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Office of Continuing Legal Education at the University of Kentucky College of Law

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Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW

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PRE-BANKRUPTCY EXEMPTION PLANNING

LEGAL AND ETHICAL DILEMMAS

&

RECENT DEVELOPMENTS CONCERNING EXEMPTIONS

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Substantial portions of Parts I and II of this material were originally prepared by the author for the American Bankruptcy Institute's 1997 Southeast Bankruptcy Workshop and have been updated for the University of Kentucky's 1997 Midwest/Midsouth Bankruptcy Institute.
PRE-BANKRUPTCY EXEMPTION PLANNING
Legal and Ethical Dilemmas
and
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SECTION A
I. Introduction

In a manner of speaking, for a consumer debtor, a chapter 7 bankruptcy imposes a new exchange relationship between the debtor and her creditors. In return for the surrender of her present assets at filing, the debtor is granted a discharge of personal liability for all debts arising prior to the commencement of the case.¹ Because for bankruptcy purposes the property comprising the estate excludes the debtor’s present capacity to earn income in the future,² the effect of the discharge is to shield post-petition earnings from the statutorily-imposed new bargain.³ Moreover, not all of the debtor’s existing assets must be delivered to the trustee for liquidation and distribution to creditors. Just as some property is exempt from execution under applicable non-bankruptcy law, so too is some of the debtor’s property placed beyond the reach of her creditors in a bankruptcy proceeding.⁴ Exemption laws are intended to provide the debtor with the property necessary for his survival and to rehabilitate him financially. They also protect the debtor’s family from impoverishment and effectively impose on the debtor’s creditors the burden of providing the debtor and his family with minimal financial support rather than externalizing that cost and responsibility onto society at large. This suggests that by doing some advance planning, a debtor can maximize her outcome in bankruptcy based on the form in which the debtor’s assets are held at filing.

¹ 11 U.S.C. § 727(b). The effect of the discharge is governed by 11 U.S.C. § 524. Theories of the discharge abound. See generally Tabb, The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Discharge Debate, 59 Geo. Wash. L. Rev. 56, 89-103 (1990) (reviewing prevailing theories). However, at bottom, both the discharge and the exemptions are animated by the bankruptcy fresh start policy. See generally Lines v. Frederick, 400 U.S. 18, 19 (1970) (the basic purpose of bankruptcy is to give the debtor a new start in life).

² See 11 U.S.C. § 541(a)(1), defining the "property of the estate" as consisting of all legal and equitable interests of the debtor in property existing as of the commencement of the case. Thus, the debtor’s "human capital," represented by future earning capacity is excluded in liquidation cases.

³ Of course, in chapter 13, the definition of the property of the estate is expanded to include post-petition earnings and assets. 11 U.S.C. § 1306. As originally enacted, the Code gave the consumer debtor complete freedom to choose between a surrender of non-exempt assets in chapter 7 or the substitution of future earnings in chapter 13 as the "price" of the discharge. The addition in 1984 of a need criterion in chapter 7 (§ 707(b)) and the disposable income test in chapter 13 (§ 1325 (b)(1)(B)) increased the cost of the discharge to a debtor with substantial ability to satisfy her existing debts from future earnings. See generally Hallinan, The "Fresh Start" Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory, 21 U. Rich. L. Rev 49 (1985); Howard, A Theory of Discharge in Consumer Bankruptcy, 48 Ohio St. L.J. 1047 (1987).

⁴ However, unlike the approach under the former Act, exempt property is considered part of the estate, subject to administration in the bankruptcy court, unless and until the debtor claims the property is exempt and any objections to such claims are denied. 11 U.S.C. 522(l). See also H.R. Rep. No. 595, 95th Cong. 1st Sess. 368 (1977) (announcing that the new Code has the effect of overruling Lines v. Frederick, 400 U.S. 18 (1970)).
II. Maximization of Exemptions and "Fraudulent" Bankruptcy Planning

