federal law arising from state court decisions where a state has consented to suit in state court. Moreover, according to the majority, it has not been widely thought that the federal antitrust, bankruptcy, or copyright statutes abrogated the States' sovereign immunity: This Court never has awarded relief against a State under any of those schemes. Although the bankruptcy laws have existed practically since our Nation's inception, there is no established tradition in the lower federal courts of allowing enforcement of [bankruptcy] statutes against the States. n16

The Supreme Court later reconsidered the assumption of both the majority and the dissenting opinions in *Seminole Tribe* that the holding of that case was applicable to bankruptcy proceedings. Writing for the Court in *Central Virginia Community College v. Katz*, Justice Stevens explained that [c]areful study and reflection have convinced us that that assumption was erroneous. n17 The Court went on to hold that the Bankruptcy Clause gives Congress authority to subject states to suit in proceedings necessary to effectuate the *in rem* jurisdiction of the bankruptcy courts. n18 Thus, unlike other Article I powers, the Bankruptcy Clause itself eliminates the states' sovereign immunity, and no statutory abrogation is required. n19

Federal Sovereign Immunity. *Seminole Tribe* did not alter a debtor's ability to sue and recover from federal governmental units, including the IRS, in bankruptcy courts. Congress has the exclusive authority to waive the federal government's sovereign immunity; n20 and section 106(a) unequivocally expresses Congress's intent to do so. Thus, section 106(a) is constitutionally valid insofar as it applies to suits against the United States and its agencies. n21

State Sovereign Immunity. After the *Seminole Tribe* decision, numerous courts considered the constitutionality of section 106. Most courts, including the courts of appeals for six circuits, found that, as applied to state governmental units, section 106(a) was unconstitutional. n22 These courts held that Congress lacked the power under the Bankruptcy Clause to abrogate states' sovereign immunity under the Eleventh Amendment. The Court of Appeals for the Sixth Circuit, however, disagreed, n23 concluding that the text of the Constitution and other evidence of the Framers' intent demonstrate that under the Bankruptcy Clause of Article I, section 8, Congress has the power to abrogate state sovereign immunity, n24 and that Congress clearly exercised that power in *11 U.S.C. § 106(a)*. n25 Ultimately, the Sixth Circuit's conclusion--that the Bankruptcy Clause authorizes Congress to subject states to suit in bankruptcy proceedings--was upheld by the Supreme Court, in *Central Virginia Community College v. Katz*. n26 The Supreme Court's reasoning, however, differed somewhat from the Sixth Circuit's. Rather than concluding that section 106(a) is a valid congressional abrogation of the states' sovereign immunity, the Supreme Court held that the states gave up their immunity when they ratified the Bankruptcy Clause. Thus Congress's authority to enact bankruptcy legislation that treats states in the same way as other creditors arises from the Bankruptcy Clause itself; the relevant abrogation' is the one effected in the plan of the Convention, not by statute." n27

Katz arose out of the bankruptcy of Wallace's Bookstores, Inc., which operated a nationwide chain of college bookstores. *Katz* was appointed as the liquidating supervisor for the estate and brought preference actions against the petitioners, public institutions of higher education in Virginia. As such, they were considered to be arms of the state. *Katz* filed the preference actions in a bankruptcy court within the Sixth Circuit, and, following circuit precedent, the lower courts rejected the colleges' sovereign immunity defense. The Supreme Court granted *certiorari* in the case in

order to determine whether section 106(a) constituted a valid abrogation of state sovereign immunity. In the end, however, the Court concluded that the enactment of that provision was not necessary to authorize the Bankruptcy Court's jurisdiction over these preference avoidance proceedings. n28

The Court, in a five-to-four decision written by Justice Stevens, relied heavily on the history surrounding the ratification of the Bankruptcy Clause of the Constitution. The Court's review of this history convinced it that the provision was included in Article I in order to provide a uniform federal response to the existing problem of divergent state insolvency and bankruptcy laws and the resulting lack of enforceability of state court discharge orders in other states. n29 The primary goal of the Framers was to prevent competing sovereigns' interference with the debtor's discharge. n30 The Court further concluded that, in giving Congress the authority to enact uniform Laws on the subject of Bankruptcies throughout the United States, states agreed not to assert their sovereign immunity in proceedings authorized by Congress pursuant to the Bankruptcy Clause. This conclusion was evidenced by the fact that Congress in the early years following the ratification of the Constitution considered and eventually enacted legislation that permitted federal courts to issue writs of habeas corpus requiring the release of debtors from state prisons. Despite this federal subordination of state sovereignty, the Court found no record of any objection based on an infringement of sovereign immunity. n31

The *Katz* majority read this history as support[ing] the view that the Bankruptcy Clause of Article I simply did not contravene the norms this Court has understood the Eleventh Amendment to exemplify. n32 In giving the federal government the power to enact uniform bankruptcy legislation, the states understood that they were giving Congress the power to subordinate state sovereignty, albeit within a limited sphere. n33 Thus, the Court concluded that the States agreed in the plan of the Convention not to assert any sovereign immunity defense they might have had in proceedings brought pursuant to Laws on the subject of Bankruptcies.' n34 This cession of immunity, according to the Court, extended to *in rem* bankruptcy proceedings and ancillary proceedings necessary to effectuate the *in rem* jurisdiction of the bankruptcy courts. n35 Because the states have given up their immunity, when Congress does enact bankruptcy legislation that allows states to be sued, the issue is not one of abrogation but only whether Congress' determination that States should be amenable to such proceedings is within the scope of its power to enact Laws on the subject of Bankruptcies.' n36 That preference recovery actions come within the scope of such power is beyond peradventure, said the Court. n37

Katz thus seems to put an end to the debate about the constitutionality of section 106(a). According to the Court, so long as Congress has not exceeded the scope of its legislative authority under the Bankruptcy Clause, the states acquiesced in this exercise of congressional authority to render them subject to suit in bankruptcy proceedings. The constitutionality of the Bankruptcy Code sections listed in section 106(a) is not in doubt, and thus there is no reason to believe Congress exceeded its authority under the Bankruptcy Clause in including states within the coverage of those provisions. The only reason to worry that the constitutional issue might reemerge at some point is that *Katz* was decided by a five-to-four vote, with the decisive vote being cast by Justice O'Connor one week before she stepped down from the Court. Because state sovereign immunity in recent years has been an unstable area of the law in which the Supreme Court has been closely divided, the possibility remains that *Katz* may not be the Court's last word on the impact of state sovereign immunity in bankruptcy.

Application of Section 106(a) to Municipalities and Their Agencies. The Eleventh Amendment does not generally apply to municipalities. n38 In most cases, therefore, it has not been doubted that section 106(a) is valid in its application to municipalities and municipal agencies and that bankruptcy courts may exercise jurisdiction over suits against those authorities. The Supreme Court's *Katz* decision now makes clear that, even when municipal and local authorities are deemed to be arms of the state, n39 section 106(a)'s authorization of suit against them is constitutionally valid, since the states gave up their sovereign immunity in ratifying the Bankruptcy Clause. n40

Section 106(b)

Bankruptcy Code section 106(b) provides that a governmental unit is deemed to have waived sovereign immunity with respect to claims arising out of the same transaction or occurrence as a claim filed by the governmental unit. For a number of years, it appeared that two Supreme Court decisions concerning state sovereign immunity, *Seminole Tribe v. Florida* n41 and *College Savings Bank v. Florida Prepaid Postsecondary Education Expense Board*, n42 presented concerns about the constitutionality of this provision. Under *Seminole Tribe*, state sovereign immunity is not eliminated just because Congress (acting pursuant to its Article I powers) declares it to be waived. That enactment is merely another form of abrogation, n43 which Congress lacks authority under Article I to accomplish. n44 And under *College Savings Bank*, state sovereign immunity is not eliminated just because the state files a proof of claim after being put on notice by Congress that it will lose its sovereign immunity by doing so. That situation involves constructive waiver, which the Court disallowed. n45 Thus it seemed that the constitutionality of section 106(b) depended on the extent to which a state in fact voluntarily waives its sovereign immunity by filing a proof of claim in a bankruptcy case. On that issue the lower courts were divided. n46

Any question about the constitutionality of this provision as it applies to states, however, has been eliminated by the *Katz* decision. There, the Supreme Court declared that States agreed in the plan of the Convention not to assert any sovereign immunity defense they might have had in proceedings brought pursuant to Law on the subject of Bankruptcies.' n47 Acting pursuant to its Bankruptcy Clause authority, Congress has declared that states are subject to compulsory counterclaims when they seek to recover from bankruptcy estates. Accordingly, when a state files a proof of claim in a bankruptcy case and the estate asserts a compulsory counterclaim against it, no waiver is necessary because the state previously surrendered its immunity.

Section 106(c)

Section 106(c) permits, notwithstanding any assertion of sovereign immunity, a setoff against a governmental unit's claim of any claim that the estate has against that governmental unit. Before the Supreme Court decided *Katz*, there was some uncertainty about the constitutionality of this provision insofar as it applies to states. Since the provision requires no action to be taken by the state, n48 there may be no basis for finding a voluntary waiver of the state's immunity. Moreover, because the two claims that are set off do not have to be factually related, the provision may go beyond the permissible scope of any waiver that results from the filing of a proof of claim. n49

Any constitutional concerns, however, have been eliminated by *Central Virginia Community College v. Katz*. n50 The states surrendered their sovereign immunity in ratifying the Bankruptcy Clause. They thereby gave Congress the authority to subject them to suit in connection with resolving claims to the *res* that comprises the bankruptcy estate. n51

For a complete discussion of Code section 106, see Collier on Bankruptcy, ch. 106 (Matthew Bender).

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n1 1. *Hardy v. United States (In re Hardy)*, 97 F.3d 1384, 1388 (11th Cir. 1996); *In re Lovato*, 203 B.R. 742, 749 (Bankr. D. Wyo. 1996); *Field v. Montgomery County (In re Anton Motors, Inc.)*, 177 B.R. 58, 62 (Bankr. D. Md. 1995).

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2. 546 U.S. 356, 126 S. Ct. 990, 1002, 163 L. Ed. 2d 945, 54 C.B.C.2d 1233 (2006).

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3. 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996).

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4. 491 U.S. 1, 109 S. Ct. 2273, 105 L. Ed. 2d 1 (1989).

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5. 517 U.S. 44, 59, 116 S. Ct. 1114, 1125, 134 L. Ed. 2d 252, 268, 34 C.B.C.2d 1199, 1209.

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6. 517 U.S. 44, 59, 116 S. Ct. 1114, 1125, 134 L. Ed. 2d 252, 268, 34 C.B.C.2d 1199, 1208-09 (citing *Fitzpatrick v. Bitzer*, 427 U.S. 445, 96 S. Ct. 2666, 49 L. Ed. 2d 614 (1976)).

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7. 517 U.S. 44, 72-73, 116 S. Ct. 1114, 1131-32, 134 L. Ed. 2d 252, 277, 34 C.B.C.2d 1199, 1216.

n8

8. 801 F. Supp. 655 (S.D. Fla. 1992).

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9. 11 F.3d 1016 (11th Cir. 1994).

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10. *Seminole Tribe v. Florida*, 517 U.S. 44, 58, 116 S. Ct. 1114, 1124, 134 L. Ed. 2d 252, 268, 34 C.B.C.2d 1199, 1208 (1996)

(Eleventh Amendment does not exist solely in order to preven[t] federal court judgments that must be paid out of a State's treasury.'--quoting *Hess v. Port Auth. Trans-Hudson Corp.*, 513 U.S. 30, 48, 115 S. Ct. 394, 404, 130 L. Ed. 2d 245, 260 (1994); it also serves to avoid the indignity of subjecting a State to the coercive process of judicial tribunals at the instance of private parties,'--quoting *Puerto Rico Aqueduct & Sewer Auth. v. Metcalf & Eddy, Inc.*, 506 U.S. 139, 146, 113 S. Ct. 684, 689, 121 L. Ed. 2d 605, 614 (1993)).

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11. *College Sav. Bank v. Florida Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666, 670, 119 S. Ct. 2219, 2223, 144 L. Ed. 2d 605, 613 (1999).

n12

12. *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440, 124 S. Ct. 1905, 158 L. Ed. 2d 764, 51 C.B.C.2d 627 (2004).

n13

13. *Central Virginia Community College v. Katz*, 126 S. Ct. 990, 1005, 163 L. Ed. 2d 945, 54 C.B.C.2d 1233 (2006); see Constitutionality of Section 106*infra*.

n14

14. 517 U.S. 44, 77, 116 S. Ct. 1114, 1134, 134 L. Ed. 2d 252, 280, 34 C.B.C.2d 1199, 1218-19 (1996) (Stevens, J., dissenting).

n15

15. 209 U.S. 123, 28 S. Ct. 441, 52 L. Ed. 714 (1908).

n16

16. *Seminole Tribe v. Florida*, 517 U.S. 44, 73, n.16, 116 S. Ct. 1114, 1132, n.16, 134 L. Ed. 2d 252, 277, n.16, 34 C.B.C.2d 1199, 1216, n.16 (1996). But see *Hood v. Tennessee Student Assistance Corp. (In re Hood)*, 262 B.R. 412, 424 (B.A.P. 6th Cir. 2001) (contrary to the dicta in *Seminole Tribe*, the Supreme Court has traditionally recognized that the States' sovereignty is limited in the area of bankruptcy), *aff'd*, 319 F.3d 755 (6th Cir. 2003), *aff'd on other grounds*, 541 U.S. 440, 124 S. Ct. 1905, 158 L. Ed. 2d 764, 51 C.B.C.2d 627 (2004); *In re Barrett Refining Corp.*, 221 B.R. 795, 806 n.16 (Bankr. W.D. Okla. 1998) (disagreeing with statement in *Seminole* opinion that there is no tradition of allowing the bankruptcy courts to enforce bankruptcy laws against the states); *O'Brien v. Vermont Agency of Natural Resources (In re O'Brien)*, 216 B.R. 731, 736, 39 C.B.C.2d 685, 690 (Bankr. D. Vt. 1998) (same).

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17. 546 U.S. 356, 126 S. Ct. 990, 996, 163 L. Ed. 2d 945, 54 C.B.C.2d 1233 (2006).

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18. 546 U.S. 356, 126 S. Ct. 990, 1005, 163 L. Ed. 2d 945, 963.

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19. 546 U.S. 35, 126 S. Ct. 990, 1005, 163 L. Ed. 2d 945, 964 (the relevant abrogation' is the one effected in the plan of the Convention, not by statute); see Constitutionality of Section 106 *infra*.

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20. *United States v. Lee*, 106 U.S. 196, 1 S. Ct. 240, 27 L. Ed. 171 (1882).

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21. *Liebersohn v. IRS (In re C.F. Foods, L.P.)*, 265 B.R. 71, 85 (Bankr. E.D. Pa. 2001) (Although the constitutionality of § 106 may sometimes be in dispute with respect to abrogating a state governmental unit's sovereign immunity defense, there is no question that Congress can abrogate the federal government's sovereign immunity. (citing *Thibodaux v. United States (In re Thibodaux)*, 201 B.R. 827, 832 (Bankr. N.D. Ala. 1996)).

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22. *E.g.*, *Georgia Higher Educ. Assistance Corp. v. Crow* (*In re Crow*), 394 F.3d 918, 921 (11th Cir. 2004) (we join five of the six circuits that have considered the issue in holding that § 106(a)'s purported abrogation of Eleventh Amendment immunity in bankruptcy proceedings, which is clear and specific, is nonetheless invalid in light of *Seminole Tribe of Florida v. Florida*); *Nelson v. La Crosse County Dist. Attorney* (*In re Nelson*), 301 F.3d 820, 832, 49 C.B.C. 2d 101 (7th Cir. 2002) (Congress did not validly abrogate State sovereign immunity when enacting Section 106(a) pursuant to its Article I legislative power. [W]e find no reason to distinguish Congress' power under the Indian Commerce Clause, that it purported to exercise in *Seminole Tribe*, from its power under the Bankruptcy Clause for purposes of State sovereign immunity.); *Mitchell v. California Franchise Tax Bd.* (*In re Mitchell*), 209 F.3d 1111 (9th Cir. 2000); *Sacred Heart Hosp. of Norristown v. Pennsylvania Dep't of Pub. Welfare* (*In re Sacred Heart Hosp. of Norristown*), 133 F.3d 237, 245, 32 C.B.C. 2d 238 (3d Cir. 1998); *Department of Transp. & Dev. v. PNL Asset Mgm't Co., LLC* (*In re Estate of Fernandez*), 123 F.3d 241, 246, 38 C.B.C. 2d 1249 (5th Cir. 1997); *Schlossberg v. Maryland* (*In re Creative Goldsmiths of Washington, D.C., Inc.*), 119 F.3d 1140, 1147, 38 C.B.C.2d 574 (4th Cir. 1997), cert. denied, 523 U.S. 1075, 118 S. Ct. 1517, 140 L. Ed. 2d 670 (1998); *Elias v. United States* (*In re Elias*), 39 C.B.C. 2d 782, 218 B.R. 80 (B.A.P. 9th Cir. 1998), aff'd, 216 F.3d 1082 (9th Cir. 2000); *Quesada v. Puerto Rico* (*In re Arecibo Community Health Care*), 233 B.R. 625, 629 (D.P.R. 1999) (Because we find that Congress enacted § 106(a) pursuant to its Article I powers, rather than pursuant to its faculties under the Fourteenth Amendment, we must also find that § 106(a) is an unconstitutional abrogation of the states' Eleventh Amendment immunity.), aff'd on other grounds and remanded, *Arecibo Community Health Care v. Puerto Rico*, 270 F.3d 17, 21 (1st Cir. 2001) (The parties to this appeal do not challenge the lower court's conclusion that Congress lacks the authority to abrogate Puerto Rico's Eleventh Amendment immunity pursuant to § 106(a).), cert. denied, 537 U.S. 813, 123 S. Ct. 73, 154 L. Ed. 2d 15 (2002); *In re LTV Steel Co., Inc.*, 264 B.R. 455, 464-65 (Bankr. N.D. Ohio 2001); *Askey v. Pennsylvania Dep't of Public Welfare* (*In re Askey*), 261 B.R. 160 (Bankr. W.D. Pa. 2001); *Peterson v. Florida Dep't of Revenue* (*In re Peterson*), 254 B.R. 740 (Bankr. N.D. Ill. 2000); *IRS v. Gosselin*, 252 B.R. 854, 858 (Bankr. D. Mass. 2000) (holding that [a]lthough the First Circuit has not yet addressed the issue of the constitutionality of section 106 of the Bankruptcy Code, the abrogation of the state's Eleventh Amendment immunity in section 106 is invalid because Congress does not have the power to abrogate sovereign immunity under its Article I powers); *DeAngelis v. Laskey* (*In re DeAngelis*), 239 B.R. 426 (Bankr. D. Mass. 1999); *Snyder v. Board of Regents* (*In re Snyder*), 228 B.R. 712 (Bankr. D. Neb. 1998); *United States v. Nebraska Dep't of Revenue* (*In re Doiel*), 228 B.R. 439 (Bankr. D.S.D. 1998); *Justice v. Ohio Bureau of Workers' Compensation* (*In re Justice*), 224 B.R. 631 (Bankr. S.D. Ohio 1998); *Koehler v. Iowa College Student Aid Comm'n* (*In re Koehler*), 37 C.B.C.2d 460, 204 B.R. 210 (Bankr. D. Minn. 1997).

n23

23. *Hood v. Tennessee Student Assistance Corp.* (*In re Hood*), 319 F.3d 755 (6th Cir. 2003), aff'd on other grounds, 541 U.S. 440, 124 S. Ct. 1905, 158 L. Ed. 2d 764, 51 C.B.C.2d 627 (2004); accord *Gray v. Fla. State Univ.* (*In re Dehon, Inc.*), 327 B.R. 38 (Bankr. D. Mass. 2005).

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24. 319 *F.3d* 755, 762.

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25. 319 *F.3d* 755, 759.

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26. 546 *U.S.* 356, 126 *S. Ct.* 990, 163 *L. Ed. 2d* 945, 54 *C.B.C.2d* 1233 (2006).

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27. 546 *U.S.* 356, 126 *S. Ct.* 990, 1005, 163 *L. Ed. 2d* 945, 964.

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28. 546 *U.S.* 356, 126 *S. Ct.* 990, 995, 163 *L. Ed. 2d* 945, 952.

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29. 546 *U.S.* 356, 126 *S. Ct.* 990, 999-1000, 163 *L. Ed. 2d* 945, 958.

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30. 546 *U.S.* 356, 126 *S. Ct.* 990, 1002, 163 *L. Ed. 2d* 945, 960.

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31. 546 *U.S.* 356, 126 *S. Ct.* 990, 1003, 163 *L. Ed. 2d* 945, 961-62.

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32. 546 U.S. 356, 126 S. Ct. 990, 1003, 163 L. Ed. 2d 945, 962.

n33

33. 546 U.S. 356, 126 S. Ct. 990, 1004, 163 L. Ed. 2d 945, 963.

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34. *Id.*

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35. 546 U.S. 356, 126 S. Ct. 990, 1005, 163 L. Ed. 2d 945, 963.

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36. 546 U.S. 356, 126 S. Ct. 990, 1005, 163 L. Ed. 2d 945, 964.

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37. *Id.*.

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38. *Mt. Healthy City Sch. Dist. v. Doyle*, 429 U.S. 274, 280, 97 S. Ct. 568, 572, 50 L. Ed. 2d 471, 479 (1977) (The bar of the Eleventh Amendment does not extend to counties and similar municipal corporations.); *see also Hadley v. North Ark. Community Technical College (In re Hadley)*, 76 F.3d 1437, 1438 (8th Cir. 1996) (Eleventh Amendment immunity does not extend to independent political subdivisions created by the State, such as counties and cities.); *D'Orio v. Town of East Haddam (In re D'Orio)*, 58 B.R. 263, 266 (Bankr. D. Conn. 1985).

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39. *See Franceschi v. Schwartz*, 57 F.3d 828, 831 (9th Cir. 1995); *Christy v. Pennsylvania Turnpike*

Comm'n, 54 F.3d 1140, 1144-45 (3d Cir. 1995); *Belanger v. Madera Unified School Dist.*, 963 F.2d 248 (9th Cir. 1992); *AJ Contracting Co. v. City of New York (In re AJ Contracting Co.)*, 300 B.R. 182 (Bankr. S.D.N.Y. 2003).

n40

40. *Central Virginia Community College v. Katz, U.S.*, 126 S. Ct. 990, 163 L. Ed. 2d 945, 54 C.B.C.2d 1233 (2006); see Constitutionality of Section 106 *supra*.

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41. 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996).

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42. 527 U.S. 666, 119 S. Ct. 2219, 144 L. Ed. 2d 605 (1999).

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43. See *Schlossberg v. Maryland (In re Creative Goldsmiths of Washington, D.C., Inc.)*, 119 F.3d 1140, 1147, 38 C.B.C.2d 574 (4th Cir. 1997), *cert. denied*, 523 U.S. 1075, 118 S. Ct. 1517, 140 L. Ed. 2d 670 (1998) ([E]ven the language of 11 U.S.C. § 106(b) itself--that a state is deemed to have waived sovereign immunity'--amounts to language of abrogation.).

n44

44. 517 U.S. 44, 72-73, 116 S. Ct. 1114, 1131-32, 134 L. Ed. 2d 252, 277, 34 C.B.C.2d 1199, 1216.

n45

45. 527 U.S. 666, 683, 119 S. Ct. 2219, 2229, 144 L. Ed. 2d 605, 621 (1999).

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46. See, e.g., *Ossen v. Connecticut Dep't of Soc. Servs. (In re Charter Oak Assocs.)*, 361 F.3d 760, 770 (2d Cir.), cert. denied, 543 U.S. 955, 125 S. Ct. 408, 160 L. Ed. 2d 316 (2004); *Arecibo Cmty. Health Care, Inc. v. Commonwealth of Puerto Rico*, 270 F.3d 17, 28 (1st Cir. 2001), cert. denied, 537 U.S. 813, 123 S. Ct. 73, 154 L. Ed. 2d 15 (2002); *Schlossberg v. Maryland (In re Creative Goldsmiths of Washington, D.C., Inc.)*, 119 F.3d 1140, 1148, 38 C.B.C.2d 574 (4th Cir. 1997), cert. denied, 523 U.S. 1075, 118 S. Ct. 1517, 140 L. Ed. 2d 670 (1998); *Jones v. Yorke (In re Friendship Med. Ctr., Ltd.)*, 710 F.2d 1297, 1301 (7th Cir. 1983).

n47

47. *Central Virginia Community College v. Katz, U.S.*, 126 S. Ct. 990, 1004, 163 L. Ed. 2d 945, 963, 54 C.B.C.2d 1233 (2006).

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48. See Duties of Trustee or Debtor in Asserting a Right to Offset a Claim *infra*.

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49. See *Schlossberg v. Comptroller of Treasury (In re Creative Goldsmiths of Washington, D.C., Inc.)*, 119 F.3d 1140, 1148, 38 C.B.C.2d 574 (4th Cir. 1997), cert. denied, 523 U.S. 1075, 118 S. Ct. 1517, 140 L. Ed. 2d 670 (1998); Richard H. Fallon et al., *Hart and Wechsler's The Federal Courts and the Federal System*, 1037 (5th ed. 2003) (noting uncertainty about whether filing of proof of claim permits a claim against the state that does not arise out of the same transaction or occurrence as the state's claim).

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50. 546 U.S. 356, 126 S. Ct. 990, 163 L. Ed. 2d 945, 54 C.B.C.2d 1233 (2006).

n51

51. See Constitutionality of Section 106 *supra*.

ABOUT THE AUTHOR(S):

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192 of 197 DOCUMENTS

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Bad Faith Involuntary Bankruptcy Filings Under Sect. 303(b) of the Bankr. Code

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Collier on Bad Faith Involuntary Bankruptcy Filings Under Section 303(b) of the Bankruptcy Code

By Collier

November 9, 2007

SUMMARY: Bankruptcy Code Section 303(b) does not expressly refer to good faith filings. However, since section 303(i) specifically refers to bad faith filings, it is generally agreed that involuntary filings must be in good faith and that consequences flow if they are not. This Emerging Issues Analysis illustrates the five tests for determining what constitutes bad faith and provides specific examples of bad faith.

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ARTICLE: Collier on Creditors Bad Faith Involuntary Filings

Bankruptcy Code Section 303(b) does not expressly refer to good faith filings. However, since section 303(i) specifically refers to bad faith filings, n1 it is generally agreed that involuntary filings must be in good faith and that consequences flow if they are not. Dismissal is one possible consequence. If there has been bad faith, a debtor may be awarded damages, including punitive damages, under section 303(i)(2). n2 However, an award under section 303(i) does not always follow a finding of bad faith. If only dismissal is the court's preferred remedy, section 303(i) is not implicated. In addition to section 303(i), new section 303(l), added in 2005, n3 specifically addresses additional consequences for filing an involuntary case against an individual (as distinguished from a corporation or partnership) based on materially false, fraudulent or fictitious statements.

In addition to dismissal, these added consequences include a prohibition on the reporting of information related to the filing to a credit reporting agency. Moreover, the 2005 amendments also add language to 18 U.S.C. § 157 to ensure that fraudulent filings constitute a bankruptcy crime. n4

Bad faith for purposes of section 303(b) is not defined within the Code, although the legislative history to new subsection (l) is illustrative. n5 Numerous acts and omissions have been considered as bad faith, and courts have developed differing tests for determining whether creditors are exhibiting bad faith. Once the legal standard is known, a finding of bad faith is based on a factual determination. There is a presumption in favor of good faith filings, and the burden is on the debtor to show by a preponderance of the evidence that the filing is in bad faith. n6

Tests for Determining Bad Faith. There have been a wide range of tests applied by the courts for determining bad faith. n7 There are now five identifiable standards: (1) the subjective test; (2) the improper purpose test; (3) the objective test; (4) the improper use test; and (5) the combined objective and subjective test, sometimes referred to as the Rule 9011 test. One court has suggested a sixth approach: the nose test.

The subjective test looks at what the petitioning creditor in question believed, n8 focusing on the petitioning creditor's motivation in filing an involuntary case. n9 For example, if the creditor's motive in filing was simply to harass the debtor rather than to collect an unpaid obligation, there would be subjective evidence of bad faith.

Other courts adopt an improper purpose test, which is similar to the subjective test and assesses why the creditor sought to file the involuntary case in the first instance. n10 Examples include ruining and destroying the debtor and maliciously seeking to undermine the debtor's business.

Other courts utilize an objective standard, assessing what a reasonable person in the creditor's position would have done. n11 This calls for an assessment of the reasonableness of the creditor's action in filing an involuntary petition.

Still other courts create an improper use test which looks at whether the creditor's conduct takes disproportionate advantage of other creditors. n12 Examples include using the bankruptcy to acquire corporate control, reducing an obligation on a guaranty or treating the bankruptcy process as if it were the creditor's own private collection agency.

Other courts utilize a test that contains both objective and subjective elements. n13 This is considered a broad, inclusive test. n14 The combined test has been likened to the test utilized in Bankruptcy Rule 9011. One court has criticized this approach because Rule 9011 deals with careless omissions that do not rise to the level of bad faith. n15

Finally, the smell test, which is actually the broadest of all the standards, looks to all of the foregoing tests and operates on the premise that if it smells like bad faith, it can be fit into any, indeed all, of the above-listed tests. n16 This is akin to a totality of the circumstances test. n17 There is clearly some overlap among the tests.

The test which has gained the greatest acceptance is that which combines the objective and subjective elements, namely the Rule 9011 standard. Under this test, the following specific questions can be framed. n18 Answering one or more of the first three questions in the negative and the fourth question in the affirmative can lead to dismissal of the petition:

. Did the petitioning creditor make a reasonable inquiry into relevant facts and pertinent law before commencing the involuntary filing? Was the involuntary filing well grounded in fact?

. Was the involuntary filing warranted by existing law or by a good faith argument for change in the current law?

. Was the filing undertaken for an improper purpose such as harassment, delay or an effort to increase costs to obtain advantage?

Considering the variety of available tests, and in view of the treatment of other issues of good and bad faith under the Code, n19 the Rule 9011 test is best suited to resolving the issues, although the addition of subsection (I) changes the calculus for cases involving fraudulent statements in cases filed against individual debtors.

The smell test is not as predictable and is harder to apply consistently. The other tests, while capturing part of the inquiry, can miss key aspects of a situation.

The complexities of determining what constitutes bad faith under section 303(b) are clarified somewhat by the addition of subsection (I) in 2005. n20 This new section provides that if dismissal occurs when a petition is false or contains materially false, fictitious or fraudulent statements with respect to an individual debtor, additional consequences flow. n21 The identification of this specific subcategory of acts--namely, falsity or materially false,

fictitious or fraudulent statements--signals that these acts are evidence of bad faith. This is further supported by the H.R. Report 109-31, which specifically addresses cases filed against public officials that were dismissed for being in bad faith; some of these cases had been filed as part of obstreperous litigation tactics or what is termed paper terrorism. n22

Specific Examples of Bad Faith. If a petitioning creditor actually knows that it has a bona fide dispute as to liability or amount with the debtor, that creditor's good faith can be challenged. n23 If a single petitioning creditor knows that the debtor has more than 11 creditors, the filing can be challenged on the basis of bad faith. n24 Actual or constructive knowledge of the other creditors should be sufficient. n25 Reckless disregard of information can be evidence of bad faith. n26 A creditor is required to conduct such inquiry as a reasonable person would conduct to determine the number of creditors a debtor has; that does not mean the creditor's search must be perfect or complete. The fact that the debtor and petitioning creditors are engaged in state court litigation does not support a finding of bad faith. n27 The filing in the latter instance may be necessary to preserve assets or because of the condition of the debtor's business. Bad faith can also be evidenced by filing a case solely to create havoc, as a form of protest or to harass public officials or private individuals. n28

The examples of bad faith noted by courts reveal their concern over improper involuntary cases. As expressed by one court, an allegation of bankruptcy can leave a permanent scar even if properly dismissed. n29 Some of the concerns expressed by courts will be addressed by new subsection (l), added in 2005. n30 Recognizing the difficulty of creating a clean slate for a case improperly filed against an individual, the new legislation prohibits the reporting of false or fraudulent filings to credit reporting agencies. n31 In addition, there are provisions for sealing records and eventually expunging the involuntary petition from the debtor's records when there is no longer a need for them in a criminal case, as these convictions may contain information with respect to the wronged debtor. n32 It should also be noted that, even if there is the subsequent intervention of a good faith creditor, bad faith is usually not considered purged, and the involuntary petition should be dismissed. n33

For a complete discussion of Code section 303, see *Collier on Bankruptcy*, ch. 303 (Matthew Bender).

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n1 See *Collier on Bankruptcy*, 303.15[5].

n2 See *Collier on Bankruptcy*, 303.15[5].

n3 Pub. L. No. 109-8, § 332(b) (2005), effective in cases commenced on or after October 17, 2005; see *Collier on Bankruptcy*, 303.18.

n4 Pub. L. No. 109-8, § 332(c) (2005), effective in cases commenced on or after October 17, 2005.

n5 See *Collier on Bankruptcy*, 303.18. Section 332 of the 2005 Act, which created new subsection (l) of section 303, was based on a previously passed bill titled The Involuntary Bankruptcy Improvement Act, passed on June 10, 2003, by the House as H.R. 1529. The legislation was intended to respond directly to a rash of involuntary filings against public officials in Ozaukee County, Wisconsin.

n6 *In re Alta Title Co.*, 55 B.R. 133 (Bankr. D. Utah 1985). Absent extraordinary circumstances, a debtor (and a nonfiling general partner of a partnership debtor) are the only entities authorized to contest the involuntary petition under Rule 1011(a) (i.e., by filing a responsive pleading or seeking dismissal under section 303(j)). *In re Blutrich, Herman & Miller*, 227 B.R. 53 (Bankr. S.D.N.Y. 1998). Even a government agency, such as the Federal Trade Commission, lacks standing to so move. *FTC v. American Inst. for Research and Dev.*, 219 B.R. 639, 647 (D. Mass 1998). However, a court can *sua sponte* dismiss under section 305(a) to prevent abuse of the bankruptcy system. *Id.*

n7 See, e.g., *In re Wavelength, Inc.*, 61 B.R. 614 (B.A.P. 9th Cir. 1986).

n8 *Basin Elec. Power Coop. v. Midwest Processing Co.*, 47 B.R. 903 (D.N.D. 1984), *aff'd*, 769 F.2d 483, 13 CBC2d 500 (8th Cir. 1985), *cert. denied*, 474 U.S. 1083, 106 S. Ct. 854, 88 L. Ed. 2d 894 (1986).

n9 *In re Fox Island Square P'ship*, 106 B.R. 962 (Bankr. N.D. Ill. 1989).

n10 See, e.g., *In re Salmon*, 128 B.R. 313 (Bankr. M.D. Fla. 1991).

n11 *In re Crown Sportswear, Inc.*, 575 F.2d 991 (1st Cir. 1987); *In re Midwest Processing Co.*, 41 B.R. 90 (Bankr. D.N.D. 1984).

n12 *In re Nordbrock*, 772 F.2d 397 (8th Cir. 1985); *In re Westerleigh Dev. Corp.*, 141 B.R. 38 (Bankr. S.D.N.Y. 1992); *In re F.R.P. Indus.*, 73 B.R. 309 (Bankr. N.D. Fla. 1987).

n13 *In re United States Optical, Inc.*, 1993 U.S. App. LEXIS 6960 (4th Cir. Apr. 1, 1993) (unpublished); *In re Petrallex Stainless, Ltd.*, 78 B.R. 738 (Bankr. E.D. Pa. 1987).

n14 *In re Dino's Inc.*, 183 B.R. 779 (S.D. Ohio 1995).

n15 *In re Val W. Poterek & Sons, Inc.*, 169 B.R. 896 (Bankr. N.D. Ill. 1994).

n16 *In re Better Care, Ltd.*, 97 B.R. 405 (Bankr. N.D. Ill. 1989).

n17 *In re Mundo Custom Homes, Inc.*, 179 B.R. 566 (Bankr. N.D. Ill. 1995).

n18 *See In re K.P. Enter.*, 135 B.R. 174 (Bankr. D. Me. 1992).

n19 *See Collier on Bankruptcy*, 303.15[5].

n20 *See Collier on Bankruptcy*, 303.18.

n21 *See 11 U.S.C. § 303(l)*.

n22 *See Jeff Cole, "Paper Terrorist" Gets Five Years in Prison*, Milwaukee J. Sentinel, Jan. 18, 2003, at 1B.

n23 *In re Laroche*, 969 F.2d 1299 (1st Cir. 1992).

n24 *In re Dino's, Inc.*, 183 B.R. 779 (S.D. Ohio 1995).

n25 *Downers Grove Nat'l Bank v. Fox (In re Fox)*, 1994 U.S. Dist. LEXIS 12471 (N.D. Ill. Sept. 1, 1994).

n26 *In re Dino's, Inc.*, 183 B.R. 779, 783 (S.D. Ohio 1995).

n27 *Subway Equip. Leasing Corp. v. Sims (In re Sims)*, 994 F.2d 210, 29 C.B.C.2d 443 (5th Cir. 1993); *In re Everett*, 32 C.B.C.2d 1565, 178 B.R. 132 (Bankr. N.D. Ohio 1994).

n28 *See, e.g., In re Kennedy*, No. 02-26100-MDM (Bankr. E.D. Wis. May 21, 2002).

n29 *In re Dino's, Inc.*, 183 B.R. 779, 783 (S.D. Ohio 1995).

n30 Pub. L. No. 109-8, § 332(b) (2005), effective in cases commenced on or after October 17, 2005; *see Collier on Bankruptcy*, 303.18.

n31 *See Collier on Bankruptcy*, 303.18.

n32 *Id.* The legislative history related to subsection (l) of 303 specifically notes the difficulties of wiping the slate clean for those who have been damaged by wrongfully filed involuntary cases. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 84 -86 (2005).

n33 *In re Norriss Bros. Lumber Co., Inc.*, 25 C.B.C.2d 1571, 133 B.R. 599 (Bankr. N.D. Tex. 1991).

ABOUT THE AUTHOR(S):

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193 of 197 DOCUMENTS

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Collier on Debtor Reporting Requirements under Section 308 of the Bankr. Code

2008 Emerging Issues 906

Collier on Debtor Reporting Requirements under Section 308 of the Bankruptcy Code

By Collier

November 9, 2007

SUMMARY: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 mandates uniform reporting requirements for "small business debtors." Reporting requirements are nothing new even before the passage of the 2005 Act, debtors in possession have been required to file periodic reports in almost all chapter 11 cases. This Emerging Issues Analysis details the reporting requirements for small business debtors under Section 308 of the Bankruptcy Code.

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ARTICLE: Overview of Section 308

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act) n1 mandates uniform reporting requirements for small business debtors. n2 Reporting requirements are nothing new. Even before the passage of the 2005 Act, debtors in possession have been required to file periodic reports in almost all chapter 11 cases.

These reports are required by local bankruptcy rules, or by guidelines adopted by the United States Trustee or bankruptcy administrators in districts in Alabama and North Carolina. n3 The reports assist United States Trustees and bankruptcy administrators in monitoring a debtor in possession's progress toward reorganization; they also provide financial information that is used by United States Trustees and bankruptcy administrators in assessing the feasibility of debtors' plans. n4

The periodic reports are especially useful in smaller chapter 11 cases in which creditors' committees typically do not function. Although periodic reports have been required in almost all courts, there has been no national consistency with respect to what the reports must contain.

The 2005 Act will ensure uniform reporting requirements. It states that the Judicial Conference of the United States shall prepare rules and prescribe forms that direct small business debtors to file periodic reports relating to 1) the debtor's profitability; 2) the debtor's cash receipts and disbursements; and 3) whether the debtor is timely filing tax returns and paying taxes and other administrative expenses when due. n5

The uniform reporting requirements for small businesses in chapter 11 cases are to be implemented by Federal

Rules of Bankruptcy Procedure and Official Forms. The rules and forms must be designed to achieve a practical balance among 1) the reasonable needs of the bankruptcy court, the United States Trustee, creditors, and other parties in interest for reasonably complete information; 2) a small business debtor's interest that required reports be easy and inexpensive to complete; and 3) the interest of all parties that the required reports help such debtor to understand such debtor's financial condition and plan such debtor's future. n6

The requirement in section 308 that small business debtors file periodic reports does not take effect until 60 days after the necessary rules and forms have been prescribed under 28 U.S.C. § 2075. n7

Periodic Reports

Section 308(b) requires small businesses to file periodic financial and other reports, but it does not specify either what period of time the report is to cover or when and how often the report must be filed. Section 586(a)(7)(A)(iii) of title 28 provides that one of the United States Trustee's duties is to explain the debtor's obligations to file monthly operating reports and other required reports, but the scope and timing of the reports will be left to the Federal Rules of Bankruptcy Procedure and perhaps also to scheduling orders entered in connection with status conferences held pursuant to section 105(d)(1).

Uncertainty about the definition of a small business debtor may cause difficulty for some chapter 11 debtors in determining whether or not they must file the periodic reports required by section 308. A chapter 11 debtor's status as a small business debtor as that term is defined in section 101, n8 depends in part on whether or not a creditors' committee is appointed and on whether or not an appointed committee is sufficiently active and representative to provide oversight of the debtor. Creditors' committees are, pursuant to section 1102(a)(1), supposed to be appointed in every chapter 11 case, but in actual practice the committees are rarely established in smaller cases.

Small businesses in chapter 11 cases are frequently reorganized on a fast track, and that practice, which no doubt will continue under the 2005 Act, may determine how often periodic reports must be filed. n9 For example, if the court required a small business debtor to file a plan within 90 days after the order for relief, monthly reports would be more appropriate than quarterly reports because a quarterly report of the debtor's postpetition activities might not be due until after the conclusion of the confirmation hearing.

The court has discretion with respect to distribution and publication of reports. *Rule 2015(d) of the Federal Rules of Bankruptcy Procedure* provides that in a chapter 11 case the court may direct that copies of reports, such as those required by section 308, be mailed to creditors, equity security holders, and indentured trustees, and that summaries of the reports be published. n10

Required Financial Reports for Small Business Debtors

Profitability Report. Section 308(b)(1) of title 11 requires a small business debtor to file a report regarding the debtor's profitability, defined loosely in section 308(a) as the amount of money that the debtor has earned or lost during current and recent fiscal periods. There are many levels of profitability analysis, but given the preference expressed in section 435 of the 2005 Act for forms that are easy and inexpensive to complete, the requirement will probably be simply a basic profit and loss statement reflecting total sales or revenue less cost of goods sold less operating expenses. n11 In section 308 the current and recent fiscal periods to be covered by the profitability report are not specified. It is not yet clear whether the reports should include prebankruptcy activity or will be limited to the debtor's postpetition operations.

Cash Receipts and Disbursements Reports. Subsections 308(b)(2) and (3) require the debtor to file periodic reports

that include reasonable approximations of the debtor's projected cash receipts and cash disbursements over a reasonable period and comparisons of actual cash receipts and disbursements. Although section 435(a) requires the Judicial Conference of the United States to propose bankruptcy rules and official forms directing a small business debtor to file periodic reports that include the debtor's cash receipts and disbursements, sections 308(b)(2) and 308(b)(3) do not specifically require the filing of a report of actual cash receipts and disbursements, except as part of a comparison with the debtor's projected cash receipts and disbursements. The Federal Rules of Bankruptcy Procedure may further require a report of actual cash receipts and disbursements for a period before which projections are made, or may require that projections be filed with or shortly after the petition is filed. n12

Other Required Financial Reports. Pursuant to Code section 521(a)(1)(B)(ii), all debtors must file, unless the court orders otherwise, a schedule of current income and current expenditures. The 2005 Act amended section 521 to require all debtors to file, unless otherwise ordered by the court, a statement of the amount of monthly net income, itemized to show how the amount is calculated and a statement disclosing any reasonably anticipated increase in income or expenditures over the 12-month period following the date of the filing of the petition. n13 Although this subsection presumably was intended to apply only to consumer debtors in chapter 7 and 13 cases, its application will extend to debtors in possession in chapter 11 as well. n14 The 2005 Act also amended title 28 to require the Attorney General to issue rules and uniform forms for periodic reports by debtors in possession or trustees in cases under chapter 11 of title 11, including periodic reports showing cash receipts, cash disbursements and profitability of the debtor for the most recent period and cumulatively since the date of the order for relief. n15

Reports of Compliance

Statement of Material Compliance with Postpetition Requirements. A small business debtor must file a periodic report stating that it is in compliance in all material respects with requirements imposed by the Bankruptcy Code and by the Federal Rules of Bankruptcy Procedure. n16 The requirements would include both those required of small business debtors under section 1116, and those imposed by the Federal Rules of Bankruptcy Procedure to implement the uniform reporting requirements of section 308(a). Additionally, the small business debtor must file a periodic report stating that it is timely filing tax returns and other required government filings.

What is meant by required government filings is not clear, but it could include such things as statutorily required payments toward workers' compensation insurance. The statute appears to contemplate required filings that, like tax returns, involve payments of some kind. However, depending on the nature of the debtor's business operations, other types of filings will often be required as a condition of operation by federal, state or municipal authorities. For example, documentation of compliance with environmental or health care statutes and regulations will be necessary for a debtor doing business as a chemical manufacturer or a health care provider. There can be little disagreement that some required government filings are more important than others, given the purposes they serve, but the obligation to file does not make exceptions for required government filings that the debtor may consider to be insignificant.

The compliance report must also state whether the debtor is paying taxes and other administrative expenses when due. Paying taxes entitled to an administrative priority is one of a small business debtor's duties under section 1116(6)(B), and failure to pay taxes is cause for dismissing a case or converting the case to chapter 7 under section 1112(b)(4)(I). Paying administrative expenses, however, is not an enumerated duty of a small business debtor under section 1116, and it is not specifically identified as a cause for dismissing or converting a case to chapter 7 under section 1112(b).

Disclosure of Noncompliance and Debtor's Plans for Cure. If a debtor is not in compliance with the debtor's requirements under the Bankruptcy Code or Federal Rules of Bankruptcy Procedure, or is not filing tax returns and other required government filings or paying taxes and other administrative expenses, the debtor must identify the failures and state how, at what cost, and when the debtor intends to remedy the failures. n17

Other Required Compliance Reports. The 2005 Act amended title 28 to require the Attorney General to issue rules and uniform forms for periodic reports by debtors in possession or trustees in cases under chapter 11 of [this title], including periodic reports showing compliance with title 11, [and] whether or not tax returns and tax payments since the date of the order for relief [have] been timely filed and made. n18

Disclosure of Matters in the Best Interests of the Debtor and Creditors, and in the Public Interest

Section 308(b)(4)(C) requires a small business debtor to file a periodic report regarding such other matters as are in the best interests of the debtor and creditors, and in the public interest in fair and efficient procedures under chapter 11 of this title. n19 This requirement is so vague as to be useless. Because failure to comply may have severe consequences, n20 the requirement may lead to unnecessary litigation.

The specifics of what must be disclosed under this subsection may be the subject of scheduling orders crafted for the needs of each case. Periodic reports under this subsection might include an aging of a manufacturer's accounts receivable, a listing of a construction company's new construction contracts, or the progress of litigation.

Privacy Implications of Periodic Reports

All the reports required by section 308(b) are filed with the court, not merely with the United States trustee or the bankruptcy administrator. They consequently become part of the public record and are open to examination. n21 An entity may be protected, however, at the discretion of the court with respect to a trade secret or confidential research, development or commercial information. n22 A debtor when filing the reports also must observe the privacy protections afforded by the Bankruptcy Code. n23

For a complete discussion of Code section 308, *see* Collier on Bankruptcy, ch. 308 (Mathew Bender).

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n1 Pub. L. No. 109-8 (2005).

n2 Small business debtor is defined in 11 U.S.C. § 101(51D), added by Pub. L. No. 108-9, § 432(a) (2005).

n3 *See* 3 United States Trustee Manual, Chapter 11 Case Administration (1998); United States Bankruptcy Administrator, E.D.N.C., Discussion of Duties of Chapter 11 Debtor in Possession under Local Bankruptcy Rule No. 4002-1(b), EDNC, available at www.nceba.uscourts.gov; E.D.N.C. Local Bankr. R. 4002-1 (listing debtor duties).

n4 The United States Trustee has the obligation to supervise the administration of chapter 11 cases, 28 U.S.C. § 586(a)(3), and in small business cases must review and monitor diligently the debtor's activities, to identify as promptly as possible whether the debtor will be unable to confirm a plan, 28 U.S.C. § 586(a)(7)(C). The United States Trustee must take these actions to ensure that all of debtor's reports are properly and timely filed. 28 U.S.C. § 586(a)(3)(D). The bankruptcy administrators in North Carolina and Alabama supervise the administration of cases under chapters 7, 11, 12 and 13 of title 11. 3 Admin. Office of the Courts, Guide to Judiciary Policies & Procedures, § A, ch. 9, part E, ex. E-1 § 3.01 (1992).

n5 Pub. L. No. 109-8, § 435(a) (2005).

n6 Pub. L. No. 109-8, § 435(b) (2005).

n7 Pub. L. No. 109-8, § 434(b) (2005); *see Collier on Bankruptcy 308.07* (Matthew Bender)

n8 *See Collier on Bankruptcy 101.51D* (Matthew Bender)

n9 The National Bankruptcy Review Commission specifically recommended that in addition to enactment of uniform filing and confirmation deadlines through the process of bankruptcy reform, bankruptcy judges also should continue to use modern case-management techniques in all small business cases to further reduce cost and delay. National Bankruptcy Review Comm'n, *Bankruptcy: The Next Twenty Years--National Bankruptcy Review Commission Final Report* (1997).

n10 *Fed. R. Bankr. P. 2015(d)*; *see Collier on Bankruptcy ch. 2015* (Matthew Bender)

n11 This is the type of profitability report that has been required by United States Trustees and by bankruptcy administrators. *See* 3 United States Trustee Manual, *Chapter 11 Case Administration* (1998); United States Bankruptcy Administrator, E.D.N.C., *Discussion of Duties of Chapter 11 Debtor in Possession under Local Bankruptcy Rule No. 4002-1(b)*, EDNC, available at www.nceba.uscourts.gov.

n12 Section 1116(1)(A), added by Pub. L. No. 109-8, § 436(a) (2005), and effective in cases commenced on or after October 17, 2005, requires a debtor in possession in a small business case to file, with its petition, the

debtor's most recent cash-flow statements. United States Trustees and bankruptcy administrators routinely require chapter 11 debtors in possession to file monthly reconciliations of their bank accounts. *See* 3 United States Trustee Manual, 3-2.7; United States Bankruptcy Administrator, E.D.N.C., *Discussion of Duties of Chapter 11 Debtor in Possession under Local Bankruptcy Rule No. 4002-1(b)*, EDNC, available at www.nceba.uscourts.gov.

n13 11 U.S.C. § 521(a)(1)(B)(v) & (vi), added by Pub. L. No. 109-8, § 315(b)(1) (2005), effective in cases commenced on or after October 17, 2005.

n14 Section 315 of the 2005 Act, which amended section 521 to include these reports, is entitled Giving Creditors Fair Notice in Chapters 7 and 13.

n15 28 U.S.C. § 589b(a)(2) & (4), added by Pub. L. No. 109-8, § 602(a) (2005).

n16 11 U.S.C. § 308(b)(4)(A)(i), added by Pub. L. No. 109-8, § 434(a) (2005).

n17 11 U.S.C. § 308(B)(4)(B), added by Pub. L. No. 109-8, § 434(a) (2005).

n18 28 U.S.C. § 589b(a)(2) & (5), added by Pub. L. No. 109-8, § 602(a) (2005).

n19 11 U.S.C. § 308(b)(4)(C), added by Pub. L. No. 109-8, § 434(a) (2005).

n20 The unexcused failure to timely file a report constitutes cause for the dismissal or conversion of the case. 11 U.S.C. § 1112(b)(4)(F). Grounds for dismissal or conversion of a chapter 11 case are also grounds for appointing a trustee or examiner. 11 U.S.C. § 1104(a)(3).

n21 11 U.S.C. § 107(a).

n22 11 U.S.C. § 107(b)(1).

n23 See 11 U.S.C. §§ 112, 332, 351. The Federal Rules of Bankruptcy Procedure also address privacy concerns and the additional rules that will be implemented in connection with the new sections and with the E-Government Act of 2002, Pub. L. No. 107-347 (2002).

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Fraudulent Involuntary Bankr. Filings under Section 303(l) of the Bankr. Code

2008 Emerging Issues 907

Collier on Fraudulent Involuntary Bankruptcy Filings under Section 303(l) of the Bankruptcy Code

By Collier

November 9, 2007

SUMMARY: Bankruptcy Code section 303(l), added in 2005, is designed to address a specific category of involuntary filings that are improper--those filed against public officials or private individuals. This new section, together with changes to *18 U.S.C. § 157*, makes it clear that wrongful involuntary filings against individuals will lead to serious consequences for the offenders and deter such filings.

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ARTICLE:

Bankruptcy Code section 303(l), added in 2005, n1 is designed to address a specific category of involuntary filings that are improper--those filed against public officials or private individuals. Since the Code was enacted in 1978, some people have used section 303 as a means of harassment; this was an effective technique in the sense that even if the wrongful cases were dismissed (after effort to be sure), they resulted in serious consequences for the victim of the wrongful filing. n2 Those consequences included the listing of the bankruptcy filing on credit reports and in other public databases, including those of the bankruptcy courts. This new section, together with changes to *18 U.S.C. § 157*, makes it clear that wrongful involuntary filings against individuals will lead to serious consequences for the offenders n3 and deter such filings.

Background. Section 303(i) provides that entities wronged by involuntary filings can seek relief, including costs and in appropriate circumstances, punitive damages. n4 However, section 303(i) is limited to monetary recovery. With the growth of access to public records and the serious consequences that can flow from the data in these records, the remedies in section 303(i) were determined to be inadequate to address wrongful involuntary case filings. The amendments to *18 U.S.C. § 157* also make it clear that wrongful involuntary filings should be punished. Two recent trends--information access and use of litigation to terrorize--militated in favor of the 2005 amendments to section 303 and

title 18.

Requirement for Sealing. Section 303(l) provides that the records of a fraudulent involuntary filing and all references thereto can be sealed if certain requirements are met. n5 First, pursuant to section 303(l)(1)(A), sealing can

occur only in cases in which the filing was false or there were materially false, fictitious or fraudulent statements. Second, pursuant to section 303(l)(1)(B), sealing can only occur in cases in which the victim of the wrongful filing is an individual. Records of false filings or in cases with false, fictitious or fraudulent statements in filings involving corporate or partnership debtors will not be sealed, at least pursuant to section 303(l). n6 This presents a situation similar to that which exists under section 362(k)(1) in which actions for willful violations of the automatic stay give rise to actual damages and punitive damages only in cases involving individuals. Some courts, despite the delimiting language in section 362(k)(1), have permitted recovery by corporate debtors who have been wronged by willful stay violations. n7 Although it is too early to tell, a similar result could occur in section 303(l), permitting corporate and other nonindividual debtors to seal records. n8 With the advent of online filing and increased public access to information through the Internet, a wrongful filing can also negatively impact nonindividuals. n9 Other protections with respect to data that may harm an individual are contained in new section 107(c). n10 These are in addition

To the sealing provisions in section 303(l).

The third requirement for sealing, contained in section 303(l)(1)(C), provides that the offending case must be dismissed. Also, the desired remedy--sealing of records--can occur only upon a motion of the debtor. This effort will cost the debtor money for attorney's fees which perhaps will be part of any recovery awarded under section 303(i). The limitation on who can move for relief under section 303(l) means that others related to the debtor or impacted by the wrongful filing against the debtor cannot be movants. One can picture a scenario in which a separated spouse or an adult child with the same name might want, and be fiscally able, to move for a sealing of the records. However, the latter is not permitted under section 303(l).

The key operative words within section 303(l)(1), namely, false, fictitious and fraudulent, are not defined. Courts will then turn to definitions of these terms under state law.

Section 303(l)(1) permits the sealing of more than the petition itself. References to the wrongful petition can also be sealed. This was intended to include reference to docket sheets and other pleadings that might have been filed, including motions to dismiss or answers to the involuntary petition.

Prohibition of Consumer Credit Reporting of Dismissed Case. Section 303(l)(2) provides an additional remedy for those individuals harmed by a wrongful involuntary filing, n11 namely the nonreporting to a consumer credit reporting agency as that term is defined in section 603(f) of the Fair Credit Reporting Act (FCRA"). More specifically, subsection (2) only applies in cases involving individual debtors. Next, dismissal by the court of the wrongful case is a prerequisite to nonreporting. The nonreporting is discretionary; a court is permitted, but not required, to order a prohibition on reporting. It is not specified who can be the movant under this situation, although it is not limited to the debtor as is the case in section 303(l)(1).

The value of nonreporting cannot be underestimated. Section 605 of the FCRA permits cases filed under title 11 of the United States Code to appear on consumer reports (as that term is defined in section 603 of the FCRA) n12 for 10 years from the order for relief or the date of adjudication. n13 That has generally been determined to mean that all bankruptcy cases can remain on an individual's credit report for 10 years from the date of discharge. The FCRA does not require that the report designate the chapter under which relief was sought or whether the relief was sought voluntarily or involuntarily. This means that a person reviewing a credit report cannot distinguish between the bankruptcy of an individual who voluntarily sought debt relief and the victim of a wrongful involuntary filing.

There are additional implications of an improper bankruptcy on a credit report. A recent bankruptcy on a credit report, without full information, can affect one's credit score negatively. This is significant because a credit score is that all important number that determines the price consumers pay for credit, and it also has applicability in terms of obtaining insurance and employment. n14 Until recently, many individuals did not know about credit scoring, and until 2002, credit scores were not generally available to individuals. So, many individuals did not find out about the credit-scoring consequences of improper involuntary bankruptcy filings until they sought and were denied new credit.

With the increasing access to credit scores and the issuance of free credit reports annually to those individuals who request them pursuant to the amendments to the FCRA--namely, the Fair and Accurate Credit Transactions Act signed into law in December 2003 (FACTA)--individuals are able to determine the credit consequences of bankruptcy filings. n15

Nonreporting, the action contemplated by section 303(l)(2), is different from expungement or even sealing. Consumers are entitled to dispute inaccurate information in their credit reports pursuant to section 611 of the FCRA. However, this correction procedure, even through improved by the FACTA amendments, is still a difficult process. n16 It is also time consuming and costly, particularly if one needs legal representation to vindicate one's rights. Moreover, by the time the erroneous entries are fixed, the needed loan or job may have evaporated. Even if credit reporting agencies were to expunge data with respect to improper bankruptcy filings, the erroneous data existed in the system (even if briefly) and there are numerous credit reporting agencies that may have incorporated the information into their own databases. Although there are certain major credit reporting agencies that are now well-known (Experien, Equifax and Trans Union), there are myriad other reporting agencies, making expungement of released data a practical nightmare. n17 Section 303(l)(2) permits nonreporting, then, which remains an unusual step in that most matters of public record can and are disclosed on credit reports. But, it is not as good as solution as it might appear.

Despite the well-meaning nature of this aspect of section 303(l), it does not completely fix the problem of credit reporting of improper involuntary bankruptcy filings. This is because it is possible for there to be reporting before the improper case is dismissed and/or the records sealed pursuant to section 303(l)(1). Both paragraphs (1) and (2) of subsection (l) require dismissal before the designated remedy may be sought. By the time dismissal occurs, the data may already be in the credit reporting system. This is in part a problem of electronic filing of all bankruptcy records. As soon as a case is filed electronically, which most cases will be in the federal bankruptcy court system, the information will be accessible. n18 One suggestion to ameliorate this problem would be for the courts to agree that involuntary filings should not enter the electronic database system of PACER until a decision has been made as to whether the case should be dismissed or an order for relief entered. This would protect information from being released. How this could work as a practical matter is another issue but it must be remembered that there are actually very few involuntary cases which would ease the practical burden.

Amendments to Title 18. The 2005 Act also amended 18 U.S.C. § 157, one of the bankruptcy crimes provisions. In particular, section 157 was amended to reference fraudulent involuntary bankruptcy petitions in each of the section's three separate provisions. n19 Arguably, section 157 already covered fraudulently filed involuntary cases within its ambit. Hence, the legislative change may provide more in the way of emphasis than change. What is interesting is that subsections (1) and (2) of section 157 address the wrongs of the person who files the fraudulent petition or a fraudulent document in conjunction with a fraudulent petition, activities that seem to be targeted to the actual wrongdoer--the petitioning creditors. However, subsection (3) of 157 can be read more broadly. It seeks to punish a person who makes a false statement or fraudulent representation including with respect to a fraudulent involuntary petition. This could extend the potential criminal activity beyond the person actually filing documents with the court, such as a petitioning creditor's lawyer or other coconspirator.

Expungement. New section 303(l)(3)²⁰ provides for expungement of bankruptcy records resulting from a violation of sections 152 and 157 of title 18 but only upon expiration of the criminal statute of limitations (which is five years under section 3282 of title 18). The expungement can be ordered only by the court if sought by the debtor and for good cause shown. This is something of an odd section in that individual debtors can move to get their records sealed without any time limitations but for expungement they must wait five years. Perhaps this is because expungement is a more serious and permanent remedy than sealing. It is worth observing that expungement may be a better way of purging databases of information related to an involuntary filing, although the practicalities of expungement are complex. This section is ambiguous in its wording and references expungement of any records related to a petition filed under section 303(l). The question is whether any "only relates to bankruptcy records or whether it could be read more broadly to reference any other records that mention the fraudulent filing (such as employment records, divorce records or any other official record in existence).

For a complete discussion of Code section 303, see Collier on Bankruptcy, ch. 303 (Matthew Bender).

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n1 Pub. L. No. 109-8, § 332(b) (2005), effective in cases commenced on or after October 17, 2005. While designated as (l), it would have been more correctly designated as (k), since original subsection (k) was repealed by the 2005 amendments. *See Collier on Bankruptcy*, 303.17 (Matthew Bender).

n2 This is reflected in the legislative history to section 332, creating section 303(l) of title 11. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 84 -86 (2005). This legislative history notes an earlier, but not identical, initiative passed by the House of Representatives in 2003. *See* H.R. 1529, 108th Cong. (2003).

n3 *See* Pub. L. No. 109-8, § 332(c) (2005), effective in cases commenced on or after October 17, 2005.

n4 *See Collier on Bankruptcy*, 303.15 (Matthew Bender).

n5 Subsection (l) was added in 2005. *See* Pub. L. No. 109-8, § 332(b) (2005), effective in cases commenced on or after October 17, 2005.

n6 Such relief could, however, be sought under section 105.

n7 *See Collier on Bankruptcy*, ch. 362 (Matthew Bender).

n8 As noted, such relief may be available under section 105.

n9 *See* Peter C. Alexander & Kelly Jo Slone, *Thinking About the Private Matters in Public Documents*:

Bankruptcy Privacy in an Electronic Age, 75 *Am. Bankr. L.J.* 437 (2001); J. Rich Leonard, *Having Thought About Private Matters: The Federal Courts' Initial Response*, 77 *Am. Bankr. L. J.* 9 (2003).

n10 Section 107(c) was added in 2005. Pub. L. No. 109-8, § 234(a) (2005), effective in cases commenced on or after October 17, 2005.

n11 Subsection (l) was added in 2005. *See* Pub. L. No. 109-8, § 332(b) (2005), effective in cases commenced on or after October 17, 2005.

n12 15 *U.S.C. § 1681a*.

n13 The Fair Credit Reporting Act appears at 15 *U.S.C. §§ 1681 -1681t*.

n14 For a detailed discussion of the role of both credit scoring and credit reporting in today's consumer financial markets, *see* Evan Hendricks, *Credit Scores and Credit Reports: How the System Really Works, What You Can Do* (2004).

n15 Pub. L. No. 108-159 (2003).

n16 *See* Peter C. Alexander, *Identity Theft and Bankruptcy Expungement*, 77 *Am. Bankr. L.J.* 409 (2003).

n17 For a sample of the large number of credit reporting agencies, *see* www.creditworthy.com/providers/agency.asp?ID=15.

n18 *See* Fed. R. Bankr. P. 5005(a)(2). According to the Administrative office of the United States, most bankruptcy courts have implemented or are in the process of implementing the case management/electronic case filing system. *See* http://www.uscourts.gov/cmefc/cmefc_faqs.html.

n19 Pub. L. No. 109-8, § 332(c) (2005), effective in cases commenced on or after October 17, 2005.

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195 of 197 DOCUMENTS

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Collier on Partnership Bankr. Filings Under Section 303(b)(3) of the Bankr. Code

2008 Emerging Issues 911

Collier on Partnership Bankruptcy Filings Under Section 303(b)(3) of the Bankruptcy Code

By Collier

November 9, 2007

SUMMARY: Bankruptcy Code section 303(b)(3) contains very specific provisions regarding partnership filings. In section 303(b), paragraph (3) differs from paragraphs (1) and (2) in that it eliminates the requirements regarding the number, amount and nature of the claims of petitioning entities.

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ARTICLE: *Bankruptcy Code section 303(b)(3)* contains very specific provisions regarding partnership filings. As a general matter, a partnership is an eligible debtor under section 303(a) based on the definition of the term person. n1 When state law provides that a partnership dissolves when a bankruptcy petition is filed against one of its partners, that partnership in dissolution should still be considered a person for the purposes of an involuntary bankruptcy petition filing. n2 Otherwise, dissolved partnerships could never file chapter 7 or 11 cases (although there is conflicting authority regarding a chapter 11 petition seeking reorganization). The term partnership, unlike the term corporation, n3 is not specifically defined in the Code. The definition of corporation includes a small category of partnerships, but the statutory language and the legislative history make it very clear that limited and general partnerships are not corporations. n4 However, if the partnership fits within the definition of farmer, it will be ineligible. n5

In section 303(b), paragraph (3) differs from paragraphs (1) and (2) in that it eliminates the requirements regarding the number, amount and nature of the claims of petitioning entities. This makes involuntary filings easier under paragraph (3), since there are fewer threshold requirements to be alleged and proved by the petitioners. However, elimination of the requirements of paragraphs (1) and (2) does not eliminate the need for the petitioning entities to satisfy the requirements of section 303(h). n6 The petitioning entity would still need to allege and prove that the debtor was not generally paying its debts as they became due. The requirement of a bona fide as to liability or amount dispute would reappear under section 303(h), although it need not be addressed under section 303(b)(3).

General Requirements under Subsection (b)(3)

Subsection (b)(3) provides that an involuntary case can be filed by (a) fewer than all the general partners or (b) if all the general partners are in bankruptcy, a general partner, trustee of the general partner or holder of a claim against

the partnership. These specific provisions do not preclude an involuntary filing by a partnership's creditors if those creditors satisfy the requirements of section 303(b)(1) or (2). Under Bankruptcy Rule 1004, a filing under section 303(b)(3) requires that the petitioning partners or creditors cause a copy of the petition to be sent or served on nonpetitioning general partners. The failure to effect service means an order for relief cannot be entered because there is no personal jurisdiction. n7 Rule 1004 does not address partnership filings under section 303(b)(1) and (2). However, a prudent course of conduct is to send or serve the involuntary petition on the general partners.

General Partners as Petitioners

Under section 303(b)(3)(A), if all the general partners do not consent to a voluntary filing, a filing by fewer than all of the general partners is treated as an involuntary case. This provision is particularly useful when there is disagreement among the general partners. A general partner may want to file a petition when that partner believes the other partners have committed acts detrimental to the partnership and its creditors, particularly if those acts could result in personal liability of the petitioning partner. The petitioning partner would want the filing so that there could be an orderly liquidation and administration of the partnership, including the recovery of avoidable transfers and invalidation of liens; all of this would serve to increase the size of the distributable estate. The legislative history indicates that such a filing is permissible notwithstanding an agreement to the contrary between partners or because of state or local law. n8 Of course, the general partner must actually be a general partner; otherwise, standing to bring the involuntary can be challenged. n9 The determination is based on the underlying agreements among the parties, as governed by state law. n10 Moreover, purchase of an interest in a partnership does not make the acquirer a substitute partner for purposes of filing an involuntary case. n11 The non-joining general partner may contest the involuntary filing. n12 A filing under section 303(b)(3)(A) does not eliminate the requirement that the filing general partner satisfy the requirements of section 303(h), namely that the partnership is generally not paying its debts as they become due and those debts are not subject to bona fide disputes as to liability or amount. On occasion, the actual filing is commenced as a voluntary case but it is treated as an involuntary petition under section 303(b)(3)(A). n13

A word of caution to lawyers counseling a failing partnership: If one of the partners determines to file an involuntary case after the lawyer has conferred with the partners about filing a voluntary bankruptcy case, then that lawyer cannot represent the petitioning partner; to do so is a violation of the Rules of Professional Conduct. n14

When All of the General Partners Are Debtors

Under section 303(b)(3)(B), if an order for relief has been entered against *all* of the general partners, an involuntary case can be commenced by one of three entities: a general partner of the partnership; the trustee of the general partner; or a holder of a claim against the partnership. Subparagraph (B) differs from section 303(b)(3)(A) in that it addresses the situation in which general partners are in bankruptcy. The petitioning entity must still prove the requirements of section 303(h). However, the petitioning partners do not need to satisfy the requirements of subsections 303(b)(1) and (2).

Intersection of Partnership and Bankruptcy Law

The intersection between the Bankruptcy Code and state partnership law is by no means clear, and there are many open issues involving partnership bankruptcies. n15 Involuntary partnership cases raise the tension and even conflict between federal bankruptcy law and state partnership law (as well as the underlying partnership agreements). The problems become evident in the context of section 303 if the petitioning general partner is a debtor.

Debtor General Partner. There is a question whether a debtor general partner is eligible to file an involuntary petition against the partnership under section 303. (By its terms, section 303(b)(3)(B) permits such a filing if *all* of the general partners, as distinguished from *one* general partner, are in bankruptcy.) State partnership law (or the underlying partnership agreement) could restrict the power of a bankrupt general partner. That general partner's bankruptcy would cause the dissolution of the partnership, under either or both state partnership law or the terms of the partnership agreement. This arguably would divest the bankrupt petitioning general partner of all authority over the partnership. This was the position of the court in *In re Sunset Developers*.ⁿ¹⁶ There is authority that a debtor general partner cannot file an involuntary case against the partnership.ⁿ¹⁷

There is a powerful counter-argument. Nothing in the Bankruptcy Code precludes a petitioning general partner who is in bankruptcy from commencing a case. Indeed, section 303(b)(3)(B) explicitly contemplates a situation in which all of the general partners are in bankruptcy. Paragraph (B) seems to recognize that, at least when all of the general partners are in bankruptcy, there would need to be some entity capable of putting the partnership into bankruptcy. There is case law supporting the position that a general partner's bankruptcy does not divest that partner of all authority with respect to the partnership.ⁿ¹⁸ There is also case law explicitly permitting a debtor general partner to file an involuntary case against the partnership.ⁿ¹⁹

While it is true that bankruptcy law controls who may file an involuntary petition, state partnership law controls who has the power to file. Under state law, partnership dissolution may not actually terminate the partnership, suggesting that a bankruptcy filing would still have meaning. The process of liquidating (as distinguished from running) the partnership remains. On the other hand, if state partnership law provides that a general partner ceases to be a general partner if that partner is in bankruptcy, the Bankruptcy Code could be seen as, in essence, usurping state partnership law. The question in that instance is whether the cessation" as a general partner is designed to prohibit prospective business activity, namely, acting as a manager; if so, state partnership law does not necessarily preclude the winding-up.ⁿ²⁰

Looking to Sections 365 and 541 for Guidance. The Supremacy Clause argument does not completely answer the question of whether a debtor general partner can file against the partnership. If state law specifically addresses who is an eligible petitioner and that provision conflicts with the Bankruptcy Code, the Code would prevail as federal law would preempt state law. However, bankruptcy law cannot create state substantive partnership rights, vesting parties with powers they would not otherwise have. The question then is what power does a general partner have when that partner is a debtor? Sections 365 and 541 are instructive in answering this question. There is general consensus that a partnership agreement is an executory contract under section 365.ⁿ²¹ That suggests that the debtor general partner's estate may have an interest in the partnership. If it does, then that general partner should be able to preserve that interest, either in its own name or through a trustee, for the benefit of its estate. Moreover, the restrictions based on the general partner's bankruptcy would be unenforceable under section 541(c).ⁿ²²

However, even if a partnership agreement is an executory contract, the nature of that contract raises two key issues that affect the scope of the property interest: (1) Can the partnership agreement be assumed or is it a personal service contract (which would preclude assumption); and (2) Is the bankruptcy termination provision of the partnership agreement an unenforceable *ipso facto* clause under section 365(e)?ⁿ²³ If the partnership agreement cannot be assumed and the *ipso facto* clause is enforceable, the scope of the debtor general partner's property interest is virtually nil. Since current case law has not resolved these issues as yet under sections 365 and 541, uncertainty remains in section 303. Once resolved, these questions will help resolve the question of a debtor general partner's power to file an involuntary case against the partnership.

Resolution Options. There are clearly merits to both sides of the argument. In resolving the tension between partnership law and bankruptcy law, the better argument is that while partnership law should govern who has the power to act on behalf of a partnership outside of bankruptcy, the debtor general partner should have the power to file a

petition against the partnership. If it cannot, then the bankruptcy of the general partner would effectively preclude, at least in some situations, a partnership bankruptcy. If the partnership is in financial difficulty, then recourse to the federal bankruptcy laws should not be precluded by virtue of the bankruptcy status of the general partner and state partnership laws. The power of the general partner, however, remains a thorny issue and one with respect to which legislative change may be the only workable solution.

Limited Liability Partnerships

Limited liability partnerships (LLPs²⁴), introduced into the legal system in the early 1990s, afford partners at least some degree of limited liability protection. Generally, LLPs are formed by partnerships of attorneys, accountants or other professionals. State law treats LLPs as general partnerships. n24 LLP status is granted to the partnership when the partners in a general partnership register with the secretary of state as an LLP. n25 The nature and extent of the limitation on liability of partners varies from state to state, but generally includes protection from liability for the professional negligence of the other partners. In some states, partners in an LLP enjoy full vicarious liability protection from partnership debts similar to the protection given to shareholders of a corporation, and in some states a partner is not a proper party to a suit against the partnership. n26

A question that may arise is whether fewer than all general partners in an LLP may file an involuntary petition against a partnership under section 303(b)(3). Though they were not in existence at the time the Bankruptcy Code was drafted, LLPs in states that grant partners full limited liability protection, similar to the liability limitations afforded shareholders of a corporation, fall within the Code's definition of corporation, which includes a partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association. n27 It could be argued that, by defining corporation to include such partnerships, Congress intended that they should not be treated as partnerships under the Code. Moreover, in view of its purpose, which is to protect general partners who are exposed to personal liability for partnership obligations by enabling them to preserve the value of partnership assets through bankruptcy, section 303(b)(3) should not be available to LLP partners who are not personally liable for partnership debts. In this context, it would not make sense to distinguish partners in an LLP from shareholders in a corporation.

However, in states where LLP partners are protected from liability only with respect to vicarious liability for malpractice claims of other partners, or protection from liability is otherwise not as extensive as that afforded shareholders of a corporation, the LLP should be treated under the Code as a partnership, not as a corporation. A 1994 amendment to section 723(a) of the Code supports the argument that, at least where partners do not have the same kind of limited liability as that enjoyed by corporate shareholders, the LLP should be treated under the Code as a partnership. The amendment clarified that, in a chapter 7 case of a partnership in which the partnership property is insufficient to pay all partnership debts, the trustee shall have a claim against general partners to the extent that under applicable nonbankruptcy law such general partner is personally liable for such deficiency. n28 The legislative history of the amendment states that the purpose of the amendment was to clarify that a partner of a registered LLP would be liable under section 723(a) only to the extent the partner would be personally liable for a deficiency according to the applicable LLP statute. n29 Because section 723(a) is a provision that deals only with partnerships, it appears that Congress understood and intended that LLPs in which partners have liability for at least some debts of the partnership would be treated as partnerships under the Code.

For these reasons, if an LLP is registered in a state that grants its general partners the same type of limited liability afforded to shareholders of a corporation, rather than merely protecting them from vicarious liability for negligence or other acts of wrongdoing by another partner, section 303(b)(3) should not be applicable. However, if the applicable LLP statute affords general partners a more limited form of protection so that partners would be personally liable for at least some debts of the partnership, section 303(b)(3) should be applicable so that fewer than all general partners may file an involuntary petition. n30

Limited Liability Companies

Most states have enacted statutes that permit the formation of limited liability companies (LLCs), a relatively new type of entity whose popularity has been increasing. LLCs are hybrids of partnerships and corporations, having certain features of both. n31 LLCs are not mentioned in the Bankruptcy Code, which is not surprising because state statutes permitting their formation did not exist at the time the Code was drafted. Nonetheless, LLCs are persons eligible for relief under the Code. n32

An important feature of an LLC is that it is owned by members, rather than partners or shareholders, and the members enjoy the same general limited liability protection as that afforded to shareholders of a corporation. Though a few bankruptcy courts have analogized members of an LLC to partners of a partnership in certain contexts, such as when considering the effect of a member's bankruptcy on its continued exercise of membership rights, n33 LLCs are not partnerships and members are not general partners. n34 Therefore, *section 303(b)(3) of the Bankruptcy Code*, which provides that fewer than all general partners may file an involuntary petition against a partnership, should not be available to members of an LLC. Moreover, it would not further the purpose of section 303(b)(3), which is to protect general partners who are personally liable for debts of the partnership, to make it available to LLC members who have limited liability protection similar to that afforded shareholders of a corporation. n35

Trustee of a Partnership and the General Partner

Paragraphs (1) and (2) of section 303(b) permit a creditor to file an involuntary case against a partnership, assuming the requirements of those paragraphs are satisfied. n36 Creditors are also permitted to file an involuntary case against a general partner under paragraphs (1) and (2), again assuming the requirements of those paragraphs are satisfied. However, if a trustee of a debtor general partnership seeks to file an involuntary petition against a general partner, the requirements of paragraphs (1) and (2) n37 would need to be met and that could prove to be an insurmountable hurdle. As trustee of the partnership, the trustee would hold a claim against the partner that could be administered outside of bankruptcy. However, it may be more expeditious to administer the general partner's assets under the bankruptcy law. If the debtor general partner has more than 11 creditors, other creditors may be unwilling to join the involuntary petition. It is also possible that the trustee's claim is the subject of a bona fide dispute. Arguably, it may be contingent as to liability in some situations. One possible area of legislative change is to create a new subsection within section 303 relating specifically to trustees of a partnership and enabling them to commence an involuntary case against a general partner without satisfying the requirements of paragraphs (1) and (2). However, the requirements of section 303(h) would still need to be satisfied.

For a complete discussion of Code section 303, see Collier on Bankruptcy, ch. 303 (Matthew Bender).

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n1 1. 11 U.S.C. § 101.

n2

2. *In re Hagerstown Fiber L.P.*, 226 B.R. 353 (Bankr. S.D.N.Y. 1998); *In re Shea & Gould*, 38 C.B.C.2d 1453, 1461, 214 B.R. 739, 745-46 n.3 (Bankr. S.D.N.Y. 1997). But see *C-TC 9th Ave. P'ship v. Norton Co.*, 113 F.3d 1304, 38 C.B.C.2d 115 (2d Cir. 1997) (partnership in dissolution may not file a chapter 11 petition for reorganization; presumably an involuntary petition for the same purpose may not be filed against it, at least in the Second Circuit); see *Collier on Bankruptcy*, 109.05 (Matthew Bender).

n3

3. 11 U.S.C. § 101.

n4

4. 11 U.S.C. § 101; H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 309-310 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 22-23 (1978).

n5

5. See *Collier on Bankruptcy*, 303.02[4][a] (Matthew Bender).

n6

6. See *Collier on Bankruptcy*, 303.14 (Matthew Bender).

n7

7. *In re Blutrich, Herman & Miller*, 227 B.R. 53 (Bankr. S.D.N.Y. 1998).

n8

8. 124 Cong. Rec. H11,091 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17,407 (daily ed. Oct. 6, 1978).

n9

9. *In re Pallet Reefer Co.*, 233 B.R. 687 (Bankr. E.D. La. 1999).

n10

10. *Id.*

n11

11. *Sable v. Morgan Sangamon P'ship*, 280 B.R. 217 (N.D. Ill. 2002).

n12

12. 11 U.S.C § 303(d); see *Collier on Bankruptcy*, 303.10 (Matthew Bender).

n13

13. See *In re The Food Gallery at Valleybrook*, 222 B.R. 480 (Bankr. W.D. Pa. 1998).

n14

14. *In re Jones & McClain, LLP*, 271 B.R. 473 (Bankr. W.D. Pa. 2001).

n15

15. See generally Calton J. Eibl, *Strategies for Partners Under the Bankruptcy Code When the Partnership is Insolvent*, 61 Am. Bankr. L.J. 37 (1987); Frank R. Kennedy, *Partnerships and Partners Under the Bankruptcy Reform Act and the New (Proposed) Bankruptcy Rules*, 27 St. Louis U. L.J. 507 (1983); Note, *Partner Bankruptcy and Partnership Dissolution: Protecting the Terms of the Contract and Ensuring Predictability*, 59 Fordham L. Rev. 619 (1991).

n16

16. 69 B.R. 710 (Bankr. D. Idaho 1987); see *Phillips v. First City, Texas-Tyler, N.A. (In re Phillips)*, 966

F.2d 926 (5th Cir. 1992); Turner v. Lee (In re Minton Group), 27 B.R. 385 (Bankr. S.D.N.Y. 1983), aff'd, 11 C.B.C.2d 1442, 46 B.R. 222 (S.D.N.Y. 1985).

n17

17. *Phillips v. First City, Texas-Tyler, N.A. (In re Phillips), 966 F.2d 926, 929-30 (5th Cir. 1992); In re Sunset Developers, 69 B.R. 710, 711-12 (Bankr. D. Idaho 1987).*

n18

18. *In re Clinton Court, 160 B.R. 57 (Bankr. E.D. Pa. 1993); In re Cardinal Indus., Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990); In re Safren, 16 C.B.C.2d 315, 65 B.R. 566 (Bankr. C.D. Cal. 1986).*

n19

19. *In re BC & K Cattle Co., 84 B.R. 69 (Bankr. N.D. Tex. 1988); In re Corky Foods Corp., 18 C.B.C.2d 1087, 85 B.R. 903 (Bankr. S.D. Fla. 1988); see also In re Pallet Reefer Co., 233 B.R. 687 (Bankr. E.D. La. 1999).*

n20

20. *In re Cardinal Indus., Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990).*

n21

21. *Breeden v. Catron (In re Catron), 158 B.R. 624 (Bankr. E.D. Va. 1992), aff'd, 158 B.R. 629 (E.D. Va. 1992), aff'd, 25 F.3d 1038 (4th Cir. 1994).*

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22. *In re Daugherty Constr. Inc., 188 B.R. 607 (Bankr. D. Nev. 1988); In re DeLuca, 194 B.R. 65 (Bankr. E.D. Va. 1996); JTB Enterprise L.C. v. D & B Venture, L.C. (In re DeLuca), 194 B.R. 79 (Bankr. E.D. Va. 1996).*

n23

23. *Summit Inv. and Dev. Corp. v. LeRoux*, 69 F.3d 608 (1st Cir. 1995) (holding that it is not a personal service contract); *Breeden v. Catron (In re Catron)*, 158 B.R. 624, 625 (Bankr. E.D. Va. 1992) (holding that it is a personal service contract).

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24. See Larry E. Ribstein, *Possible Futures for Unincorporated Firms*, 64 U. Cin. L. Rev. 319, 343 (1996).

n25

25. Limited liability partnerships (LLPs) are formed when a general partner of a limited partnership files a similar certificate. This discussion of LLPs with respect to involuntary petitions and the applicability of section 303(b)(3) to LLPs would also apply to the filing of an involuntary petition against an LLP by fewer than all general partners.

n26

26. See Robert R. Keatinge et al., *Limited Liability Partnerships: The Next Step in the Evolution of the Unincorporated Business Organization*, 51 Bus. Law. 147 (1995); Larry E. Ribstein, *Possible Futures for Unincorporated Firms*, 64 U. Cin. L. Rev. 319, 343 (1996).

n27

27. 11 U.S.C. § 101(9)(A)(ii).

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28. 11 U.S.C. § 723(a).

n29

29. 140 Cong. Rec. H 10,767 (Oct. 4, 1994) (This section clarifies that a partner of a registered limited liability partnership would only be liable in bankruptcy to the extent a partner would be personally liable for a deficiency according to the registered limited liability statute under which the partnership was formed.).

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30. In at least one case, fewer than all general partners filed an involuntary petition against an LLP where the partners were personally liable for debts of the partnership, but the application of section 303(b)(3) was not questioned. See *In re Jones & McClain, LLP*, 271 B.R. 473 (Bankr. W.D. Pa. 2001).

n31

31. See Michael D. Fielding, *Preventing Voluntary and Involuntary Bankruptcy Petitions by Limited Liability Companies*, 18 Bankr. Dev. J. 51 (2001); The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Limited Liability Companies and Bankruptcy*, 51 *The Record* 46 (1996); Jonathan R. Macey, *The Limited Liability Company: Lessons for Corporate Law*, 73 *Wash. U.L.Q.* 433 (1995); Thomas Blakemore, *Limited Liability Companies and the Bankruptcy Code: A Technical Overview*, 13 *Am. Bankr. L.J.* 12 (1994).

n32

32. *In re ICLNDS Notes Acquisition, L.L.C.*, 259 B.R. 289 (Bankr. N.D. Ohio 2001); see 101.09, 301.04.

n33

33. See *In re Deluca*, 194 B.R. 65 (Bankr. E.D. Va. 1996).

n34

34. Even if LLCs were considered partnerships, they would fall within the Code's definition of corporation, which includes a partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association. 11 U.S.C. § 101.

n35

35. See Thomas F. Blakemore, *Limited Liability Companies and the Bankruptcy Code: A Technical Review*, 13 *Am. Bankr. Inst. L.J.* 12 (1994); Sally S. Neely, *Partnerships and Partners and Limited Liability Companies and Members in Bankruptcy*, 71 *Am. Bankr. L.J.* 271 (1997). For a fuller discussion of these issues, see Karen Gross, Kathryn R. Heidt & Lois R. Lupica, *Legislative Messages and the Bankruptcy Code*, U. Pitt. L. Rev. (forthcoming 2005).

n36

36. *In re Elsub Corp.*, 15 C.B.C.2d 1256, 66 B.R. 172 (Bankr. D.N.J. 1986).

n37

37. *In re Lamb*, 10 C.B.C.2d 1298, 40 B.R. 689 (Bankr. E.D. Tenn. 1984).

ABOUT THE AUTHOR(S):

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196 of 197 DOCUMENTS

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Collier on the Pre-Bankruptcy Counseling Requirement under the Bankruptcy Code

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November 9, 2007

SUMMARY: This Emerging Issues Analysis details the pre-bankruptcy counseling requirement under the Bankruptcy Code.

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ARTICLE: Who Must Obtain Counseling

Section 109(h), added as part of the 2005 Act, n1 provides that an individual (unless subject to one of the specified exceptions) may not be a debtor unless the individual has received, within 180 days preceding a bankruptcy filing, budget and credit counseling from an approved budget and credit counselor. Section 521(b), added as part of the 2005 Act n2 and addressing additional debtors' duties, provides, among other things, that an individual debtor filing for bankruptcy relief must file with the court a certificate describing the services received from an approved budget and credit counselor. The form of that certificate has not been determined. The minimum elements, if any, that must be contained within the form, have also not been identified.

Individual Debtors. The only debtors obligated to receive the prescribed pre-bankruptcy credit counseling are individuals. It does not matter under which chapter an individual is seeking relief; the counseling requirement is a prerequisite to relief in all chapters. No distinction is made among individual debtors to determine whether they would benefit from the mandated counseling; it is assumed that all individuals can benefit from this new ticket to access the bankruptcy process. n3

It is useful to consider why, if counseling is deemed so useful, it is not required of businesses, at least small businesses run by individuals who may lack financial acumen and a thorough sense of alternatives for their financial distress. One has to wonder whether the rationale for requiring this counseling has been consistently applied. Perhaps the real reason for the requirement is to curb the number of individuals who can access the bankruptcy system in the first instance by requiring that they receive counseling and, perhaps through counseling, pursue a non-bankruptcy alternative. The effectiveness of debt management plans, the option offered by many, although not all, consumer credit counseling agencies, has been questioned on more than a few occasions. It is possible that the requirement of credit

counseling may delay the bankruptcy filing of some consumers and by the time they actually seek access to the bankruptcy system, dollars that could have been distributed to creditors will have been paid to the credit counseling agencies for their fees and expenses. n4 Some consumers in debt management plans may actually be in worse financial shape post-counseling than before they entered such a program.

Exceptions. In an earlier version of the 2005 Act, counseling was required of all individual debtors (unless there were insufficient approved counselors or exigent circumstances). n5 However, when the Senate considered S. 256 in 2005, a new provision was added that describes certain individual debtors who are not required to obtain the certificate of completion of pre-bankruptcy counseling. Under section 109(h)(4), a court can determine that because of incapacity, disability, or active military duty in a military combat zone, the requirements of section 109(h) should be deemed inapplicable. n6 Section 109(h)(4) defines incapacity and disability very narrowly.

Incapacity is defined as being incapable of realizing or making rational decisions by reason of mental illness or mental deficiency. Whether such an incapacitated person could be a debtor in the first instance, without a custodian acting on the person's behalf, is questionable. n7 Disability is defined as physical impairment of such a level that the individual cannot participate, after reasonable effort, in counseling in person or by telephone or through the Internet. n8 Because counseling is permitted in these alternative venues, an individual would have to be extraordinarily impaired to be incapable of even telephone or Internet counseling. Reasonable efforts is not a defined term and case law will need to flesh out its meaning. The final exception relates to those in active military duty--but only if they are in a combat zone. This, then, is a very limited exception.

Perhaps the most problematic feature of section 109(h)(4) is that individual debtors cannot obtain an exception without a court order. This suggests that a debtor would need to bring a motion to obtain an exception--which would likely require counsel. Consider, then, how difficult it might be for an incapacitated or disabled person or someone on active military duty in a combat zone to satisfy this requirement and what it would cost them to do so. In other words, there are exceptions but garnering their benefits seems to be onerous.

Providers of Credit Counseling

Section 111 provides that credit counseling can be conducted only by approved nonprofit budget and credit counseling agencies. Section 111(a)(1) provides that the clerks of court are required to maintain a list of eligible approved agencies. This list must be publicly available, although section 111(a)(1) does not clarify the means by which it will be available. One would hope that the list of approved providers will be accessible at the courthouse as well as online and perhaps even via a telephone hotline.

Approval Process. The approval process rests in the hands of the United States trustee (or bankruptcy administrator) pursuant to sections 111(b) and (c). The legislation does not clearly indicate who will make the approvals, namely the Executive Office for United States Trustees or the regional offices or some combination thereof (the most likely result). n9 A later reference specifically to the Executive Office for United States Trustees in section 111(d)(1)(D) suggests that when that office was implicated, it was specifically referenced. Nor is it clear within the statute whether approvals, by whoever made, will be done on a court-by-court basis, a region-by-region basis or a national basis. However, there is a suggestion in section 111(b)(3) that listings will on a district basis since that section speaks to entities not appearing on the initial district list. This suggests that whoever makes the decisions, those agencies approved will be listed by district; although not defined specifically, it appears that district means judicial district. For example, Web site listings for the offices of the United States trustee program are done by region and within the regions by judicial districts based on location. These are relevant questions in that there may be providers of credit counseling who have a broad national reach, and it is unclear whether, as a practical matter, they have to get approval from each court or each region or district (which would be cumbersome) or whether there can be some nationwide approval process. One can also anticipate a thorny issue if a credit counselor is approved by one district or

one region but not approved by another.