A. The Statutory Framework

1. The Exemptions

The Bankruptcy Act of 1898 did not contain specific exemptions. Rather, it recognized state and other federal non-bankruptcy exemption statutes. The legislative history of the current Bankruptcy Code evinces a much stronger federal interest in the exemptions and exemption policy. The 1973 Report of the Commission on the Bankruptcy Laws of the United States recommended adoption of a mandatory set of federal exemptions in bankruptcy, but this proposal met with considerable opposition from the states. The compromise reached in the Code was to adopt a uniform set of federal exemptions in section 522(d), but to allow the debtor to choose between the federal exemptions or the exemptions permitted by the law of her state of domicile. However, section 522(b) also permits the states to enact specific legislation depriving debtors in their states of that choice, thereby limiting debtors in such "opt-out" jurisdictions to the exemptions from execution applicable in that state as of the state of filing. About two-thirds of the states have passed opt-out legislation and it is important to recognize that local exemption laws vary widely from state to state. A complete compilation of state exemptions prepared by Chief Judge A. Jay

5 Bankruptcy Act § 6.

6 See generally, Woodward, Exemptions, Opting Out, and Bankruptcy Reform, 43 Ohio St. L.J. 335, 342-44 (1982).

7 See Kennedy, Limitations of Exemptions in Bankruptcy, 45 Iowa L. Rev. 445, 452 (1960) (pointing up the problem). Concern was also voiced that the existence of different exemption schemes under state and federal law might precipitate strategic bankruptcy filings by debtors and creditors designed to gain the benefit of whichever scheme was considered to be the most advantageous. See generally Vukowich, The Bankruptcy Commission's Proposal Regarding Bankrupt's Exemption Rights, 63 CAL. L. REV. 1439 (1975) (detailing the arguments pro and con).


9 11 U.S.C. § 522(b)(1). The constitutionality of the Code's opt out provision has been unsuccessfully challenged on several occasions; e.g., In re Sullivan, 680 F.2d 1131 (7th Cir. 1982); In re Lausch, 16 B.R. 162 (Bankr. M.D. Fla. 1981); and is now no longer an issue. The constitutionality of a similar provision under the Act was also found constitutional. Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902) (holding that the uniformity required of the bankruptcy laws by the Constitution is "geographical and not personal). See also In re Butcher, 189 B.R. 357 (Bankr. D. Md. 1995) (finding § 522(b) not only satisfies the uniformity requirement of the Bankruptcy Clause of the Constitution, but also holding that it meets as well the substantive due process requirement of the Fifth Amendment).

10 The wide disparity in state exemption laws can be traced to a variety of historical and political reasons. See generally Note, Bankruptcy Exemptions: Critique and Suggestions, 68 Yale L.J. 1463 (1959). There is a Uniform State Exemptions Act, but it has not been widely accepted to say the least. Ordinarily, states exempt property by dollar amount, category of property, or some combination of the two. California, Florida, and Texas are generally noted for their liberal exemption laws; therefore, many of the reported cases dealing with prebankruptcy planning practices come from bankruptcy courts in these jurisdictions. The exemption laws of all 50 states are collected in 7 COLLIER ON BANKRUPTCY (15th ed. 1993).
Cristol, of the Southern District of Florida, is contained in Appendix I attached to this material.

Recently, Senator Herb Kohl of Wisconsin has introduced legislation (S 530) that would cap the state homestead exemption at $100,000. Titled the "Bankruptcy Abuse Reform of 1997" this provision would principally affect debtors in unlimited homestead jurisdictions, like Florida and Texas. Senator Kohl proposed similar legislation in 1995 that was not acted upon, and included an amendment in the Bankruptcy Technical Corrections Act of 1996, also not enacted, which would have limited the maximum homestead exemption in bankruptcy to $500,000. Somewhat troubling is the fact that neither this bill nor its predecessors contain a floor that would ensure a minimum homestead exemption for debtors in jurisdictions with very low homestead exemption amounts. The proposal of the National Bankruptcy Review Commission on exemptions, discussed below in Part II.I of these materials, would rectify that oversight by imposing a floor of $20,000.