Section 111(b) identifies three specific steps that must be followed by the United States trustee (or bankruptcy administrator) in the context of approving nonprofit budget and credit planners. First, pursuant to section 111(b)(1), the United States trustee must have thoroughly reviewed the qualifications of the applicants for whom it can require additional information. While some of the specific qualifications are identified in section 111(c)(2), it is unclear what other qualifications might be assessed and what particular information might be solicited. n10 Neither the nature of what will be reviewed nor the relative weight given to various obtained information is specified. n11 One can assume that the Executive Office for United States Trustees will create some sort of checklist for its regional offices, unless all of the decisions, including initial vetting, are to be made at the national level.

Second, section 111(b)(2) provides that the United States trustee must have determined that the provisions contained more generally in section 111 have been met. For providers of pre-bankruptcy counseling, these are the requirements set forth in subsections 111(c)(1) and (2). The statutory language says the requirements must be fully satisfied, suggesting that the identified requirements are mandatory, not discretionary.

Third, section 111(b)(3) provides, in somewhat awkward language, that if a nonprofit budget and credit counselor does not appear immediately on the initial approved district list, the entity can have provisional approval for a period not to exceed six months. Although it is not explicitly stated, these agencies must still be approved under subsections 111(b)(1) and (2). Section 111(b)(4) then provides that this provisional period can be extended for successive one-year periods if the applicable agency has demonstrated that it has met the applicable standards and can meet them in the future. Section 111(b)(4) is clear in terms of the length of approvals; they cannot exceed one year, suggesting that there will be some ongoing evaluation process of the approved agencies. The mechanisms for ongoing evaluation have not been determined.

The legislative history to this section suggests that all approvals are probationary and that, in addition, none can be for a period in excess of one year. n12 Although the statute itself is not as clear as it should be on this point, all approvals for agencies should proceed under sections 111(b) and (c), not section 111(a); section 111(a) should apply only to the maintenance of lists, not who gets approved and for what time period. Section 111(b)(3) speaks about agencies that did not appear on the approved list required under section 111(a). The language in section 111(b)(3) is hard to decipher and states, in relevant part, that if an agency did not appear on the approved list for the district under subsection (a) immediately before approval under this section [section 111(b)(3)], approval under this subsection shall be for a probationary period not to exceed six months. Section 111(b)(4) then specifically cross-references section 111(b)(3). This suggests that the term of approval is a probationary six months, following by one year approvals, only for those approved under section 111(b)(3), not those approved initially. This is because the limitation of term (either probationary or one year) does not cross-reference sections 111(a)(1) or 111(b)(1) and (2), which contain the list of those approved. Thus, there is a seeming gap in terms of the length of term for those who appear on the initial list. In an entity is approved initially, the term of that approval should both be probationary and not exceed one year thereafter. While at first blush, it would appear to make a significant difference if an agency appeared on the initial or subsequent lists, that position cannot be supported. The statutory gap is eliminated if all approvals are treated as covered by sections 111(b) and (c). Thus, all approvals, whether initial or subsequent, should be for a probationary period followed by a one-year term and any permitted renewals.

There is also some ambiguity in terms of how an agency gets approved immediately as opposed to approved in a probationary manner. The Executive Office for United States Trustees will need to provide some initial approval process, and the criteria in sections 111(b) and (c) will need to be satisfied. By its terms, just as noted, section 111 suggests those who get approved and listed initially will have benefits not available to those approved later, but that distinction should not be permitted. It is unclear how many agencies will get approved initially and how many will be approved for a probationary period. Nor is it clear whether the question of immediate or probationary approval is based on the differing qualities of the applicants or timing alone.

Review Process. Section 111(b)(5) provides that within 30 days after final decisions are made under section 111(b)(4), they can be reviewed by an appropriate district court. Appeals can be brought by any interested person, a term not defined in the Code, although the term party in interest is defined in section 1109. One could posit several groups that might be particularly interested in appealing a decision on a credit counseling agency: the party denied approval under section 111(b)(4) or a group or a person that believes that an approval under section 111(b)(4) was improvidently granted. It is unclear why approvals or denials under section 111(b)(4) are the only ones referenced in section 111(b)(5). Suppose that someone objected to an entity approved pursuant to section 111(b)(1); does the specificity in section 111(b)(4) preclude an interested party from seeking judicial review under section 111(b)(5)? The authority to review these decisions is housed in the district court; this could reflect an effort to comply with 28 U.S.C. § 1334, but one can assume that the reviews would then be delegated, at least in most instances, to the bankruptcy court pursuant to 28 U.S.C. § 157, which contemplates a referral from the district court to the bankruptcy court. Another possibility is that these types of decisions would fall within the purview of the Administrative Procedures Act. It is also not evident how interested parties would know of the decision under section 111(b)(4) in sufficient time to have it reviewed, unless they participated in the approval process itself. This issue may be resolved by internal procedures established by the Executive Office for United States Trustees. One could assume that positive decisions might be made public somehow (perhaps by the name of the approved agency appearing on the public list referenced in section 111(a)(1)). It is unclear how parties (other than the one directly affected) would hear about negative decisions.

To make the review process meaningful, the Executive Office for United States Trustees should disclose the names and addresses of those entities seeking to be approved in some readily available publication or Web site; this will facilitate a monitoring of the applicants by interested parties and then facilitate their objecting to the decisions made. Another by-product of this approach is that it would enable commenting by interested parties before a decision is actually rendered and those comments could be considered by the Executive Office as it makes its decisions.

The question of when and how one can review decisions of the United States trustee is not unique to this situation. In the case of appointments to a creditors' committee in a chapter 11 case, section 1102(4), added by the 2005 Act, provides that a court (in this instance usually a bankruptcy court) may change the membership of a committee appointed by the United States trustee. The court can enter its order following a request of a party in interest (as opposed to the interested party referenced in section 111(b)(5)) and after notice and a hearing.

Section 111(e) adds that the district court can review the qualifications of nonprofit agencies currently listed as approved under section 111(a) and request needed documentation. As with new section 111(b)(5), one likely possibility is that the district courts will refer these decisions to the bankruptcy courts pursuant to 28 U.S.C. § 157, unless this is treated as an administrative decision governed by the Administrative Procedures Act. Moreover, the section provides that the court may remove an agency from the approved list if the agency does not meet the qualifications in section 111(b). There is a question as to whether the section under which approval is sought (under section 111(b)(1) and (2) with a listing in section (a) or, alternatively, under section 111(b)(3)) affects a district court's (or bankruptcy court's) review. It would seem that the court should be able to review all approvals, whether under sections (b)(1) and (2) or (b)(3) and (4). Notably absent is any reference to section 111(c), which details the qualifications of nonprofit budget and credit counselors. One can posit that the requirements in section 111(c) apply to all appointments--whether immediate or probationary.

General Requirements. Section 111(c)(1) sets forth general criteria that must be satisfied before a budget and credit counselor can be approved. These are less specific than the mandatory minimum requirements set forth in section 111(c)(2). Section 111(c)(1) requires that nonprofit budget and credit counseling agencies demonstrate that they will (1) provide qualified counselors, (2) maintain protections for client funds, (3) provide adequate counseling with respect to their clients' credit problems, and (4) deal responsibly and effectively with other matters relating to the quality, effectiveness and financial security of the service provided.

None of these four criteria is fleshed out in the statute. n13 For example, what constitutes qualified counselors--a critical issue if the budget and credit counseling is to be useful to consumers--is not detailed. It is not specified whether

these counselors need to have college degrees, whether they need specialized initial and ongoing training and, if so, by whom, whether they need to belong to an accrediting or membership organization and whether there is some standardized measure of quality. At least in non-English speaking communities, qualification might include the ability to communicate in a language other than English. Whether some nationwide accrediting system will be created is unknown, although that is the approach that Canada has adopted. n14 The dangers of unqualified counseling are real; poor counseling can lead to individuals losing property or legal rights.

The general requirement that approved agencies must maintain protections for client funds is also not detailed. It is worth noting, *ab initio*, that it is presumed that approved agencies will actually have client funds, which presumes that approved agencies will be creating, or have the potential to create, debt management plans for their clients. Whether a nonprofit budget and counseling agency could be approved if it does not have that capacity or is not desirous of creating such plans is an important issue and arises again in the context of section 111(c). n15 It is also important to note that some states have fiscal requirements for budget and credit counselors, including bonding requirements. It is unclear whether the Executive Office for United States Trustees will look to state laws to determine criteria for approval. n16 It is also unclear whether nonprofit budget and credit agencies approved for purposes of the bankruptcy system will also need to comply, independently, with state licensing requirements. In some states, licensing is needed only if there is access to client funds, and so the issue of whether approved agencies in bankruptcy must at least offer debt management plans will impact on licensing obligations.

The other two general requirements lack specificity as well. It is unclear how determinations will be made as to whether counseling is adequate and what measures, empirical or otherwise, will be put into place to make that determination. Section 111(c)(2)(E) does detail aspects of counseling adequacy, n17 given that specificity, one has to assume that the more general requirement means something more than what is specified in section 111(c)(2)(E). What other measures need to be put into place to insure quality, effectiveness and financial security is also undetermined. One would hope, at a minimum, that there will be meaningful guidelines put into place to insure that individual debtors are getting value for their money and will not lose property or legal rights due to ineffective counseling. An entry level counseling requirement for accessing the bankruptcy system that is ineffective and of low quality or risks the consumer's money, property and rights is not worth having. Given current issues within the credit counseling industry, there is every reason to take these generalized requirements seriously so that they are not in name only.

Specific Qualifications. To be considered for approval, a nonprofit budget and credit counseling agency must satisfy eight minimum requirements. The use of the word minimum suggests that other requirements may be added or taken in account. These requirement minimums are set forth in section 111(c)(2)(A). All agencies providing counseling, regardless of whether they are approved under section 111(a) or (b), must be approved. For approval, a nonprofit budget and credit counseling agency must at least:

- . have a board of directors, the majority of which is not employed directly by the agency and will not benefit financially (directly or indirectly) from the outcome of the services; n18
- . charge a fee, if any, that is reasonable and provide services without regard to fees; n19
- . provide safekeeping and payment of client funds, including annual audits and employee bonding; n20
- . make disclosures to the clients related to, among other things, funding sources, counselor qualifications, possible impact on credit reports and any other costs of the program and how they will be paid; n21
- . provide adequate counseling that includes an analysis of the client's current financial condition, factors that caused that financial condition and how such client can develop a plan to address these problems without incurring a negative amortization of debt; n22
- . provide no bonuses or commissions based on the outcomes of the counseling for the trained counselors who must

have experience and have been adequately trained to provide counseling and handle the above-described matters; n23

- . demonstrate adequate experience and background in providing credit counseling; n24 and

- . have adequate financial resources to provide continuing support services for budget plans over the life of the plan. n25

There is no detailed discussion of these minimum requirements in the legislative history. The requirement in section 111(c)(2)(A) appears to preclude an attorney or law firm from creating a nonprofit credit counseling agency if the lawyers creating it sit on the board of that entity and obtain some financial benefit from the services provided. Since the benefit could be indirect (referring clients for bankruptcy assistance), lawyers who have a counseling agency that refers bankruptcy clients to them certainly benefit. Perhaps lawyers will form such nonprofit agencies but not serve on their boards. If they are not on the board, they are not precluded explicitly from benefiting from the counseling services. Another approach would be for lawyers to set up different nonprofits but agree that they would each sit on one another's boards. The counseling agencies could refer, then, only to the non-board member lawyers. Whether attorney-run credit counseling agencies will be approved by the United States trustee is certainly open to question; they may also have trouble obtaining nonprofit status. This section does suggest the importance of questioning the ownership structure of the nonprofit credit counseling agencies applying for approval.

A related issue is whether any of the language in section 111(c)(2)(A) affects the ability of a legal aid clinic or other similar organization to provide counseling and then, if appropriate, assist the client with a bankruptcy filing. Indeed, some existing organizations already do just this: they counsel clients as to their financial problems and then are in a position to offer needed legal assistance. Nothing in this language would seem to require a change in how legal service organizations handle their debtor clients; these entities could perform both counseling and lawyering since they are nonprofits and are not direct fee-for-services entities. Since legal aid providers generally have guidelines for client eligibility (based on both income levels and geographic locale), they would not be able to accept clients who do not meet their own internal guidelines; one would hope that these limitations would not preclude legal aid providers from qualifying as approved agencies. Also, there are nonprofit budget and credit counselors that provide bankruptcy legal services. In these agencies, the nonprofit determines the best approach for the client, and if bankruptcy is warranted, the individual is referred to the in-house bankruptcy lawyer. This structure, if done correctly, is also not prohibited by the language of the statute. Whether one stop fits all" nonprofits will be approved by the United States trustee is an open question.

There are presently no guidelines in terms of what constitutes a reasonable fee for the required pre-bankruptcy counseling services, although they will likely be forthcoming from the Executive Office for United States Trustees. The credit counseling mandate is unfunded (in terms of government resources); so, its costs must be borne directly by individual debtors. The legislation does suggest that approved providers must provide services without regard to ability to pay, but the criteria for entitlement to free counseling are not prescribed. The language could be read very broadly, suggesting that counseling is free if a debtor does not want to pay. The statute does not make clear whether approved counselors can turn away non-fee paying clients and whether there will be cherry picking among potential clients based on ability to pay. For example, it is unclear whether approved agencies can do an initial screening to determine ability to pay and accept only a certain percentage of nonpaying clients. The language in section 111(c)(2)(B) does contemplate approved agencies that will provide the counseling service for free, evidenced by the word if before a fee. There is another issue for legal service organizations that provide services for free--but only for those who meet their income and geographic guidelines: these entities are not in a position to provide services to those who do not meet their guidelines. One important unanswered question is whether the reasonableness of price will be set by the Executive Office for United States Trustees or by the market. It is useful to note that in the Canadian system, which has mandatory counseling, the fees are regulated by the government and there is a different (and larger fee) for individual as opposed to group counseling. n26 That approach seems to have affected the type of counseling offered; since individual counseling

pays the counselors more money, that approach appears to be the norm. n27 Under section 109(h), counseling can either be done individually or in a group, and that choice may affect price. The failure of nonprofit agencies to provide services to those in need should be a basis for denying or revoking their approval.

Section 111(c)(2)(C) requires the safekeeping and payment of client funds. The section then provides for, at a minimum, annual audits of trust funds and appropriate employee bonding requirements. The requirements in section 111(c)(2)(C) will be expensive for approved agencies. n28 These are also similar to requirements that some states have in place for their budget and financial planners. n29 These specific requirements respond to the more general requirement in section 111(c)(1) that approved agencies provide financial security with respect to services. These requirements create the inference that approved agencies will have client funds, again raising the issue whether agencies that are unwilling to perform debt management plans or keep client monies will be able to qualify. The lead-in to this requirement does not contain the word if, leading to the conclusion that all agencies--whether or not they have client funds--will need annual audits. The word appropriate does appear before the word employee bonding, suggesting that if there is no employee handling of monies, no bond is needed. This also suggests that some approved agencies will not have client funds in their possession.

Section 111(c)(2)(D) is a disclosure requirement, signaling the need for approved agencies to provide their clients with the specified information. The agency is to provide full disclosures to a client, including funding sources, counselor qualifications, possible impact on credit reports, and any costs of such program that will be paid by such client and how such costs will be paid. By use of the word including, the five identified items will need to be disclosed and other items will need to be disclosed if they are necessary for full disclosure. n30 This requirement reflects the concerns of many that most consumer credit counseling agencies have gotten at least some portion of their funding from selected credit card companies pursuant to what is known as a fair share. This fair share has enabled credit card companies to set the parameters of the arrangements they will accept with the counseling agencies' clients. Clients, then, were often unaware of the fact that their counselor was paid by the credit industry and that the terms of the payouts were, at least in part, dictated by creditors. n31

Several additional aspects of this disclosure requirement merit attention. First, if counseling can be done by telephone and through the Internet, it is not clear how the disclosure will be made. With in-person counseling, the client can receive any needed disclosures in writing or orally. Whether the client would need to click to reflect that the disclosure was seen and read. With telephonic counseling, the disclosure could be read to the consumer, but that could be lengthy and difficult to understand. If a telephonic provider offered to send the disclosure after the counseling, that would not be adequate either as the individual would have already paid for the service before seeing the disclosure that, if known, might have dissuaded the person from using this particular counselor.

Second, some potential disclosure that is needed but not specifically enumerated relates to the relationships between approved credit counselors and lawyers. If there are fee arrangements or other relationship that dictate payments or referrals, then these matters would need to be disclosed. n32

Third, it must be recognized that the presence of disclosure may not protect consumers fully. Even if consumers see, read or hear the disclosure, that does not mean they understand it; moreover, even if they understand it that does not mean that they will act on it. Hence, even the best disclosure may not protect individual debtors. n33

Section 111(c)(2)(E) addresses the requirement that the counseling must be adequate and then includes the basic aspects of adequacy. This section serves, then, to outline the minimum requirements of the content of the counseling itself. n34 Subparagraph (G) contains a similar requirement, namely that the agency approved have adequate experience and background in credit counseling. This latter provision suggests that new entrants in the field may have trouble getting approved. Subparagraph (G) does not address the experience of the individual counselors; that is addressed in subparagraph (F). Whether an agency can circumvent its own lack of history by hiring experienced personnel or having experienced ownership is unknown. n35 However, it is already clear that new counseling entities are now being created and these entities hope to be approved by the Executive Office for United States Trustees. It is

not, then, altogether clear whether existing credit counseling agencies will want to handle this new bankruptcy related counseling or whether new entities will be created to perform the needed tasks.

Section 111(c)(2)(F) speaks to the requirement that the counselors have adequate experience and be trained. What levels of experience or training will be needed is undefined at present. n36 This suggests the creation of another new industry--those who will train the credit counselors--unless we turn to the creation of a nationwide certification process. One option to consider is an array of potential programs that qualify as training programs. Counselors who need approval under section 111 would need to attend one of these identified programs annually or biannually. This section also provides that counselors cannot be paid on a commission or bonus basis. Although this is also not addressed explicitly in the legislative history, there is literature suggesting that some credit counselors may have encouraged debt management plans for clients not because the plans were suitable but because the counselor reviewed financial incentives for putting clients in such plans. n37

Section 111(c)(2)(H) provides that the approved agencies must have adequate financial resources to provide continuing support services for budgeting plans over the life of that plan. This provision suggests, yet again, the expectation that approved providers will have debt management plans within their agencies. One could argue that the requirement is only applicable if the agency has such services but should not be read to require such services. This is similar to the argument with respect to section 111(c)(2)(C) pertaining to safeguarding of client funds.

There are both positives and negatives in reading the legislation to require approval only of agencies that provide debt management plans. On the positive side, a required debt management option would mean that expensive telephone-only counseling, with no other services and little true counseling, would be insufficient. One has to wonder whether short and expensive telephone counseling can produce positive results, although the legislation clearly contemplates telephone counseling, and it may be appropriate in some circumstances if well-priced and of high quality. An expensive and impersonal Internet counseling session is also problematic, although well-priced quality Internet programming may be feasible. On the other hand, pushing debtors into agencies that then push debt management plans is also unwise. These plans are not always useful, and counselors that do not provide plans will not be tempted to urge this alternative, particularly since they will have no remuneration connected to it. n38 What is problematic and worth further evaluation is the combination of linked telephone counseling and debt management plans or linked Internet counseling and debt management plans, because it is hard to picture consistent, adequate and individualized counseling for a debt management plan by telephone or through the Internet. The best solution seems to be to de-link counseling and debt management plans. One can posit the possibility of true quality counseling taking place (whether in person, by telephone or through the Internet) but with no debt management plans offered by the counselors. For example, counseling done through an educational institution, such as a law school, business school or graduate school specializing in Family Economics would be precluded from occurring. If debt management plans are required, one must offer to be an approved counselor under section 111. The Executive Office for United States Trustees will ultimately need to make a decision on this important issue as it will provide the structure for all counselors seeking approval.

There is another way to read the various financial requirements placed on approved credit counselors. If these counselors tried to negotiate settlements of the debts, other than in a formal debt repayment plan, monies might flow from the debtor to the nonprofit counselor. This possibility is raised by section 502(k), which references alternative repayment schedules. Although it is unclear whether this was meant to mean debt management plans, failure of a creditor to accept a reasonable settlement option presented on the debtor's behalf by an approved agency under section 111 will result in a reduction of that creditor's claim in bankruptcy. n39 One possibility is that the language in section 502(k) creates an incentive for debtors at least to try to enter into debt repayment plans; otherwise, they forego the ability, if it is rejected, to reduce the rejecting creditor's claim. This argument would favor linking approved credit counseling and debt management plans. An alternative and better argument based on the wording of the statute is that any type of settlement offered to a creditor by an approved agency, whether or not it is an official debt management plan, will--if rejected--lead to a reduced creditor's claim. Thus, approved agencies may want to try to negotiate repayments and in that context, they may--but would not necessarily need to--have access to client monies. This position ensures that counseling could be provided by approved agencies that do not have debt management plans.

These agencies could, however, attempt to negotiate settlements of clients' debts. One can suppose, however, that there could be excellent counseling that did not actually carry out such negotiations on the debtor's behalf. For example, some quality counselors could note the possibilities of negotiating with creditors without actually participating in the negotiations. Some debtors may be willing to forgo the reduction contemplated in section 502(k), although it seems wise for some debtors to pursue this opportunity.

Further support for the contemplation of some sort of monetary flow between approved agencies and individuals appears in section 547(h), added by the 2005 Act. ⁿ⁴⁰ This section provides that a transfer made as part of an alternative repayment schedule created by an approved agency cannot be avoided (without a time limitation). If an avoidance action is considered, a payment must have been made. This is the same language used in section 502(k). Whether the language alternative repayment schedule means the same thing as debt management plan is unclear, but alternative repayment schedules are potentially more flexible.

Removal. Section 111(f) provides that the United States trustee or a bankruptcy administrator is required to notify the court clerk if a previously approved nonprofit budget and credit counselor is removed from the list maintained pursuant to section 111(a).

There are several ways in which removal can occur. First, the United States trustee can decide not to renew the term of a formerly approved agency renewed pursuant to section 111(b)(4). Second, the district court may order removal pursuant to section 111(e). In both instances, the United States trustee (or bankruptcy administrator) would notify the appropriate clerk. It is hard to anticipate how frequently removal will occur and whether maintenance of lists will be cumbersome. If the lists are not accurate, an individual contemplating bankruptcy could unknowingly receive counseling from an unapproved agency. If that were to occur, even though the agency had been on the list, it would appear that that individual would not be eligible for relief under section 109(h) since the counseling would not have been from an approved agency. The resultant hardship would be significant, and one has to posit that if the counseling is received in good faith, there might be an equitable argument raised under section 105 to permit the individual to have access to the bankruptcy system.

Should this problem occur, the best approach would be for the consumer to be deemed to have received approved counseling as long as the counselor's name appeared on the required list, even if that list was inaccurate or not updated in a timely fashion at the time the debtor received the counseling.

Content of the Credit Counseling

The requisite counseling is described very generally in section 109(h)(1) as individual or group briefings, whether in person, by phone or through the Internet, that outline the opportunities for available credit counseling and assist the debtor in performing a related budget analysis. The length of the counseling is not referenced, although the use of the word briefing suggests that it can be short in duration. That said, one wonders how quality counseling and budgeting can necessarily be done in a short session.

The very general content description in section 109(h)(1) is augmented, at least indirectly, in sections 111(c)(1) and (2). These sections relate to the criteria to be employed to approve nonprofit budget and credit counselors. Within the criteria are indicators with respect to the content of the counseling. Section 111(c)(1) refers to the need for qualified counselors who can provide adequate counseling with respect to client credit problems. This seems to be broader than the language in section 109(h); client credit problems can span a wide range of issues, and counseling as to available credit counseling and budget analysis may not be enough to address credit problems. The suggested expansion of role in section 111(c)(1) is reinforced by the language in section 111(c)(2), most particularly subparagraph (E). This subparagraph specifically requires credit counselors, at a minimum, to provide counseling on credit problems--the terminology used in section 111(c)(1)--including an analysis of such client's financial problems, factors that caused such financial condition and how such a client can develop a plan to respond to the problems without a negative amortization

of debt. These are not easy topics on which to counsel individuals in debt. The last requirement, namely assistance in developing a plan, appears to be a reference, albeit vague, to debt management plans. Perhaps it could also be read to reference alternative repayment schedules as identified in section 502(k). The opprobrium against negative amortization is targeted at loans, for example, certain home equity loans, that lead to further debt because the monthly payments do not even reduce the accruing interest. Similarly, a traditional debt management plan could be so costly and the payments could be so small that the indebtedness actually grows rather than diminishes, resulting in negative amortization. Obviously, counseling that places individuals further in debt is unwise.

Regardless of content, no attention has been paid to the need to have that content translated into multiple languages or at least, if the counseling is telephonic, conducted by counselors who are multilingual. The absence of multilingual counseling should be an indicator that a specific district lacks adequate counseling. n41

Timing of Counseling

Section 109(h)(1) provides that individuals must obtain counseling within 180 days prior to filing for bankruptcy relief. Yet, despite this timing mandate, it does not require any minimum time period between the counseling and the filing, as long as the counseling occurs within 180 days. The counseling briefing could be 180 days or it could be several hours before the petition is filed. For example, there is nothing to preclude individuals from obtaining the counseling through the Internet and then proceeding to file for bankruptcy relief immediately, as long as the Internet provider was approved as a nonprofit budget and credit counselor. This means that for some individuals, the counseling is right on the heels of the bankruptcy filing, rather than vice versa and there will be no debt management plan. This possibility suggests that the intended counseling by the approved agencies will be brief (perhaps an hour or even less). On the other hand, there seems to be a disincentive for those who actually enter into debt management plans. For consumers who have the approved counseling, it is possible for them to enter into a debt management plan and then file, as long as they do so within 180 days. If they spend a longer time in the plan or their plan fails after six months (which could easily occur), then the individuals would, presumably, need to repeat the counseling before seeking bankruptcy relief. This creates a disincentive on briefings that encourage debt management plans, as entry into them may require, in addition to other things, re-counseling if the 180-day period is missed.

Exception Due to Unavailability of Counseling. Despite the mandatory time period, the Code does have certain explicit exceptions. Section 109(h)(2)(A) provides that for a debtor who resides in a district for which it has been determined by the United States trustee (or bankruptcy administrator) that there are insufficient approved agencies to provide adequate services, the requirement for mandatory counseling in section 109(h)(1) shall not apply. n42 It is not clear how the determinations as to the unavailability of adequate counseling will be made. Suppose that there are no in-person providers and the debtor wants in-person as opposed to Internet or telephone counseling. This would not seem to qualify for the exception. Alternatively, suppose there are approved nonprofit budget and credit counselors but they are more than an hour away by car and not accessible by public transportation. Or suppose that the counselors are available but appointments will take 30 days to arrange. A related issue relates to counseling in a particular language. If such counseling is not available, then its absence fits within this provision, meaning that the debtor would be exempted from the requirements of section 109(h)(1). Answers to some of these questions will hinge on the positions taken by the United States trustee and the inevitable litigation.

Exception Due to Exigent Circumstances. A further exception is housed in section 109(h)(3). This exception has three subparts. First, pursuant to section 109(h)(3)(A)(i), individuals must certify to the court that there are exigent circumstances and they cannot obtain the counseling required in section 109(h)(1). What will constitute exigent circumstances sufficient to warrant a waiver of counseling will need to be determined by the courts. Second, pursuant to

section 109(h)(3)(A)(ii), the debtor has to have requested and been unable to obtain counseling from an approved agency within five days of requesting the counseling. Today, it has been reported that there is a two-day wait period for counseling at some agencies. With the increase in pre-bankruptcy filings, this time period may increase. Debtors making the request should, no doubt, indicate the dates they sought counseling and the first date for services that they were offered in response. Whether this can be obtained in writing or by taping a telephone conversation is unknown. Given that counseling can occur by telephone and through the Internet, it is unclear how many individuals will be unable to receive counseling. If an individual does not have a computer or phone and there are no in-person counselors, then it would be easier to satisfy these standards. Another situation to consider is how this exception applies to individuals who need immediate bankruptcy assistance and cannot wait out the five days for counseling--even if it were to be available. For example, suppose a debtor needed to file immediately (posit a foreclosure scheduled for the next day). Assume counseling was available only two days into the future (one beyond the foreclosure date). For this debtor, the availability of counseling within the five-day window is not adequate; the individual needs counseling today or tomorrow. Would that individual be able to obtain bankruptcy relief under this subsection, particularly since the person could get counseling immediately after seeking bankruptcy relief and this delayed receipt of counseling is permitted under section 109(h)(3)(B)?ⁿ⁴³ In other words, the person would still get counseling within five days but they would also have sought bankruptcy relief. While section 109(h)(3)(A)(ii) does not appear to cover this situation, it could be so extended; otherwise, individuals who need counseling and cannot wait five days to get it would be excluded from accessing the bankruptcy system, which is an unacceptable result. The third requirement, contained in section 109(h)(3)(A)(iii), is that the debtor's certification must be satisfactory to the court. This suggests, as a pragmatic matter, that debtors who need to seek relief immediately and who have not obtained a counseling certificate, will need to file a certification with their petition to satisfy the requirements of section 109 and section 521.

Despite the counseling reprieve for qualifying debtors under section 109(h)(3)(A), section 109(h)(3)(B) provides that the counseling exemption ceases to apply as soon as the requirements of section 109(h)(1) are met (namely obtaining counseling). In no event may the counseling exemption exceed 30 days after the debtor has sought relief, except that for cause, the court may grant an additional 15-day extension. What this means is that even individuals who filed without counseling because there were exigent circumstances must still obtain the counseling within 30 days (subject to any extension). Note that the type of counseling that would be needed once the debtor is within the bankruptcy system differs from the ordinary pre-bankruptcy counseling, particularly on the issue of whether bankruptcy is a suitable option. If a debtor receives counseling post-filing based on criteria set up for pre-bankruptcy counseling, it is unclear whether that counseling will be at all meaningful. What if the counselor determines that the debtor would have been better served by not accessing the bankruptcy system? Should the debtor then seek to have the case dismissed? This possibility is raised by the 2005 addition of section 362(i), which contemplates a filing followed by a debt management plan and dismissal.ⁿ⁴⁴

The exigent circumstances provisions do require court involvement at two stages. First, the certification must be satisfactory to the court under section 109(h)(3)(A)(iii). Then, if an extension is needed, court approval is required. These are but two of the instances in which the courts will become increasingly involved in consumer bankruptcy cases.

Consequences of Failure to Obtain Mandated Counseling or Comply with Related Requirements

The primary consequence of noncompliance with the credit counseling mandate is that the individual debtor's case can be dismissed or the debtor's plan of reorganization can fail to be confirmed. These are harsh consequences, signaling the importance of complying with the mandates.

Dismissal of Case or Failure to Confirm Plan. Section 707(a)(3) provides that failure to comply with the requirements of section 521 can be the basis for dismissal of a chapter 7 case. Section 707(a)(3) does not reflect the

re-lettering and renumbering in section 521; the requirement for a pre-filing certificate is in section 521(b), not section 521(1). Despite this gaff, it is clear that Congress intended the failure to obtain a certificate of completion of approved pre-bankruptcy counseling to be a basis for discharge. Absent a technical amendments bill, an argument could be made that failure to obtain a certificate is not a basis for dismissal, although that argument is unlikely to convince a court.

Under section 521(b)(1), the debtor is required to submit to the court the certificate describing the approved credit counseling obtained. Assuming its applicability, according to section 707(a)(3), the actual document can be submitted after filing, but the counseling itself must have been received, absent an exception, before the petition is filed.

Section 1307(c)(9) provides that a case may be dismissed for failure to file the information requested in section 521(2); however, that subsection no longer exists. Section 521(a)(2) references the statement of intention, not the other requirements such as a certificate of completion of pre-filing approved counseling (which is referenced in section 521(b)(1)). Although it appears to have been intended that failure to complete pre-bankruptcy approved counseling would be a basis for dismissal, the Code does not so explicitly provide. Even if the statute had the correct alphabetical and numerical cross-referencing, no similar dismissal provision appears in either chapters 11 and 12; although one would posit that noncompliance with section 521 would be cause for dismissal under section 1112(b) and section 1208(c).

Section 1325(a)(1) provides that a plan cannot be confirmed if it does not comply with the law, and failure to have completed pre-bankruptcy counseling would be noncompliance with the law. However, once a chapter 13 plan is confirmed, confirmation has *res judicata* effect with respect to chapter 13 eligibility. ⁿ⁴⁵ Similar provisions exist in section 1129 and section 1225(a)(3).

Duty to Submit Debt Management Plan. Section 521(b)(2), added by the 2005 Act, ⁿ⁴⁶ also provides that individual debtors must submit to the court a copy of a debt repayment plan, if any, developed under section 109(h). This requirement recognizes that debt management plans may be developed pre-bankruptcy but recognizes that they will not be utilized by all debtors, as exemplified by the use of the words if any. The addition of the words if any do not answer the larger question of whether credit counselors must at least be in a position to offer such plans, even if a debtor determines not to participate in such an option. Given the cross-referencing errors, it is unclear whether failure to submit this copy will be the basis for dismissal of a debtor's case, although dismissal is likely the intended consequence.

The more significant question raised by section 521(b)(2) is the purpose of the court having a copy of the debt management plan into which a debtor has entered. One reason is that this plan will be utilized to determine the size of payments debtors were making, perhaps as a basis for determining prospective plan payments in a chapter 13 case or the determination of income and expenses for the means test calculations under section 707(b). Use of a debt management plan for either of these purposes is immensely problematic in that the criteria used to determine payment amounts in a debt management plan are not the same as those used in a chapter 13 plan. Moreover, the counseling with respect to debt management plan payments may not reflect other payments that would be made in a chapter 13 plan but that are not calculated in a debt management plan. For example, some debt management plans do not include payments to nonparticipating creditors like doctors and hospitals, payments that would be made in a chapter 13 plan. Moreover, there are additional costs in a chapter 13 plan as well as priority payments, none of which are reflected in a debt management plan. Further, if the counseling is not adequate and the debtor is given bad advice--even if the counselor is approved--this could lead to a faulty and inaccurate debt management plan. A debtor should not be saddled with a counselor's bad judgments in a subsequent bankruptcy case. Hence one has to question the utility of a debt management plan in determining chapter 13 plan payments.

Using the debt management plan as a proxy for income and expenses in either chapter 7 or chapter 13 is also

unwise in that not all income and expenses are necessarily included when one determines payments under a debt management plan. In addition, circumstances may have changed in the last several months since the debt management plan was entered into, a fact evidenced by the conclusion that the plan must have failed--otherwise, the debtor would not now be seeking bankruptcy relief. Thus, it would make no sense to use the figures that led to a failed debt management plan. It is unclear whether United States trustees will undertake this type of review.

One of the best uses of this provision would be for the United States trustee (and perhaps the debtor's lawyer as well) to use the information in the debt management plans to determine whether the individual debtors who entered into them were well-served by them and if not, the plans would be the basis for removing an approved nonprofit counseling agency from the list of permitted providers under section 111(a). If, for example, a plan had negative amortization or the fees charged were excessively high compared to the benefits gained, then the United States trustee under subsections 111(b)(4) and (f) would have a basis for removing the approved agency from the list in section 111(a) and the court would have a concrete basis upon which to move for removal of an approved credit counseling agency under section 111(e). It would also provide other parties in interest, perhaps the debtor's own lawyer, grounds to object to an approval or renewal under section 111(b)(5). Once again, effectuating this suggestion requires added district court time and access to the debt management plan from a debtor's file.

The fact that these plans will be submitted to the court should set up a cautionary signal for both debtors entering into such plans and the agencies arranging them. Debtors should be aware that they may be used to determine eligibility for chapter 7 or plan payments in a chapter 11 or 13 plan. Nonprofit agencies providing plans should know that those plans could, indeed should, be scrutinized to determine whether they were in the individual debtor's best interest. Moreover, attorneys representing consumer debtors should evaluate those plans before filing a petition to determine how the numbers used in the debt management plan were derived. Since the plan may have been arranged telephonically (if permitted), the developer will have less information than would be available to an attorney actually reviewing all the debtors' books and records pre-filing.

There is an additional, albeit somewhat unrelated, change in section 362. Section 362(i) provides that if a case is dismissed due to the creation of a debt management plan, any subsequent case dismissed shall not be presumed to be filed in bad faith (and hence not subject to stay termination under new section 362(c)(3)).ⁿ⁴⁷ This 2005 addition does stress the likelihood of debt management plans intersecting with bankruptcy, something also suggested by section 111. And the provision further suggests that a debtor within the bankruptcy system could then enter into a debt management plan and move to dismiss the filing. The timing seems odd in that the pre-bankruptcy counseling is where the issue would arise unless this provision is geared to an individual who had exigent circumstances and could not obtain counseling pre-bankruptcy.

Costs and Fees

Section 111(c)(2)(B) states that, to be approved, a nonprofit agency's fees must be reasonable.ⁿ⁴⁸ There are no guidelines presently in place for what constitutes reasonable. Since counseling can occur in person, by telephone or through the Internet, one would expect that the fees would be different depending on how the counseling is delivered. Moreover, one might expect that there could be different types of approved counseling and that fees might depend on the nature of that counseling. For example, a short phone call with limited counseling time would be different from an intensive hour-long in-person session.ⁿ⁴⁹ In Canada, which has mandatory counseling, individual sessions are more expensive than group sessions.ⁿ⁵⁰

Fees raise a serious concern about a race to the bottom. With more than two million individuals in need of counseling providing that counseling will be a growth industry. However, it is likely that there will be considerable effort among providers to provide the cheapest counseling to increase their clientele. Providers with perhaps higher quality products and thus somewhat higher (but still reasonable) fees may be driven from the market, a problematic outcome.

It is also possible that fees will be different in different parts of the country. Counseling in cities may be more expensive given higher overhead costs. It is also possible to imagine a cost-adder if the counseling is needed immediately. Thus, consumers who need immediate counseling might have to pay more for the same counseling they would receive in three weeks if they were in a position to wait. One can also foresee added costs if the counseling is needed in a language other than English. If the fee for pre-bankruptcy counseling is linked to post-filing financial management education, then there could be one composite fee that might be higher than counseling alone but less than that charged if one went to two separate entities for these needed services; this type of bundled services and bundled fees is problematic. n51 Guidance on all of these issues will be needed from the United States trustee, and aspects of this may be litigated. Excessive or inappropriate fees are and should be utilized as a basis for denying approval or renewal to an agency or removing an already approved provider from the list. Again, the United States trustees and interested parties will need to remain vigilant on this issue, and district courts, which have removal power under section 111(e), will need some mechanism for tracking fees, in addition to parties, bringing it to their attention.

In an effort to keep fees reasonable and to secure approval, one could imagine approved nonprofit agencies providing the required course for a low fee and then providing added and more complex services for a higher and additional fee. Thus, consumers would be offered a bare-bones course and then, if they wanted more detailed and individualized counseling, they would need to pay more. This type of marketing of services can be difficult for individuals to untangle, and consumers could well purchase additional services that are not needed or required, without being aware of exactly what they are purchasing and why. The Executive Office for United States Trustees will need to be especially vigilant to determine if approved providers are also providing other services and consumers are being offered package deals where services are bundled together. Moreover, if packaging is permitted, which practice should be scrutinized, then there should be disclosure made as to what is required by law to access the bankruptcy system and why added services are needed. n52 One can easily picture providers who will provide the cheaper service to acquire a list of individuals in need to whom they can market other products and services. n53

Fee Waivers. Section 111(c)(2)(B) does provide that approved agencies must provide counseling without regard to ability to pay. This wording can lead to several interpretations. n54 What is unclear is how many nonpaying clients an agency must take. For example, no budget and credit counseling agency, unless grant supported or supported by outside contributions, could survive if all of its clients were nonpaying. That said, it is unclear how determinations will be made as to who should be paying for their counseling.

Section 111(c)(2)(B) recognizes the possibility of approved agencies that provide counseling without any fees at all to the individual. For example, legal aid offices, if they are permitted to do counseling, could provide it to their clients without charge. Typically, such clients will fit within prescribed income guidelines. Hence, it would not be possible for legal services organizations to provide services, free or otherwise, to clients who do not comply with their own guidelines. There may be others willing to provide counseling without charge; however, the requirements for approval are sufficiently onerous that this may discourage pro bono counseling efforts. In particular, if approved counselors must be able to provide debt management plans, this will discourage many pro bono efforts. Excessive bonding requirements could also prove problematic for certain potential providers. Given the liability provisions in section 111(g), counselors will likely carry insurance in the event of losses.

Referral Fees. An unaddressed issue in the statute is whether approved nonprofit agencies can pay fees to lawyers referring clients to them. n55 For example, one can imagine contractual or informal relationships between approved nonprofit counselors and lawyers pursuant to which all of the lawyers' clients are directed to a particular agency in exchange for a fee paid by the agency to the lawyer. One can also imagine the inverse, namely, approved agencies that refer cases to particular lawyers when a bankruptcy filing is needed based on the results of the counseling. Section 155 of title 18 does not appear to cover this type of situation, since that section references payments made from property of the estate. n56 Pre-bankruptcy, there is no property of the estate, and the payments would be made by the counselors and the lawyers, not the debtor or the estate. If the payments were being shared among lawyers (for example if a credit

counseling agency were lawyer-owned), section 504 would need to be considered. n57 It is unclear whether Code section 504 would prohibit fee sharing between a lawyer-owned credit counseling agency and a lawyer doing bankruptcy-related work. Section 504 appears to address fees among professionals entitled to compensation under section 503(b), and whether the pre-bankruptcy counseling could fit into this section is unresolved.

If there were such fees running either from the lawyers to the counselors or the counselors to the lawyers, a strong argument could be made that, at a minimum, these fees must be disclosed pursuant to section 111(c)(2)(D). That section specifically mentions funding sources as something that must be disclosed to the individual debtor. If such an arrangement were uncovered, a court could also move for removal of the agency from the approved list pursuant to section 111(e). One would hope that the United States trustee would issue guidelines that explicitly prohibit such arrangements. n58

Tying Arrangements. Section 111 does not explicitly address whether there can be a relationship between an approved nonprofit budget and credit counselor and lawyers of a law firm. While the statute does make clear that no one on the board of an approved credit counseling agencies can benefit economically, there is nothing to preclude benefits where there are no board members. n59 This would permit lawyers and counselors to have arrangements whereby they would provide services to each other's clients. Even if there were no referral fees among the professionals, there could be an expectation of such cooperation. From the perspective of the consumer, this would affect--if the consumer was aware of this--the choice of counselor or lawyer. If the client were first to visit the counselor, then the counselor would arguably be required to make disclosure of the fact that all its clients in need of bankruptcy assistance are referred to a single firm or lawyer. Such a disclosure requirement would be found in section 111(c)(2)(D). If the counseling were telephonic, it is unclear how disclosure would occur. It is also unclear whether, even if disclosure were made, it would affect consumer decision-making. n60 If post-filing debtor education courses, also required, were added as part of these referrals, the issue gets even more complex, as does the needed disclosure. n61

An additional but different type of tying would involve entities that provide both pre- and post-filing services for individual debtors. For example, an approved budget and credit counselor might also provide post-filing debtor education if the counseled individual accessed the bankruptcy system. One can imagine a situation in which the fees would also be tied together. In other words, for a single fee, an individual would receive the pre-bankruptcy counseling and, if necessary, the additional course needed to obtain a discharge for little or no additional money. This would ensure that the approved counselors would have a tie to the individual client going forward.

Credit Reporting Prohibition

Section 111(g)(1) provides that budget and credit counseling agencies are prohibited from reporting that individuals sought or received personal financial management instruction. It is unclear whether this prohibition relates only to reporting with respect to post-filing financial management courses, required to obtain a discharge, or whether it includes any financial education received pre-bankruptcy through the nonprofit budget counselors. It is the choice of the word instructions that is problematic. It is clear that the post-filing financial management courses would fit within the term instruction. However, it is ironic that those cannot be reported to credit reporting agencies, since these courses can actually work to a consumer's benefit. Indeed, at least one of the newer credit reporting agencies is noting completion of financial management courses in its database and using the information to create consumer achievement scores. n62 Thus, the prohibition with respect to post-filing courses is, it seems, the inverse of what it should be.

On the other hand, it is credit counseling advice that, if reported, can hurt consumers and potentially lower their credit score. But it is unclear if the prohibition covers pre-bankruptcy counseling, although it should clearly be read to do so. Moreover, although it is not stated, one has to assume that the prohibition relates only to approved nonprofit agencies. Whether the activities of credit counselors qualify as instructional is certainly open to debate, particularly since that word does not appear in any of the references to the activities of the counselors in section 109(h) and

section 111(c). One solution would be for credit counselors to label at least some portion of their counseling as instruction and then to reference it in the certificate that the debtor is obligated to present to the court under section 521(b). If this were done, there is a strong argument that the counseling obtained cannot be reported to a credit counseling agency. Clarification of the section is needed, and this is an instance in which the statutory language should be corrected.

Compliance with Applicable State Credit Counseling Laws

There is an open issue whether approved nonprofit budget and credit counseling agencies will be required to comply with applicable state laws for budget and credit counselors. n63 This is an important issue. There is no explicit waiver in the 2005 Act and, hence, it would appear that if the activities of the approved agencies fit within the activities for which state law requires licensing, such licensing would be needed. One can suppose that states could amend their respective statutes to exempt entities approved pursuant to section 111, but that would be a slow process. Absent federal legislation, a rule or directive from the United States trustee would not solve this problem. It would appear that if licensing is required, existing budget and credit counselors will be at an advantage. This is because, at least in some jurisdictions, licensing for these types of activities is not easy and requires, among other things, satisfaction of various financial requirements. It is also unclear how licensing will operate for national approved counselors and which state laws apply. There may be entities like legal aid and educational institutions that cannot be licensed, either because they do not have the ability to meet the needed state requirements or their leadership does not want to incur the added liability. This would discourage some potentially very worthy counselors from participating--even if they were approved by the United States trustee. It is also possible that the United States trustee or the Executive Office for United States Trustees will require compliance with state law as a pre-condition for approval, something that could be one of the added requirements that are permitted under section 111(c)(2). n64

Agency Noncompliance

Section 111(g)(2) provides that if an agency willfully or negligently fails to comply with any of the requirements of this title, that entity can be subjected to actual damages sustained by the debtor as well as court costs and reasonable attorney's fees incurred in an action to recover those damages. Several features of this provision are noteworthy. First, the standard *willful or negligent* is lower than others within the Code. For example, in section 523(a)(6), the standard is willful and malicious. n65 In section 362, the standard is willfulness. n66 Second, the potential actual damages to a debtor could be significant and might include items such as defamation of credit. Attorney's fees and costs are also recoverable but this does suggest that a debtor will need to find an attorney willing to take the case. Third, only actual, as distinguished from punitive, damages are covered, which means that some of the remedial power of the section is curtailed. For example, section 303(i) permits punitive damages, so it would not have been unusual to have provided for them. n67 Fourth, the potential causes of action relate to the entire Code, evidenced by the language under this title. Clearly, this was intended to cover the many sections that deal with pre-bankruptcy counseling and financial management courses. n68 It could also be read more broadly, to cover other harms done under title 11 but not specifically sections referring to counseling or post-filing education. Suppose, for example, that a debtor received inadequate counseling from an approved credit counselor and that counselor suggested a bankruptcy filing that in turn led to a job loss and loss of credit worthiness. Resultant damages could be significant. How frequently this new section will be invoked is a relevant issue.

Implementation

There are enormous issues with respect to implementing a nationwide pre-bankruptcy counseling mandate. Each step of the process--from the providers to the content of the programming to the removal of unsatisfactory providers--is complex. Moreover, in addition to the initial steps, there will need to be thoughtful ongoing monitoring of this entire aspect of the bankruptcy system. Courts will also need to be apprised of the details of this program since they will have

to address many of these issues and, indeed, can raise some on their own. There will need to be opportunities for the participants in the system to provide their input. The pilot debtor education program referenced in Section 105 of the 2005 Act specifically requires that the Executive Office for United States Trustees consult with those with experience in financial management education. One would hope that this consultative obligation would extend to pre-bankruptcy counseling and the non-pilot aspects of financial management courses. It would make little sense to limit consultancy to a pilot initiative. With major implementational issues and the key rights that could be affected thereby, the Executive Office should consult with recognized experts on consumer credit counseling and financial management education.

Empirical Assessment

The 2005 Act has some provisions related to empirical assessment. For example, section 159 was added to title 28 and relates to bankruptcy statistics. Section 589(b) was created in title 28 to gather increased information about the bankruptcy system, encouraging transparency. Section 105 of the 2005 Act requires a pilot financial management program in six regions of the country with a study of its effectiveness. There is no similar mandate with respect to pre-bankruptcy credit counseling, which is a shortcoming in that there are myriad issues to be assessed. Such issues include an assessment of the effectiveness of the counseling, the effect of the counseling on bankruptcy filing rates, the success of the debt repayment programs into which more individuals may be directed, and the relative success of the three different types of delivery systems for counseling (in person, by telephone or through the Internet). At present, there are no specific mandates or funding to study these important issues.

For a complete discussion of Code section 111, see Collier on Bankruptcy, ch. 111 (Matthew Bender).

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[Return to Text](#)

n1 1. Pub. L. No. 109-8, § 106(a) (2005), effective in cases commenced on or after October 17, 2005.

n2

2. Pub. L. No. 109-8, § 106(d)(2) (2005), effective in cases commenced on or after October 17, 2005.

n3

3. Recent empirical work questions whether all individuals accessing the bankruptcy system have the same profile in terms of behavior and hence, further research is needed to establish whether a one-size-fits-all mandate is wise for both pre-bankruptcy counseling and post-filing debtor education. See Richard L. Wiener et al., *Unwrapping Assumptions: Applying Social Analytic Jurisprudence to Consumer Bankruptcy Law and Policy*, 79 Am. Bankr. L.J. (forthcoming 2005). For two pieces wary with respect to the value of credit counseling based on the Canadian experience where there is mandatory consumer credit counseling, see Saul Schwartz, *The Effect of Bankruptcy Counseling on Future Creditworthiness*, 77 Am. Bankr. L.J. 257 (2003); Iain Ramsay, *Mandatory*

Counseling: The Canadian Experience, 7 *Fordham J. Corp. & Fin. L.* 525 (2002).

n4

4. See Memorandum of Professor Michael Greenfield to the Consumer Debt Counseling Drafting Committee dated May 8, 2005, and available at www.law.upenn.edu/bll/ulc/UCDC/oct2003memo.htm.

n5

5. See *Collier on Bankruptcy*, 111.05[2] and 1110.05[3] (Matthew Bender).

n6

6. See *Collier on Bankruptcy*, 109.09 (Matthew Bender).

n7

7. See *Federal Rule of Bankruptcy Procedure 1004.1*, which addresses petitions by incompetent persons. Clearly, pre-bankruptcy counseling would not be required of the guardian, conservator or other appointed representative of the incompetent person.

n8

8. Section 109(h)(1) provides that counseling can be done in person, by telephone or through the Internet, and individually or in groups.

n9

9. The Forms promulgated by the Executive Office suggest that the Executive Office itself will be taking the laboring oar. See *Collier on Bankruptcy*, 111.01 (Matthew Bender). Indeed, on October 4, 2005, the Executive Office announced approval of 41 credit counseling agencies. According to the press release, available at <http://www.usdoj.gov/ust/>, [t]here are approved credit counseling agencies serving all federal judicial districts for which the United States Trustee Program is responsible. A list of approved agencies can be found on the Program's Web site, <http://www.usdoj.gov/ust/>, and will be updated as more agencies are approved.

n10

10. One possibility is that if there is bundling of services in ways that are inappropriate, that could be a basis for denying approval. *See* Tying Agreements *infra*. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

n11

11. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

n12

12. *See* H.R. Rep. No. 109-31, 109th Cong., 1st Sess. (2005).

n13

13. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

n14

14. *See Collier on Bankruptcy, 111.02*[1], note 3 (Matthew Bender).

n15

15. *See Collier on Bankruptcy, 111.03*[4] and 111.04 (Matthew Bender).

n16

16. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

n17

17. The forms promulgated by the Executive Office for United States Trustees hint at how these issues will

be resolved. *See Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n18

18. *See 11 U.S.C. § 111(c)(2)(A)(i)(ii).*

n19

19. *See 11 U.S.C. § 111(c)(2)(B).*

n20

20. *See 11 U.S.C. § 111(c)(2)(C).*

n21

21. *See 11 U.S.C. § 111(c)(2)(D).*

n22

22. *See 11 U.S.C. § 111(c)(2)(E).*

n23

23. *See 11 U.S.C. § 111(c)(2)(F).*

n24

24. *See 11 U.S.C. § 111(c)(2)(G).*

n25

25. See 11 U.S.C. § 111(c)(2)(H).

n26

26. Fees in Canada are established by Canadian Reg. 368 Bankruptcy and Insolvency General Rules. Rule 131 sets the fees for individual counseling at \$85 per session and \$25 per group session. These fees are not inflation linked and have not changed since they were instituted. These can be accessed at <http://strategis.ic.gc.ca/epic/internet/inbsf-osb.nsf/en/home>.

n27

27. In Canada, counseling is done by trustees. Although data are not available, the majority of counseling appears to be individual in Canada and occurs as part of the routine pursuant to which trustees meet with individual clients. Some trustees do contract out the counseling portion of their duties to credit counseling agencies.

n28

28. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n29

29. By way of example, Part 402 of the New York State Banking Laws, as amended by Part 404, sets forth a myriad of criteria for budget planners in New York. For a state-by-state summary, see National Consumer Law Center, *Credit Counseling in Crisis Update: Poor Compliance and Weak Enforcement Undermine Laws Governing Credit Counseling Agencies* (Nov. 2004), available at www.nclc.org/initiatives/credit_counseling/content/cc_enforcement.pdf.

n30

30. Bundling of services, with a lawyer and/or an approved financial management course provider, would be an example of information that should be disclosed to the individual debtor. See Tying Agreements *infra*. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n31

31. See Consumer Federation of America & National Consumer Law Center, *Credit Counseling in Crisis: The Impact on Consumers of Finding Cuts, Higher Fees and Aggressive New Market Entrants* (Apr. 2003), available at www.consumerfed.org/credit_counseling_report.pdf; see also Testimony of Deanne Loonin, November 20, 2003, before the House Ways and Means Subcommittee on Oversight, titled Non-Profit Credit Counseling Organizations and available at www.consumerlaw.org/initiatives/test_and_comm/credit_counseling.shtml.

n32

32. See Costs and Fees *infra*.

n33

33. See Richard Wiener, Susan Block-Lieb, Karen Gross & Corinne Donovan, *Unwrapping Assumptions: Applying Social Analytic Jurisprudence to Consumer Bankruptcy Law and Policy*, 79 Am. Bankr. L.J. (2005).

n34

34. See Content of the Credit Counseling *infra*.

n35

35. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n36

36. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n37

37. For an example of a lawsuit making this claim, see *Missouri v. Ameridebt*, available at <http://ago.missouri.gov/lawsuits/2003/091103ameridebt.pdf>.

n38

38. *See 11 U.S.C. § 109(h)(1); see also Collier on Bankruptcy*, ch. 109 (Matthew Bender) and Costs and Fees *infra*.

n39

39. *See Collier on Bankruptcy*, ch. 502 (Matthew Bender).

n40

40. Pub. L. No. 109-8, § 201(b) (2005), effective in cases commenced on or after October 17, 2005.

n41

41. *See Timing of Counseling infra*.

n42

42. On October 4, 2005, the Executive Office for United States Trustees announced a temporary waiver of the credit counseling requirement in areas affected by Hurricane Katrina. According to the press release announcing the waiver, available at <http://www.usdoj.gov/ust/>:

The [2005 Act] permits United States Trustees to waive the credit counseling requirement within a judicial district where approved credit counseling agencies are not reasonably able to provide adequate services to bankruptcy filers. The United States Trustee for Region 5 made this determination with respect to the Eastern, Middle, and Western Districts of Louisiana, and the Southern District of Mississippi.

n43 43. *See Timing of Counseling infra*.

n44

44. *See Duty to Submit Debt Management Plan infra*.

n45

45. *See* Binding Effect Extends to All Issues Determined by Confirmation Order *infra*.

n46

46. Pub. L. No. 109-8, § 106(d)(2) (2005), effective in cases commenced on or after October 17, 2005.

n47

47. *See* Collier on Bankruptcy, ch. 362 (Matthew Bender).

n48

48. *See* Specific Qualifications *supra*.

n49

49. The Forms promulgated by the Executive Office hint at counseling being a minimum of 90 minutes. How length will affect pricing is unknown. *See Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n50

50. *See* Specific Qualifications *supra*.

n51

51. *See* Tying Agreements *infra*.

n52

52. For a discussion of this issue in the context of financial management courses, *see Collier on Bankruptcy*,

111.18[4] (Matthew Bender).

n53

53. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

n54

54. *See Specific Qualifications supra*.

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55. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

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56. *See Collier on Bankruptcy*, ch. 504 (Matthew Bender).

n57

57. *See Collier on Bankruptcy*, ch. 504 (Matthew Bender).

n58

58. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. *See Collier on Bankruptcy, 111.01*, note 2 (Matthew Bender).

n59

59. *See Specific Qualifications supra*.

n60

60. See Specific Qualifications *supra*.

n61

61. See *Collier on Bankruptcy*, 111.17[3] and 111.17[4] (Matthew Bender).

n62

62. For an example of a credit reporting agency that does consider financial management programs, see PayRent Build Credit's Achiever's 100+ score which takes into account consumer completion of approved courses. See <http://prbc.com/partners/achievers.php?>.

n63

63. The Forms promulgated by the Executive Office hint at how some of these issues will be resolved. See *Collier on Bankruptcy*, 111.01, note 2 (Matthew Bender).

n64

64. See *Collier on Bankruptcy*, 111.01, note 1 (Matthew Bender).

n65

65. See *Collier on Bankruptcy*, ch. 523 (Matthew Bender).

n66

66. See *Collier on Bankruptcy*, ch. 362 (Matthew Bender).

n67

67. See *Collier on Bankruptcy*, ch. 303 (Matthew Bender).

n68

68. For the potential causes of action with respect to financial management courses, *see Collier on Bankruptcy*, 111.21 (Matthew Bender).

ABOUT THE AUTHOR(S):

Collier on Bankruptcy. This Emerging Issues Analysis was adapted from material appearing in *Collier on Bankruptcy* (Matthew Bender). Written and edited by leading scholars and practitioners, *Collier on Bankruptcy* is the preeminent treatise in the bankruptcy field. Long recognized as the most authoritative and comprehensive single source of bankruptcy law information, and available both in print and online, *Collier* is an indispensable resource for any firm with a substantial bankruptcy practice. Cited in hundreds of opinions each year, *Collier* is a benchmark authority. For more information on *Collier on Bankruptcy*, consult the online LexisNexis bookstore.

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197 of 197 DOCUMENTS

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Sommer on Marrama v. Citizens Bank

2008 Emerging Issues 866

Sommer on Marrama v. Citizens Bank

By Henry J. Sommer

November 5, 2007

SUMMARY: In *Marrama v. Citizens Bank*, the Supreme Court held that a debtor who has acted in bad faith does not have an absolute right to convert a chapter 7 case to chapter 13. In his expert commentary, Henry J. Sommer, the editor-in-chief of *Collier on Bankruptcy*, limns the Court's reasoning and suggests that in practice it is not always easy to determine the "plain meaning of the Code."

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ARTICLE: Supreme Court Rules That Chapter 7 Debtor Does Not Have an Absolute Right to Convert to Chapter 13

The Supreme Courts decision in *Marrama v. Citizens Bank* resolved a split among the courts of appeals concerning whether a chapter 7 debtor who has not previously converted from another chapter of the Bankruptcy Code has an absolute right to convert a case to chapter 13 if the debtor met the chapter 13 eligibility requirements of section 109 of the Code.

In *Marrama*, the debtor filed a voluntary petition under chapter 7 of the Bankruptcy Code. In his attached and verified schedules, the debtor made a number of misleading or inaccurate statements about his principal asset, which was a house in Maine. Specifically, he listed its value as zero, when it fact it had considerable value. Further, he denied that he had transferred any property other than in the ordinary course of the business during the year preceding the filing of the petition, whereas he had transferred the house into a newly created trust for no consideration. After the trustee indicated that he would attempt to recover the Maine house as an asset of the estate, the debtor filed a notice of conversion to chapter 13. The trustee and principal creditor opposed the conversion on the ground that the request was made in bad faith and would constitute an abuse of the bankruptcy process. In response, the debtor explained that the misstatements on the Maine property were a result of scriveners error and that he had filed under chapter 7 because he was unemployed at the time. The bankruptcy court rejected these arguments and denied the request for conversion on the ground of debtors bad faith. The Court of Appeals for the First Circuit upheld the denial of the right to convert, ruling that the right is not absolute and that a court could deny conversion if the debtor had acted in bad faith.

Affirming, the Supreme Court ruled that a debtor who in bad faith has concealed significant assets, whose case under chapter 13 would be subject to immediate dismissal under section 1307(c), does not have the right to convert to chapter 13 in the first instance. Such a debtor, the Court held, comes within the description in section 706(d) of debtors who do not have a right to convert because the debtor is not someone who may be a debtor under such chapter. [*Marrama*, 166 L. Ed. 2d at 964-66.]

The Court also found authority for its decision in section 105, because conversion of a case from chapter 7 to chapter 13 by a debtor whose chapter 13 case would be immediately dismissed or reconverted to chapter 7 could be an abuse of process of the type courts may prevent under section 105(a). [*Marrama*, 166 L. Ed. 2d at 966-67.] In particular, the Court discussed the possibility that a debtor could gain control of assets once a case is converted to chapter 13 and dissipate them before the case could be reconverted to chapter 7. [*Marrama*, 166 L. Ed. 2d at 967 n.13.]

The Court emphasized that denial of the right to convert to chapter 13 should be limited to extraordinary cases of bad faith and should not apply to other cases. [*Marrama*, 166 L. Ed. 2d at 966 n.11.] It also suggested that the showing of bad faith necessary to deny conversion should be very clear, and more than might be required for denial of plan confirmation under section 1325(a)(3). [*Id.*]

The Court rejected the position of four dissenting justices that the plain language of the Code provides for an alternative procedure to handle bad faith conversions, namely the dismissal or reconversion of the case after it is converted to chapter 13, and that the right of a statutorily eligible debtor to convert to chapter 13 is absolute. [*Marrama*, 166 L. Ed. 2d at 967-69.] The dissent also argued that section 105(a) could not be used to contravene the Code's plain language, although it could have served as authority to enter orders to prevent actions, such as dissipation of property, that the majority feared could occur in a bad faith conversion. [*Marrama*, 166 L. Ed. 2d 956, 971-72.]

The decision once again shows that, although the Court frequently espouses the plain meaning approach to interpreting the Bankruptcy Code, it may not always follow that approach, at least as it is interpreted by Justice Scalia, its foremost proponent, who joined the dissent. [*But see BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994), in which Justice Scalia seemingly ignored the plain meaning of the word value and found it to be the amount realized for a property at a foreclosure sale.] At a minimum, the decision demonstrates that in practice it is not always easy to determine the plain meaning of the Code.

Perhaps even more intriguing is the Court's use of section 105(a) as an alternative basis for its decision. The Court suggests that the broad authority of that provision is surely adequate to short-circuit the usual procedure of conversion followed by a reconversion if that is necessary to prevent an abuse of process. [*Marrama*, 166 L. Ed. 2d at 966-67.] In light of many lower court holdings that section 105(a) cannot be used to circumvent the specific provisions of the Code, it will be interesting to see if courts now will rely on this language in taking actions that appear contrary to the Code's standard procedures.

For further discussion of conversion from chapter 7 to chapter 13, see *Collier on Bankruptcy*, 15th ed. rev., 706.02, and *Collier Consumer Bankruptcy Practice Guide*, 24.03.

For further discussion of the bankruptcy courts' power under Code section 105, see *Collier on Bankruptcy*, 15th ed. rev., ch. 105.

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Henry J. Sommer is Supervising Attorney at the pro bono Consumer Bankruptcy Assistance Project in Philadelphia. He has litigated many major cases involving bankruptcy, consumer law, civil rights, and other issues. Previously, he was the head of the Consumer Law Project at Community Legal Services in Philadelphia, where he worked for over 21

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1 of 16 DOCUMENTS

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Klee on Hamilton v. Lanning

2010 Emerging Issues 5116

Professor Kenneth N. Klee on the Supreme Court's Holding in Hamilton v. Lanning, 2010 U.S. LEXIS 4568 (2010)

By Prof. Kenneth N. Klee

June 14, 2010

SUMMARY: In this Emerging Issues Analysis, Professor Klee comments on the Court's ruling in Hamilton v. Lanning. Even when a statute contains a detailed and precise definition of a term or concept, the Court will construe the statute pragmatically to preserve judicial discretion to depart from the definition in circumstances when mechanical application of the definition would produce senseless results that Congress did not intend.

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The Lesson To Be Learned:

Even when a statute contains a detailed and precise definition of a term or concept, the Court will construe the statute pragmatically to preserve judicial discretion to depart from the definition in circumstances when mechanical application of the definition would produce senseless results that Congress did not intend. Such an approach accommodates not only the language but the purposes of the Bankruptcy Code: Debtors are not required to fund amounts that their incomes no longer support, and creditors need not fear debtor manipulation by timing the filing the chapter 13 petition shortly before an expected increase in monthly income.

Legal Background:

A chapter 13 debtor typically is required to commit "projected disposable income" to the repayment of creditors over 3 to 5 years under a repayment plan. *See 11 U.S.C. § 1325(b)(1)* (2010). In calculating the amount of projected disposable income required, some courts take a mechanical approach by averaging the debtor's monthly income during a 6-month look-back period, generally preceding the date of the filing of the bankruptcy petition. *See 11 U.S.C. § 101(10A)(A)(i)* (2010). Other courts use a forward-looking approach which adopts the mechanical approach result as a starting point and, in unusual cases, takes "into account other known or virtually certain information about the debtor's future income or expenses." The Court pragmatically opts to uphold the forward-looking approach.

Facts and Proceedings Below:

Debtor Stephanie Lanning received a substantial one-time buyout from her former employer, causing her average current monthly income for the six months before her bankruptcy filing to increase substantially to \$5,343.70, exceeding her State's median income. Under a mechanical approach, she would have been required to pay \$750 per month to her creditors over the 60-month life of her chapter 13 plan. Based on Lanning's income from her new job, however, she had actual total monthly income of \$1,922, well below her State's median income. Deducting actual monthly expenses of \$1,772.97 from her income left Lanning monthly disposable income of \$149.03. Thus, she proposed a plan to pay creditors \$144 per month for 36 months.

Hamilton, the chapter 13 trustee, objected to confirmation on the basis that Lanning's plan did not devote "projected disposable income" to the repayment of creditors as required by the statute. Because Lanning's actual income was insufficient to pay disposable income calculated under the mechanical approach and her actual monthly income had decreased substantially, the bankruptcy court declined to use the mechanical approach. Instead, the bankruptcy court used the forward-looking method to compute projected disposable income based on Lanning's actual income level and confirmed a plan requiring payment of \$144 per month over a 60 month period. The bankruptcy court concluded that the word "projected" in Bankruptcy Code § 1325(b)(1)(B) required consideration of Lanning's actual income as reported in her bankruptcy schedules (*In re Lanning*, 2007 Bankr. LEXIS 1639, Bankr. L. Rep. (CCH) P80927 (Bankr. D. Kan. May 15, 2007)).

The Tenth Circuit BAP affirmed, noting that although Congress, in 2005, had amended the Bankruptcy Code to define "disposable income," it did not define the pre-existing term "projected disposable income." Thus the bankruptcy judge correctly continued the pre-2005 practice of considering the debtor's actual income and expenses (*In re Lanning*, 380 B.R. 17, 2007 Bankr. LEXIS 4107 (B.A.P. 10th Cir. 2007)).

Hamilton appealed to the Court of Appeals for the Tenth Circuit which likewise affirmed. The Tenth Circuit panel reasoned that a bankruptcy court should start with the amount generated by a mechanical application of the statute. Although this amount is presumed correct, the debtor may rebut it based on actual income. Because Lanning proved a substantial change in circumstances, she rebutted the presumption and the bankruptcy court was correct in using an amount of projected disposable income based on her then-current income (*Hamilton v. Lanning* (*In re Lanning*), 545 F.3d 1269, 2008 U.S. App. LEXIS 23563 (10th Cir. Kan., 2008)).

The Court granted certiorari to resolve whether a bankruptcy court should use the mechanical approach or the forward-looking approach in determining projected disposable income (*Hamilton v. Lanning*, 130 S. Ct. 487, 175 L. Ed. 2d 343, 2009 U.S. LEXIS 7655 (U.S. 2009)).

Analysis:

Writing for a majority of eight Justices, Justice Alito authored an opinion holding "that when a bankruptcy court calculates a debtor's projected disposable income, the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation." The forward-looking approach is supported by the ordinary meaning of the term "projected." Moreover, in a legislative context, Congress rarely has used "projected" to refer to simple multiplication. In the Bankruptcy Code, when Congress wants to mandate simple multiplication, it uses the term "multiply." See, e.g., 11 U.S.C. §§ 704(b)(2), 707(b)(6), and 1325(b)(3) (2006). Furthermore, the forward-looking approach continues the pre-2005 amendment approach used by the courts to determine projected disposable income in which courts exercised judicial discretion to account for known or virtually certain changes in the debtor's income. Absent a clear indication that Congress intended to change pre-2005 amendment practice, the Court will not interpret the Bankruptcy Code to erode past practices.

By comparison, the mechanical approach's retrospective focus clashes with the express terms of Bankruptcy Code § 1325 which refers to disposable income "to be received in the applicable commitment period." See 11 U.S.C. § 1325

(b)(1)(B) (2006). Moreover, Bankruptcy Code § 1325(b)(1) requires the bankruptcy court to determine projected disposable income "as of the effective date of the plan." If the retrospective mechanical approach were correct, the amount would be determinable on the date of the filing of the petition and would not have to be determined as of the effective date of the plan.

Finally the mechanical approach produces senseless results when the debtor's actual disposable income is substantially lower or higher than the amount averaged during the 6 month look-back period. Under circumstances when the debtor's income has declined, the mechanical approach will preclude confirmation of chapter 13 plans. On the other hand, when the debtor's income has greatly increased, the mechanical approach would permit the debtor to confirm a plan that substantially underpays creditors. Thus, the Court rejects the mechanical test and adopts the more pragmatic and sensible forward-looking test to determine projected disposable income.

Practice Tips:

Creditors learning of a chapter 13 debtor's increased regular monthly income will be able to ask the bankruptcy court to increase projected disposable income at or before confirmation instead of relying exclusively on post-confirmation plan modification. Debtors filing at the nadir of their monthly earnings cannot expect to game the system by repaying creditors a low level of income based on the mechanical approach.

By the same token, debtors whose prepetition income is above the level of current income will be able to propose and confirm a feasible chapter 13 plan based on projections grounded in actual current income. The law does not require debtors to be stuck with a mechanical approach that requires them to commit to repay income at levels they cannot sustain based on circumstances changing at or shortly before the filing of the chapter 13 petition.

[Return to Text](#)

n1 Justice Scalia dissented. Using a textualist approach, he would have applied the mechanical test based on the plain meaning of the statute. By refusing to hold that Congress meant what it said, Justice Scalia contends that the Court deprives Congress of the ability to mean what it says in the future. He would trust Congress to correct the law if what it previously prescribed is wrong.

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Kenneth N. Klee is a nationally recognized expert on bankruptcy law. He is a tenured professor at the UCLA School of Law and a founding partner of Klee, Tuchin, Bogdanoff & Stern LLP, specializing in corporate reorganization, insolvency, and bankruptcy law. From 1974 to 1977, Professor Klee served as associate counsel to the Committee on the Judiciary, U.S. House of Representatives, where he was one of the principal drafters of the 1978 Bankruptcy Code. He served as a consultant on bankruptcy legislation to the U.S. Department of Justice in 1983-1984. From 1992-2000, he served as a member of the Advisory Committee on Bankruptcy Rules to the Judicial Conference of the United States. From 2000-2003, and previously from 1988-1990, Professor Klee served as a lawyer delegate to the Ninth Circuit Judicial Conference. From 2005 to 2008 he served as member of the executive committee of the National

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2 of 16 DOCUMENTS

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The New COD Deferral Election

2009 Emerging Issues 3651

The New COD Deferral Election

By Carl M. Jenks, Candace A. Ridgway, John D. Currivan and Carolyn Joy Lee

May 28, 2009

SUMMARY: In this Emerging Issues Analysis, four partners from the law firm of Jones Day offer their perspective on new section 108(i) of the Internal Revenue Code. The new provision creates a mechanism that will allow many borrowers to substantially reduce or avoid the adverse tax consequences that may be generated by exchanges or deemed exchanges of old debt for new debt, as well as repurchases or other retirements of debt at a discount.

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ARTICLE: Overview

The American Recovery and Reinvestment Tax Act of 2009 ("ARRTA")ⁿ¹ inserted a new section 108(i) into the Internal Revenue Code. That new section permits corporations and certain non-corporate borrowers to elect to defer cancellation of debt ("COD") income for up to five years, followed by ratable inclusion of the COD income over the next five years. In the simple case in which an obligor (or a related party) buys back or settles its own debt for less than face, this new election will allow borrowers to postpone reflecting COD income on their tax returns for a substantial period of time, thereby obtaining a time value benefit. More importantly perhaps, this election will often permit borrowers who have syndicated bank debt outstanding to negotiate significant modifications to that debt without running the risk that COD income will be generated as a result.

Background

When borrowing money, a taxpayer does not have taxable income, because the cash received is precisely offset by an obligation to repay that amount to the lender, thereby generating no net accretion to the borrower's wealth. If, however, the taxpayer is released from some or all of its repayment obligation, taxable income generally results because at that time the taxpayer's net wealth has increased.ⁿ² Despite this rather obvious principle of income taxation, Congress has over the years lent a sympathetic ear to suggestions that it is unfair to impose tax on various types of taxpayers who have incurred COD income.ⁿ³ After all, COD income is often associated not with prosperity or economic well-being, but with a deterioration in the taxpayer's economic fortunes. Imposing a tax on someone who has suffered such a financial reversal seems harsh.

For many years, the Internal Revenue Code and applicable case law have displayed some sympathy for this point of view by excluding from taxable income COD income triggered by a Title 11 bankruptcy discharge or when (and to the extent that) the obligor is insolvent. n4 The price exacted for the exclusion of COD income in these situations is a requirement that the borrower reduce its tax attributes (principally its net operating loss carryforwards and its tax basis in assets) in the rather complicated fashion outlined in sections 108(b) and 1017.

The current economic crisis has created severe financial problems for many businesses, but also some opportunities to work out of those difficulties. Unfortunately, in many cases the COD rules work against those opportunities. The opportunities arise because much business debt is currently trading at well below par, n5 because of the general loss of market confidence in the creditworthiness-or ability to reliably assess creditworthiness-of many, if not most, borrowers. Historical investors in such debt are now more interested in trying to purge their portfolios of doubtful debts than in investing in more. This presents a great opportunity for debtors-or their owners-with sufficient resources to strengthen their balance sheets by buying back their debt at substantial discounts. But they are inhibited from doing so by the COD rules that would impose significant current or future tax, through recognition of current taxable income or loss of valuable tax attributes, on the debtors' COD income resulting from such a debt buyback.

In addition, and much to the surprise and dismay of many borrowers that have been negotiating changes to their syndicated bank lines of credit, those changes might produce COD income even if the changes being negotiated neither reduce the face amount of the debt nor result in a reduction in the net present value of future debt service obligations. This surprising COD income results from the interaction of two different parts of the tax law: the "deemed exchange" rules set forth in the regulations governing exchanges of debt instruments, and the "issue price" rules set forth in the original issue discount ("OID") regulations. n6 Under current market conditions, the situation is materially exacerbated by the potential application of the so-called AHYDO (applicable high-yield debt obligation) limitations on interest deductions. n7

Consider the following example.

Example 1

Debtor owes its bank syndicate \$100 million. The debtor's repayment obligation is secured by inventory, and bears a 9% interest rate. The debtor has made all debt service payments as they have come due, but is in covenant default. After negotiations between the debtor and the syndicate's agent bank, the debtor and lenders agree to modify the terms of the debt by adding the corporate headquarters to the collateral, increasing the interest rate from 9% to 10%, and paying \$1 million in fees. Under the "deemed exchange" regulations, the existing debt has been "significantly modified," thus resulting in a deemed exchange of a new debt for the old. The debtor will have COD income if the issue price of the new debt is less than the adjusted issue price of the old debt. If the debt is not treated as publicly traded, the issue price will be the face amount, thereby generally avoiding COD income. However, if the debt is treated as publicly traded either before or after the modifications, the issue price of the "new" debt will be fair market value-generally the price at which the debt trades at or about the time of the modification-which under current market circumstances is likely to be less than face. Thus, the result of the modification would be COD income to the borrower.

"But My Debt's Not Publicly Traded."

Upon hearing this analysis, the normal reaction from corporate CFOs and tax directors is that, since their company's debt is not listed on a securities exchange, it is not publicly traded and thus there cannot be a COD issue. That reaction, while completely understandable, is not necessarily accurate in this context. An extremely expansive definition of public trading applies in this area, and there exist a variety of online quotation or trading platforms specializing in otherwise unlisted debt (including syndicated bank debt). In order to be treated as publicly traded for this purpose, a debt need not be listed on a securities exchange: it is enough that trades and/or offering prices for that debt are being reported on a readily available (including through subscription) debt quotation or trading reporting services that provide a reasonable basis for determining fair market value. n8

In simpler times, bank lines of credit were retained by the lending bank, in much the same way that home mortgages used to be retained by the banks or savings and loans advancing the funds. In more recent times, however, bank lines of credit are frequently syndicated among several financial institutions, just as home mortgages have been packaged and syndicated to outside investors. While the borrower will always know who the original members of the lending syndicate are, syndicate members may be able to transfer their positions to other qualified institutions once the line has been established, and if that happens the borrower may or may not be kept aware of those changes in syndicate membership. If changes in syndicate membership take place, and if the prices at which those transactions occur become known to other participants in the debt market (through proprietary online quote services or otherwise), the debt in question may be treated as publicly traded for these purposes, regardless of whether the borrower has had any involvement in the trading, or is even aware that it is taking place.

"But the Modifications We Are Considering Aren't Significant."

Once convinced that there is at least some concern that their companies' debt is publicly traded, CFOs and tax directors may question whether the changes under consideration are "significant," especially when they don't change the basic terms of the debt, such as its principal amount or maturity. Once again, however, the detailed rules that apply will tend to result in a modification being treated as "significant" even though it might not strike a layman as such.

The "deemed exchange" regulations lay out a number of specific rules governing when particular types of changes are or are not "significant."

- significant. n9
- significant if more than the greater of $\frac{1}{4}$ % (25 basis points) or 5% of the old debt's annual yield. n10
- significant if it results in a material deferral. n11
- automatically significant if the debt is recourse; not significant if the debt is nonrecourse. n12
- significant if it results in a change of payment expectations. n13
- automatically significant if the debt is nonrecourse; significant if the debt is recourse and the modification results in a change of payment expectations. n14
- significant if it results in a change in payment expectations. n15
- automatically significant. n16
- i.e., Equity) -- automatically significant. n17

These rules generally reflect the approach taken by the U.S. Supreme Court in the *Cottage Savings* case, where an exchange of one set of mortgages for another set of basically identical mortgages was treated as a taxable event for each party (thus allowing them both to recognize their tax loss), even though the two sets of mortgages were of equal value and even though the transaction was treated as a non-event for regulatory accounting purpose. n18 The basic impact of the *Cottage Savings* decision and the "deemed exchange" regulations was to increase the likelihood that a given change to a debt instrument would result in a deemed exchange of new debt for old.

"But Isn't the COD Income Offset by OID Deductions?"

It is true that, if a debt modification results in a deemed exchange that generates COD income, the new debt will generally be treated as issued with an equal amount of OID, which will in turn generate OID deductions over the life of the new debt. The creation of OID may not fully neutralize the cost of the borrower's COD income, however. While the COD income is generally recognized and taxed immediately, the OID deductions are only claimed over the remaining life of the instrument, and on a back-end loaded (yield-to-maturity) basis, so that the present value of the tax savings from the OID deductions may be significantly less than the current tax cost of the COD income.

In addition, because prevailing interest rates are now so low, the new debt may be treated as subject to the AHYDO rules if its remaining maturity is more than five years and the debtor is a corporation. As a result, interest

deductions claimed on the new debt's OID may be postponed until actual payment (if the yield to maturity on the new debt is 500 basis points over the applicable federal rate ("AFR"), which is currently in the neighborhood of 2% for mid-term debt) or disallowed altogether (to the extent that the yield to maturity on the new debt exceeds the AFR by more than 600 basis points).

Example 2

Debtor Corp. borrows \$100 million from its bank syndicate in 2007. The loan bears interest at 9%, is due in 2011, and is issued without any original discount. In 2009, the terms of the loan are modified significantly enough for a deemed exchange to occur: the interest rate is raised from 9% to 10% (an increase of more than 5% of the original rate) and the maturity is extended to 2016. Since the old debt has been quoted regularly on publicly available websites at 70 cents on the dollar, the new debt may be deemed to have an issue price of \$70 million, thereby generating \$30 million of OID. In that case, since the debt as modified has a remaining term of six years, it may be subject to the AHYDO rules because the yield to maturity (interest rate plus OID) exceeds the mid-term AFR by more than 500 basis points. Thus, the accrued OID will not be deductible until paid, and the amount in excess of a yield to maturity of the AFR plus 600 basis points will be disallowed altogether. The lenders, however, will still generally include the OID as interest income as it accrues, although they may be eligible for the "dividends received deduction" with respect to the AHYDO-disallowed portion of the OID. n19

The Impact of ARRTA

ARRTA creates a mechanism that will allow many borrowers to substantially reduce or avoid the adverse tax consequences that may be generated by exchanges or deemed exchanges of old debt for new debt, as well as repurchases or other retirements of debt at a discount. n20 However, the new election will not always produce the best tax result, and considerable complexity will arise where the borrower is a pass-thru entity like a partnership or an LLC. State and local tax complications also abound.

ARRTA permits taxpayers to elect to defer COD income arising from an acquisition of business debt by the debtor or certain related parties in 2009 or 2010, in a variety of contexts: where the debt is bought back by the issuer (or a related party); where there is an actual or a deemed exchange of new debt for old; where there is a taxable exchange of debt for stock or an interest in an entity treated as a partnership; where debt is contributed to capital; and where debt is completely forgiven. In lieu of current inclusion, the debtor may irrevocably elect to include the COD income ratably over five years beginning in 2014.

If a debtor elects to defer COD income in the case of a debt exchange that results in new debt with OID, the debtor's OID deductions will be deferred to the same extent as the COD income. n21 In addition, high rates of OID resulting from such transactions in 2009 will be exempted from the deduction limitations set forth in the AHYDO rules if the new debt was exchanged for a debt that was not itself an AHYDO debt. n22 As a result of these provisions, if the remaining life of the new debt is between five and ten years, the combination of the deferred and later OID deductions will offset or more than offset the deferred COD income, potentially causing the deemed exchange to produce a small net deduction to the borrower on a present value basis.

The deferral election is in lieu of other exclusions currently available under section 108. Thus, a taxpayer that is insolvent or in bankruptcy at the time of the COD event or the later income inclusion will give up its existing rights of exclusion under 108 if it elects to defer the COD income under section 108(i). n23 Each situation must be examined on an individual basis, taking all relevant facts into account, before one can decide whether making the deferral election would be wise.

Example 3

Debtor expects to generate \$30 million in COD income in connection with several planned modifications to its syndicated bank debt. Debtor has \$35 million in NOL carryforwards that will expire in 2010, 2011, and 2012. Debtor

may conclude, after examining its ability to utilize its NOL carryforwards before they expire, that it would be better to recognize the COD income currently in order to use up the expiring NOLs, and to allow the OID deductions generated by the deemed exchange to be taken over the remaining life of the new debt instead, as long as the AHYDO limitations on those OID deductions can be avoided by having the new debt come to maturity within five years of the date of deemed issuance.

The new section 108(i) election is available to any corporate debtor, and to any non-corporate person that incurred the debt in connection with the conduct of its trade or business. In the context of a partnership, this rule raises a number of issues. For example, it appears from the language of the statute that the partnership itself must be engaged in a trade or business. n24 This requirement could be a problem for some partnerships, such as a private equity partnership whose only activity is holding the stock of corporations in which it invests, or a real estate partnership whose only asset is vacant land. Such partnerships may be treated as engaged in an investment activity rather than in a trade or business.

Another interesting issue is whether a partnership that is not engaged in a trade or business, but has a C corporation as a partner, will be eligible for any relief under the new legislation. In the context of the AHYDO rules, the tax law looks through the partnership to its corporate partners. n25 As a result, even though the AHYDO rules by their terms apply only to corporations, n26 if a partnership with a corporation as a partner issues high yield debt, the portion of the debt attributable to the corporation is subject to the AHYDO rules. Whether a similar approach will be taken in the context of COD deferral remains to be seen.

Although the deferral election is irrevocable once made, it can be made on a debt-by-debt- including, in the case of a bond issuance, on a bond-by-bond-basis. n27

The deferral ends (and all remaining COD income is recognized) upon the occurrence of a number of events, such as the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a Title 11 or similar case), and the cessation of business by the taxpayer. Acceleration is also required in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity at the time the COD occurred. n28

As a technical matter, the debtor's election to defer its COD income (thereby deferring its OID deductions as well) has no impact on the timing of the lender's recognition of OID income. At least in the case of an exchange or deemed exchange of debts constituting "securities" (which would be treated as a transaction resulting in no gain or loss to the lender, and a transfer of its basis in the old debt to the new debt), the "acquisition premium" rules n29 will generally eliminate the timing-mismatch problem. Absent these rules, the lenders would have to include OID income as it accrues, and only recognize the ultimate loss on the debt upon its maturity, creating a tax cost with a present value that could be significant. (Lenders participating in an exchange that is not nontaxable would receive their deductible tax loss up front, although there still may be an unfortunate mismatch of character-capital loss, followed by ordinary income.) In the case of the nontaxable exchange participants, however, the difference between their carryover basis in the debt and its deemed issue price is treated as acquisition premium, and the acquisition premium rules reduce OID in the ratio that the acquisition premium bears to the discount. In the typical exchange or deemed exchange in which the principal amount has not been reduced, the acquisition premium will equal the discount, which will in turn eliminate all OID income that would otherwise be recognized by the holder.

Pass-Thru Entities

A number of complications can arise when the borrower is a pass-thru entity, such as a partnership, an LLC that is treated as a partnership for tax purposes, or an S corporation. One such complication relates to the election itself. If a partnership or other pass-thru entity wishes to take advantage of the opportunity for deferral of COD income, the election must be made by the entity, not by its members. n30 On the other hand, in the case of a partnership, the availability of various exclusions from recognition of COD income, such as bankruptcy and insolvency, is determined at the partner level. n31 This rule can place the decision maker in a very uncomfortable position, because those exclusions

become unavailable if the deferral election is made. n32 For example, a partnership might have one partner that is bankrupt or insolvent, and another that is not eligible for any exclusion of COD income. The partnership may be viewed as favoring one partner over the other depending on whether the partnership makes the deferral election or not.

Another complication relates to the effects of the deferral election. When a partnership borrows money, the partners' respective shares of debt are treated as deemed contributions to the partnership for purposes of determining their basis in their partnership interests ("outside basis"). n33 Similarly, when partnership debt is reduced, the reductions in the partners' shares of debt are treated as deemed distributions, which can reduce the partners' outside basis. n34 If the deemed distribution to a partner exceeds the partner's outside basis, the partner recognizes gain to the extent of the excess distribution. n35 When the cause of the deemed distribution is the forgiveness of partnership debt, normally the resulting COD income is allocated among the partners, thus increasing their outside basis and offsetting the effect of the deemed distribution. n36 If the partnership elects to defer the recognition of COD, however, then there is no allocation of COD income to increase a partner's outside basis, and the partner may recognize gain as a result of the deemed distribution.

To address this problem, the new legislation includes a provision that suspends the deemed distribution to the extent that it would trigger gain. n37 The partner's basis is thus reduced to zero, and any further distribution of cash to the partner will trigger gain unless there is a corresponding allocation of income. Later, when the deferred COD income is recognized, the partner takes the suspended distribution into account at the same time and in the same amount as the deferred income that is recognized, until the suspended distribution is eliminated. n38

Example 4

A and B contribute cash of \$100 million each to form a partnership. The partnership allocates all profits and losses and all liabilities equally to A and B. The partnership borrows \$800 million from an unrelated lender. Each partner's outside basis is thus \$500 million (the sum of the cash contribution of \$100 million and the partner's debt share of \$400 million). The partnership experiences losses of \$700 million, which it allocates equally to A and B, reducing the outside basis of each partner to \$150 million. In 2009, the partnership works out an arrangement with the lender under which the amount of the debt is reduced from \$800 million to \$300 million. This reduction gives rise to \$500 million of COD income for the partnership, and a \$500 million deemed distribution to the partners. If the partnership does not elect to defer the COD income, then each partner's allocation of COD income of \$250 million will offset that partner's deemed distribution in the same amount, and each partner's outside basis will be unchanged. On the other hand, if the partnership elects to defer the COD income, then the deemed distribution of \$250 million to each partner has the potential to trigger \$100 million of gain to each, since each partner's outside basis prior to the deemed distribution was only \$150 million. Accordingly, for each partner, only \$150 million of the deemed distribution is currently taken into account. Each partner's outside basis is reduced to zero, and no gain is triggered. The remaining \$100 million of the deemed distribution for each partner is suspended. In 2014, the first year of the partnership's five-year inclusion period, \$100 million of the deferred COD income is recognized, and is allocated \$50 million to each partner. Although the language of the statute is not crystal clear on this point, it appears that \$50 million of each partner's suspended deemed distribution will be taken into account in 2014. Thus, the partners' suspended deemed distributions will be fully taken into account over a two-year period even though the COD income is recognized over a five-year period.

Another issue that arises in the context of pass-thru entities is the treatment of transfers of interests. As noted above, the recognition of all deferred COD income is triggered when certain events occur, such as death, liquidation, sale of substantially all assets, and cessation of business. For pass-thru entities, this acceleration rule also applies on a sale or exchange or redemption of an interest in the entity. n39 The statute does not specify whether a sale or exchange of one member's interest causes all the deferred COD income of the entity to be recognized, or just the member's share of that income. Although a definitive answer will have to await further guidance from Treasury, it seems that triggering only the member's share of deferred COD income would be the most sensible approach, particularly in light of the way the allocations are required to be made in partnerships.