Finally, it bears noting that while the formulation of exemptions in the opt-out jurisdictions will be determined under state law, as it was under the prior Bankruptcy Act, the Code parts company with the prior legislation by applying federal law to resolve a number of ancillary issues relating to the assertion of exemption rights, state and federal, in bankruptcy proceedings.11 For instance, applying the preemptive provision of § 522(c)(1), the Fifth Circuit recently ruled that the Texas homestead exemption law is inoperative against the debtor’s former spouse who is entitled under the Bankruptcy Code to proceed against the otherwise exempted property to satisfy her alimony, maintenance, and child support judgment.12

2. The Discharge

The bankruptcy discharge is the principal instrument for effectuating the goals of the consumer bankruptcy system, chief among them being to provide the "honest but unfortunate" debtor a financial fresh start.13 However, an individual debtor’s right to a

11 The Code’s broad definition of property, for example, includes exempt as well as nonexempt property. Similarly, the provisions of § 522(e) (prohibiting enforcement of waiver of exemption claims in favor of unsecured creditors) and § 522(f) (permitting avoidance of certain liens that impair an exemption to which the debtor a debtor would otherwise be entitled) also affect the application of state exemption in a bankruptcy context. See Owen v. Owen, 500 U.S. 305, 311-13 (1991) (indicating that the purpose of § 522(f) is to enlarge exemptions in bankruptcy by permitting the stripping away of liens regardless of whether the lien would be enforceable outside of bankruptcy).

12 Davis v. Davis (In re Davis), 1997 U.S. App. Lexis 12770 (5th Cir. 1997). The bankruptcy and district courts in that case had ruled that while the former spouse’s judicial lien securing the debt against the exempted property was unavoidable, the former spouse was nevertheless precluded from levying upon the property to pay the debt.

13 H.R. Rep. No. 595, 95th Cong., 1st Sess. 125 (1977) ("The purpose of straight bankruptcy...is to obtain a fresh start, free from creditor harassment and free from the worries and pressures of too much debt."). See also Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (bankruptcy gives the “honest but unfortunate debtor” a new opportunity in life). Of course, the concept of a discharge is not inherent in a
discharge of her pre-petition debts is not absolute. In appropriate circumstances, the discharge be denied in whole or part. Of particular interest for this topic, section 727(a)(2)(A) of the Code provides for denial of discharge to any person shown to have transferred, removed, destroyed, or concealed property of the debtor within one year prior to the date of filing with the intent to hinder, delay, or defraud a creditor.

B. The Problem: Conversion of Non-Exempt Assets to Exempt Form in Contemplation of Bankruptcy

These two core constituents of the fresh start policy -- discharge and exemptions -- have come to interact at a critical juncture, and the lack of clear direction on the issue continues to generate uncertainty for bankruptcy practitioners and added litigation for bankruptcy courts. The question is can the debtor's urge to exempt as much property as possible from liquidation in bankruptcy, if indulged, at some point form the basis for an action to deny discharge under sections 727(a)(2)14 of the Code or disallowance of exemption claims under section 522(b)?15 As discussed below, most courts answer the question in the affirmative, but these decisions fail to articulate a uniform, workable standard.

A classic example of the uncertainty that attends the law in this area is illustrated by the now-famous bankruptcy cases of Drs. Tveten and Johnson.16 The two doctors were partners in, among other investments, failed real estate ventures in which they sustained substantial losses. They went to the same bankruptcy attorney for advice and both filed petitions in the District of Minnesota in January of 1986, Dr. Tveten under chapter 11 and Dr. Johnson under chapter 7. Prior to filing, both of the doctors had engaged in rather aggressive prebankruptcy planning.

Dr. Tveten's planning included selling over $700,000 of nonexempt assets and purchasing a Lutheran Brotherhood annuity with the proceeds.17 Dr. Johnson liquidated over $400,000 bankruptcy system and, in fact, did not become part of American bankruptcy law until 1841. See generally Tabb, The Historical Evolution of the Bankruptcy Discharge, 65 Am. Bankr. L.J. 325 (1991).