The rule for allocating deferred COD income in a partnership is not a model of clarity. The rule tells us that the deferred COD income must be allocated to the partners in the partnership immediately before the discharge in the same manner as that income would have been allocated if the deferred COD income had been recognized at that time. Although the meaning of this is not entirely clear, the rule seems to suggest that the partnership must perform a pro forma allocation of the COD income to the partners at the time of the discharge, and then keep track of each partner's suspended COD income amount. It is not clear whether these amounts are reflected in the partners' capital accounts. The language of the statute can be read to suggest that they are not so reflected. n40 However, if they are not reflected anywhere on the balance sheet, it would seem that the balance sheet will not balance, n41 and including them in the partners' capital accounts may be a sensible solution. If the partnership's membership remains unchanged until the five-year inclusion period or an earlier event that triggers full inclusion, then allocation of the deferred COD income will be done in accordance with the partners' suspended COD income amounts. On the other hand, if a partner sells its interest in the interim, that sale presumably triggers the recognition of the portion of the deferred COD income reflected in that partner's suspended COD income amount.

There are many other unanswered questions in the context of partnerships and other pass-thru entities, such as how the rules will work in the context of tiered partnerships, and how partial transfers or redemptions of interests will be treated. Answers to these questions will have to await further guidance.

State and Local Tax Implications

As is evident from the foregoing, the new section 108(i) election has a variety of moving parts. When overlaid on the basic federal analysis, these can make the analysis of the state and local tax benefits of the election rather complex.

The first and most basic question is whether states will conform to the new federal provision, or instead decouple, needing the immediate revenues for strained state and local coffers. If, as has been suggested, some states are unwilling to follow the new federal rules, then there will be no state benefit from the section 108(i) election.

At its core, the election represents a deferral event. COD that might otherwise arise in 2009 or 2010 is instead delayed, and reflected serially in the five tax years commencing with 2014. Because taxpayers' state and local positions can change significantly from year to year, and because the attributes available at the state and local level can differ from those available federally, the state and local tax perspective on the elective deferral can differ markedly from the federal analysis.

For example, where COD arises from a simple write-down of outstanding indebtedness, section 108(i) operates to defer income, but at the price of forgoing the attribute reduction otherwise available to taxpayers who are in bankruptcy or are insolvent. Evaluating the state and local costs and benefits of that basic trade-off requires comparing the current year's state tax posture to the posture expected in future years, not necessarily an easy thing to predict.

Where, by contrast, the COD in question results from a debt modification, or a deemed modification resulting from the acquisition of debt by a related party, then the borrower has both COD and OID. Coordinating the timing of those mirrored tax items involves different considerations, particularly if there is a related party in the picture accruing interest income.

Partnerships and similar entities present other unique problems. While these may be "pass-thrus" for federal purposes, there are numerous state and local tax provisions that treat these as substantive taxpayers—for example, imposing withholding in respect of partners. Partners tasked with choosing whether a partnership should choose to make the election may well need to take into consideration not only the differing situations of the partners, but also the very practical concerns of coming out of pocket to pay taxes in respect of partners' non-cash income.

In short, addressing the world of state and local taxes, as applied to this election, may well require looking at the available options from a completely different angle.

Summary

The potential tax costs to debtors of modifying, exchanging, repurchasing, or otherwise settling their outstanding debt to relieve financial distress (and ultimately rationalize the debt market) have significantly inhibited such activities, to the detriment of the economy as a whole. Provisions in ARRTA have been designed to provide short-term relief for these tax costs and to encourage debt workouts. These provisions include optional four-to-five-year deferral of COD income resulting from debt workouts, with inclusion in the succeeding five years, an OID-matching provision, and a provision providing relief from the AHYDO restrictions on deductibility for certain exchanges occurring in 2009. These provisions may substantially reduce or even eliminate the adverse tax consequences to debtors of engaging in debt workout transactions. Every taxpayer considering such a transaction must, however, carefully evaluate whether, in its particular situation, the general tax rules or the special rules under ARRTA provide the better tax answer.

Return to Text

n1 Pub. L. No. 111-5.

n2 See, e.g., *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

n3 For example, in 2007, Congress enacted sections 108(a)(1)(E) and 108(h), which exclude from taxable income COD income generated with respect to certain types of home mortgage indebtedness. (Unless otherwise noted, section references herein are to sections of the Internal Revenue Code of 1986, as amended.) Similar exclusions have been adopted at various times with respect to certain types of farm indebtedness and real property business indebtedness. See 26 U.S.C. § 108(a)(1)(C), (D), (c), (g).

n4 26 U.S.C. § 108(a)(1)(A)-(B), (3). Both exclusions arise from the judicially-developed concept that the "accretion to wealth" necessary for taxable income does not occur unless and until the taxpayer becomes solvent -- i.e., has positive net worth-as a result of the COD. See, e.g., *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937); *Haden Co. v. Comm'r*, 118 F.2d 285 (5th Cir. 1941); *Texas Gas Distributing Co.*, 3 T.C. 57 (1944). See generally James Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 246-48 (1959):

n5 See, e.g., Alan Rappeport, *U.S. Economy Shrinks at Rate of 6.1%*, Financial Times, Apr. 29, 2009, available at <http://www.ft.com/cms/s/0/06299c8e-3437-11de-9eea-00144feabdc0.html>.

n6 Treas. Reg. § 1.1001-3; Treas. Reg. § 1.1273-2.

n7 26 U.S.C. § 163(e)(5).

n8 Treas. Reg. § 1.1273-2(f).

n9 Treas. Reg. § 1.1001-3(e); applies to all changes than those specifically listed (below), if separately or together they are "economically significant".

n10 Treas. Reg. § 1.1001-3(e)(2).

n11 Treas. Reg. § 1.1001-3(e)(3); a safe harbor of five years or 50% of original term applies.

n12 Treas. Reg. § 1.1001-3(e)(4)(i), (ii). This does not apply if the change occurs pursuant to certain "step-into-the-shoes" transactions, such as reorganizations, to which section 381 applies.

n13 Treas. Reg. § 1.1001-3(e)(4)(iii). Note that the circumstances in which a "change in payment expectations" has occurred is fairly narrow: the debtor's debt repayment capacity must change from "adequate" to "primarily speculative"-or vice versa-as a result of the modification.

n14 Treas. Reg. § 1.1001-3(e)(4)(iv). Substitution of fungible collateral (such as government securities) does not count for this purpose, nor does substitution of a similar commercially available credit enhancement contract.

n15 Treas. Reg. § 1.1001-3(e)(4)(v).

n16 Treas. Reg. § 1.1001-3(e)(5)(ii). This does not apply if the debt continues to be secured only by the original collateral (or its fungible equivalent) and the modification does not result in a change in payment

expectations.

n17 Treas. Reg. § 1.1001-3(e)(5)(i). For this purpose, however, a deterioration in the debtor's ability to pay is generally not taken into account.

n18 *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991).

n19 26 U.S.C. § 163(e)(5)(B).

n20 26 U.S.C. § 108(i).

n21 26 U.S.C. § 108(i)(2)(A)(i).

n22 26 U.S.C. § 163(e)(5)(F). This suspension of the AHYDO rules applies whether or not the exchange occurs by reason of a significant modification of the debt instrument, and also applies to successive exchanges. The suspension does not apply (i) to certain newly issued contingent debt instruments described in section 871(h)(4) (without regard to the grandfather exception of section 871(h)(4)(D)), or (ii) to newly issued debt instruments issued to a person related to the issuer.

N23 26 U.S.C. § 108(i)(5)(B)(iii).

n24 26 U.S.C. § 108(i)(3)(A)(ii).

n25 Treas. Reg. § 1.701-2(f), Example 1.

n26 26 U.S.C. § 163(e)(5)(A).

n27 26 U.S.C. § 108(i)(5)(B)(ii).

n28 26 U.S.C. § 108(i)(5)(D)(ii).

n29 Treas. Reg. § 1.1272-2(a), (b)(4).

n30 26 U.S.C. § 108(i)(5)(B)(iii).

n31 26 U.S.C. § 108(d)(6).

n32 26 U.S.C. § 108(i)(5)(C).

n33 26 U.S.C. § 752(a).

n34 26 U.S.C. § 752(b).

n35 26 U.S.C. § 731(a)(1).

n36 The allocation of COD income increases a partner's outside basis under section 705(a)(1)(A). The deemed distribution under section 752(b) is treated as an advance or drawing of money under Treas. Reg. § 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership taxable year. *Rev. Rul. 94-4, 1994-1 C.B. 196*. Since it is possible for the allocation of COD income under section 704 to be different from the allocation of debt under section 752, one should not assume that the allocation of COD income will always match the deemed distribution.

n37 26 U.S.C. § 108(i)(6) (second sentence).

n38 26 U.S.C. § 108(i)(6) (third sentence).

n39 26 U.S.C. § 108(i)(5)(d)(ii).

n40 The first sentence of section 108(i)(6) requires that the deferred COD income be allocated among the partners "in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such income were recognized at such time." This sentence, including the reference to section 704, suggests that the deferred COD income is not included in the partners' distributive shares at the time of discharge, and that the capital accounts are therefore not credited with that income.

n41 In Example 4, if the partnership elected deferral, its balance sheet would have shown assets of \$300 million, debt of \$300 million, and capital accounts with total negative balances of \$500 million.

RELATED LINKS: For discussion of discharge of indebtedness and IRC section 108 relief, see

■ Collier on Bankruptcy Taxation, ch. TX6.

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3 of 16 DOCUMENTS

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Sommer on Marrama v. Citizens Bank

2010 Emerging Issues 4930

Sommer on Marrama v. Citizens Bank

By Publisher's Editorial Staff

January 9, 2009

SUMMARY: This Emerging Issues Analysis contains links to documents related to Marrama v. Citizens Bank of Massachusetts.

ARTICLE: Choose an option below to search Marrama v. Citizens Bank of Massachusetts documents.

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4 of 16 DOCUMENTS

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Fifth Amendment Privilege in Bankruptcy Proceedings

2008 Emerging Issues 3181

Overview of Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings

By Publishers Editorial Staff 2008

December 18, 2008

SUMMARY: Invocation of the Fifth Amendment privilege against self-incrimination can be a challenge for bankruptcy practitioners but being prepared to handle such an issue can make the difference between a debtors discharge and his or her incarceration. This Emerging Issues Analysis examines the possible issues arising from use of the privilege, including forfeiture, immunity, adverse inferences and denial of discharge.

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ARTICLE: Introduction

Although the privilege against self-incrimination provided for in the Fifth Amendment of the United States Constitution is rarely invoked in bankruptcy cases, bankruptcy practitioners and trustees should recognize and be prepared to address the various issues that can arise when a witness claims the privilege. A witness can claim the privilege against self-incrimination whenever he or she has a reasonable belief that compelled testimony will result in disclosing information that may tend to incriminate the witness. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 Neb. L. Rev. 497 (1997). There are many instances during a bankruptcy case when the privilege can be claimed, from preparing and filing the bankruptcy schedules to trial in an adversary proceeding.

The issues arising in bankruptcy, and addressed in this commentary, include invocation of the Fifth Amendment privilege against self-incrimination, forfeiture of the privilege, use and derivative use immunity under 11 USCS § 344, and the consequences of relying on the privilege, such as adverse inferences and denial of discharge. Practitioners representing debtors and creditors would do well to be familiar with the privilege against self-incrimination in the bankruptcy context. Many decisions, such as whether to claim the privilege or seek an order compelling testimony withheld under the privilege, must be made early in the proceedings.

Failure to understand and properly use the Fifth Amendment privilege can result in adverse consequences for

debtors and creditors. Bankruptcy cases can be dismissed and debtors can face incarceration for contempt. The administration of the bankruptcy estate can be much harder when the privilege is claimed.

The Administrative Office of the U.S. Courts noted that 967,831 bankruptcy petitions were filed in the 12-month period from July 1, 2007, to June 30, 2008. During the previous 12-month period, only 751,056 petitions were filed. Bankruptcy Filings up 28.9 Percent, *Consumer Bankruptcy News* (Sept. 25, 2008). With the nearly 30 percent increase in the number of bankruptcy filings, the chance that a practitioner will face the use of the Fifth Amendment privilege in a bankruptcy case also increases. The prudent practitioner will pay heed and be responsive to the claim of privilege when it arises.

Discussion

Fifth Amendment Privilege against Self-Incrimination in General

The Fifth Amendment of the United States Constitution provides the privilege against self-incrimination:

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; **nor shall be compelled in any criminal case to be a witness against himself**, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation. USCS Const. Amend. 5 (emphasis added).

The Fifth Amendment privilege against self-incrimination is available in any proceeding, criminal, civil, administrative, judicial, investigatory or adjudicatory, to protect a witness from being compelled to give testimony that might tend to show that the witness committed a crime. The Fifth Amendment privilege protects a witness's compelled disclosure that is testimonial and incriminatory. All three elements, (1) compelled (2) testimonial (3) self-incrimination, must exist simultaneously before the Fifth Amendment privilege can be validly claimed. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 *Neb. L. Rev.* 497 (1997).

Claiming the Privilege against Self-Incrimination

Only an individual can claim the privilege against self-incrimination. Corporations, partnerships, and other legal persons have no privilege against self-incrimination, even if the testimony will incriminate an officer of the entity. 3-344 *Collier on Bankruptcy*-15th Edition Rev. P 344.03. The individual must claim the privilege in a timely way. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 *Neb. L. Rev.* 497 (1997). That is, when a witness is asked a question that would require a self-incriminating answer, the witness must claim the privilege. An attempt to claim the privilege at a later time, such as during a contempt hearing based upon the witness's failure to answer questions during the deposition, fails. *Id.*

Further, a witness may not claim a blanket Fifth Amendment privilege against self-incrimination as to all questions during a deposition or other compelled examination. 3-344 *Collier on Bankruptcy*-15th Edition Rev. P 344.03. The witness must claim the privilege each time the witness refuses to answer a particular question where the answer might

tend to be self-incriminating. Allan B. Diamond & Erin E. Jones, *Avoiding Litigation Pitfalls: An Introduction to the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 27-3 ABIJ 20 (Apr. 2008). This permits a court to determine if the privilege is justified in each instance. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 Neb. L. Rev. 497 (1997).

If the claim of Fifth Amendment privilege is challenged, the witness has the burden to present a reasonable basis for his or her belief that the witness's testimony could result in self-incrimination. *Id.* Of course, the ultimate burden of persuasion with respect to the validity of the claim of privilege rests with the party opposing the claim. However, the presumption exists that the claim of privilege is valid.

Forfeiting the Privilege against Self-Incrimination

The Fifth Amendment privilege can be forfeited or waived by a witness. The witness can voluntarily waive the Fifth Amendment privilege if granted immunity from criminal prosecution for doing so. *Id.* The privilege may also be waived when the witness voluntarily offers testimony on his or her own behalf or answers incriminating questions. Allan B. Diamond & Erin E. Jones, *Avoiding Litigation Pitfalls: An Introduction to the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 27-3 ABIJ 20 (April 2008). The privilege is forfeited if it is not invoked or if it is invoked inconsistently. *Id.* Waiver of the Fifth Amendment privilege is limited to the particular proceeding in which the waiver occurs. *Id.* There is no requirement that the waiver of the privilege be knowing and intelligent. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 Neb. L. Rev. 497 (1997). As with the claim of the privilege, a blanket waiver of the privilege is not permitted.

Fifth Amendment Privilege against Self-Incrimination in Bankruptcy

As noted, the Fifth Amendment privilege against self-incrimination is available in any criminal or civil proceeding. This includes bankruptcy proceedings. Whenever a witness is compelled to provide testimony that might be incriminating, the privilege against self-incrimination may be claimed. For example, a debtor can claim the Fifth Amendment privilege rather than answer a creditor's question during a deposition.

A claim of the Fifth Amendment privilege against self-incrimination by a witness in a bankruptcy proceeding can delay or prevent the administration of a bankruptcy estate. It can also lead to a variety of consequences from a stay of the bankruptcy case to its outright dismissal. Failure to claim the Fifth Amendment privilege may also have dire consequences for the debtor, such as a jail sentence. Therefore, a debtor's bankruptcy counsel should determine as early as possible whether and when the debtor will claim the privilege against self-incrimination. Once the claim is made, counsel for both the debtor and creditors should be vigilant that the debtor's use of the privilege is consistent. An inconsistent use of the privilege waives it.

The Fifth Amendment privilege against self-incrimination may be raised in a number of bankruptcy proceedings, such as a debtor's testimony at any examination or deposition. When the privilege is claimed during a *USCS Bankruptcy R 2004* examination, best practice dictates that the examining party should not end the examination just because the witness has indicated an intention to assert the privilege against self-incrimination as to any and all questions. To validly claim the Fifth Amendment privilege against self-incrimination, a witness must take the oath and listen to each of the examiner's questions. The witness must specifically invoke the privilege for each particular question because there is no right to a blanket claim of the privilege. 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.03. However, counsel for the witness can indicate to the examiner that the witness will continue to invoke the privilege as to all questions regarding a certain subject matter. Further, the privilege can be forfeited if it is not claimed or if it is claimed inconsistently.

11 USCS § 341 Meeting of Creditors

The Fifth Amendment privilege against self-incrimination may also be claimed during the *11 USCS § 341* meeting of creditors. The practitioner must be cautioned that at least one bankruptcy court has ruled that a debtor's testimony in a creditors' meeting conducted pursuant to *11 USCS § 341* was not a waiver of the privilege, which the debtor later claimed in response to certain interrogatories propounded in a fraudulent transfer adversary proceeding. In *Krasney v. Nam (In re Nam)*, 245 B.R. 216 (Bankr. E.D. Pa. 2000), the bankruptcy court found that the debtor had not testified to incriminating facts during the creditors' meeting.

A witness's waiver of the privilege against self-incrimination in one proceeding is not a waiver of the right in a separate proceeding. The bankruptcy court in *In re Nam* discussed at length the separate proceeding doctrine in the context of bankruptcy proceedings. Bankruptcy trustees and counsel should carefully consider whether the *11 USCS § 341* meeting and the adversary proceeding are two phases of one proceeding rather than separate proceedings for purposes of claiming or waiving the Fifth Amendment privilege.

Preparation and Filing of *11 USCS § 521(a)(1)* Documents

The Fifth Amendment privilege against self-incrimination may also be claimed in the preparation and filing of the *11 USCS § 521(a)(1)* schedule of assets and liabilities, the schedule of current income and current expenditures, and the statement of financial affairs. 4-521 Collier on Bankruptcy-15th Edition Rev. P 521.08. The debtor can claim the privilege and refuse to produce documents only if the act of authenticating the documents is incriminating. The debtor cannot be compelled to comply with *11 USCS § 521(a)(1)* if he or she claims the privilege where preparing in writing the list of creditors, the schedule of assets and liabilities, and the statement of financial affairs could result in information that might be incriminating.

Other Opportunities to Claim the Privilege

Naturally, a debtor can, if applicable, claim the Fifth Amendment privilege in response to questions posed in depositions upon oral examination, *USCS Bankruptcy R 7030*; in depositions upon written request, *USCS Bankruptcy R 7031*; and in interrogatories, *USCS Bankruptcy R 7033*. Further, the Fifth Amendment privilege is available to the debtor in response to requests for admission, *USCS Bankruptcy R 7036*.

Likewise, a debtor can claim the Fifth Amendment privilege against self-incrimination in response to a complaint either to determine the dischargeability of a debt or to deny the debtor's discharge; in the debtor's efforts to confirm a plan of reorganization; in the debtor's preparation and filing of periodic operating reports; in response to a motion to convert or dismiss the bankruptcy case; in response to a motion to appoint a trustee or an examiner or to remove the debtor as debtor in possession; and in objection to a creditor's proof of claim.

Conversely, a Chapter 7 trustee can claim the Fifth Amendment privilege against self-incrimination in response to a motion to remove the trustee.

Use and Derivative Use Immunity

A debtor can voluntarily waive the Fifth Amendment privilege if granted immunity for doing so. A grant of immunity is not automatic. In a bankruptcy proceeding, immunity is governed by *11 USCS § 344*, which provides that [i]mmunity for persons required to submit to examination, to testify, or to provide information in a case under this title [*11 USCS §§ 101 et seq.*] may be granted under part V of title 18 [*18 USCS §§ 6001 et seq.*].

The immunity provided to a bankruptcy witness under *11 USCS § 344* is use and derivative use immunity. 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.05 This immunity prohibits the use of the witness's compelled testimony in any way, directly or indirectly, which could result in criminal penalties. It does not provide immunity from criminal prosecution.

The United States Supreme Court, in *Kastigar v. United States*, 406 U.S. 441 (U.S. 1972) reh den 408 U.S. 931 (U.S. 1972), held that the immunity from use and derivative use provided by 18 USCS § 6002 is coextensive with the scope of the privilege against self-incrimination found in the Fifth Amendment. The Supreme Court also reaffirmed its decisions upholding the constitutionality of immunity statutes.

In *Doe v. United States*, 487 U.S. 201 (U.S. 1988), the Supreme Court noted that the prohibition from use and derivative use assumes that the debtor's initially compelled communication was testimonial.

As a result of use and derivative use immunity under the federal witness immunity statute, 18 USCS § 6002, the witness may not rely on the Fifth Amendment privilege against self incrimination. The witness must testify regarding the withheld matter because the grant of immunity removes the dangers against which the Fifth Amendment privilege protects.

Procedure for Grant of Immunity

The four-step procedure to be followed for a request of immunity is set out in 18 USCS § 6003. 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.05. First, a debtor must claim the Fifth Amendment privilege against self-incrimination in a bankruptcy proceeding. The debtor may remain silent unless the bankruptcy court determines that the claim is invalid. Second, if the claim of privilege is valid and a party in interest wants the withheld information produced in the bankruptcy case, someone must contact the United States Attorney for the district in which the bankruptcy case is pending and request an application for an order of immunity. *In re Minton Group, Inc.*, 43 B.R. 705 (Bankr. S.D.N.Y. 1984); 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.05.

Nothing in 18 USCS § 6003 provides a format for the request to the United States Attorney. Further, 18 USCS § 6003 does not state who may make the request. Given the potential adverse consequences of proceeding without immunity, the debtor's counsel should consider making the request on the debtor's behalf rather than hoping that someone else does.

Third, the United States Attorney has discretion in making an application to the district court for an order under 18 USCS § 6003(a) requiring a witness to give testimony or provide other information that was withheld under a claim of the Fifth Amendment privilege against self-incrimination. 18 USCS § 6003(b) provides that the United States Attorney may apply for an order of immunity if he or she determines that (1) the testimony or other information from such individual may be necessary to the public interest; and (2) such individual has refused or is likely to refuse to testify or provide other information on the basis of his privilege against self-incrimination. There is no automatic immunity. 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.04. There is no guarantee that the United States Attorney will file an application for an order of immunity. *In re Minton Group, Inc.*, 43 B.R. 705 (Bankr. S.D.N.Y. 1984)

Fourth, only the United States district court can grant an order of immunity. As noted in *In re Sealed Case*, 253 U.S. App. D.C. 8 (D.C. Cir. 1986), district courts have no discretion to deny a request by a United States Attorney for an order under 18 USCS § 6003(a) compelling testimony as long as the request complies with the statute's jurisdictional and procedural requirements. The bankruptcy court has no power under 18 USCS § 6003 to issue such an order. However, the bankruptcy judge communicates the district court's order of immunity, if granted, to the debtor. Under the order of immunity, the debtor must testify regarding the withheld information upon penalty of contempt. *In re Minton Group, Inc.*, 43 B.R. 705 (Bankr. S.D.N.Y. 1984)

Pursuant to 18 USCS § 6002, the debtor's testimony and any information directly or indirectly derived from such testimony may only be used against the debtor in a prosecution for perjury, giving a false statement, or otherwise failing to comply with the order of immunity. The debtor, however, is protected from 'taint' in future criminal proceedings. 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.05. The testimony can be used in the bankruptcy case and may aid the debtor in avoiding the dismissal of his or her case and other adverse consequences.

If the debtor is granted immunity but still refuses to testify, the bankruptcy court has discretion to issue a civil contempt order, to incarcerate the debtor, or deny the debtor discharge of his or her debts. 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.05. If no order of immunity is granted, the debtor may still claim the Fifth Amendment privilege against self-incrimination in the bankruptcy proceeding. Allan B. Diamond & Erin E. Jones, *Avoiding Litigation Pitfalls: An Introduction to the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 27-3 ABIJ 20 (April 2008).

Consequence of Adverse Inferences

The Fifth Amendment privilege against self-incrimination neither bars nor mandates the drawing of an adverse inference in any bankruptcy case. 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.04. The bankruptcy court may draw an adverse inference regarding certain facts from a witness's refusal to answer a question after claiming the privilege. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 Neb. L. Rev. 497 (1997). That is, the bankruptcy court could decide that the testimony the witness would have given, except for the privilege, was against the witness's interests in the bankruptcy case. An adverse inference is not an admission of fact. *Id.* The drawing of adverse inferences is dependent upon the circumstances of the case. *Id.*

The bankruptcy court's discretion to draw an adverse inference is not unlimited. Allan B. Diamond & Erin E. Jones, *Avoiding Litigation Pitfalls: An Introduction to the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 27-3 ABIJ 20 (Apr. 2008). The court should determine whether the adverse inference is trustworthy and whether it will advance the search for the truth. To assess the adverse inference's trustworthiness, the bankruptcy court may consider whether it is corroborated by independent and admissible evidence. *Id.* For example, a debtor's books and records could sufficiently support drawing an adverse inference from the debtor's silence regarding the debtor's transfer of an asset to a nonparty.

The United States Court of Appeals for the Second Circuit, in *LiButti v. United States*, 107 F.3d 110, 123-125 (2d Cir. N.Y. 1997), set out the following four, nonexclusive factors to guide a court in determining whether an adverse inference is appropriate under the circumstances when a witness, who is not a party to the proceeding, invokes the Fifth Amendment privilege against self-incrimination:

- (1) the nature of the relationship between the party and the nonparty;
- (2) the degree to which the party controls the nonparty;
- (3) the compatibility of interests of the party and nonparty in the outcome of the litigation; and
- (4) the role of the nonparty witness in the litigation. *LiButti* at 124-125.

A party in the bankruptcy case may request that the bankruptcy court draw an adverse inference from a witness's silence, but the inference alone will not meet the party's burden of proof in the case. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 Neb. L. Rev. 497 (1997). While the bankruptcy court can give significant weight to an adverse inference in ruling on a case, independent evidence is needed before the court will draw inferences against a party who has claimed the Fifth Amendment privilege against self-incrimination. Gaumer & Nail, 76 Neb. L. Rev. 497

An inference against a debtor is permissible as long as he or she remains silent. In *LiButti v. United States*, 178 F.3d 114, 120 (2d Cir. N.Y. 1999), the Second Circuit noted that silence when one would be expected to speak is a powerful persuader. A practitioner representing a witness claiming the Fifth Amendment privilege must balance the consequences of advising the witness to claim or to forfeit the privilege. Silence that is not immunized may not be golden in the long run.

Use of an Adverse Inference

A debtor may be denied a discharge under 11 USCS § 727 if he or she conceals property or records; knowingly and fraudulently gives a false oath or account; fails to explain a loss of assets; or refuses to obey a lawful order of the court. An adverse inference drawn against a debtor in a bankruptcy case after the debtor has claimed the Fifth Amendment privilege against self-incrimination can be used to deny the discharge.

For instance, if a debtor, claiming the privilege, fails to produce documents that were shown to have been in his or her possession, a negative inference can arise that the documents would have been damaging to the debtor. See *Leonard v. Coolidge (In re Nat'l Audit Def. Network)*, 367 B.R. 207 (Bankr. D. Nev. 2007). The bankruptcy court can use that inference to deny the debtor's discharge on the ground that the debtor is concealing records. If the bankruptcy court has ordered that the documents be produced and the debtor fails to comply, discharge can also be denied under 11 USCS § 727.

Other Consequences of Claiming Privilege

A debtor claiming the Fifth Amendment privilege against self-incrimination faces more than adverse inferences if he or she remains silent. The bankruptcy case could be dismissed for cause under 11 USCS § 707(a). The bankruptcy court could also deny discharge to the debtor under 11 USCS § 727(a)(5) on the ground of failure to explain satisfactorily a loss of assets or for transferring, removing, destroying, mutilating, or concealing property of the debtor or of the estate, or permitting such property to be transferred, removed, destroyed, mutilated, or concealed. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 Neb. L. Rev. 497 (1997).

Further, a bankruptcy court could determine that a particular creditor's claim against the debtor is nondischargeable. *Id.* Confirmation of the debtor's plan of reorganization in Chapters 11, 12, and 13 could be denied. *Id.* The court could strike or bar evidence presented by the debtor. *Id.* The debtor could be held in contempt for refusing to testify after being ordered to do so by the bankruptcy court. *Id.*

Stay of Bankruptcy Proceedings

Discovery in the bankruptcy proceedings can be stayed as the parties deal with issues related to a witness's claim of the Fifth Amendment privilege against self-incrimination. Craig Peyton Gaumer & Charles L. Nail, Jr., *Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 76 Neb. L. Rev. 497 (1997). As noted in *White v. Mapco Gas Products, Inc.*, 116 F.R.D. 498, 501-502 (E.D. Ark. 1987), a court deciding whether to order a stay of discovery must weigh the competing interests of the party requesting the stay and the party who wants to proceed. In balancing the competing interests, the court listed five issues that should be considered:

(1) the interest of the plaintiff in continuing expeditiously with the litigation, and the prejudice to the plaintiff due to any delay caused by the stay;

(2) the burden the stay would impose on the defendants;

(3) the efficient use of judicial resources and convenience to the court;

(4) the interests of other persons who were not parties to the litigation; and

(5) the interest of the public in both the pending criminal and civil litigation. *Id.* at 502.

In *In re Ahead By A Length, Inc.*, 78 B.R. 708 (Bankr. S.D.N.Y. 1987), the federal government, which was prosecuting two defendants in a criminal case related to an adversary proceeding brought by a bankruptcy trustee to avoid fraudulent transfers of a debtor's property, requested, among other relief, a protective order staying discovery in the adversary proceeding while the criminal case was pending. After considering the five factors set out in *White v. Mapco Gas Products, Inc.*, 116 F.R.D. 498, 501-502 (E.D. Ark. 1987), the United States Bankruptcy Court for the Southern District of New York stayed for six months not only the discovery but the adversary proceeding.

The need for the stay was initiated by a witness's claim of the Fifth Amendment privilege against self-incrimination in a deposition taken by the defendants in the adversary proceeding. A stay of discovery or an adversary proceeding is just another unforeseen development that can result from the use of the privilege in the bankruptcy context. Practitioners should take heed.

Conclusion

As bankruptcy filings increase, so do the chances that a bankruptcy practitioner will face a claim of the Fifth Amendment privilege against self-incrimination. Bankruptcy proceedings can be very complex without the addition of issues related to the Fifth Amendment privilege. However, by understanding 1) when the privilege can be claimed, waived, or forfeited, 2) what use immunity and derivative use immunity are, and 3) the consequences of reliance on the privilege, bankruptcy practitioners are better prepared to handle those issues in bankruptcy cases.

Further, the bankruptcy practitioner should be prepared to recognize the times during a bankruptcy case when a client needs to be counseled on claiming the privilege, for instance, to prevent its forfeiture. When the privilege is claimed, the practitioner must be able to advise the client on the possibility of an order of immunity and on the consequences, such as an adverse inference or the dismissal of the case.

Finally, being prepared to address the claim of privilege allows the practitioner to protect the client's interests in the bankruptcy proceedings. Whether the client is a party or a nonparty to the proceedings, the practitioner's advice and subsequent decisions regarding the claim of privilege can prevent consequences that could jeopardize the client.

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RELATED LINKS: For a discussion of the Fifth Amendment Privilege in Bankruptcy, see

- 2-35 Collier Bankruptcy Practice Guide P 35.05.;
- 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.04;
- 3-344 Collier on Bankruptcy-15th Edition Rev. P 344.05;
- 4-521 Collier on Bankruptcy-15th Edition Rev. P 521.08;
- 10-7056 Collier on Bankruptcy-15th Edition Rev. P 7056.02.

Allan B. Diamond & Erin E. Jones, Avoiding Litigation Pitfalls: An Introduction to the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings,

- 27-3 ABIJ 20 (Apr. 2008).

Craig Peyton Gaumer & Charles L. Nail, Jr., Truth or Consequences: The Dilemma of Asserting the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings,

- 76 Neb. L. Rev. 497 (1997).

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5 of 16 DOCUMENTS

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Hedge Funds, Private Equity, and Corporate Restructuring

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The Effect of Hedge Fund and Private Equity Lending on Corporate Restructuring

By Publishers Editorial Staff 2008

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SUMMARY: During the housing market boom, hedge funds and private equity groups capitalized on opportunities to invest in distressed companies, causing bankruptcy filings to drop to an all-time low. However, the housing bubble has burst, bringing with it a credit crunch, and cautious investors. This article examines the current financial environment and analyzes the likely effect it will have on Chapter 11 filings.

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ARTICLE: Introduction

Times were good for the U.S. economy in 2006; corporate profits grew, credit was plentiful, and consumer spending was strong. Marie Beaudette, Chapter 11 Filings Seen Rising, *The Wall Street Journal* (Jan. 4, 2007). A strong economy also meant a slow year for corporate restructuring, as Chapter 11 filings dropped to their lowest level in more than a decade. *Id.* This drop in bankruptcy filings was due in part to the ability of distressed companies to easily obtain financing from non-traditional sources such as private equity groups (private investment funds that are exempt from the requirement to register with the Securities Exchange Commission under 15 USCS § 80a-3(c)(1), (7); 1-7 Investment Advisers: Law & Compliance § 7.10) and hedge funds (lightly regulated, privately held investment vehicles typically open only to select wealthy investors, Peter M. Gilhuly et al, Living on the [H]edge: New Ethical Challenges, 2007 *National Conference of Bankruptcy Judges* (2007)), who would lend money generally at a higher interest rate and subject to tighter conditions. Aleksandrs Rozens, Fasten Your Seatbelts: Harvey Miller, the Godfather of Bankruptcy, Says It's Going to be a Bumpy Ride. Why This Wave of Restructurings will be Different, *Investment Dealers Digest* (Mar. 3, 2008).

It is undeniable that in recent years hedge funds and private equity groups have had a tremendous impact on the corporate restructuring process. However, with the collapse of the subprime mortgage market and the subsequent credit crunch, a loss of funding has occurred as investors shy away from funds relying on risky instruments like collateralized debt obligations. As the economy worsens and more companies suffer from the effects of the housing market

breakdown, it seems likely that the inability of hedge funds and private equity groups to finance distressed companies will lead to an increase in Chapter 11 bankruptcy filings.

This article's review of the effect of hedge fund lending on corporate restructuring is divided into three substantive sections. First, it will review how hedge funds and private equity groups have been able to prevent companies from having to seek Chapter 11 protection by various funding strategies, as well as the impact that investment in distressed companies has had on the bankruptcy process. Second, it will discuss how the subprime mortgage crisis has negatively impacted the liquidity and ability of hedge funds and private equity groups to offer financing to distressed companies by highlighting recent events, including the collapse of high-profile hedge funds and private equity groups, and discussing recent proposals for increased federal regulation. Finally, this article will examine whether this confluence of events will lead to an increase in Chapter 11 filings, concluding that a new wave of corporate restructurings is likely.

Discussion

1. Hedge Funds and Private Equity Groups Contributed to a Lull in Corporate Restructuring

During the private equity boom, lenders anxious to get into the business were willing to excise covenants that provided for some control and oversight over their borrowers' operations. Aleksandrs Rozens, *Fasten Your Seatbelts: Harvey Miller, the Godfather of Bankruptcy, Says It's Going to be a Bumpy Ride. Why This Wave of Restructurings will be Different*, *Investment Dealers Digest* (Mar. 3, 2008). If a distressed company began to suffer a liquidity crisis, a hedge fund or other lender would offer refinancing to prevent bankruptcy and the accompanying exposure of the company's financial troubles. *Id.* Private equity firms also got into the act, seeking to finance ailing businesses, help restore them to profitability, thus realizing a return on their investment. Jonathan Stempel, *The Owner of Chrysler gets a Harsh Reassessment*, *The International Herald Tribune* (Feb. 26, 2008). This period also saw tremendous growth in the area of distressed debt investing, in which so-called vulture funds would buy bonds no other investor would touch at a steep discount in hopes of realizing a profit when the distressed firms emerged from Chapter 11. *The Vultures Take Wing; Investing in Distress*, *The Economist* (Mar. 31, 2007).

One of the most notable private equity bailouts of ailing companies has been the purchase and subsequent privatization of Chrysler by Cerberus Capital Management, which had already become famous for earning big returns on investments in troubled companies like Vanguard Car Rental, Netherlands-based AerCap Holdings, and Montreal-based Teleglobe International. Jonathan Stempel, *The Owner of Chrysler gets a Harsh Reassessment*, *The International Herald Tribune* (Feb. 26, 2008); Andrew Ross Sorkin, *A Savior for Chrysler? Read on*, *The New York Times* (Feb. 19, 2008). Before Cerberus appeared, Chrysler had been in a failing nine-year partnership with German automaker Daimler-Benz. Joann Muller, *Chrysler's Last Stand*, *Forbes Asia* (Dec. 10, 2007). Cerberus has made headlines with the pace of the changes that it implemented: billion-dollar decisions that once took months to make occur in minutes, with engineers being told to speed up quality improvements. *Id.* With Chrysler, Cerberus hoped to realize the same kinds of returns as it did with AerCap, where it invested \$370 million and realized a \$1.5 billion return when it took the company public again.

Other private equity transactions have helped distressed companies avert financial trouble. They include an infusion of \$ 7 billion into Washington Mutual by private equity firm TPG and other investors in order to boost the bank's capital at a time when it has been hard-hit with rising delinquencies and defaults in subprime mortgages, of which it was one of the largest originators in 2006, Donna Block, *TPG to Lead WaMu's \$7B Recap*, *Daily Deal/The Deal* (Apr. 9, 2008); a \$60 million investment by private equity firm Sun Capital Partners into the subprime lending subsidiary of investment bank Friedman, Billings, Ramsey Group, *FBR Moves to Limit Subprime Exposure by Selling Majority Stake in First NLC*, *The Associated Press* (Jul. 26, 2007); a \$1.1 billion deal between H&R Block and private equity firm WL Ross & Company for the Option One mortgage servicing company, Lou Whiteman and Luisa Beltran, *Ross Buys H&R Block Subprime Unit*, *Daily Deal/The Deal* (Mar. 18, 2008); and a deal by private equity group Warburg Pincus to purchase

any preferred convertible stock not publicly purchased at a \$750 million offering by bond insurer MBIA and an option to purchase up to \$300 million in additional shares, Peter Moreira, MBIA Races to Raise Cash, *Daily Deal/The Deal* (Feb. 8, 2008).

Hedge funds, which are generally exempt from regulation with the SEC and from federal disclosure requirements, have also become significant investors in distressed companies. Peter M. Gilhuly et al, Living on the [H]edge: New Ethical Challenges, *2007 National Conference of Bankruptcy Judges* (2007). Like private equity firms, hedge funds approached distressed companies and offered financing when no other lender would in order to help stave off bankruptcy. Aleksandrs Rozens, Fasten Your Seatbelts: Harvey Miller, the Godfather of Bankruptcy, Says It's Going to be a Bumpy Ride. Why This Wave of Restructurings will be Different, *Investment Dealers Digest* (Mar. 3, 2008). The extraordinary buildup of liquidity in the economy over the last several years helped to prevent defaults from happening and to keep companies that might otherwise fail out of bankruptcy. Liz Peek, Rising Default Prospects Yield Opportunities, *The New York Sun* (Jan. 10, 2008). In many cases, it was not that companies were performing better, but rather the easy availability of funding from hedge funds, which pushed other potential investors out of the market that contributed to the lull in corporate restructurings. *Id.*

In addition to contributing funding to keep companies out of bankruptcy, hedge funds have also participated in the bankruptcy process itself, becoming pervasive and active participants in corporate bankruptcy proceedings. Eric B. Fisher and Andrew L. Buck, Hedge Funds and the Changing Face of Corporate Bankruptcy Practice, *American Bankruptcy Institute Journal* (Jan. 2007). Hedge funds often acquired multiple different stakes in a bankrupt debtor, such as publicly traded bonds and secured bank debt, purchased at a discount prior to the bankruptcy filing, unsecured trade claims acquired at a discount after the bankruptcy filing, and short positions in the debtor's stock. *Id.*

Such investors added new complexity to the Chapter 11 process. Unlike traditional vulture investors, who focused on a particular segment of a debtor's capital structure, hedge funds often acquired holdings at multiple levels, presenting strategic alternatives that sometimes put them at odds with the interests of more conventional creditors. *Id.*

Unlike banks and private equity groups, who typically got involved early in the bankruptcy process in order to obtain long-term benefits through restructuring, many hedge funds required short-term strategies in order to maintain liquidity, making them more likely to seek short-term returns that were not necessarily aimed at a successful reorganization, such as forcing a sale of the debtor's assets to realize quick gains on its acquired debt. *Id.* Unlike traditional creditors, hedge funds were not necessarily interested in transacting future business with the debtor and thus could be unconcerned about returning the debtor to profitability. *Id.* Finally, hedge funds with short positions on stock might not be interested in maximizing the value of the bankruptcy estate for all constituencies, but rather in maximizing returns only on their particular holdings, even if such actions were adverse to the interests of equity holders. *Id.* Hedge funds in such situations could actually benefit from poor returns to equity holders. *Id.* These positions often placed hedge funds in conflict with the Bankruptcy Code's traditional emphasis on the rehabilitation and reorganization of debtors as a going concern. *Id.*

Hedge funds may also become involved in bankruptcy reorganizations to obtain control over distressed companies. H. Slayton Dabney and Richelle Eisendrath, When Hedge Funds Compete, *American Bankruptcy Institute Journal* (Jan. 2008). This may arise out of pre-petition trading strategies that turn on control of the debtor or through post-petition efforts to provide exit financing and new equity investments as hedge funds with limited pre-petition involvement and the support of debtor management struggle for control with hedge funds that have purchased significant pre-petition interests. *Id.*

One highly publicized example of how hedge funds have impacted the reorganization process involved auto parts manufacturer Delphi, which had filed a reorganization proceeding in 2005. *Id.* At least three groups, each led by hedge funds, made competing investment proposals for the troubled auto parts supplier. *Id.* In December 2006, Delphi agreed to an equity commitment and purchase agreement and a pre-plan framework providing that the plan investors would agree to buy about \$220 million in common stock and \$12 billion in preferred stock as part of a rights offering to

existing shareholders. In return, the parties would agree to support plan terms related to distributions to creditors and shareholders, treatment of claims, pension funding, and the control of the reorganized corporation. *Id.* One of the leading proponents of this agreement was a hedge fund affiliated with private equity group Cerberus. *Id.*

Another hedge fund, the second largest beneficial owner of Delphi, objected to the approval of the original framework agreement on behalf of itself and related entities. *Id.* The fund also submitted a December 2006 proposal to Delphi offering to buy up to \$4.7 billion of the reorganized Delphi's stock subject to terms identical to the original Cerberus proposal. *Id.*

Delphi sought an extension of its statutory right to develop its own reorganization plan without interference from creditors for a limited period of time, a provision designed to allow companies to retain control over the restructuring process. Patrick Fitzgerald, Potential Investor Objects to Extending Delphi's Control over its Bankruptcy Reorganization, *The Associated Press* (Jan. 5, 2007).

The second hedge fund accused Delphi of trying to limit plan development to the original proposal. *Id.* Ultimately, Delphi elected to accept yet a third proposal offered by two other hedge funds, one of which was affiliated with the original proposal. H. Slayton Dabney and Richelle Eisendrath, When Hedge Funds Compete, *American Bankruptcy Institute Journal* (Jan. 2008).

It is clear that in recent years, market conditions were such that private equity groups and hedge funds were able to provide financing to distressed companies both inside and outside of the bankruptcy process, and that as a result of the ready supply of liquidity, the number of corporate reorganizations remained low. However, the ability of such firms to continue to provide financing in the same way as they had in prior years has grown increasingly unlikely as the economic turmoil has accelerated.

2. The Subprime Mortgage Crisis Dramatically Affected the Availability of Financing for Distressed Companies from Hedge Funds and Private Equity by Freezing Up the Availability of Credit

During rosier economic times, hedge funds often relied on leverage, the practice of borrowing money to supplement funds provided by investors, to generate above-market returns. Mila Getmansky et al, Do Hedge Funds Increase Systemic Risk? *Economic Review Federal Reserve Bank of Atlanta* (4th Qtr. 2006). Extensive leveraging expands both the opportunity for profit and the risk of loss, so when changes in market prices reduce the value of collateral, the fund's credit evaporates and the subsequent forced liquidation of large positions over short periods of time can wipe out substantial amounts of paper wealth. *Id.* The less liquid and the more extensively leveraged the fund's portfolio is, the more vulnerable its capital is to a decline in market conditions. *Id.*

When the subprime mortgage market collapsed, the loss of value of mortgage-backed securities and collateralized debt obligations devastated many highly-leveraged funds who had invested extensively in securities backed by subprime mortgages. Maria Chan, Subprime Fallout May Stretch to \$200USb, *South China Morning Post* (Nov. 6, 2007). The subprime market collapse led to a collapse in leverage and the resulting death of a number of hedge funds with exposure to subprime loans. *Id.* The resulting tightening of credit standards further exacerbated the problem. *Id.* Some notable hedge funds that found themselves collapsing as a result of the subprime mortgage fallout include:

- The \$1 billion Basis Capital Yield Alpha Fund, managed by Australian manager Basis Capital Funds Management, had over \$50 million in US assets and unsuccessfully sought bankruptcy protection. Patrick Fitzgerald, Federal Judge Denies Bankruptcy Protection for Basis Fund, *The Associated Press* (Jan. 16, 2008); Ross Kelly, Loans Scare Investors, *The Daily Telegraph (Australia)* (Jul. 23, 2007).
- Britain's Cheyne Capital Management was forced to sell one of its structured investment vehicles (SIV's), which sold commercial paper and bought longer-dated assets like mortgage-backed securities and collateralized debt obligations, to

investment firm Goldman Sachs as SIV holdings shrank by over \$100 billion in 2007 because investors became exposed to the subprime market collapse, drying up credit markets and causing a loss of liquidity as asset-backed securities lost value. Bill McIntosh, Cheyne SIV Agrees to Goldman Sale, *Daily News* (Dec. 24, 2007).

■ Swiss bank UBS suffered over \$37 billion in subprime mortgage-related writedowns due to its rush to set up its Dillon Read Capital Management hedge fund in 2005. Cheap funding and an ambitious growth strategy that emphasized the importance of making profits on short-term investments made the situation worse. Much of UBS' subprime writedowns also stemmed from heavy investment in collateralized debt obligations that lost their value as homeowners whose mortgages formed the basis of the securities defaulted on their loans. Christine Seib, UBS Reveals the Failures that led to its \$37bn Sub-Prime Writedowns, *The Times* (London) (Apr. 22, 2008); Martin Wolf, Why Today's Hedge Fund Industry May Not Survive, *Financial Times* (London, England) (Mar. 19, 2008).

One of the most dramatic illustrations of the impact that the subprime mortgage crisis has had involves the sudden death of investment bank Bear Stearns. Before its fall, Bear Stearns was the fifth-largest investment bank in New York, with renowned trading house, brokerage, advisory, and asset management businesses. David Victor-Smith, What Bear Stearns' Fall Could Mean for Economy, Students, *University Wire* (Mar. 27, 2008). Bear Stearns maintained two hedge funds: the High-Grade Structured Credit Fund and the High-Grade Structured Credit Enhanced Leveraged Fund, which invested in complex debt instruments like collateralized debt obligations and borrowed extra money to do so. *Id.*

As the housing market collapsed, the Bear Stearns funds lost all of their value and collapsed by mid-2007. *Id.* On March 14, Bear Stearns' stock lost more than 47 percent of its value, ending up with a loss of \$5.7 billion in value in a matter of minutes. *Id.* At the same time, the bank's liquidity, which had consisted of over \$21 billion in cash at the beginning of March after pressure from the SEC convinced the bank to increase its cash resources, plummeted, ending at only \$2 billion by mid March, including a loss of over \$10 billion in one day, and prompting calls for an emergency bailout. More Than \$10bn of Bear's Liquidity Evaporated in One Day, Congress Hears, *Guardian Unlimited* (Apr. 3, 2008).

In order to prevent the collapse of the bank itself, rival JP Morgan agreed to buy Bear Stearns under the condition that the Federal Reserve Bank of New York guaranteed approximately \$30 billion of the bank's riskiest assets. *Id.* After Bear Stearns' stock had reached a high price of \$170 per share in December 2007, JP Morgan agreed to a final sale price of only \$10 per share. David Victor-Smith, What Bear Stearns' Fall Could Mean for Economy, Students, *University Wire* (Mar. 27, 2008).

The collapse of Bear Stearns was so sudden and dramatic that Federal Reserve and SEC officials felt that they were forced to put up public funds to guarantee the JP Morgan purchase in order to prevent an abrupt and disorderly bankruptcy that would have threatened the nation's financial stability, according to testimony given before Congress. More Than \$10bn of Bear's Liquidity Evaporated in One Day, Congress Hears, *Guardian Unlimited* (Apr. 3, 2008). Federal Reserve officials testified that increased risk-taking, the invention of elaborate derivatives such as subprime-mortgage-backed collateralized debt obligations, and a deterioration in underwriting standards contributed to the collapse. *Id.*

Dean Foster at the Wharton School of the University of Pennsylvania and Peyton Young of Oxford University and the Brookings Institution explain how the inherent characteristics of hedge fund business, combined with the sudden collapse of the subprime mortgage industry, so drastically affected financial institutions like Bear Stearns and UBS. Martin Wolf, Why Today's Hedge Fund Industry May Not Survive, *Financial Times* (London, England) (Mar. 19, 2008). The investment strategies of highly-leveraged hedge funds led to a high probability of modest gains and a low probability of massive losses. *Id.* Funds that borrow massively in short-term money markets to buy higher-yielding paper and correctly estimate the risk can, with sufficient leverage make profits for years; but such a fund is also very likely to be wiped out, at some point, if market conditions deteriorate, as they did when the subprime mortgage industry collapsed. *Id.*

The financial troubles caused by falling home prices and the resulting losses on mortgage-backed securities were exacerbated by poor oversight and lax practices at Fannie Mae and Freddie Mac, the government sponsored housing finance giants now under government control. Committee Holds Hearing on Causes and Effects of Lehman Brothers Bankruptcy, States News Service (Oct. 8, 2008). Accused of playing a game of high-stakes musical chairs in Congressional testimony, firms like Lehman Brothers found themselves without solid financial footing when housing prices stopped rising and the foreclosures started. *Id.*

The packaging of investments like subprime mortgages into complex derivatives concentrated large amounts of risk into the hands of a few derivatives dealers, and created a situation where trouble for one could quickly impact the rest, wrote Warren Buffett to Berkshire Hathaway shareholders in 2003. Peter S. Goodman, The Reckoning Taking Hard New Look at a Greenspan Legacy, The New York Times (Oct. 9, 2008). Although prevailing wisdom considered the derivatives market to be a stabilizing factor due to the sharing of risk among multiple parties, that perceived stability turned infectious when the housing crisis grew and mortgages went bad. *Id.* Derivatives actually worsened the financial downturn because firms like Bear Stearns and Lehman Brothers, as well as their customers, were so closely linked to each other by their investments in derivatives. *Id.*

Collapses like that of Lehman Brothers have had a further effect on highly leveraged hedge funds. Their liberal use of borrowed money makes them reliant on entities like Lehman Brothers in order to obtain the short-term loans needed to cover margin calls. The Next Moment of Truth, Financial Armageddon (Oct. 6, 2008). Hedge funds have also seen record withdrawals of money, as investors flee to less risky vehicles. *Id.* In addition, the sudden loss of access to cash caused by collapses of prime brokers like Lehman Brothers, whose bankruptcy has effectively frozen billions of dollars in hedge fund trades, recent bans on short selling (a common hedge fund tactic of profiting from stocks that decline), volatile markets, and the shortage of credit caused by loss of liquidity resulting from the subprime mortgage crisis have forced additional fund liquidations and are likely to result in the collapse of many small and mid-sized hedge funds. Kate Walsh, Bonfire of the Hedgies, The Sunday Times (Oct. 5, 2008). Lehman Brothers' bankruptcy has embroiled it in a dispute with PricewaterhouseCoopers, its bankruptcy administrator, over whether the investment bank improperly transferred billions of dollars to a subsidiary shortly before its bankruptcy filing. Landon Thomas, Funds Try to Lose Ties to Lehman, The New York Times (Oct. 2, 2008). The resulting inability of hedge funds to get their money out of Lehman Brothers has turned into life or death struggle for some highly exposed funds. *Id.* The funds, who argue that Lehman Brothers should have segregated their money instead of making it part of routine cash transfers, are caught between Lehman Brothers, prospective buyer Barclay's Capital, and the United States Bankruptcy Court. Gerelyn Terzo, Hedgies To Lehman: Not So Fast, Investment Dealers' Digest (Sep. 29, 2008). If the hedge funds cannot recover their money, they will have to borrow money to cover their exposure, which is more difficult than ever. *Id.*

Finally, hedge funds themselves are vulnerable to sudden declines in the value of their assets because they themselves traded in repackaged collateral fund obligations, which are similar to the collateralized debt obligations that have brought down so many banks. Grace Ng, Hedge Funds: Next in Line? The Straits Times (Oct. 4, 2008). As ratings agencies downgrade the value of these assets, hedge funds may find themselves forced to write them down, further contributing to a departure of funds from the industry triggering fears of a collapse. *Id.* Indeed, the hedge fund industry, once known for its reputation for large gains, has suffered losses of 10 percent in the past year, leaving managers facing a potential run on cash as risk-adverse investors seek safety and placing underperforming hedge funds in danger of collapse. Hedge Funds at Risk of Mass Withdrawal, The Irish Times (Oct. 3, 2008).

3. The Availability of Easy Funding Before the Subprime Mortgage Collapse Delayed the Onset of a Wave of Corporate Restructuring Through Bankruptcy, But the Collapse and Its Impact on Credit Markets Has Set the Stage for a New Wave of Reorganizations

In response to the fallout from the subprime mortgage crisis, the United States Treasury Department has proposed a blueprint for regulating private equity firms and hedge funds traditionally accustomed to light regulation. Joshua Boak, Proposal Targets Private' Funds: Many Would Move Overseas, Some Fear, *Chicago Tribune* (Apr. 1, 2008). Under this long-term plan, the Federal Reserve would serve as a forensic accountant, entitled to review the detailed financial

information of firms like Bear Stearns, whose investments could have a significant impact on the economy. *Id.* The blueprint proposes allowing the Federal Reserve to allow previously lightly regulated hedge funds and private equity groups to disclose information about their financial positions and would empower the Fed to force firms to correct problems with their financial stability. *Id.* This is a clear signal that times are changing and that regardless of the outcome, there will be an impact on companies that previously would have been able to avoid bankruptcy by obtaining easy financing from a hedge fund or a private equity group.

The subprime mortgage collapse and its broader impact on the economy has led to an increase in business bankruptcy filings, which rose 44 percent to 28,322 in 2007, up from 19,965 in 2006. Bankruptcy Filings up 38 Percent Last Year Amid Weak Economy, *The Associated Press* (Apr. 16, 2008). Among the businesses that have sought or may seek bankruptcy protection are The Sharper Image, Lillian Vernon, Levitz Furniture, Wickes Furniture, and Linens and Things. Michael Barbaro, Retailing Chains Caught in a Wave of Bankruptcies, *The New York Times* (Apr. 15, 2008).

The combination of a slowing economy, a credit crunch, and a lack of liquidity resulting from the subprime mortgage collapse, combined with high energy costs and decreased consumer spending is setting the stage for significant increase in corporate restructuring filings. A Wave of Corporate Restructuring is About to Hit; Savvy Turnaround Investors Reposition Their Portfolios, *Business Wire* (Aug. 20, 2007). As banks try to preserve cash supplies, short-term financing has become increasingly expensive, which makes it difficult for businesses to carry on their operations.

The collapse of hedge funds and private equity firms precipitated by the subprime mortgage crisis has, despite interest rate cuts by the Federal Reserve, significantly reduced available liquidity in the market. The era of easy money is ending. Ingrid Bagby and Sheryl Saleeby, Bankruptcy Trends: What's Next in the Restructuring World? 2008 may be Remembered as the Year Bankruptcy Became Active Once Again, *Commercial Lending Review* (Nov. 1, 2007). The increasing cost of new loans as a result of the volatile credit market and increasingly discriminating lenders has deprived companies of ready access to inexpensive capital and force them to restructure. Further, subprime lenders themselves have sought bankruptcy protection as early payment defaults forced them to buy back loans they had resold to other investors, indicating a growing intolerance for risk in the market. *Id.*

This has had an impact on the broader market as well. Investors have become more discriminating, squeezing leveraged products. *Id.* Until the wave of subprime bankruptcies settles, they are likely to continue to impact the broader credit market. *Id.* The subsequent tightening of credit is likely to result in continued tightening of consumer spending, which will in turn impact companies that depend on discretionary spending to thrive, such as retail and consumer products. *Id.*

Conclusion

It is likely that current trends are forming the beginning of a new wave of corporate bankruptcies and restructuring. Aleksandrs Rozens, Fasten Your Seatbelts: Harvey Miller, the Godfather of Bankruptcy, Says It's Going to be a Bumpy Ride. Why This Wave of Restructurings will be Different, *Investment Dealers Digest* (Mar. 3, 2008). Times have changed from a few years ago, when lenders were anxious for business and willing to forego traditional contractual protections in order to book new business, confident that the level of liquidity in the market brought about by aggressive hedge funds and private equity groups would enable distressed companies to refinance if they got in trouble. *Id.* The market conditions that have put off a natural uptick in bankruptcy filings are gone, and as a result, companies are finding themselves without the safety net of hedge fund or private equity financing, due in significant part to the subprime mortgage fallout. *Id.* As investors continue to shy away from complex products like collateralized debt obligations and mortgage backed securities, credit has become harder to obtain and private equity transactions have slowed down. Ingrid Bagby and Sheryl Saleeby, Bankruptcy Trends: What's Next in the Restructuring World? 2008 may be Remembered as the Year Bankruptcy Became Active Once Again, *Commercial Lending Review* (Nov. 1, 2007). The recent lull in corporate restructuring depended in large part on the ready availability of financing from groups like hedge funds and private equity. Aleksandrs Rozens, Fasten Your Seatbelts: Harvey Miller, the Godfather of

Bankruptcy, Says It's Going to be a Bumpy Ride. Why This Wave of Restructurings will be Different, *Investment Dealers Digest* (Mar. 3, 2008). As the subprime mortgage collapse has destroyed major sources of that funding by contributing to the collapse of a number of major hedge funds and the fall of Bear Stearns, that safety net is gone. Further troubles such as the collapse of Lehman Brothers have compounded the problem by tying up money that hedge funds had placed there in order to obtain the short-term financing that they need to do business. Landon Thomas, Big Hedge Funds Chasing Assets Held by Lehman, *The International Herald Tribune*, (Oct. 2, 2008). Without easy access to credit, companies finding themselves in financial distress may have no choice but to restructure. Ingrid Bagby and Sheryl Saleeby, Bankruptcy Trends: What's Next in the Restructuring World? 2008 may be Remembered as the Year Bankruptcy Became Active Once Again, *Commercial Lending Review* (Nov. 1, 2007).

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RELATED LINKS: For a discussion of Hedge Funds, Private Equity, and Corporate Reorganization individually, see

- 1-3 Regulation of Investment Companies § 3.02;
- 1-3 Regulation of Investment Companies § 3.07;
- 1-7 Investment Advisers: Law & Compliance § 7.10;
- 7-1100 Collier on Bankruptcy-15th Edition Rev. P 1100.01 through 1100.10.

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6 of 16 DOCUMENTS

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Sommer on Marrama v. Citizens Bank

2008 Emerging Issues 866

Sommer on Marrama v. Citizens Bank

By Henry J. Sommer

November 5, 2007

SUMMARY: In *Marrama v. Citizens Bank*, the Supreme Court held that a debtor who has acted in bad faith does not have an absolute right to convert a chapter 7 case to chapter 13. In his expert commentary, Henry J. Sommer, the editor-in-chief of *Collier on Bankruptcy*, limns the Court's reasoning and suggests that in practice it is not always easy to determine the "plain meaning of the Code."

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ARTICLE: Supreme Court Rules That Chapter 7 Debtor Does Not Have an Absolute Right to Convert to Chapter 13

The Supreme Courts decision in *Marrama v. Citizens Bank* resolved a split among the courts of appeals concerning whether a chapter 7 debtor who has not previously converted from another chapter of the Bankruptcy Code has an absolute right to convert a case to chapter 13 if the debtor met the chapter 13 eligibility requirements of section 109 of the Code.

In *Marrama*, the debtor filed a voluntary petition under chapter 7 of the Bankruptcy Code. In his attached and verified schedules, the debtor made a number of misleading or inaccurate statements about his principal asset, which was a house in Maine. Specifically, he listed its value as zero, when it fact it had considerable value. Further, he denied that he had transferred any property other than in the ordinary course of the business during the year preceding the filing of the petition, whereas he had transferred the house into a newly created trust for no consideration. After the trustee indicated that he would attempt to recover the Maine house as an asset of the estate, the debtor filed a notice of conversion to chapter 13. The trustee and principal creditor opposed the conversion on the ground that the request was made in bad faith and would constitute an abuse of the bankruptcy process. In response, the debtor explained that the misstatements on the Maine property were a result of scriveners error and that he had filed under chapter 7 because he was unemployed at the time. The bankruptcy court rejected these arguments and denied the request for conversion on the ground of debtors bad faith. The Court of Appeals for the First Circuit upheld the denial of the right to convert, ruling that the right is not absolute and that a court could deny conversion if the debtor had acted in bad faith.

Affirming, the Supreme Court ruled that a debtor who in bad faith has concealed significant assets, whose case under chapter 13 would be subject to immediate dismissal under section 1307(c), does not have the right to convert to chapter 13 in the first instance. Such a debtor, the Court held, comes within the description in section 706(d) of debtors who do not have a right to convert because the debtor is not someone who may be a debtor under such chapter. [*Marrama*, 166 L. Ed. 2d at 964-66.]

The Court also found authority for its decision in section 105, because conversion of a case from chapter 7 to chapter 13 by a debtor whose chapter 13 case would be immediately dismissed or reconverted to chapter 7 could be an abuse of process of the type courts may prevent under section 105(a). [*Marrama*, 166 L. Ed. 2d at 966-67.] In particular, the Court discussed the possibility that a debtor could gain control of assets once a case is converted to chapter 13 and dissipate them before the case could be reconverted to chapter 7. [*Marrama*, 166 L. Ed. 2d at 967 n.13.]

The Court emphasized that denial of the right to convert to chapter 13 should be limited to extraordinary cases of bad faith and should not apply to other cases. [*Marrama*, 166 L. Ed. 2d at 966 n.11.] It also suggested that the showing of bad faith necessary to deny conversion should be very clear, and more than might be required for denial of plan confirmation under section 1325(a)(3). [*Id.*]

The Court rejected the position of four dissenting justices that the plain language of the Code provides for an alternative procedure to handle bad faith conversions, namely the dismissal or reconversion of the case after it is converted to chapter 13, and that the right of a statutorily eligible debtor to convert to chapter 13 is absolute. [*Marrama*, 166 L. Ed. 2d at 967-69.] The dissent also argued that section 105(a) could not be used to contravene the Code's plain language, although it could have served as authority to enter orders to prevent actions, such as dissipation of property, that the majority feared could occur in a bad faith conversion. [*Marrama*, 166 L. Ed. 2d 956, 971-72.]

The decision once again shows that, although the Court frequently espouses the plain meaning approach to interpreting the Bankruptcy Code, it may not always follow that approach, at least as it is interpreted by Justice Scalia, its foremost proponent, who joined the dissent. [*But see BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994), in which Justice Scalia seemingly ignored the plain meaning of the word value and found it to be the amount realized for a property at a foreclosure sale.] At a minimum, the decision demonstrates that in practice it is not always easy to determine the plain meaning of the Code.

Perhaps even more intriguing is the Court's use of section 105(a) as an alternative basis for its decision. The Court suggests that the broad authority of that provision is surely adequate to short-circuit the usual procedure of conversion followed by a reconversion if that is necessary to prevent an abuse of process. [*Marrama*, 166 L. Ed. 2d at 966-67.] In light of many lower court holdings that section 105(a) cannot be used to circumvent the specific provisions of the Code, it will be interesting to see if courts now will rely on this language in taking actions that appear contrary to the Code's standard procedures.

For further discussion of conversion from chapter 7 to chapter 13, see *Collier on Bankruptcy*, 15th ed. rev., 706.02, and *Collier Consumer Bankruptcy Practice Guide*, 24.03.

For further discussion of the bankruptcy courts' power under Code section 105, see *Collier on Bankruptcy*, 15th ed. rev., ch. 105.

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7 of 16 DOCUMENTS

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Hon. Ralph R. Mabey on In re Dana Corp.

2008 Emerging Issues 867

Hon. Ralph R. Mabey on In re Dana Corp.

By Ralph R. Mabey

November 5, 2007

SUMMARY: One of the outstanding questions created by the 2005 bankruptcy legislation is whether Code section 546 provides an independent federal right of reclamation to sellers who provide goods to insolvent buyers. A leading bankruptcy court has now ruled on the issue. In his expert commentary, the Hon. Ralph R. Mabey describes the decision and its context, and trenchantly parses the court's reasoning, concluding that the issue will not be definitively settled until there is further judicial action.

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ARTICLE: S.D.N.Y. Bankruptcy Court Holds That Revised Section 546(c) Does Not Create A New Federal Right Of Reclamation In Bankruptcy

One of the many questions created by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) is whether the modifications to *section 546(c) of the Bankruptcy Code* (11 U.S.C.) give rise to a new federal right of reclamation. Bankruptcy Judge Burton R. Lifland, of the Southern District of New York, is the first judge squarely to address this question. In *In re Dana Corp.*, 2007 Bankr. LEXIS 1466 (Bankr. S.D.N.Y. Apr. 19, 2007), he expressly held that amended section 546(c) does not create a federal right of reclamation.

Framing the Debate. In late 2005, the Bankruptcy Code was substantially amended by BAPCPA. Among the many changes to the Code was an overhaul of the reclamation provisions contained in section 546(c). The substantive effect of many of the changes was clear; among other things, BAPCPA (1) extended the reclamation reach-back period from 10 to 45 days, (2) expanded the postpetition grace period from 10 to 20 days, and (3) created an entirely new kind of administrative expense claim for parties that sell goods to a debtor within 20 days of the petition date.

Among the more confusing changes to section 546(c) is Congress's decision to remove the phrase any statutory or common law before right of a seller of goods that has sold goods to the debtor and replace it with the word *the*. It was common practice under pre-BAPCPA doctrine for courts and parties to reference state law, most often section 2-702 of the Uniform Commercial Code, to define the contours of any right a seller of goods that has sold goods to the debtor may have under section 546(c). *See, e.g., In re Coast Trading Co.*, 744 F.2d 686 (9th Cir. 1984). Such a practice was clearly appropriate because a reclamation right arising under section 2-702 of the U.C.C. is a statutory or common law right. BAPCPA's use of the definite article *the* instead of *statutory or common law* gives rise to substantial questions

about whether it remains appropriate to reference the U.C.C. or other state law when analyzing reclamation issues in bankruptcy. See generally Sally S. Neely, *How BAPCPA Affects the Rights of Unpaid Prepetition Sellers of Goods*, 32nd Lawrence P. King & Charles Seligson Workshop on Bankruptcy and Business Reorganization, at 12-24 (Sept. 27-29, 2006) (discussing various issues arising from amended section 546(c), including a number of arguments for and against the proposition that amended section 546(c) creates a new federal right). As noted in the *Dana* opinion: Congress provided no explanation in the legislative history of section 546(c) for what it intended by this deletion. 2007 Bankr. LEXIS 1466, at *17. Thus, a critical issue facing courts after BAPCPA is whether Congress modified section 546(c) so as to give rise to a new fount of reclamation rights--a locus wholly detached from the U.C.C. and other applicable nonbankruptcy law.

The Facts and Posture of *Dana*. The underlying debtors in *Dana* (the Debtors) were part of a sizeable family of corporations and entities that manufactured and supplied various equipment used in the automotive industry. Soon after the Debtors filed for bankruptcy, Judge Lifland entered an order establishing procedures for reclamation claims. The Debtors then received over 450 letters from various parties (the Reclamation Claimants) demanding the return of certain goods and asserting putative reclamation claims of nearly \$300,000,000.

In response to the many reclamation demands, the Debtors (1) filed a notice reconciling the reclamation claims and (2) argued that a so-called Prior Lien Defense rendered the claims valueless. Specifically, the Debtors maintained that the existence of significant prepetition secured indebtedness, which debt was secured by liens on substantially all of the Debtors assets, including the goods sought to be reclaimed, functioned to reduce the value of all the reclamation claims to zero. (These liens were not only the product of prepetition contracts, but also stemmed from postpetition replacement liens approved by the court in connection with a debtor-in-possession credit facility.)

The Reclamation Claimants countered the Debtors Prior Lien Defense by arguing that the prepetition debt was satisfied by a source other than the underlying goods (i.e., the debtor-in-possession financing), which meant that the prior lien on the goods was released, and thus the reclamation claims could be valued in full. As legal authority for their position, the Reclamation Claimants relied upon *In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003). In the alternative, the Reclamation Claimants asserted that the post-BAPCPA version of section 546(c) created a new federal right of reclamation that is not subject to previous case law interpreting and applying the pre-BAPCPA version of section 546(c).

The *Dana* Opinion. The courts substantive opinion proceeded in three stages. The court began its analysis by providing a brief overview of reclamation law prior to BAPCPA and of the changes effected by the BAPCPA. See 2007 Bankr. LEXIS 1466, at *11-16. The court then turned its attention to the Reclamation Claimants argument that the deletion of the reference to state law in the amended section 546(c) no longer incorporates the state law right of reclamation, and instead creates a brand new federal bankruptcy law right. *Id.* at *17. The court disagreed for numerous reasons.

First, the court found section 546(c)s placement in the Bankruptcy Code significant. Specifically, section 546(c) is grouped with the other provisions of section 546 under the heading Limitations on avoiding powers. Consequently, section 546 is not a section dedicated to granting an independent federal right of reclamation nor does it create a coherent comprehensive federal scheme for reclamation. *Id.* at *19. Furthermore, the court also noted how if amended section 546(c) was a new federal reclamation right arising under the Bankruptcy Code, it would not be subject to the avoiding powers. *Id.* at *20.

Second, the court cited several Supreme Court cases to support a framework of interpretation that requires clear congressional intent to alter past bankruptcy practice via a statutory change. See *id.* at *21. This principle, when combined with the absence of any legislative history and the fact that Congress did not use the language of creation in BAPCPA, further supported the conclusion that section 546(c) does not give rise to a new federal right. See *id.* at *19-21.

Third, the court discussed several problems arising from the fact that section 546(c) does not create a coherent comprehensive federal scheme for reclamation. Foremost on the court's mind was the fact that, while section 546(c) explicitly addresses the prior rights of a secured creditor, it does not deal with the rights of other purchasers or buyers of goods. *Id.* at *21-22. As a result, any federal right of reclamation would arguably give a reclaiming seller broad rights superior to those of buyers in the ordinary course of business, lien creditors or good faith purchasers. *Id.* at *22. The court thought that such a result would be absurd and could not have been intended by Congress. *Id.* The court was further troubled by the fact that section 546(c) contains no reference to long-established defenses to reclamation, including those arising when (1) the goods have already been paid for, (2) the seller was aware of the debtor's insolvency, (3) the goods have been commingled, or (4) the goods are no longer in the debtor's possession. *Id.* at *23-24. At bottom, the court simply seemed to believe that the text of amended section 546(c) is too scant to give rise to a distinct, substantive right. *Id.* at *24-25 (stating that the use of the definite article *the* . . . indicates that the right already exists and concluding that the only available referent for such prior rights is nonbankruptcy law).

Fourth and finally, the court concluded that a new bankruptcy-specific reclamation right would be at odds with the general principle that the filing of a bankruptcy petition, by itself, should not serve to enhance the rights of one set of creditors at the expense of other creditors. *Id.* at *25-26; *see also generally* Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (1986) (developing the proposition that the proper role of bankruptcy law is to provide a collective forum that overlays, rather than supplants, the substantive rights created by nonbankruptcy law).

After concluding that the amended 546(c) does not create a new federal right of reclamation, *id.* at *26, the court turned to the Debtors Prior Lien Defense. Here, the court faced a conflict between the decisions in *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003), and *In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003). The court ultimately concluded that *Dairy Mart* is the better decision, thereby rejecting the reasoning of *Phar-Mor*. More specifically, the court noted how prepetition liens arising from secured credit can be integrated with postpetition liens arising from a debtor-in-possession facility and the related adequate protection provided to a prepetition secured creditor. *Id.* at *33-34. Hence, if the goods securing the prepetition credit either are used to satisfy the prepetition indebtedness *or* are used as collateral for the debtor-in-possession facility, the functional effect is that the goods are used to satisfy the prepetition debt. The net result of such a process is that any reclamation claims smaller than the prior lienholders' claim are rendered valueless pursuant to the Prior Lien Defense. *Id.* at *34.

Commentary on the Dana Opinion. Although the discussion of the Prior Lien Defense in *Dana* is interesting and adds to a growing body of jurisprudence on the subject, the *Dana* opinion is particularly noteworthy because it is among the first decisions squarely to address the nature of reclamation rights in bankruptcy following BAPCPA.

The four core points on which Judge Lifland based his rejection of a federal right of reclamation are cogent and compelling. Nevertheless, the *Dana* opinion is unlikely to resolve fully all questions about the nature of the rights referenced by, or arguably created by, section 546(c). After all, while Congress may not have provided specific discussion of its intent in the BAPCPA's legislative history, it is unclear what purpose could be served by deleting the phrase *any* statutory or common law before the word *right* and replacing it with the other than uncoupling state law reclamation rights from the bankruptcy process. Moreover, amended section 546(c) plainly provides *some* detail about the extent of reclamation rights in bankruptcy, such as the expanded 45 and 20-day periods. These expanded time periods presumably could not be narrowed or eliminated by contrary state legislation due to federal preemption principles. Thus, section 546(c) unquestionably contains some definition of the extent to which a reclamation right will be countenanced in bankruptcy. It is not an extreme analytic leap to conclude that it is therefore appropriate to wrap the entirety of reclamation in bankruptcy in the cloak of federal law. As such, *Dana* arguably does not reach the right result.

It may be the case, however, that the debate about whether reclamation is a product of state law, such as the U.C.C., or of federal bankruptcy law is in some respects about a distinction without a difference. This conclusion flows from the Supreme Court's opinion in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 59 L. Ed. 2d 711 (1979), which involved the question of how to fix the priority of liens arising under a federal lending program. The Court ultimately held that while the issue was one of federal law, the readymade body of state law should be adopted as the proper federal rule of

decision until Congress strikes a different accommodation since there were no concrete reasons for rejecting well-established commercial rules which have proven workable over time. *440 U.S. at 740*. The rationale for incorporating generally applicable state law principles of commercial law into the federal law was aptly stated by Judge Richard A. Posner when he observed that the federal courts have neither the time nor the specialized knowledge to forge a new body of commercial law; by doing so they would simply be adding to the already excessive complexity of American law. *United States v. Stump Home Specialties Mfg., Inc.*, 905 F.2d 1117, 1119 (7th Cir. 1990). Under these principles, then, it seems appropriate to look to case law interpreting section 2-702 of the U.C.C. to fill the many gaps remaining in the post-BAPCPA version of section 546(c). As a result, the substantive nature of any federal right of reclamation may mirror the nature of such a right under applicable state law. While problems could arise if the underlying state law is some non-uniform variant of section 2-702 of the U.C.C., much of the force of the federal right vs. non-federal right dispute seems to dissipate in light of *Kimball Foods*.

In sum, *Dana* is a well-reasoned decision that provides a comprehensive analysis of various issues flowing from the BAPCPA's changes to *section 546(c) of the Bankruptcy Code*. Nevertheless, uncertainty about the true nature of section 546(c) will likely persist until there is further judicial (and perhaps appellate) review.

For a complete discussion of Code section 546, see *Collier on Bankruptcy*, ch. 546 (Matthew Bender).

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8 of 16 DOCUMENTS

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Hon. Ralph R. Mabey on In re Fortune Natural Resources Corp.

2008 Emerging Issues 868

Hon. Ralph R. Mabey on In re Fortune Natural Resources Corp.

By Ralph R. Mabey

November 5, 2007

SUMMARY: A bankruptcy court in Louisiana turned down a request for compensation from members of a debtor companys board of directors for services rendered during the companys bankruptcy case. As the Hon. Ralph R. Mabey explains in his expert commentary on the case, the court took the minority position and determined that the board members were acting as professionals and should have sought appointment under Code section 327.

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ARTICLE: As Professionals, Members of Board of Directors Were Required to Apply for Compensation under Code Section 327; Their Work Did Not Qualify as an Administrative Expense under Code Section 503(a)(1)(B)

In April 2007, the United States Bankruptcy Court for the Eastern District of Louisiana considered a request by members of a board of directors for allowance of compensation as an administrative expense under *Bankruptcy Code section 503(b)(1)(A)*. The bankruptcy court denied the request, finding that the directors were professionals under *Bankruptcy Code section 327*, and were consequently precluded from obtaining compensation under *Bankruptcy Code section 503(b)(1)(A)*. *In re Fortune Natural Resources Corp.*, 2007 Bankr. LEXIS 1350 (Bankr. E.D. La. Apr. 12, 2007). Facts. On April 10, 2006, the Bankruptcy Court confirmed the reorganization plan (the Plan) filed by Fortune Natural Resources Corporation (the Debtor). Shortly after confirmation, the Debtors former directors (the Directors) filed a motion under *Bankruptcy Code section 503(b)(1)(A)* seeking allowance of an administrative claim in the amount of \$275,000 for services rendered to the Debtor during the bankruptcy case. **The Unsecured Creditors Committee and the Plans Disbursement Trustee filed oppositions to the Directors motion.**

Courts Legal Analysis. *Bankruptcy Code section 503(b)(1)(A)* provides that [a]fter notice and a hearing, there shall be allowed administrative expenses . . . including . . . the actual necessary costs and expenses of preserving the estate.

In reviewing the Directors motion, the bankruptcy court initially referred to controlling Fifth Circuit authority on administrative claims, which maintains that in order to qualify as an actual and necessary cost under section 503(b)(1)(A), a claim against the estate must have arisen post-petition and as a result of actions taken by the trustee that benefited the estate. *Total Minatome Corp. v. Jack/Wade Drilling, Inc. (In re Jack/Wade Drilling, Inc.)*, 258 F.3d 385, 387 (5th Cir. 2001). The bankruptcy court also pointed out that the Directors had the

burden of proving that their claim was for actual and necessary costs and that the words actual and necessary were to be narrowly construed to mean that the debt must benefit the estate and its creditors. *See In re Transamerican Natural Gas Corp.*, 978 F.2d 1409, 1415 (5th Cir. 1992). Finally, the bankruptcy court stated that the Directors request was subject to heightened scrutiny, since the Directors were fiduciaries and there was no independent trustee in the case.

Generally, a debtors corporate officers and directors do not need court approval to continue their employment and obtain compensation for their professional services. *See Collier on Bankruptcy* 330.03[5] (15th ed. rev. Matthew Bender); *In re All Seasons Indus.*, 121 B.R. 822 (Bankr. N.D. Ind. 1980). However, according to the *Fortune* court, this presumption applies only if the terms and conditions of the postpetition employment and compensation are identical to the prepetition terms and conditions. In *Fortune*, before filing for bankruptcy protection, the Debtor compensated the Directors through payment of warrants or shares of the Debtor. However, in their motion, the Directors sought payment of cash. Therefore, the Court found that the Directors could not rely on the precedent set forth in *All Seasons* and other cases to obtain payment of fees.

In considering the Directors request, the Bankruptcy Court analyzed the actions performed by the Directors during the case and placed them in two categories: (1) actions that would be expected from the directors of a company in bankruptcy; and (2) activities that would be performed by professionals that need their employment to be approved by the bankruptcy court under *Bankruptcy Code* section 327(a). The activities in the second category included (i) filing a chapter 11 petition, (ii) negotiating DIP financing, (iii) working with consultants to build financial models, (iv) negotiating bids for the Debtors assets, (v) preparing schedules, (vi) evaluating litigation claims, (vii) negotiating with the Committee, (viii) drafting settlement agreements, (ix) preparing objections to claims and settling claims and (x) drafting the plan. Given that the second group of activities consist[ed] entirely of activities the court would expect a professional person approved by the court under § 327 to perform, the court concluded that the Directors were professional persons who needed to obtain court approval of their employment.

The court then held that bankruptcy professionals cannot utilize section 503(b)(1)(A) to obtain approval of compensation claims. In support of this assertion, the court cited a bankruptcy court decision from the Southern District of Georgia:

The . . . question is whether an individual who serves as a professional within the meaning of Section 327 . . . may . . . receive compensation under 503(b)(1) for actual and necessary services rendered to preserve the estate. While some cases authorize payments to professionals who fail to meet the requirements of Section 327, the majority, and better reasoned cases do not. The rationale is clear. To apply Section 503(b)(1) to professional compensation would make the language of Section 503(b)(2) superfluous. Congress enacted Sections 327, 330(a), and 503(b)(2) to provide the exclusive method for a debtors retention of professionals, subject to numerous safeguards, including the requirement of disinterestedness. A court should not circumvent the limitations placed on retention of professionals by compensating a disqualified professional under Section 503(b)(1)(A). Instead, Section (b)(1)(A) is properly applicable only to authorize priority treatment of non-professional employee claims, including wages, salaries, and commissions.

In re Concrete Prods., 208 B.R. 1000, 1010 (Bankr. S.D. Ga. 1996).

Applying the law to the facts before it, the bankruptcy court denied the motion. Since the Directors were professionals, they were obligated to file employment applications under Code section 327. The Directors failure to file such applications precluded them from obtaining any compensation from the Debtors bankruptcy estate.

Commentary. The most notable part of the *Fortune* opinion is the bankruptcy courts decision that the Directors were professionals under Code section 327. The *Fortune* decision represents the minority view on whether directors and officers are professionals who must obtain bankruptcy court approval of their employment. Generally, courts do not

require debtors to seek approval to compensate officers and directors, because courts are reluctant to become involved in the day-to-day administration of the debtors estates. As stated in *Collier on Bankruptcy*: The employment and compensation of officers of the debtor should be considered within the ordinary course of the debtors business subject to oversight by other parties in interest. *Collier on Bankruptcy*, 330.03[5] (15th ed. rev. Matthew Bender).

The *Fortune* court initially suggests that it would have approved the Debtors postpetition compensation of the Directors on the same terms that existed prepetition without a court order. However, this proposition conflicts with the courts later statements that all professionals seeking compensation must obtain approval under Code section 327. The safest reading of the *Fortune* decision (and those courts taking the minority position) is that officers and directors who engage in tasks that are intimately involved in the administration of the debtors estate must first obtain a court order authorizing their employment and compensation.

But if directors determine that they must seek a court order authorizing their employment as professionals, they cannot rely on section 327(a). To be employed under section 327(a), a professional must show that he or she is disinterested. Pursuant to Code section 101(14), an individual can be disinterested only if the individual is not an insider under section 101(31)(b). However, the definition of insider includes directors. Accordingly, a director can never be disinterested, and consequently can never properly be employed under section 327(a).

Rather, a director must obtain employment approval under Code section 327(b), which states that [i]f the [debtor in possession] is authorized to operate the business of the debtor . . . and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the [debtor in possession] may retain or replace such professional persons in the operation of such business. Hence, if a director is planning to take responsibility for tasks that are central to the administration of the bankruptcy estate, it should file an application for employment under Code section 327(b) and Rule 2014 at the commencement of the debtors bankruptcy case.

However, some bankruptcy courts have adopted local rules and United States Trustee Guidelines that eliminate the need for court approval of employment under Code section 327(b).

For example, in the Central District of California, certain procedures for payment to insiders that were promulgated by the Office of the United States Trustee (OUST) have been adopted by the bankruptcy courts. At the inception of a bankruptcy proceeding in the Central District of California, a debtor must file a Notice of Setting/Increasing Insider Compensation for each director (the Insider Notice) with the OUST. The Insider Notice is served on the debtors secured creditors and the creditors committee or the 20 largest unsecured creditors (if no committee has been appointed). Parties have 15 days to object to the Insider Notice, and if an objection is filed, the Bankruptcy Court must resolve the issue at a hearing. However, if there are no objections to the Insider Notice, the debtor is authorized to pay the proposed compensation to the director without a court hearing. Obviously, before filing a chapter 11 petition, debtors should review the Local Bankruptcy Rules and Local OUST Guidelines in order to ensure compliance with the appropriate procedure for compensation of officers and directors.

The implication of *Fortune* is that one person may wear two hats, that of a director and that of a professional. In those cases, compensation must be sought under two different regimes.

For a discussion of the employment of professional persons, see *Collier on Bankruptcy*, ch. 327 (15th ed. rev. Matthew Bender) and *Collier Compensation, Employment and Appointment of Trustees and Professionals in Bankruptcy Cases*, ch. 1, (Matthew Bender).

For a discussion of compensating the officers of the estate, see *Collier on Bankruptcy*, ch. 330 (15th ed. rev. Matthew Bender).

For a discussion of the allowance of administrative expenses, see Collier on Bankruptcy, ch. 503 (15th ed. rev. Matthew Bender).

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9 of 16 DOCUMENTS

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Hon. Ralph R. Mabey on VFB LLC v. Campbell Soup Co.

2008 Emerging Issues 869

Hon. Ralph R. Mabey on VFB LLC v. Campbell Soup Co.

By Ralph R. Mabey

November 5, 2007

SUMMARY: The Third Circuit has held that market data are a more reliable measure of market value than expert witness testimony. In his expert commentary, the Hon. Ralph R. Mabey suggests that, although *VFP LLC v. Campbell Soup Co.* will be much cited in all valuation disputes involving publicly traded companies, a close reading of the decision indicates that its impact should be circumscribed.

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ARTICLE: The Third Circuit Prefers Market Capitalization Data Over Expert Witness Testimony in Determining Reasonably Equivalent Value

In *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007), the Court of Appeals for the Third Circuit relies on an objective rule for determining value in the context of fraudulent transfer litigation involving a publicly traded company. Although the case arose out of litigation premised on New Jersey's version of the Uniform Fraudulent Transfer Act, the Third Circuit's rationale for preferring market capitalization data over hindsight expert witness testimony is applicable to other valuation disputes involving publicly traded companies. Based on the continuing popularity of the District of Delaware as a venue for chapter 11 cases, the Third Circuit's decision in *VFB* will be much cited.

Facts. The case arose out of a plan by Campbell Soup Co. to improve its stock price by disposing of certain underperforming subsidiaries and product lines. To implement its strategy, Campbell Soup created a wholly owned subsidiary in 1998, Vlastic Foods International, Inc., to spin off those underperforming divisions and product lines. In what is described as a leveraged spin transaction, Vlastic Foods paid \$500 million to Campbell Soup for those assets, the funding for which came from a loan secured by all of Vlastic Foods newly acquired assets. Campbell Soup then distributed the stock of Vlastic Foods to its own shareholders as an in-kind dividend.

The terms of the leveraged spin transaction were negotiated by Campbell Soup and a group of high-ranking Campbell Soup employees, who eventually became the future management of Vlastic Foods. According to the testimony of the future Vlastic Foods managers, Campbell Soup dictated the terms of the negotiations. The businesses to be transferred to Vlastic Foods and the Vlastic Foods initial debt level (i.e., the amount Campbell Soup got paid) were not negotiable. The future Vlastic Foods managers also testified that they were not given

sufficient resources to analyze and research the transaction and, as a result, the transaction contained various terms unfavorable to Vlastic Foods. Nevertheless, the deal closed on March 30, 1998, after the transaction was approved on Vlastic Foods side by pre-spin directors, who were also Campbell Soup executives and who understood their sole task to be approving the transaction and then resigning. Essentially, through the leveraged spin transaction, Campbell Soup removed underperforming businesses from its balance sheets and received \$500 million in cash without encumbering any of its remaining valuable assets.

Soon after the closing of the transaction, it was discovered that Campbell Soup had inflated earnings for the businesses transferred to Vlastic Foods prior to the spin-off by, among other things, giving bulk discounts and other promotions to increase short term sales. This had the effect of decreasing later sales. As a result, by June 1998, just three months after the closing, Vlastic Foods had to lower its earnings estimates from \$143 million to \$70 million for the fiscal year 1998. Nevertheless, because the earnings inflation was generally known in the market, the price of Vlastic Foods shares on the New York Stock Exchange remained essentially steady for a time, and its market capitalization did not drop below \$1.1 billion until January 1999. Vlastic Foods business continued to struggle. The entity took on more debt in hopes of surviving, in the form of \$200 million in unsecured bonds sold to institutional investors. These measures were unavailing, and Vlastic Foods filed chapter 11 bankruptcy in 2001.

Before and during the chapter 11 bankruptcy case, Vlastic Foods sold its assets piecemeal, generating \$504 million. This price may be discounted back to \$385 million as of the time of the spin-off--meaning the assets were sold for \$115 million less than Vlastic Foods paid for them in March of 1998.

Under its plan of reorganization, Vlastic Foods assigned all of its legal claims and causes of action against Campbell Soup to VFB, LLC, a Delaware limited liability company, whose members were the impaired unsecured creditors of Vlastic Foods bankruptcy estate. VFB initiated an adversary proceeding against Campbell Soup, alleging that the leveraged spin transaction was a constructive fraudulent transfer under *Bankruptcy Code* section 544(b) and New Jerseys version of the Uniform Fraudulent Transfer Act.

The District Courts Decision. A key issue at trial before the district court was whether the assets acquired by Vlastic Foods in March 30, 1998, were in fact worth the \$500 million that Vlastic Foods paid for them. The parties presented the district court with three types of evidence on reasonably equivalent value: (1) market capitalization data based on the price at which Vlastic Foods shares were trading on the New York Stock Exchange; (2) various valuations prepared before and soon after the spin-off; and (3) testimony from expert witnesses. The first and second types of evidence generally showed that the divisions and product lines spun off to Vlastic Foods were worth above \$500 million, meaning Vlastic Foods received reasonably equivalent value. VFB, therefore, relied on the third type of evidence, expert testimony, including discounted cash flows, to prove that the transfer of assets as part of the leveraged spin transaction was not for reasonably equivalent value.

Unfortunately for VFB, the district court concluded that both sides expert testimony was flawed, primarily due to hindsight bias--in this case the use of assumptions by the expert witnesses that were not publicly available at the time of and soon after the spin-off. Instead, the district court believed that the market capitalization evidence, produced by one of the most efficient capital markets in the world, was dispositive evidence of the value of the assets spun off to Vlastic Foods. As a result, the district court concluded that Vlastic Foods did receive reasonably equivalent value for the assets spun off by Campbell Soup.

The Third Circuits Decision. The Court of Appeals for the Third Circuit affirmed the district courts judgment. On appeal, VFB argued that market capitalization is an unreliable measure of value because it is often based on investors expectations of future earnings, and that those expectations may be wrong. The Third Circuit rejected this argument and concluded that [e]quity markets allow participants to voluntarily take on or transfer among themselves the risk that their projections will be inaccurate; fraudulent transfer law cannot rationally be invoked to undermine that function. 482 F.3d at 631.

The Third Circuit also rejected VFBs argument that the market capitalization data were unreliable due to Campbell Soups manipulation of earnings prior to the spin-off, noting that the stock traded at a healthy market capitalization even after the manipulation became public. The Third Circuit, like the district court, assumed that the stock market is an efficient capital market--that the investors buying and selling stock on the New York Stock Exchange are well informed and rational. The Third Circuits view is exemplified in footnote 4 of the opinion, where the court assumes, without citing to any record on appeal or outside sources, that the investing public must have understood and taken into account Campbell Soups manipulation of earnings, through the product loading strategy, when they bought *Vlasic Foods stock*. 482 F.3d at 632 n.4.

Based on the views expressed by the Third Circuit, it is not surprising that it held that absent some reason to distrust it, market data are a more reliable measure of value than expert witness testimony.

Commentary on VFB. The Third Circuit is not the first court to apply an objective standard in the context of fraudulent transfer litigation, although it is true that most courts have applied the totality of the circumstances test to determine reasonably equivalent value or fair consideration. See *In re Morris Communications NC Inc.*, 914 F.2d 458, 466 (4th Cir. 1990); *In re Ozark Restaurant Equip. Co.*, 850 F.2d 342, 344 (8th Cir. 1988); *In re North Babylon Estates, Inc.*, 30 F.2d 372, 374 (2d Cir. 1928); *Folsom v. Seapy*, 10 F.2d 322, 326 (8th Cir. 1925). Still, in the limited context of fraudulent transfer litigation arising out of state-regulated foreclosure sales, the Supreme Court of the United States held that, absent collusion or procedural irregularity, the price obtained at the foreclosure sale is, as a matter of law, reasonably equivalent value. *BFP v. Trust Resolution Corp.*, 511 U.S. 531, 545, 114 S. Ct. 1757, 128 L. Ed. 2d 556 (1994).

Unlike the Supreme Courts very focused holding in *BFP*, however, the *VFB* reasoning is not limited to constructive fraudulent transfer litigation. The Third Circuits trust in market data could apply to any valuation dispute involving publicly traded equity or debt. Indeed, because valuation disputes are central to many bankruptcy cases, the Third Circuits reasoning in *VFB* may have widespread impact. Discounted cash flow and weighted average cost of capital analyses performed by expert witnesses have long been the major currency for valuing assets and businesses both in and out of bankruptcy cases. The Third Circuits decision in *VFB* may undermine reliance on those methods where public markets are involved.

There are, however, two good reasons for subsequent courts to circumscribe the impact of *VFB*.

First, the Third Circuits holding is simply that the district court did not commit clear error in its weighing of the evidence and its approbation of market capitalization. Moreover, the district court had other valuation evidence contemporaneous with the transaction (and Campbell Soups expert testimony) to sustain on appeal its view of *Vlasic Foods* value. Further, *VFB*, according to the Third Circuit, failed adequately to rebut the finding of reasonably equivalent value: [*VFB*] never engages with the relevant numbers in any detail, explaining by how much Campbells various manipulation techniques affected its statistics, or by how much the statistical inflation affected VFIs market capitalization. 482 F.3d at 634. Given this procedural and factual posture, it would be a step too far to say that the Third Circuit establishes a rebuttable presumption in favor of market capitalization as the trump card in valuation disputes.

Second, the Third Circuits reasoning that [a]bsent some reason to distrust it, the market price is a more reliable measure of the stocks value than the subjective estimates of one or two expert witnesses, *id.* at 633, deserves careful scrutiny. Certainly the stocks value, or the value of marketable debt, is the price someone will pay for it. But that price, particularly in distressed circumstances, is a function of short sales, hedging, arbitrage, maneuvering for confirmation advantage, balancing of inconsistent investment positions, disparate information between buyer and seller, and rank speculation--as well as a nod to the value of the underlying assets. At a time when trading in distressed equities and debt is both vocation and avocation, these markets are chiefly efficient in their complexity and opacity. Cf. *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007). To this state of affairs may be added recent economic theory that emphasizes the subjective human element at play in markets. These forces serve to attenuate the connection between a

troubled enterprises underlying economic value and the price of its equities and debt. In order to stabilize the flutter on the traders screen, courts may still favor EBITDA over market data.

For a discussion of *Bankruptcy Code* section 544(b)(1) and the ability of a trustee to stand in the shoes of an existing unsecured creditor, see Collier on Bankruptcy, 544.09 (15th ed. rev. Matthew Bender).

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10 of 16 DOCUMENTS

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Hon. Ralph R. Mabey on In re Adbox

2008 Emerging Issues 831

Hon. Ralph R. Mabey on In re Adbox

By Ralph R. Mabey

November 1, 2007

SUMMARY: In a decision of great procedural importance, *In re Adbox*, the Ninth Circuit has refused to allow a creditors counterclaim in a trustees preference suit where the claim arose out of the debtors prepetition conduct. In his Expert Commentary, the Hon. Ralph R. Mabey concludes that, although *Adbox* was a chapter 7 case, the courts rationale should apply to a preference action initiated by a debtor in possession in a chapter 11 case.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: The Ninth Circuit Rules Out Most Counterclaims to Preference Suits and Holds That the Earmarking Doctrine Is Not an Affirmative Defense

When a bankruptcy trustee initiates a preference action, it is not unusual for the defendant-creditor to assert a counterclaim against the trustee based upon the debtors alleged prepetition conduct. But, *Rule 13 of the Federal Rules of Civil Procedure* requires that a counterclaim be asserted only against the opposing party, and a trustee in bankruptcy may not be an opposing party. Moreover, *Federal Rule of Bankruptcy Procedure 7013* modifies Rule 13 to state that a defendant in a preference action need not state as a counterclaim any claim that the party has against the debtor, the debtors property, or the estate, unless the claim arose after the entry of an order for relief. A creditors prepetition claim against a debtor, therefore, does not constitute a compulsory counterclaim that must be asserted in a preference action. *In re PCH Assocs.*, 949 F.2d 585, 594-95 (2d Cir. 1991).

Unfortunately, citation to Rule 13 and Bankruptcy Rule 7013 sometimes does not dissuade a determined defendant-creditor or its counsel from trying to litigate counterclaims against a trustee who is not an opposing party. A trustees next step may be to move to dismiss the counterclaims based on well-established law that when a party sues in its representative capacity, it is not subject to counterclaims in its individual capacity. See *In re Casale*, 62 B.R. 899, 900 (Bankr. E.D.N.Y. 1986) (It is fundamental that in an action brought by a party in a representative capacity, a counterclaim cannot be asserted against the [trustee] in his individual capacity.). Although generally successful, not all bankruptcy courts protect a trustee or the bankruptcy estate by dismissing counterclaims based on this well-established law. See *American Fabricators, Inc. v. v. Florida Power Corp.*, 186 B.R. 526, 529 (Bankr. M.D. Fla. 1995).

The Ninth Circuit's recent decision in *Adbox* strengthens Bankruptcy Rule 7013. Although the *Adbox* decision did not completely foreclose the possibility of a preference defendant asserting a counterclaim, the holding would eliminate most of these counterclaims.

In *Adbox*, the Ninth Circuit for the first time also held that the earmarking doctrine applied to a preference is not an affirmative defense but a challenge to a trustee's claim that the funds constituted property of the estate to begin with. Accordingly, a defendant does not waive the earmarking defense as a result of failing to plead it as an affirmative defense in the answer to a complaint. Because the earmarking defense is actually part of a trustee's affirmative case, the Ninth Circuit also held that the burden of proof is initially borne by the trustee to prove that the funds came from the debtors property.

Facts. Donald and Janet Metcalf and Christer Wernerda formed Adbox, Inc. in 1992. The Metcalfs were the primary financial backers for Adbox and agreed to pay the company's expenses until it became self-sufficient. Wernerda, for his part, agreed to run the business. The Metcalfs and Wernerda operated Adbox under this arrangement until 1998, when they agreed to separate. Wernerda agreed to pay \$200,000 for the business and \$115,139.36 for consulting services to the Metcalfs and become the sole owner of Adbox. Instead of paying the full amount, Wernerda sued the Metcalfs in state court, alleging, among other things, usury, and seeking a declaratory judgment that the consulting agreement was unenforceable. During the litigation, Wernerda paid \$200,000 to the Metcalfs for the business but disputed the consulting fees owed to the Metcalfs. Following a bench trial, the state court found for the Metcalfs on the consulting fees but in an amount less than requested, and both parties appealed. The trial court also denied the Metcalfs' request for attorneys' fees as the prevailing party. Ultimately, on appeal, the Metcalfs prevailed and were awarded the full amount of their consulting fees, plus \$612,684 in attorneys' fees and costs.

At the conclusion of the appeal, Adbox did not have sufficient funds to satisfy the judgment obtained by the Metcalfs. Wernerda obtained a loan from another company interested in Adbox, which was first deposited into his personal account and then transferred to Adbox's bank account. Adbox then wired \$21,035.58 (the amount outstanding for consulting fees but not including the award of attorneys' fees and costs) to its attorney, who then sent the amount to the Metcalfs. Less than 90 days later, Adbox filed a chapter 7 bankruptcy case, and Jeffrey I. Golden was appointed as the chapter 7 trustee.

In his capacity as trustee, Golden initiated a preference action pursuant to *Bankruptcy Code* sections 547 and 550(a) to recover \$21,035.58 from the Metcalfs. In response, the Metcalfs filed a counterclaim against Golden alleging that Adbox's conduct before bankruptcy constituted tortious interference with prospective economic advantage, fraudulent transfer under California law, and conspiracy to commit those acts. Golden moved to dismiss the counterclaims and also moved for summary judgment on the preference action. After a hearing on the motion to dismiss the counterclaims, the bankruptcy court construed it as a motion for summary judgment and granted it. The bankruptcy court, after a separate hearing, also granted Golden's motion for summary judgment on the preference action. The Metcalfs appealed to the U.S. District Court, which affirmed both rulings. The Metcalfs then appealed to the Court of Appeals for the Ninth Circuit.

Bankruptcy Rule 7013 and Dismissal of Counterclaims. The Ninth Circuit first addressed the dismissal of the Metcalfs' counterclaims against Golden. The court started with the plain language of Rule 13, adopted by Bankruptcy Rule 7013, which requires that a counterclaim be against an opposing party. Accordingly, a party sued by a trustee may assert a counterclaim only if the trustee is an opposing party within the meaning of Rule 13. In the context of the *Adbox* case, the Ninth Circuit framed the question as whether the trustee is an opposing party when the trustee brings a preference action that belongs to the bankruptcy estate, not the debtor, and the counterclaim alleges causes of action that could have been brought against the debtor prior to its bankruptcy filing. In holding that Golden was not an opposing party under Rule 13, the Ninth Circuit looked to well-established law that when a trustee sues in its official capacity, it is not subject to counterclaims in its individual capacity. See *Pioche Mines Consol., Inc. v. Fidelity-Philadelphia Trust Co.*, 206 F.2d 336, 337 (9th Cir.), cert. denied, 346 U.S. 899 (1953). Although the Metcalfs counterclaimed against Golden in his official capacity as the chapter 7 trustee, because the Metcalfs' counterclaims were based solely on

Adbox's prepetition conduct, the Ninth Circuit held that Golden would have to stand in the shoes of the debtor, Adbox, to defend the counterclaims. Such a position would be a representative capacity different from the representative capacity of a trustee who brings a preference action because a preference action belongs specifically to the bankruptcy estate and could not have been brought by Adbox before its bankruptcy filing. Moreover, if the Metcalfs' allegations in the counterclaims were true, Golden could pursue fraudulent transfers for the benefit of all creditors. In the preference action, Golden was suing for the benefit of all creditors, except the Metcalfs. Accordingly, the Ninth Circuit held that Golden was not an opposing party within the meaning of Rule 13 and affirmed the dismissal of the counterclaim.

Earmarking Doctrine. The court next addressed the granting of Golden's motion for summary judgment on the preference action. The Metcalfs' key defense to the motion for summary judgment was the earmarking doctrine. The earmarking doctrine is a court-made exception to a preference that applies when a third party or a lender loans or advances money to the debtor subject to an agreement requiring that the debtor use the funds to pay off another creditor. *Adams v. Anderson (In re Superior Stamp & Coin Co.)*, 223 F.3d 1004, 1007 (9th Cir. 2000). In short, the Metcalfs claimed that the \$21,035.58 they received was borrowed by Adbox from a third party for the sole purpose of paying off their claim and was never property of the debtor.

The Metcalfs, however, did not plead the earmarking doctrine as one of their affirmative defenses in the answer to the complaint, and Golden argued that the Metcalfs waived it. The Ninth Circuit noted that it had not previously addressed whether the earmarking doctrine is an affirmative defense and also noted that out-of-circuit cases reach conflicting conclusions. *Compare Shubert v. Lucent Techs. Inc. (In re Winstar Commns, Inc.)*, 348 B.R. 234, 273 (Bankr. D. Del. 2005) (earmarking is an affirmative defense and waived because not pled in the answer), *with Stingley v. AlliedSignal, Inc. In re Libby Intl, Inc.*, 247 B.R. 463, 467 (B.A.P. 8th Cir. 2000) (The earmarking doctrine is not strictly an affirmative defense under section 547(c)).

After surveying the existing cases, the Ninth Circuit agreed with the Eighth Circuit Bankruptcy Appellate Panel in *Libby International* that the earmarking doctrine is not one of the enumerated affirmative defenses in *Rule 8 of the Federal Rules of Civil Procedure*. The court held that, properly understood, the earmarking doctrine is a challenge to a trustee's claim that the funds in question were property of the debtor under *Bankruptcy Code* section 547(b). Therefore, the court held, the Metcalfs did not waive the earmarking doctrine by failing to raise it as an affirmative defense.

The court next asked who bears the burden of proof of the earmarking doctrine. Once again, the Ninth Circuit noted substantial confusion among courts on the issue and held that the trustee, as the plaintiff, bears the initial burden of establishing that a transfer is an avoidable preference under section 547. Once the trustee establishes that the transfer of disputed funds was from one of the debtors' accounts over which the debtor ordinarily exercised total control, the burden shifts to the defendant to show that the funds were earmarked.

Ultimately, the Ninth Circuit affirmed the bankruptcy court's summary judgment in favor of Golden because the Metcalfs could not prove that the third party loaned money to Adbox for the specific purpose of paying the Metcalfs.

Commentary. The decision in *Adbox* should greatly reduce meritless counterclaims asserted against trustees in preference actions. Although the Ninth Circuit left open the possibility of a creditor bypassing the proof of claim process by filing a counterclaim under different circumstances, the fact pattern that the Ninth Circuit frowned upon in *Adbox* is the typical case of a counterclaim asserted in a preference action. After *Adbox*, at least in the Ninth Circuit, a creditor who is sued for a preference action by a trustee should not be able to assert a counterclaim based on a debtor's prepetition conduct.

Moreover, although the decision in *Adbox* arose out of a chapter 7 case involving a trustee, the Ninth Circuit's rationale should apply to a preference action initiated in a chapter 11 case by a debtor-in-possession. Like a trustee, a debtor-in-possession in a preference action is suing in its representative capacity for the benefit of all creditors, except the defendant-creditor. In addition, a debtor-in-possession could not have brought the preference action prior to the bankruptcy case. Moreover, Bankruptcy Rule 7013 clearly states that a defendant need not assert a counterclaim against

the debtor unless the claim arose after the order for relief. Although the question was not addressed, it is, therefore, likely that the Ninth Circuit's decision in *Adbox* would also apply to a preference action initiated by a debtor-in-possession.

The Ninth Circuit's decision in *Adbox* also greatly clarifies the earmarking doctrine. The court held for the first time that the earmarking doctrine is not an affirmative defense and, as a result, is not waived if not pled in the answer. It appears that the Ninth Circuit is the first circuit level authority to address this issue, although there are lower level decisions from other circuits that are contrary. Until a circuit split develops and the Supreme Court decides the issue, the reasoning and ruling of the Ninth Circuit on this issue should carry the day in earmarking and conduit cases.

The Ninth Circuit for the first time also clarified the burden of proof on the earmarking doctrine. Its burden shifting approach flows from its decision that the earmarking doctrine is not an affirmative defense. If the earmarking doctrine is merely a challenge to a trustee's main preference allegations, it is only logical that a trustee, as the plaintiff, bears the initial burden to prove that the funds in dispute came from property of the debtor.

For further discussion of *Federal Rule of Bankruptcy Procedure 7013*, see Collier on Bankruptcy, ch. 7013 (Matthew Bender).

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11 of 16 DOCUMENTS

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Hon. Ralph R. Mabey on In re El Toro Materials Co.

2008 Emerging Issues 832

Hon. Ralph R. Mabey on In re El Toro Materials Co.

By Ralph R. Mabey

November 1, 2007

SUMMARY: Code section 502(b)(6) limits a real property lessors claims against the debtor that are for damages resulting from the termination of the lease. Following a decision by the Ninth Circuit Bankruptcy Appellate Panel, many courts have long held that this cap applies to claims for repair and maintenance. In *In re El Toro Materials Co.*, the Ninth Circuit has overruled that precedent, reasoning that such tort claims do not flow from rejection of the lease. According to the Hon. Ralph R. Mabey in his Expert Commentary, the decision is significant because landlords in the Ninth Circuit are now free to pursue against the debtors estate the full amount of claims that exist independently of lease termination.

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ARTICLE: The Ninth Circuit Effectively Overrules *McSheridan* and Holds That *Bankruptcy Code Section 502(b)(6)* Does Not Cap Damages Against Debtor Lessees for Waste, Nuisance, and Trespass

In *Saddleback Valley Community Church v. El Toro Materials Company, Inc. (In re El Toro Materials Company, Inc.)*, 2007 U.S. App. LEXIS 22991 (9th Cir. Oct. 1, 2007), the United States Court of Appeals for the Ninth Circuit analyzed a narrow question relating to claims asserted by landlords: Does *Bankruptcy Code section 502(b)(6)* limit a landlords tort claim against a debtor/lessee for the removal of waste, equipment, and other materials? In a brief but clear opinion authored by Judge Kozinski, the Ninth Circuit (1) held that the landlords tort claim was not limited by section 502(b)(6) and (2) effectively overruled an oft-cited Ninth Circuit Bankruptcy Appellate Panel opinion, *In re McSheridan*, 184 B.R. 91 (B.A.P. 9th Cir. 1995).

Facts and Procedural History. El Toro Materials Company, Inc. (the Debtor) was a lessee under a lease with Saddleback Valley Community Church (the Lessor). After filing bankruptcy, the Debtor rejected the lease and vacated the Lessors premises. The Lessor alleged that the Debtor left on the premises approximately one million tons of its wet clay goo, mining equipment, and other materials. Accordingly, the Lessor commenced an adversary proceeding against the Debtor that claimed \$23 million in damages for the alleged cost of removing the goo under theories of waste, nuisance, trespass, and breach of contract.

In a partial summary judgment order, the bankruptcy court held that the Lessors damages would not be limited by *Bankruptcy Code section 502(b)(6)*. On appeal, the Bankruptcy Appellate Panel of the Ninth Circuit reversed the

bankruptcy court and held that the Lessors damages would be capped by *Bankruptcy Code section 502(b)(6)*. The Lessor appealed the decision to the Ninth Circuit.

Legal Analysis. *Bankruptcy Code section 502(b)(6)* limits a real property lessors claim against a debtor if such claim is [a] claim . . . for damages resulting from the termination of a lease of real property.

In *McSheridan*, the appellate panel had held that a lessors claims for repair and maintenance were capped by *Bankruptcy Code section 502(b)(6)*. The appellate panel reasoned that since the repair and maintenance claims emanated from the terms of the lease between the landlord and debtor, such claims should be limited by section 502(b)(6). *McSheridan* was followed by over thirteen other courts in published opinions, and was relied upon by practitioners within the Ninth Circuit for over a decade.

However, the Ninth Circuit took a different approach towards analyzing a landlords tort claims. The Ninth Circuit first noted that the specific language of section 502(b)(6) applied only to damages resulting from the rejection of the lease. The court then articulated a test to determine whether the Lessors damages resulted from the rejection of the lease: Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it? 2007 U.S. App. LEXIS 22991, at *7.

In the Lessors case, the answer was yes. The Lessor would have possessed its waste, nuisance, and trespass causes of action against the Debtor even if the Debtor had not rejected the lease. As stated by Judge Kozinski:

Here, [the Lessor] would still have the same claim it brings today had [the Debtor] accepted the lease and committed to finish its term: The pile of dirt would still be allegedly trespassing on Saddlebacks land and Saddleback still would have the same basis for its theories of nuisance, waste and breach of contract. The million-ton heap of dirt was not put there by the rejection of the lease--it was put there by the actions and inactions of El Toro in preparing to turn over the site.

Id. Accordingly, the Ninth Circuit held that the Lessors waste, nuisance, and trespass causes of action were not limited by *Bankruptcy Code section 502(b)(6)*. In reaching this decision, the Ninth Circuit effectively overruled the *McSheridan* opinion [t]o the extent that *McSheridan* holds section 502(b)(6) to be a limit on tort claims other than those based on lost rent, rent-like payments or other damages directly arising from a tenants failure to complete a lease term. *Id.* at *9.

Commentary. The *El Toro Materials* opinion is a significant one. In the Ninth Circuit, debtors are now unable to limit landlords claims against them for damages arising from tortious conduct that is unrelated to the lease. While this result may initially seem inimical to the policy of limiting landlords claims in bankruptcy, it is consistent with the statutory language of *Bankruptcy Code section 502(b)(6)*.

Since the 1934 amendments to the Bankruptcy Act, Congress has sought to limit the claims of landlords, since such claims are often substantial and can quickly deplete [the debtors] estate, to the detriment of other creditors. *In re Best Prods. Co.*, 229 B.R. 673, 676 (*Bankr. E.D. Va.* 1998). At the same time, Congress has recognized that a debtors breach of a long term lease can cause significant harm to a landlord, particularly in poor markets. Accordingly, since 1934, the Bankruptcy laws have struck a compromise--landlords are entitled to assert claims for lost future rent, but only up to a specified limit. Under the Bankruptcy Act, lessors were authorized to assert a claim for back rent to the date of abandonment of the lease, along with damages of up to one year future rent. Presently, the Bankruptcy Code limits forward lease damages to the greater of one year, or 15 percent, not to exceed three years of the remaining term of such lease.

However, the Bankruptcy Code only limits a lessors claim that result[s] from the termination of a lease of real property. Since tort claims for waste and nuisance would exist regardless of whether an underlying lease was terminated, it is appropriate, under the language of *Bankruptcy Code section 502(b)(6)*, to allow a lessor to assert the full amount of such claim against the debtors estate.

While the Ninth Circuit's decision in *El Toro Materials* is consistent with the plain meaning of *Bankruptcy Code* section 502(b)(6), the court also cited policy in support of its decision. In stating that the section 502(b)(6) cap should not cover collateral damages, the Ninth Circuit opined, with apparent hyperbole, that [i]f the tenant's debt to the landlord already exceeded the cap then there would be no deterrence against even the most flagrant acts in violation of the lease, possibly even to the point of the tenant burning down the property in a fit of pique. 2007 U.S. App. LEXIS 22991, at *9. Presumably, even if the Bankruptcy Code failed to deter such behavior, debtors would be reluctant to burn or otherwise destroy leased property due to the existence of applicable criminal statutes.

Regardless, in sum, the *El Toro Materials* decision will certainly impact future bankruptcy proceedings, particularly ones in the Ninth Circuit. In determining whether a lessor's claim should be capped by *Bankruptcy Code* section 502(b)(6), bankruptcy courts will now need to apply the *El Toro Materials* test: Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?

For further discussion of section 502 of the *Bankruptcy Code*, see Collier on Bankruptcy, ch. 502 (Matthew Bender).

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12 of 16 DOCUMENTS

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Hon. Ralph R. Mabey on In re Northwest Airlines Corp.

2008 Emerging Issues 833

Hon. Ralph R. Mabey on In re Northwest Airlines Corp.

By Ralph R. Mabey

November 1, 2007

SUMMARY: The bankruptcy court in the Northwest Airlines case refused to reconsider its previously approved rejection of the collective bargaining agreement with the flight attendants union. Rejection under Code section 1113 is a final step, the court held, and cannot be later questioned in light of changed financial circumstances. In so ruling, the court relied on what the Hon. Ralph R. Mabey calls the Second Circuits poof theory of contract rejection. Yet, as he explains in his Expert Commentary, the decision leaves unresolved the far-reaching consequences of this theory.

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ARTICLE: Rejection of a Collective Bargaining Agreement under Code Section 1113 Is Not Reviewable for Changed Circumstances and, Unlike

Rejection under Section 365, Does Not Result in a Damages Claim

The bankruptcy-court approved rejection by Northwest Airlines Corporation of its collective bargaining agreement with the Association of Flight Attendants (the AFA) was not appealed. After the approved contract changes had been implemented, however, the AFA asked the bankruptcy court to reconsider its rejection decision based upon changed circumstances. In the meantime, the U.S. Court of Appeals for the Second Circuit had upheld the district courts issuance of an anti-strike injunction against the AFA in *Northwest Airlines Corp. v. Association of Flight AttendantsCWA (In re Northwest Airlines Corp.)*, 483 F.3d 160 (2d Cir. Mar. 29, 2007) (Second Circuits *Northwest* Decision). Based upon certain of the holdings of the Second Circuit, the bankruptcy court denied the AFAs request for reconsideration and disallowed the AFAs contract rejection damages claim.

Changed Circumstances

Nine months after the bankruptcy court issued an order (the Rejection Order) granting Northwests application to reject its collective bargaining agreement with the AFA, the AFA filed a motion for relief from the Rejection Order. *In re Northwest Airlines Corp.*, 366 B.R. 270, 271 (*Bankr. S.D.N.Y.* 2007). The AFA contended that Northwests financial condition had vastly improved between the time that the Rejection Order was entered and the time the motion for relief

was brought and that the court would not have issued the Rejection Order in the first place had it been based upon Northwest's since-improved condition. The Rejection Order had been entered following the court's consideration of the facts of the case at that time, and upon a determination that the equities of the case strongly favored rejection of the collective bargaining agreement as required by *Bankruptcy Code section 1113*.

The court disagreed with the AFAs' contention that the rejection of a collective bargaining agreement under section 1113 should be reconsidered under the facts and circumstances before it. First, the court found that Northwest's improved financial condition was largely the result of its rejection of collective bargaining agreements with various unions. *Id.* at 272. The court observed that reconsideration of the Rejection Order would likely lead to similar requests by other unions, many of which had already entered into new agreements with Northwest. Noting the irony of the AFAs' request, the court stated: Relief granted to AFA and the other unions would likely reverse much, if not all, of the financial improvement on which AFA relies and defeat the very foundation of its motion. *Id.*

The court then held that language from the Second Circuit's *Northwest* Decision must be read to bar the AFAs' motion for relief. The Second Circuit had recently held that Northwest's rejection of its collective bargaining agreement with the AFA meant that the agreement had been abrogated and therefore ceased to exist. *Id.* Since that agreement was no longer in existence, the bankruptcy court deduced that [t]here is nothing to revive pursuant to the terms of § 1113, as construed by the Circuit. *Id.*

In further support of its ruling, the bankruptcy court likened the rejection of a collective bargaining agreement under section 1113 to the more frequently applied rejection of an executory contract under section 365. Rejection under both provisions, according to the court, is not a tentative step to be confirmed at a later stage of the bankruptcy case, but a final act that has immediate consequences. *Id.* Moreover, the court found that neither provision requires a debtor to wait until the end of a chapter 11 case to reject an agreement, despite the fact that the possibility always exists that a debtor's financial condition may change. *Id.* Allowing reconsideration, according to the court, would undermine [a] debtor's right to seek reasonable § 1113 relief as a predicate to its ability to formulate a feasible plan. *Id.*

The court found further support for its holding from language in the neighboring provision of section 1114. *Id.* at 272-73. Section 1114 specifically allows only for modification of retiree plans, as opposed to rejection. Section 1113 allows a court to reject collective bargaining agreements, not to modify them. Therefore, the court noted, Congress intended abrogation under § 1113 to be a final step, not subject to later modification. *Id.* at 273.

The court was unmoved by the AFAs' appeal to equity in support of its motion. Despite an injunction affirmed by the Second Circuit, the AFA had threatened to engage in disruptive activities designed to force the Debtor to agree to improved collective bargaining terms, and, in response, the court invoked the maxim that [a] party who seeks equity must do equity. *Id.* at 274. In addition, the court explained that the AFAs' appeal for equitable relief was not compelling because the AFA had the option of sharing in Northwest's ongoing success by accepting a new collective bargaining agreement with Northwest. Agreements entered into by other unions had provided for substantial profit sharing and for the distribution of large and valuable proofs of claim. *Id.*

Commentary. The court was not faced with a question of fraud or mistake in its rejection decision. Had those facts been presented squarely, the court might well have found the elbow room to reconsider its decision.

Although the court did not discuss the language of section 1113 at length in the opinion, that section provides additional support for the court's ruling that changed circumstances do not warrant reconsideration. Section 1113(b)(1)(A) states that, before rejection of a collective bargaining agreement, a debtor in possession is obligated to make a proposal to the representative of the employees based upon the most complete and reliable information available *at the time of such proposal* (emphasis added). Section 1113(c) goes on to state that a court shall approve an application for rejection of a collective bargaining agreement, only if (1) the court finds that the debtor in possession made a proposal that fulfills the requirements of subsection (b)(1), (2) the employees refused to accept the proposal without good cause, and (3) the balance of the equities favors rejection.

This language of section 1113 makes clear that a court's determination of whether to reject a debtor in possession's collective bargaining agreement must be based upon the most reliable information available at the time the debtor in possession submits its proposal to the employees. Section 1113 does not state that the debtor in possession has a duty to make a new proposal whenever circumstances change, or even that the court should consider whether the facts of a case have changed between the time the proposal was made and the time that the court considers the application for rejection. Of course, the court could consider such changes in balancing the equities before the entry of an order. But nothing in section 1113 suggests that a court can or should reevaluate its decision to reject a collective bargaining agreement based upon changed circumstances following the entry of an order.

Of much greater interest, however, is the bankruptcy court's reliance upon the Second Circuit's (majority opinion) *poof* theory of contract rejection (my term). It has generally been understood that rejection of an executory contract constitutes a breach of the contract, *not* its vaporization or, to use J.K. Rowling's term, its disappearance. Because the rejected contract survives rejection as a breached contract, it has, among other things, been accepted that the innocent party is entitled to damages under section 502(g) and may be entitled to enforce certain provisions of the rejected contract such as non-compete clauses, nondisclosure provisions, and the like.

As the bankruptcy court correctly points out, however, the majority in the Second Circuit's *Northwest* Decision holds that a rejected contract under section 1113 is abrogated and therefore ceases to exist--it just goes *poof*. As a result, there is no contract upon which a motion to reconsider the rejection may be based.

In the Second Circuit's *Northwest* Decision, Chief Judge Jacobs concurs in the result, but not in the reasoning of the majority. The majority concluded that the debtor had not altered the status quo under the Railway Labor Act because the collective bargaining agreement, once rejected, ceased to exist and there was no status quo to alter. Second Circuit's *Northwest Decision*, 483 F.3d 160, 173. Because the debtor had not altered the status quo, the AFA was prohibited from striking under the Railway Labor Act. Chief Judge Jacobs found this line of reasoning impossible to explain [] to the flight attendants. *Id.* at 177. Instead, he accepted the traditional doctrine that a rejected labor contract continues to exist. *See id.* at 177-78. As a result, he concluded that the contract rejection may breach the status quo that is protected by the Railway Labor Act, but--on these facts--did not do so unilaterally (because of the protective statutory procedures surrounding section 1113). This reasoning led C.J. Jacobs to determine that the AFA may not strike and he, therefore, concurred in the result.

The *poof* theory of labor contract rejection adopted by the Second Circuit's majority has far-reaching consequences, as we see below.

No Damage Award for Rejection

The AFA filed two proofs of claim in the case, both in the amount of \$1.2 billion, for damages allegedly resulting from the Rejection Order. *Northwest Airlines Corp.*, 366 B.R. at 271. The AFA also sought damages resulting from the court's authorization of interim changes to the collective bargaining agreement under section 1113(e). *Id.* at 275. The bankruptcy court agreed with *Northwest* that the claims filed by the AFA for damages resulting from the Rejection Order were not allowable. *Id.*

In denying the AFAs requests for damages, the bankruptcy court relied almost exclusively on the Second Circuit's *Northwest* Decision. Specifically, the court interpreted the Second Circuit's holding to expressly exclude[] the possibility of damages for the lawful rejection of a collective bargaining agreement pursuant to § 1113. *Id.* This conclusion followed from the court's explanation that the Second Circuit had held that the rejection of a collective bargaining agreement pursuant to section 1113 abrogated (without breaching) the existing collective-bargaining agreement between

AFA and Northwest, which thereafter ceased to exist. *Id.* Since there was no collective bargaining agreement, there was no breach of it and there were no damages. *Id.*

In support of its holding the Second Circuit majority cited *In re Blue Diamond Coal Co.*, the only prior decision to hold that section 1113 does not provide for, and therefore excludes, the possibility of a proof of claim for rejection damages. *In re Blue Diamond Coal Co.*, 147 B.R. 720, 732 (Bankr. E.D. Tenn. 1992), *affd*, 160 B.R. 574, 576-77 (E.D. Tenn. 1993); *see also* *ONeill v. Continental Airlines, Inc. (In re Continental Airlines)*, 981 F.2d 1450, 1460 (5th Cir. 1993) (pre-section 1113 decision generally discussing whether a union should have a claim for breach of a rejected collective bargaining agreement).

The court finally determined that in light of the Second Circuits holding, there was no need to consider whether damages for rejection of a collective bargaining agreement are so inherently speculative and non-quantifiable that they should be disallowed as a claim for that reason. 366 B.R. at 276.

Commentary. The bankruptcy courts analysis of the AFAs proofs of claim for damages resulting from the rejection of the collective bargaining agreement is wholly consistent with the Second Circuit majoritys reasoning that the collective bargaining agreement ceased to exist once it was rejected. But the correctness of that reasoning is an open question whose answer has far-reaching implications. If a rejected collective bargaining agreement ceases to exist, what happens to the hundreds of provisions in that agreement that the debtor does not seek to alter? Are they open to renegotiation? Can they now be ignored without any risk of liability even for damages? Under the National Labor Relations Act, in cases where the Railway Labor Act does not apply, what duties and rights do the parties have absent a contract? What happens to pension and other rights contained in or dependent upon the former collective bargaining agreement?

The bankruptcy court addressed two consequences of the Second Circuits *Northwest* Decision: Reconsideration of the rejection of a collective bargaining agreement is not possible, and the union has no claim for damages. Other consequences remain unaddressed.

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Courts, parties, and the Department of Justice (U.S. Trustee Program) have appointed Judge Mabey to serve as mediator, arbitrator, examiner, or trustee in Alaska, Arizona, California, Louisiana, Michigan, New York, Texas, Utah, Virginia, and Washington, D.C.

Judge Mabey is a member of the New York and Utah Bars.



13 of 16 DOCUMENTS

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Hon. Ralph R. Mabey on In re Gencarelli

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Hon. Ralph R. Mabey on In re Gencarelli

By Ralph R. Mabey

October 23, 2007

SUMMARY: The allowance of prepayment penalties can significantly affect the ultimate distribution of funds in a bankruptcy, but there is little case law on the subject. The First Circuits decision in *In re Gencarelli* is therefore of great interest. In allowing an oversecured creditor to collect prepayment penalties as an unsecured claim, the court touched upon the relationship between sections 502 and 506(b), the vitality of the solvent debtor doctrine, and possible solutions to the analytic problem remaining after the Supreme Courts *Travelers* decision. In his Expert Commentary, the Hon. Ralph R. Mabey finds that the opinion not only reaches the correct result, but is judiciously crafted and provides meaningful guidance.

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ARTICLE: First Circuit Affirms the Validity of the Solvent Debtor Doctrine in the Context of a Dispute over Prepayment Penalties

The enforceability of so-called prepayment penalties in bankruptcy has traditionally been a contentious and difficult issue. In a recent decision with significant implications for all debtors, but particularly for solvent debtors, the U.S. Court of Appeals for the First Circuit held that an oversecured creditor may collect prepayment penalties--to the extent those penalties are enforceable under the applicable nonbankruptcy law--as an unsecured claim under the rubric of *Bankruptcy Code* section 502, even if such penalties do not meet the reasonableness test of section 506(b). *UPS Capital Business Credit v. Gencarelli (In re Gencarelli)*, 2007 U.S. App. LEXIS 20751, at *18-19 (1st Cir. Aug. 30, 2007).

Framing the Debate. A common feature of many loan agreements is a provision regarding the borrowers ability to repay the debt before its scheduled maturity. This sort of provision goes by a variety of names--prepayment penalty, prepayment provision, yield maintenance premium, etc.--but the substantive function is the same: The lender wishes to allocate the costs of a decline in interest rates to the borrower, thereby allowing the lender to take comfort in some minimal profit margin on the loan. Thus, the prepayment clause serves to compensate the lender for its loss of the regular income stream provided by the loan, which necessarily occurs whenever a borrower satisfies the debt before maturity.

The enforcement of a prepayment provision can significantly affect the distributions received by the various constituencies in bankruptcy, which likely explains why disputes over such provisions have arisen in several recent

cases, including *Northwest Airlines*, *Calpine*, and *NRG Energy*. Notwithstanding the economic importance of the issue, there is surprisingly little case law to guide the analysis, and some of the existing decisions seem inconsistent. ⁿ¹ *Gencarelli* is an important addition to the doctrine.

The Facts and Posture of *Gencarelli*. In early 2002, the Bess Eaton Donut Flour Company and its sole shareholder, Louis A. Gencarelli, Sr., borrowed approximately \$7,000,000 on a secured basis from UPS Capital Business Credit. The underlying loan documentation, which was to be governed by Rhode Island state law, provided for a floating rate of interest over the life of the agreement. The loan documentation also provided that the debt could be repaid at any time, provided that the borrowers satisfied certain prepayment penalties.

Approximately two years later, both Bess Eaton and Gencarelli filed for bankruptcy, and the two cases were consolidated. The cases ended in a section 363 sale of Bess Eatons operating assets, which fetched a far higher price than had been anticipated--so much higher that the bankruptcy estates wound up with funds sufficient to pay all creditors in full (including interest), while also leaving a multimillion dollar surplus for *Gencarelli*. 2007 U.S. App. LEXIS 20751, at *3.

Meanwhile, UPS filed timely proofs of claim in which it asserted rights to the outstanding principal and accrued interest on the debt, as well as the prepayment penalties. Based upon the formulas in the loan documents, the penalties were approximately \$200,000. Gencarelli filed an objection to UPSs prepayment penalties, arguing that although UPS was oversecured, the penalties were not reasonable under section 506(b) of the Bankruptcy Code, and thus could not be the basis for an allowable claim. The U.S. Bankruptcy Court for the District of Rhode Island agreed with Gencarellis legal construct and factual analysis, and thus found the penalties unreasonable in amount and disallowed UPSs claims for them in their entirety. *Id.* at *4-5.

UPS then appealed to the U.S. District Court for the District of Rhode Island. Although most of the briefing was devoted to whether the prepayment penalties were reasonable under section 506(b), UPS also argued that a finding that fees, costs, or charges are unreasonable under § 506(b) means only that they cannot be allowed as a secured claim, and instead must be treated as an unsecured claim. *Id.* at *5. The district court was not convinced; it agreed that section 506(b) governed and that an oversecured creditor can recover charges, such as prepayment penalties, only if they are reasonable, and also concurred with the bankruptcy courts determination that UPSs penalties were not reasonable. *Id.* at *5-6 (citing *UPS Capital Bus. Credit v. Gencarelli*, No. 1:05-cv-00039, 2006 U.S. Dist. LEXIS 94760 (D.R.I. Nov. 3, 2006)).

UPS appealed again, arguing to the First Circuit that section 506(b)s reasonableness standard is not relevant to the question of whether an oversecured creditor is entitled to a contractually-based prepayment penalty from a solvent debtor. *Id.* at *6. Gencarelli responded that this argument (i) was not preserved for appeal, (ii) is an incorrect reading of the Bankruptcy Code, and (iii) ignores the lower courts findings of unreasonableness.

The *Gencarelli* Opinion. The First Circuit, in an unanimous opinion written by Senior Circuit Judge Bruce M. Selya, began its analysis by examining the interrelationship between sections 502 and 506(b) of the [Bankruptcy] Code. *Id.* at *7. Upon doing so, the court concluded that UPSs statutory interpretation argument was correct, reasoning that:

As a matter of bankruptcy law, the lower courts should not have disallowed the claims for prepayment penalties in toto based solely upon a finding that they were not entitled to priority under section 506(b). Section 502, not section 506(b), affords the ultimate test for allowability, and any claim satisfying that test is, at the very worst, collectible as an unsecured claim. Leading commentators, case law from other circuits, and common sense all conduce to this result.

Id. at *9 (emphasis added).

Thus, the proper mode of analysis begins with section 502 in order to determine whether the creditor has any allowable claim in the first instance. If such a claim exists, one should *then* turn to section 506(b) in order to determine

whether that claim meets the conditions necessary to be included as part of the oversecured creditors secured claim. A claim that falls outside of section 506(b), including one that is not reasonable, remains a valid claim, but should be classified as unsecured. *See id.* at *10-12. The First Circuit emphasized that the opposite framework, which was adopted by the lower courts and defended by Gencarelli, would def[y] common sense and create an uneven playing field by uniquely penalizing the oversecured creditor: [I]t makes sense that oversecured creditors should not be allowed to prioritize unreasonable fees, costs, and charges; it does not make sense that oversecured creditors should be penalized by disallowing those fees, costs, and charges altogether--especially when unsecured creditors can collect them. *Id.* at *12-14.

The First Circuit further grounded its conclusion in the equities of the case--i.e., the fact that the debtors were solvent and that any amount not paid to UPS would return to Gencarelli's pockets. More specifically, the court stated:

Let us be perfectly clear. This is a solvent debtor case and, as such, the equities strongly favor holding the debtor to his contractual obligations as long as those obligations are legally enforceable under applicable non-bankruptcy law. When the debtor is solvent, the bankruptcy rule is that where there is a *contractual* provision, valid under state law, the bankruptcy court will enforce the contractual provision.

Id. at *14 (internal citation, punctuation, and footnote omitted). Thus, because Gencarelli had willingly contracted for the prepayment penalties, it was not the place of bankruptcy courts to disturb the parties' bargain so as to provide Gencarelli with a windfall.

The First Circuit rounded out the analysis portion of its opinion with a brief procedural discussion, after which it concluded that (i) UPS arguably preserved the statutory interpretation issue for appeal, albeit barely; and (ii) even if UPS had not technically preserved the issue, the court would deem it preserved in order to avoid a difficult question that has significant ramifications for the commercial lending industry but no clear-cut answer--i.e., how section 506(b)'s reasonableness requirement applies to prepayment provisions in commercial loans. *Id.* at *16-18. Rather than wander into this quagmire, the court was content to allow its analysis of the interrelationship between sections 502 and 506(b) to determine the outcome of the appeal.

Having concluded that UPS would have a valid claim for the prepayment penalties under *section 502 of the Bankruptcy Code* if they were enforceable under applicable nonbankruptcy law, the First Circuit remanded the matter so that the bankruptcy court could determine if such penalties are permitted in Rhode Island. *See id.* at *19-20. *Cf. River E. Plaza, L.L.C. v. Variable Annuity Life Ins. Co.*, 2007 U.S. App. LEXIS 19925 (7th Cir. Aug. 22, 2007) (holding, outside the context of bankruptcy, that a treasury-flat voluntary prepayment premium was valid and enforceable under Illinois state law).

Commentary on Gencarelli. The *Gencarelli* decision is a well-reasoned and judiciously crafted opinion that reaches the proper result while also highlighting several important issues.

First, the First Circuit's analysis of the relationship between *sections 502 and 506(b) of the Bankruptcy Code* is the correct one. Section 502 is clearly drafted to be the touchstone of allowability, whereas section 506(b)--situated in the Bankruptcy Code under the header determination of secured claims--performs a far more discrete function: to provide whether an oversecured creditor may add additional amounts to increase its prepetition secured claim, such as post-petition interest, attorneys' fees, and other reasonable charges. To the extent a particular claim falls outside the scope of section 506(b) but would be enforceable against the debtor outside of bankruptcy, such claim should retain its vitality as an *unsecured claim*, unless it is not allowed pursuant to some provision of section 502 or other principles of bankruptcy law. *See, e.g., 11 U.S.C. § 502(b)(2)* (post-petition interest not allowable in bankruptcy); *In re Elec. Mach. Enters.*, 371 B.R. 549 (Bankr. M.D. Fla. 2007) (discussing several noncodified principles of bankruptcy law that could arguably serve as grounds upon which to disallow an unsecured creditor's claim for post-petition attorneys' fees). While reasonable people may differ about the extent to which equitable principles should trigger the disallowance of claims for post-petition attorneys' fees, default rate interest, and prepayment penalties in insolvent cases, the point remains that

section 506(b) should never be the exclusive statutory provision guiding the analysis. This crucial point is at the core of the Gencarelli opinion.

Second, the First Circuit was correct to observe the effects of what could be called the solvent debtor doctrine on the analysis. The notion that equitable considerations weigh in favor of fully enforcing all aspects of a contract when a debtor is solvent is a sensible one that has been endorsed by numerous courts, including by appellate courts in the First, Second, Sixth, and Seventh Circuits. n2 Indeed, this concept can be traced back to the seminal decision in *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 67 S. Ct. 237, 91 L. Ed. 162 (1946). Any other rule would create improper incentives for solvent debtors to turn to the bankruptcy process--not to restructure their finances or operations, but solely to avoid otherwise enforceable obligations to the benefit of equity holders. Such a result clearly does not advance the social goals that motivate a uniform federal bankruptcy regime in the first instance.

While sensible and proper, the solvent debtor doctrine may not represent the law of the land in all circuits. For instance, the Ninth Circuit has held that a plan intended to nullify the consequences of a default (thereby avoiding the higher post default interest rate) is consistent with the purposes of the Bankruptcy Code, which means it does not violate the good faith requirement of section 1129(a)(3) for a solvent debtor to propose a plan of reorganization intended solely to accomplish this result. See *Platinum Capital, Inc. v. Sylmar Plaza, L.P. (In re Sylmar Plaza, L.P.)*, 314 F.3d 1070, 1074-75 (9th Cir. 2002), cert. denied, 538 U.S. 1035 (2003). n3 *Sylmar Plaza* arguably is at odds with the notion that solvent debtors should fully comply with all valid contractual obligations, and thus the case may be an outlier in the solvent debtor doctrine jurisprudence.

The solvent debtor doctrine also gives rise to other complicated questions, such as whether the analysis should be performed on a debtor-by-debtor or consolidated basis (this could be a key issue in the bankruptcy cases of a large corporate family, such as in *Adelphia*), as well as about the appropriate methods and time for measuring solvency. It is likely that such questions may be partially addressed in the *Calpine* bankruptcy case, perhaps during the appeal taken from Bankruptcy Judge Liflands recent opinion. See *In re Calpine Corp.*, 365 B.R. 392, 400-01 (Bankr. S.D.N.Y. 2007).

In any event, although the force of the solvent debtor doctrine appears to be the subject of a fermenting circuit split and creates many practical questions, it generally is an appropriate rule. Consequently, the First Circuit was correct to embrace that doctrine in *Gencarelli*.

Third, it is worth briefly considering two interesting footnotes in *Gencarelli* that suggest a possible solution to the issue raised by the Supreme Courts recent decision in *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.*, 127 S. Ct. 1199, 167 L. Ed. 2d 178, 57 C.B.C.2d 314 (2007). Specifically, the question of unsecured creditors rights to receive post-petition attorneys fees is likely to be the subject of intense disagreement and litigation during the next wave of bankruptcies. One argument that some advance is that section 506(b) should be read, by negative implication, to preclude an award of post-petition attorneys fees to any creditors other than those that are oversecured. Such an argument often relies upon the Courts prior decision in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988). The *Timbers of Inwood Forest* case apparently featured prominently in the parties briefing in *Gencarelli*, but the First Circuit brushed the decision aside via the following footnote:

Although both parties discuss at length the Supreme Courts decision in [*Timbers of Inwood Forest*], we regard that decision as inapposite. The case dealt with claims for post-petition interest, which--unlike the prepayment penalties at issue here--are made unavailable as unsecured claims by an explicit statutory provision. *Id.* [484 U.S.] at 372-73; see 11 U.S.C. § 502(b)(2).

2007 U.S. App. LEXIS 20751, at *12 n.2. This is an important point, one that does seem to distinguish *Timbers of Inwood Forest* in the context of claims not explicitly addressed by the Bankruptcy Code (including post-petition

attorneys fees, prepayment penalties, and the like). One hopes it is not lost on future courts considering such issues.

At various points in *Gencarelli*, the First Circuit drew an analogy between prepayment penalties and post-petition attorneys fees. *See, e.g., id.* at *10 n.1 (there is no principled basis for treating attorneys fees differently from prepayment penalties in this context). This comparison makes the following footnote particularly meaningful:

We recognize that bankruptcy courts are courts of equity, and that the balance of the equities may be different if unsecured creditors are at risk of collateral damage. For that reason, this opinion should not be construed as speaking to the different question of whether an unsecured creditor can enforce a contractual right to post-petition fees against the estate of an *insolvent* debtor under section 502. *See Travelers Cas. & Sur. Co. v. Pac. Gas & Elec. Co.*, 127 S. Ct. 1199, 1207, 167 L. Ed. 2d 178 (2007) (reserving this question).

2007 U.S. App. LEXIS 20751, at *15 n.3 (citation omitted). Although not *answering* the issue raised in *Travelers*, the First Circuits *dictum* does provide an interesting possible solution, one that would be generally consistent with other decisions that predate *Travelers*. *See, e.g., In re Loewen Group Intl, Inc.*, 274 B.R. 427, 442-45 (Bankr. D. Del. 2002) (disallowing certain unsecured creditors claims for post-petition attorneys fees because, inter alia, such claims would have an unfair dilutive effect on other unsecured creditors). This possibility further underscores the import of the solvent debtor doctrine and suggests that the doctrine may have broader implications. Ultimately, however, that must remain a different issue to be resolved another day.

Taken as a whole, the First Circuits decision in *Gencarelli* is an interesting and well-reasoned opinion that touches on a number of issues of contemporary importance to bankruptcy law, including the relationship between sections 502 and 506(b), the vitality of the solvent debtor doctrine, the enforceability of prepayment penalties, and possible solutions to the analytic problem that remains open after *Travelers*. As such, it is an important decision that should provide meaningful guidance to parties who find themselves on both sides of similar disputes in future bankruptcy cases.

For complete discussion of sections 502 and 506(b) of the Bankruptcy Code, see Collier on Bankruptcy, ch. 502 and ch. 506 (Matthew Bender).

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Return to Text

n1 . *See generally, e.g., Continental Sec. Corp. v. Shenandoah Nursing Home Pship*, 193 B.R. 769 (W.D. Va. 1996); *In re Imperial Coronado Partners, Ltd.*, 96 B.R. 997 (B.A.P. 9th Cir. 1989); *In re Granite Broadcasting Corp.*, 369 B.R. 120 (Bankr. S.D.N.Y. 2007); *In re Calpine Corp.*, 365 B.R. 392 (Bankr. S.D.N.Y. 2007); *In re Vanderveer Estates Holdings, Inc.*, 283 B.R. 122 (Bankr. E.D.N.Y. 2002); *Noonan v. Fremont Fin. (In re Lappin Elec. Co.)*, 245 B.R. 326 (Bankr. E.D. Wis. 2000); *In re Skyler Ridge*, 80 B.R. 500 (Bankr. C.D. Cal. 1987); *In re 360 Inns, Ltd.*, 76 B.R. 573 (Bankr. N.D. Tex. 1987).

n2 . *See, e.g., Official Comm. of Unsecured Creditors v. Dow Corning Corp. (In re Dow Corning Corp.)*,

456 F.3d 668 (6th Cir. 2006), cert. denied, 127 S. Ct. 1874 (2007); *In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 791 F.2d 524 (7th Cir. 1986) (Posner, J.); *Debentureholders Protective Comm. of Contl Inv. Corp. v. Contl Inv. Corp.*, 679 F.2d 264 (1st Cir. 1982), cert. denied sub nom. *Glen Corp. v. O.C. Assocs.*, 459 U.S. 894 (1982); *Ruskin v. Griffiths*, 269 F.2d 827 (2d Cir. 1959), cert. denied, 361 U.S. 947 (1960); *In re 139-141 Owners Corp.*, 313 B.R. 364 (S.D.N.Y. 2004); *Florida Asset Fin. Corp. v. Dixon (In re Dixon)*, 228 B.R. 166 (W.D. Va. 1998); *In re Calpine Corp.*, 365 B.R. 392 (Bankr. S.D.N.Y. 2007); *Clifftondale Oaks, LLC v. Silver Lake Enters., LLC (In re Clifftondale Oaks, LLC)*, 56 C.B.C.2d 13, 357 B.R. 883 (Bankr. N.D. Ga. 2006); *In re Liberty Warehouse Assocs. Ltd. Pship*, 220 B.R. 546 (Bankr. S.D.N.Y. 1998); *In re Vest Assocs.*, 217 B.R. 696 (Bankr. S.D.N.Y. 1998); *In re Consolidated Operating Partners L.P.*, 91 B.R. 113 (Bankr. D. Colo. 1988); *In re Skyler Ridge*, 80 B.R. 500 (Bankr. C.D. Cal. 1987).

n3

[3]. The *Sylmar Plaza* decision is based on the courts conclusion that its prior decision in *In re Entz-White Lumber & Supply, Inc.*, 850 F.2d 1338 (9th Cir. 1988), remains good law. Yet the *Sylmar Plaza* opinion did not consider the possible ramifications of Congresss addition of section 1123(d) to the *Bankruptcy Code* in 1994, an event that has led other courts to question the continuing validity of *Entz-White*. See, e.g., *Southland Corp. v. Toronto-Dominion (In re Southland Corp.)*, 160 F.3d 1054, 1059 n.6 (5th Cir. 1998); *In re Pacific Gas & Elec. Co.*, 49 C.B.C.2d 446, 283 B.R. 41, 59 (N.D. Cal. 2002), revd on other grounds, 350 F.3d 932 (9th Cir. 2003); *Hassen Imports Pship v. KWP Fin. VI (In re Hassen Imports Pship)*, 45 C.B.C.2d 679, 256 B.R. 916, 924 n.13 (B.A.P. 9th Cir. 2000); *Hepner v. PWP Golden Eagle Tree, LLC (In re K & J Props., Inc.)*, 338 B.R. 450, 461 (Bankr. D. Colo. 2005). But see, e.g., *Casa Blanca Project Lenders, L.P. v. City Commerce Bank (In re Casa Blanca Project Lenders, L.P.)*, 196 B.R. 140, 147 n.10 (B.A.P. 9th Cir. 1996); *Bank of Am., N.A. v. Garcia (In re Garcia)*, 276 B.R. 627, 636 n.33 (Bankr. D. Ariz. 2002); *In re Phoenix Bus. Park Ltd. Pship*, 257 B.R. 517, 520-22 (Bankr. D. Ariz. 2001). Accordingly, until the effects of section 1123(d) are fully considered by the Ninth Circuit, it may be premature to assume that *Entz-White* remains good law (and, by implication, that the decision in *Sylmar Plaza* was correct).

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Judge Mabey is the past President and Chair of the American College of Bankruptcy. He served as an appointee of the Chief Justice of the United States to the U.S. Judicial Conferences Advisory Committee on the Bankruptcy Rules. He

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committee); TWA (as counsel for the pilots); American Airlines (as counsel for the pilots); Enron (as special counsel for the debtor); Cajun Electric Power Cooperative (as chapter 11 trustee); Boston Chicken (as an expert witness); and At Home/Excite (as an expert witness).

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14 of 16 DOCUMENTS

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Hot Topic: Travelers Casualty & Surety Company of America v. PG & E

2008 Emerging Issues 3054

Hot Topic: Travelers Casualty & Surety Company of America v. Pacific Gas & Electric Co.

By LexisNexis Hot Topics

September 22, 2007

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15 of 16 DOCUMENTS

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Mabey on In re National Energy & Gas Transmission

2008 Emerging Issues 482

Mabey on In re National Energy & Gas Transmission

By Ralph R. Mabey

August 31, 2007

SUMMARY: In recovering a debt from a non-debtor guarantor, a creditor is not free to classify a payment as principal in order to collect postpetition interest, or so the Fourth Circuit has held over a vigorous dissent. The decision turns on resolution of two conflicting doctrines of bankruptcy law, and the Hon. Ralph R. Mabey explains in his expert commentary that the dissent perhaps presented the stronger argument. Certainly, from a policy perspective, the majority did not reach an optimal or efficient result.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Over a Strong Dissent, Fourth Circuit Holds That a Creditor Cannot Apply Non-Debtor Payments so as to Circumvent Section 502(b)(2)

Most bankruptcy practitioners accept the proposition that postpetition interest cannot be collected on unsecured claims against insolvent debtors. The proposition that the Bankruptcy Code cannot affect the respective rights of non-debtor parties is more controversial but is generally accepted as the proper rule. In a recent decision, the Court of Appeals for the Fourth Circuit had occasion to consider what happens when these two bankruptcy principles collide. By a 21 margin, the Fourth Circuit held that a creditor may not allocate a payment made by a non-debtor guarantor first to interest then principal, thus preserving the unpaid principal for collection in bankruptcy, because to do so would permit the creditor to collect an amount otherwise disallowed as post-petition interest. *National Energy & Gas Transmission, Inc. v. Liberty Elec. Power, LLC (In re National Energy & Gas Transmission, Inc.)*, 492 F.3d 297, 2007 U.S. App. LEXIS 16263 (4th Cir. 2007).

Framing the Debate. It has long been a maxim of bankruptcy law that the accumulation of interest on claims against a bankruptcy estate is suspended as of the date the petition in bankruptcy is filed. *See, e.g., Nicholas v. United States*, 384 U.S. 678, 682, 86 S. Ct. 1674, 16 L. Ed. 2d 853 (1966). This result is codified in section 502(b)(2) of the *Bankruptcy Code*, which provides that a claim against the estate shall not be allowed if such claim is for unmaturing interest. While the rule disallowing claims for postpetition interest is subject to certain exceptions, such as when a creditor is oversecured n1 or when the debtor is solvent, n2 the general rule is that postpetition interest is not allowed on unsecured claims.

While creditors rights in bankruptcy are cabined in many respects by the Bankruptcy Code, the bankruptcy process

generally does not affect a creditors rights as against non-debtor parties. *See generally* 11 U.S.C. § 524(e) (expressly providing that discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt). This rule is observed and applied in a number of different settings. For instance, some courts allow landlords to recover amounts in excess of the section 502(b)(6) cap from non-debtor parties on the grounds that the Bankruptcy Code does not alter rights between a pair of non-debtors. n3 Likewise, inter-creditor rights, such as those arising under a subordination agreement, are generally controlled exclusively by state law. n4 Most germane to the *National Energy* fact-pattern is a line of cases holding that non-debtor guarantors remain liable for postpetition interest that cannot be recovered from the debtor or from its bankruptcy estate. In the words of Bankruptcy Judge Leif Clark: Section 502(b)(2) only prevents unmatured interest from becoming an allowed claim against the debtors estate. Although unmatured interest cannot be collected from the debtors estate, section 502(b)(2) does not toll the accrual of unmatured interest. Thus the obligation to pay interest vis--vis a guarantor is not tolled or eliminated by operation of section 502(b)(2). *In re El Paso Refining, Inc.*, 192 B.R. 144, 146 (Bankr. W.D. Tex. 1996) (citation omitted). n5

The interplay between these two lines of bankruptcy doctrine gave rise to *National Energy*.

The Facts and Posture of *National Energy*. The underlying debtors in *National Energy* were part of a corporate group that participated in the energy trading markets. One of the debtors, ET Power, was party to a prepetition electricity tolling agreement with Liberty Electric Power, LLC. Pursuant to this agreement, ET Power paid a monthly fee, as well as other variable costs, in exchange for the delivery of energy by Liberty. ET Powers contractual obligations were backed by the separate guarantees of two related entities: (1) National Energy & Gas Transmission, Inc., ET Powers corporate parent and codebtor in bankruptcy; and (2) Gas Transmission Northwest Corporation (GTN), a sister corporation that was *not* in any bankruptcy case. The liability of each guarantor was capped at **\$140 million**.

The debtors filed voluntary chapter 11 petitions on July 8, 2003. Soon thereafter, the debtors sought to reject the agreement with Liberty, which rejection was approved by the bankruptcy court. Following the rejection, Liberty asserted that it was entitled to receive \$140 million as a termination payment, as well as approximately \$5.4 million in unpaid invoices. Libertys entitlement to the termination payment proceeded to arbitration, as a result of which Liberty was awarded the full amount it requested. The arbitration panel also awarded Liberty interest on the \$140 million, to accrue from and after the date on which the debtors first rejected the agreement.

During the arbitration proceedings, GTN was sold to a Canadian corporation. An escrow of \$140 million was established to fund GTNs guaranty liability to Liberty. Following the conclusion of arbitration, the entire \$140 million was paid to Liberty in order to satisfy fully GTNs liability. Before this payment, approximately \$17 million of postpetition interest had accrued on Libertys claim. Logically, Liberty chose to allocate the \$140 million received from the GTN proceeds first to interest, and then to principal. Liberty also continued to assert the entirety of its pre-petition claim against the debtors, on the theory that the debtors remained jointly and severally liable until Liberty received final payment in full. The rub, of course, was the character of the outstanding \$17 million, which Liberty argued did not represent disallowed post-petition interest but rather unpaid principal--the interest portion of the award having been paid by GTN. 2007 U.S. App. LEXIS 16263, at *6.

The debtors objected to Libertys claim on the theory that it was for disguised postpetition interest. The bankruptcy court sided with Liberty, however, by allowing its claim against the debtors. The bankruptcy courts decision was affirmed by the U.S. District Court for the District of Maryland, which led the debtors to appeal to the Court of Appeals for the Fourth Circuit. The appeal was heard by Circuit Judges Dennis W. Shedd and Allyson K. Duncan, with District Judge Samuel G. Wilson, of the Western District of Virginia, sitting by designation. In a 21 decision, the Fourth Circuit reversed the allowance of Libertys claim for \$17 million.

The *National Energy* Majority Opinion. The analysis portion of Judge Shedd's majority opinion begins with a brief discussion of New York guaranty law, pursuant to which GTN was a surety for ET Powers obligations to Liberty,

and thus the value of ET Powers debt to Liberty under state law is not reduced by the **\$140 million received from GTN. 2007 U.S. App. LEXIS 16263, at *9. Consequently, Liberty could assert a claim against the debtors for the full \$140 million it was owed prepetition, even though Liberty could not ultimately collect more than the outstanding \$17 million.**

The court then turn[ed] to the more fundamental question presented by this appeal: whether the Bankruptcy Code bars Liberty from collecting the \$17 million it now seeks. *Id.* The court ultimately concluded that section 502(b)(2) prevents Liberty from collecting the additional \$17 million it seeks despite Libertys classification of that amount as principal. *Id.* at *11. This conclusion was based on two core considerations.

First*, the court applied a broad substance over form analysis, concluding that it was obligated to look behind Libertys claim here to find that the claim *really* constitutes post-petition interest *disguised* as unpaid principal. *Id.* at *14 (emphasis added). The court suggested a contrary result would promote gamesmanship by allowing Liberty, or any other creditor, to classify a payment on a debt from a non-debtor guarantor as non-principal, thus preserving the full value of the principal for collection in bankruptcy. *Id.

Second*, the court was concerned about the policy interests represented by § 502(b)(2)--to wit, a fair allocation of the estates limited assets between similarly situated creditors. *See id.* at *14-15. The court believed these interests would be thwarted by allowing Libertys claim, since allowing Liberty to collect the additional amount it seeks *will* have an impact on ET Powers other creditors: namely, the loss of **\$17 million from the estate which would otherwise be available for distribution. *Id.* at *15.*

Thus, the majority held that section 502(b)(2) barred Liberty from asserting its claim against the debtors. The majority did note in a footnote that Liberty is free to classify GTNs payment as interest or to pursue collection from GTN at any time. *See id.* at *13 n.5. This result followed from the majoritys conclusion that it was merely holding that Liberty may not affect the rights of a party in bankruptcy by its classification of a payment received from a non-debtor guarantor. *Id.* Yet, given that GTN had already satisfied the full amount of its capped liability under the guaranty--i.e., \$140 million--the functional effect of the majority opinion was to deny Liberty the ability to recover the \$17 million of postpetition interest from *any* party.

The *National Energy* Dissenting Opinion. Judge Duncan dissented on the grounds that the majority advances no support for its conclusion that bankruptcy law governs the contractual relationship between a creditor and a non-debtor guarantor--and ample authority exists to the contrary. 2007 U.S. App. LEXIS 16263, at *17 (Duncan, J., dissenting). Notably, Judge Duncan was troubled by the fact that the majority opinion has the effect of limiting the non-debtor guarantors liability for interest accruing after the debtors bankruptcy petition. *Id.* at *19-20. Judge Duncan further explained how she believed:

[T]he majority would have the bar to recovery of interest from the debtor swallow the accrual of interest on the debt across all parties liable for it. There is simply nothing in the Bankruptcy Code, applicable case law, the relevant guarantee agreement, or nonbankruptcy law to support the jettisoning of basic contract law principles in favor of an expansive reading of § 502(b)(2).

Id. at *20. Indeed, beyond the lack of any authority clearly supporting the majoritys position, Judge Duncan was also concerned that the majoritys opinion violated section 524(e) by allowing the bankruptcy filing of the debtors to dictate how Liberty accounts for its contractual payment from GTN. *Id.* at *21-22.

Judge Duncan finally expressed her skepticism about the majoritys policy considerations, noting how any distributional effects were the result of Liberty bargaining for a guarantee, which other creditors could have done. *See id.* at *22.

Ultimately, Judge Duncan would have affirmed the district court (and thus the bankruptcy court) on the grounds that neither bankruptcy law nor the contract governing Libertys relationship with the non-debtor guarantor GTN limits

Libertys rights to allocate its recovery from GTN in any manner that it wishes. *Id.* at *22-23.

Commentary on the *National Energy* Opinions. Both the majority and the dissenting opinions in *National Energy* cogently outline their arguments and reference relevant supporting authority. The ultimate legal issue is a thorny one, though, and neither side is obviously correct. Still, Judge Duncan may have the stronger side of the debate.

First, it is indisputable that the substance over form mode of analysis is a critical part of any bankruptcy courts equitable arsenal. Without such principles, bankruptcy courts would have difficulty distinguishing a true sale from a disguised financing or separating a lease from a security interest. n6 Indeed, the emerging doctrine of recharacterization, whereby ostensible debts are identified as disguised equity interests, n7 would crumble without such principles. None of this is new, of course; the Supreme Court long ago articulated the bankruptcy courts equitable power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. *Pepper v. Litton*, 308 U.S. 295, 307-08, 60 S. Ct. 238, 84 L. Ed. 281 (1939). Thus, in some meaningful sense, the majority opinion in *National Energy* is consistent with the time-honed principle that parties cannot use legal formalisms to navigate around the Bankruptcy Code.

On the other hand, it is not clear that the majority opinion in *National Energy* does not give rise to a regime that is equally driven by formalism. After all, even the majority recognized that section 502(b)(2) should have no effect on Libertys rights vis--vis GTN. Thus, perhaps the entire dispute boils down to a timing issue. If Liberty had (1) collected one payment from GTN of \$123 million, which was allocated to principal, (2) asserted a claim against the debtors for the remaining \$17 million of outstanding principal, and then (3) collected a second payment from GTN of \$17 million, all of which was on account of GTNs separate obligation for postpetition interest, then the *National Energy* case probably would have come out differently. n8 If so, then the mere formalism of using two staged payments, rather than a single combined payment, seems to alter the result, which means that parties can still contract and maneuver their way around the majoritys holding.

Second, the majority opinion ultimately turns on the trickle-down effect of the actions of two non-debtor parties on the bankruptcy estate. It is obvious that, as between each other, Liberty could allocate GTNs payment however it liked. According to the majority, however, Liberty cannot take an otherwise permissible action vis--vis a non-debtor if doing so has the ultimate effect of contravening the Bankruptcy Code. While there is some authority for such an approach, n9 it nevertheless seems that the trickle-down effect in *National Energy* may have been too attenuated to support the majoritys approach. After all, consider the result if GTN had guaranteed *only* the repayment of interest (and thus was not liable for *any* of the principal). The majority opinion would seem to suggest that relabeling such interest-only payments principal, at least vis--vis the debtors, is also appropriate. Contrary to Judge Wilsons concurrence, this seems to be far more than simply call[ing] a rose by another name, 2007 U.S. App. LEXIS 16263, *16; it seems to fundamentally alter Libertys rights. At bottom, then, the fairly attenuated nature of the non-debtor interactions vis--vis the bankruptcy estate in *National Energy* gives rise to real concerns about the opinions limits--at what point can non-debtors freely interact without concern that a bankruptcy court will give greater import to their actions; how much causal distance is enough? These are not easy questions, but intuition and experience seem to pull more toward Judge Duncans restrained approach.

Third, neither the majority opinion nor Judge Duncans dissent pays sufficient attention to the effects the majoritys holding may have on the *ex ante* costs of credit. The functional result of *National Energy* appears to be that Liberty will not collect the \$17 million of postpetition interest it is owed from *any* party. As a result, Liberty will suffer a substantial *ex post* loss notwithstanding the fact that it obtained non-debtor guarantees. This loss, which could occur in a non-zero number of other cases, ultimately reduces the efficacy of guarantees and related forms of credit support. n10 If the legal form of such documents may be ignored by bankruptcy courts paying homage to the equitable principles undergirding the Bankruptcy Code, then those documents may cease to accomplish the very purpose for which they are used.

Guarantees and other forms of credit support can reduce the cost of credit to the primary obligor. n11 If such arrangements cease to be reliable, and may be unenforceable or ineffective in bankruptcy, then a rational lender will increase the costs of credit to the primary obligor on the front-end, which could ultimately trigger more corporate distress and insolvency. n12 Thus, it is not clear that the majority in *National Energy* reached an optimal or efficient result from a policy perspective.

In the final analysis, *National Energy* is a hard case that resulted in two interesting and well-reasoned opinions. Perhaps Liberty will petition for *en banc* review or *certiorari* to the Supreme Court, which would result in further judicial review of a difficult legal question. Even if the three-member panels opinion is the end of the road for ET Power, GTN, and Liberty, it is likely that the underlying legal question--i.e., the effects of section 502(b)(2) vis--vis non-debtor guarantors--will arise in other contexts and cases. In such an event, both sides of the dispute should find the majority and dissenting opinions in *National Energy* to be illuminating and important.

For a complete discussion of Code section 502, see Collier on Bankruptcy, ch. 502 (Matthew Bender).

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n1 See 11 U.S.C. § 506(b); see also, e.g., *United States v. Ron Pair Enters.*, 489 U.S. 235, 241, 109 S. Ct. 1026, 103 L. Ed. 2d 290 (1989) (explaining that section 506(b) creates an unqualified right for an oversecured creditor to receive postpetition interest).

n2 See 11 U.S.C. §§ 726(a)(5) & 1129(a)(7)(A)(ii); see also, e.g., *Official Comm. of Unsecured Creditors v. Dow Corning Corp. (In re Dow Corning Corp.)*, 456 F.3d 668, 677-80 (6th Cir. 2006) (holding that unsecured creditors may be entitled to postpetition interest at the contractual default rate under section 1129(b)s fair and equitable test in a solvent debtor case), *cert. denied*, 127 S. Ct. 1874 (U.S. 2007); Carmen H. Lonstein & Steven A. Domanowski, *Payment of Post-Petition Interest to Unsecured Creditors: Federal Judgment Rate Versus Contract Rate*, 12 Am. Bankr. Inst. L. Rev. 421 (2004) (reviewing the authorities and arguments regarding the appropriate rate of postpetition interest that unsecured creditors should receive in solvent debtor cases).

n3

[3] See, e.g., *Kopolow v. P.M. Holding Corp. (In re Modern Textile, Inc.)*, 900 F.2d 1184, 1191 (8th Cir. 1990) (noting how section 502(b)(6) does not operate to cut off and extinguish the lessors claim for amounts in

excess of the amount chargeable to the debtors estate, which means the liability of a guarantor for a debtors lease obligations is not altered by the Trustees rejection of the lease); *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 300 (B.A.P. 9th Cir. 2004) (observing how [s]everal cases have held that the liability of a guarantor that is not in bankruptcy is not limited by section § 502(b)(6), and endorsing such a principle in the context of a true third-party guarantor).

n4 See, e.g., 11 U.S.C. § 510(a) (subordination agreement is enforceable to the same extent that such agreement is enforceable under applicable nonbankruptcy law); *Chemical Bank v. First Trust of N.Y., N.A. (In re Southeast Banking Corp.)*, 156 F.3d 1114 (11th Cir. 1998) (postpetition interest may accrue as between two creditors pursuant to a subordination agreement that satisfies the so-called rule of explicitness); *In re Sunset Bay Assocs.*, 944 F.2d 1503, 1508 (9th Cir. 1991) (noting how California law provides the rules of decision for determining the parties substantive rights under a subordination agreement in bankruptcy).

n5 See also, e.g., *Stollers, Inc. v. Peoples Trust Bank (In re Stollers, Inc.)*, 93 B.R. 628, 635-36 (Bankr. N.D. Ind. 1988) (concluding that because bankruptcy proceedings do not affect the liabilities of codebtors and guarantors, non-debtor guarantors are liable for postpetition interest and attorneys fees as allowed by the terms of their guarantee).

n6 See generally, e.g., *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 613-15 (7th Cir. 2005) (noting [t]he need to look through form to substance in the context of identifying a lease under section 365, and suggesting that a contrary state law that identified a lease in a formal rather than a functional manner would conflict with the [Bankruptcy] Code), *cert. denied*, 547 U.S. 1003 (2006).

n7

[7] See, e.g., *Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225 (4th Cir. 2006); *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448 (3d Cir. 2006); *Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs., Inc.)*, 380 F.3d 1292 (10th Cir. 2004). But see, e.g., *Official Creditors Comm. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)*, 69 B.R. 112 (B.A.P. 9th Cir. 1986) (holding that bankruptcy courts do not have the authority to recharacterize a transaction as an equity investment rather than as a loan).

n8

[8] If this scenario would not change the result, then Judge Duncan is correct: the majority opinion *does* alter the respective rights and liabilities of two non-debtor parties vis--vis each other. After all, there is no coherent reason to force Liberty to wait until the distribution date in the debtors cases before it can pursue GTN

on account of GTNs separate liability under the guaranty. Thus, if Liberty *must* sacrifice its rights to collect the outstanding **\$17 million from the debtors by accepting payment from GTN, then Libertys rights do seem to be constrained in a meaningful, and probably impermissible, way.**

n9 For instance, some courts apply the automatic stay in a fashion that prohibits non-debtors from trading in claims or equity interests if their doing so would have a trickle-down effect on NOLs or other property of the bankruptcy estate. *See, e.g., In re Phar-Mor, Inc.*, 152 B.R. 924 (Bankr. N.D. Ohio 1993). Likewise, some courts prohibit one non-debtor from gifting its dividend to another non-debtor under a chapter 11 plan on the grounds that doing so violates the absolute priority rule. *See, e.g., In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005); *cf. In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993) (approving a sharing agreement between secured and unsecured creditors that resulted in payment to the unsecured creditors, but bypassed priority tax claimants). The underlying principle that drives these decisions is the notion that the Bankruptcy Codes reach may extend to, and substantively limit, the interaction of two non-debtor parties if their behavior could undermine core bankruptcy precepts. Hard questions necessarily arise when courts are forced to define the outer limits of this broad principle. In some cases, such as *National Energy*, one senses that the court may have reached too far in its quest to protect the bankruptcy process.

n10

[10] This conclusion may hold true only in instances where there is some sort of cap on the guarantors liability. Such a limit could be the result of a contractual arrangement, as in *National Energy*, or it could result from external circumstances, such as a subsequent bankruptcy filing by the guarantor. In a scenario where the non-debtor guarantors liability is unlimited, the principal effect of the majority opinion in *National Energy* is likely to be a timing one--the creditor will eventually be able to recover the full amount that it is owed, but it may need to wait to pursue its postpetition interest claim against the guarantor until after it asserts (or collects?) its principal claim against the debtor.

n11

[11] *See, e.g., Mueller v. Sullivan*, 141 F.3d 1232, 1233 (7th Cir. 1998) (noting how borrowers received lower interest rates on the guaranteed notes than the unsecured one, and thus had to decide whether the difference in rates was worth the price of the guarantee); *Fishman v. Estate of Wirtz*, 807 F.2d 520, 581 (7th Cir. 1986) (Easterbrook, J., dissenting in part) (Banks might accept lower rates if the investors guarantee the loan with their other assets . . . , but the guarantee has opportunity costs of its own because assets used to secure this loan cannot be used to finance some other venture.).

n12

[12] Similar considerations were discussed by the U.S. Court of Appeals for the Second Circuit in *Elliott Associates, L.P. v. Banco de la Nacion*, 194 F.3d 363 (2d Cir. 1999), which involved Section 489 of the New York Judiciary Law. The nation of Peru argued, and the district court agreed, that Section 489 operated to bar

the purchase of defaulted debt with the primary goal of suing to collect the amount owing. The Second Circuit ultimately reversed, and in the process it noted the likely effects of such a rule:

While the district courts rule might benefit the Debtors in the short run, the long term effect would be to cause significant harm to Peru and other developing nations and their institutions seeking to borrow capital in New York. The district courts interpretation would mean that holders of debt instruments would have substantial difficulty selling those instruments if payment were not voluntarily forthcoming. This would therefore add significantly to the risk of making loans to developing nations with poor credit ratings. The additional risk would naturally be reflected in higher borrowing costs to such nations. It could even make loans to some of them unobtainable in New York. A well-developed market of secondary purchasers of defaulted sovereign debt would thereby be disrupted and perhaps destroyed even though its existence provides incentives for primary lenders to continue to lend to high-risk countries.

Id. at 380. A parallel criticism could be levied against the majority in *National Energy*; although the result was helpful for ET Power, its affiliated debtors, and its non-Liberty creditors, the opinion may ultimately diminish the value of some guarantees, and thereby increase the costs of credit, for other borrowers.

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16 of 16 DOCUMENTS

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Mabey on In re Perrine

2008 Emerging Issues 483

Mabey on In re Perrine

By Ralph R. Mabey

August 31, 2007

SUMMARY: How does a court decide that attorney compensation was made in contemplation of a bankruptcy case and thus subject to disclosure pursuant to Rule 2016(b)? According to a bankruptcy court in California, the determination hinges on the debtors subjective intent at the time of payment. As the Hon. Ralph R. Mabey explains in his Expert Commentary on the case, this ruling is part of a trend of strict enforcement of the disclosure requirements of the compensation provisions of the Bankruptcy Code and requires the professional to read the debtors mind.

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ARTICLE: In determining whether professional services were rendered in contemplation of bankruptcy under Code section 329(a), court considered debtors subjective state of mind and held debtors attorney accountable for the disclosure under Rule 2016(b)

Section 329(a) of the Bankruptcy Code, which is implemented by *Rule 2016(b) of the Federal Rules of Bankruptcy Procedure*, requires debtors professionals to disclose fees paid or agreed to be paid within one year of bankruptcy for services rendered or to be rendered in contemplation of or in connection with the [bankruptcy] case. For many professionals representing debtors, a statement under *Bankruptcy Code section 329(a)* is merely an accounting exercise. In many cases, the debtor only recently engaged the professional; as a result, the only payment to disclose is the fee or the retainer actually received just prior to the bankruptcy case. But where a professional has maintained a long relationship with a client, the disclosure requirement is more complex. It is for the court, not the professional, and not the debtor, to determine what fees were in contemplation of bankruptcy. Moreover, the bankruptcy courts decision in *Perrine* reflects a continuing trend by courts to enforce strictly the disclosure requirement and to employ *Bankruptcy Code section 329(a)* and Bankruptcy Rules 2016(b) and 2017 as bases for avoiding or disgorging payments made to professionals. As with most reported decisions in this area, the *Perrine* case also reflects unusually bad facts.

Facts. On August 8, 2003, Eugene H. Perrine, Jr., the debtor, transferred a tract of land in Klamath Falls, Oregon, which he owned as his separate property, to the Eugene H. Perrine and Vicki L. Perrine Family Trust dated August 8, 2003. The Perrine trust was an *inter vivos* revocable trust in the name of Perrine and his wife, Vicki. In addition to the Oregon property, the Perrine Trust included the community property of the couple and another real property located in

La Habra, California.

At the time, Perrine was also the president of Perrine Electric Company, Inc. On April 29, 2004, AAA Electrical Supply, Inc. sued Perrine for the sum of \$71,167.05 based upon his personal guaranty of the debts of Perrine Electric. The Catanzarite Law Corporation represented Perrine and his company in the litigation with AAA. In connection with that representation, Perrine and his wife, individually and as the trustee of the Perrine Trust, entered into a retainer agreement with Catanzarite, whereby the Perrine Trust transferred the Oregon property to Catanzarite for a stipulated value of \$30,000 for payment of accrued attorneys fees and costs and as a credit for future attorneys fees and costs to be incurred by Perrine and Vicki Perrine and also for the purpose of securing the continued representation of the [Perrine trust] and the individuals in future litigation including without limitation, with creditors and to protect the home equity of Vicki and the pension of [Perrine]. Ten days after Perrine transferred the Oregon property to Catanzarite, he stipulated to entry of a judgment in favor of AAA in the amount of \$76,767, which he did not satisfy. Approximately three months thereafter, Perrine alone filed a voluntary chapter 7 bankruptcy case. Catanzarite also acted as counsel of record in Perrines bankruptcy case.

In his bankruptcy schedules, Perrine did not list any ownership interest in real property, failed to disclose his ownership interest in Perrine Electric, and also claimed he did not have an interest in a trust. In his statement of financial affairs, Perrine also failed to disclose the transfer of the Oregon property to Catanzarite within one year of the petition date, and in response to Question #9 of the statement of financial affairs, Perrine disclosed only that he paid Catanzarite \$3,000 for debt counseling or bankruptcy. Catanzarite, for its part, failed to disclose the receipt of the Oregon property and listed only \$3,000 in the Disclosure of Compensation of Attorney for Debtor prepared pursuant to *Bankruptcy Code section 329(a)* and Bankruptcy Rule 2016(b).

At the meeting of creditors conducted pursuant to *Bankruptcy Code section 341(a)* by the chapter 7 trustee appointed in the case, Perrines plans began to unravel. The trustee discovered that Perrine sold the La Habra Property prior to the petition date and transferred the funds to his wife, who was not a debtor in a bankruptcy case. His wife in turn appeared to have used the proceeds from the sale of the La Habra property to acquire other real property in her name. As a result of the meeting of creditors and independent investigation, the trustee sued Vicki to recover the proceeds from the sale of the La Habra Property as a fraudulent transfer and also initiated an adversary proceeding against Perrine to object to his discharge. In response, Perrine filed a motion to dismiss his bankruptcy case, but the bankruptcy court denied the motion, finding that dismissal would prejudice creditors.

In addition to pursuing Perrine and his wife, the trustee also sought an order compelling Catanzarite to amend its disclosure of compensation under *Bankruptcy Code section 329(a)* and Bankruptcy Rule 2016(b) to account for the transfer of the Oregon property to Catanzarite within one year of the petition date. In response, Perrine and Catanzarite claimed that only \$3,000, as already disclosed, was incurred in contemplation of or in connection with the bankruptcy case and that the balance of the \$30,000 in stipulated value for the Oregon property had been paid on account of nonbankruptcy services. Specifically, Catanzarite asserted that \$12,000 had been used to satisfy an outstanding balance, \$3,000 was for the bankruptcy filing, and the remaining \$15,000 was used to pay fees incurred in prebankruptcy litigation related to AAA.

The bankruptcy court disagreed and found that the entire sum of \$30,000 had been paid to Catanzarite in contemplation of bankruptcy. Thereupon, Catanzarite amended its disclosure of compensation, but once again provided statements that the bankruptcy court found to be inaccurate and misleading. Among other things, the bankruptcy court found that even in the amended disclosure of compensation, Catanzarite failed to provide a method for establishing the value of the Oregon property and that the accounting provided in it did not add up to \$30,000. The bankruptcy court scheduled a continued hearing on the amended disclosure of compensation to consider, among other things, the disgorgement of payments made to Catanzarite.

Following the continued hearing, the bankruptcy court took the matter under submission and issued the written opinion.

The bankruptcy courts decision under section 329(a); the meaning of in contemplation of bankruptcy. The court began by stating the purpose of *Bankruptcy Code* section 329(a), derived from Section 60(d) of the Bankruptcy Act of 1898, is to protect the debtor from overreaching by professionals and counteracts the temptation of a failing debtor to deal too liberally with his property in view of financial reverses and probable failure. *See 2007 Bankr. LEXIS 1432*, at *18 (quoting *Conrad, Rubin & Lesser v. Pender*, 289 U.S. 472, 477-78, 53 S. Ct. 703, 77 L. Ed. 1327 (1933)). As implemented by Rule 2016(b), *Bankruptcy Code* section 329(a) requires a debtors attorney not later than 15 days after the order for relief to disclose all compensation paid or promised for services rendered in contemplation of or in connection with the case. The bankruptcy court in *Perrine* also ruled that section 329(a) must be read in conjunction with Bankruptcy Rule 2017(a), which, taken together, gave the court express power to review payments to attorneys for excessiveness and to restore the status quo when assets have been improvidently bartered for legal services[.] *See In re Martin*, 817 F.2d 175, 180 (1st Cir. 1987).

In addressing Catanzarites attempted disclosures of compensation under section 329(a), the bankruptcy court applied a two-step analysis. In the first step, the bankruptcy court determined whether the transfer of the Oregon property was actually made in contemplation of a bankruptcy case. The *Perrine* court acknowledged that courts apply a subjective test to determine whether payments to attorneys were made in contemplation of a bankruptcy case. *See Wooton v. Dixon (In re Dixon)*, 143 B.R. 671, 678 (Bankr. N.D. Tex. 1992). More specifically, courts must try to determine the subjective state of the mind of the debtor, not the professional. *Brown v. Luker (In re Zepecki)*, 258 B.R. 719, 724 (B.A.P. 8th Cir. 2001), *affd*, 277 F.3d 1041 (8th Cir. 2002). In other words, the subjective inquiry is whether the debtor was influenced by the possibility or imminence of a bankruptcy proceeding in making the transfer. *Id.*; *see also Conrad, Rubin & Lesser*, 289 U.S. at 477 (holding that under the predecessor of *Bankruptcy Code* section 329(a), the controlling question is with respect to the state of mind of the debtor and whether the thought of bankruptcy was the impelling cause of the transaction).

In the *Perrine* case, the bankruptcy court found that the timing of the transfer of the Oregon property, just 97 days before the petition date, bound together with the fact that Perrine stipulated to the entry of a judgment with his largest creditor, AAA, shortly thereafter evidenced an intent by Perrine to deplete his assets before filing for bankruptcy. Indeed, the bankruptcy court found that once the Oregon property had been transferred to Catanzarite, there was no other major asset to satisfy Perrines creditors, including AAA.

In the second step of the analysis, the focus shifts from the debtor to the professional. Once the court determines that section 329(a) applies because of the debtors intent in making the payment to his attorneys, the court then determines whether the disclosure of compensation by the attorney was full, candid, and complete. The bankruptcy court in *Perrine* summarized the existing case law under section 329(a) and concluded that:

1. Disclosure is *mandatory*. *See Turner v. Davis, Gillenwater & Lynch (In re Investment Bankers, Inc.)*, 4 F.3d 1556, 1565 (10th Cir. 1993).
2. Disclosure is required regardless of the nature of services rendered, and it is immaterial that the attorney was not the bankruptcy counsel of record. *See In re Keller Fin. Servs. of Fla., Inc.*, 248 B.R. 859, 883 (Bankr. M.D. Fla. 2000).
3. Failure to satisfy the disclosure requirement may result in sanctions, including disgorgement of fees. *See Law Offices of Nicholas A. Franke v. Tiffany (In re Lewis)*, 113 F.3d 1040, 1045 (9th Cir. 1997).
4. The penalty for failing to comply with section 329(a) applies to both willful and inadvertent nondisclosure. *See In re Keller Fin. Servs. of Fla., Inc.*, 248 B.R. 859, 885 (Bankr. M.D. Fla. 2000).

The *Perrine* court found Catanzarites disclosures to be far from full, candid, and complete. The bankruptcy court chided Catanzarite for initially hiding the receipt of the Oregon property and the subsequent attempts to characterize the

transfer as a payment for nonbankruptcy services. The bankruptcy court did not find credible Catanzarites amended disclosure of compensation because, among other things, the amended disclosure of compensation failed to provide a method for arriving at the stipulated value for the Oregon property and the accounting of the money did not add up to **\$30,000. In addition, Catanzarites involvement in Perrines litigation with AAA implied that Catanzarite knew or should have known that the Oregon property was Perrines only major non-exempt asset. Citing the gravity of Catanzarites nondisclosure, the bankruptcy court ordered the full disgorgement of the Oregon property or the stipulated value of \$30,000, at the election of the trustee.**

Commentary. Doubtless the severity of the remedy imposed by the bankruptcy court in *Perrine* was commensurate with the conduct of Perrine and Catanzarite found by the court.

The two-step analysis used in *Perrine*, however, places the risk of reading the debtors mind squarely upon the professional. As explained in the decision, courts apply a subjective test to determine the debtors mind as to whether a payment was made in contemplation of bankruptcy. The professionals intent or knowledge is largely immaterial for purposes of determining the applicability of section 329(a) disclosure. If the debtor subjectively contemplated bankruptcy, the professional must disclose the fees received or agreed to within one year of the bankruptcy filing irrespective of the use of those fees. Under the *Perrine* analysis, it does not matter whether the nondisclosure of compensation by a professional is willful or inadvertent: If section 329(a) applies, a professionals inadvertent failure to disclose a payment as made in contemplation of bankruptcy violates the statute. This is so whether the bankruptcy professional is called in at the last minute and is unfamiliar with the decades-long work for the debtor of the professionals thousand-member firm, or whether the professional is simply mistaken--or duped--by the debtors intentions respecting a future bankruptcy.

On the other hand, the nondisclosure sanctions imposed upon a professional, though remedial, are flexible and equitable. They should take account of the professionals circumstances and understanding.

Finally, the professional has a section 329(a) disclosure safe harbor reachable without tacking or jibing: Disclose all fees received or agreed to within one year of the bankruptcy filing whether or not you are employed as a bankruptcy professional.

For a complete discussion of Code section 329, see *Collier on Bankruptcy*, ch. 329 (Matthew Bender).

For discussion of compensation generally, see *Collier Bankruptcy Practice Guide*, ch. 7 and ch. 28 (Matthew Bender).

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