14 On occasion, the challenge to the debtor's discharge for such prebankruptcy activities may take the form of an objection under § 727(a)(5) for failure to satisfactorily explain the loss of assets, or, to the extent the transfer is not properly disclosed in the debtor's schedules, for knowingly and fraudulently making a false oath in connection with the case. E.g., Gullickson v. Brown (In re Brown), 194 B.R. 514 (D. Kan. 1996). Note also that where assets are required to be listed on the schedules reliance on the advice of counsel for failing to do so is no defense. See In re Tully, 818 F.2d 106, 111 (1st Cir. 1987).

15 Other, less frequently sought, remedial responses are discussed infra Part II.H.

16 Norwest Bank, N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988) and Panuska v. Johnson (In re Johnson), 880 F.2d 78 (8th Cir. 1989). The standards established in both cases are also discussed in context infra Part II.E.

17 Ironically, the Minnesota Supreme Court later ruled that the Minnesota statute making annuities and life insurance contracts issued by fraternal benefit societies exempt without limitation violated the Minnesota state constitution. Hence Dr. Tveten was also unable to claim the exemption. Tveten, 848 F.2d at 873 n.3.
of assets and used the proceeds to pay down the mortgage on his exempt homestead residence and purchase other exempt assets. Despite the similarity in their exemption planning, the outcome of challenges to this conduct, decided by separate judges in the same district, were entirely different. Specifically, Dr. Tevten’s discharge was denied under § 727(a)(2) while Dr. Johnson’s discharge was granted. Both decisions were affirmed by different district court judges. On further appeal to the Eighth Circuit, the court held that Dr. Tevten had indeed gone too far in his prebankruptcy planning and that the lower courts could reasonably have inferred from his conduct an intent to defraud his creditors. In Dr. Johnson’s case, a different panel of the Eighth Circuit remanded the proceeding with respect to the issue of whether fraud could be established by virtue of the size of the exemption sought for newly-acquired assets, but, directly contrary to the holding in Tveten, ruled that the size of the exemption is not a factor with respect to the homestead exemption. These two cases demonstrate how difficult it is for counsel to advise clients with respect to these matters.

C. Other Prebankruptcy Asset Protection Strategies

In addition to selling nonexempt assets and using the proceeds to purchase or reduce the encumbrances against exempt assets, some other prebankruptcy planning strategies include:

- transferring individually owned real property to a nondebtor spouse as tenants by the entirety
- transferring nonexempt assets to a spendthrift trust
- transferring nonexempt assets to an ERISA-qualified plan
- transferring assets to a self-settled trust established in a jurisdiction which immunizes such transactions from fraudulent transfer recovery (popular locales include Belize, Gibraltar and the Cook Islands off of New Zealand)

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19 Curiously, on the same date, the same panel on the Eighth Circuit decided Hanson v. First Nat’l Bank in Brookings, 848 F.2d 866 (8th Cir. 1989), in which the court refused to overturn the lower courts’ determination that the debtors were entitled to claim full exemptions even though in the weeks preceding filing the debtors had liquidated approximately $30,000 of nonexempt assets and used the proceeds to acquire property for which exemption was sought. See infra Part II.H.3.
21 Johnson, 880 F.2d at 83 (refusing to apply Tveten in the case of a homestead claim absent traditional evidence of fraud unrelated to the amount of dollars involved). In effect, Johnson applied the standard articulated in Hanson (discussed supra note 19) even though the matter at issue was the debtor’s entitlement to discharge rather than the allowability of claimed exemptions.
Depending on the circumstances, each of these enhancement activities may be challenged as fraudulent or illegal. Because maximum contributions to ERISA-qualified trusts are limited by nonbankruptcy law, this form of planning would appear to be the most innocuous.\(^{22}\) Nevertheless, there are some cases suggesting that a transfer of assets to a retirement plan solely for the purpose of putting those assets beyond the reach of creditors might not satisfy the "good faith requirements" of the Bankruptcy Code.\(^{23}\) The proposal of Consumer Bankruptcy Working Group of the National Bankruptcy Review Commission on exemptions (a copy of which is contained in Appendix IV) would protect without limitation all contributions to bona fide retirement plans, whether or not ERISA-qualified.

Transferring assets to a self-settled spendthrift trust is much more problematic, although most states make such dispositions void as against the grantor's creditors anyway.\(^{24}\) The exception is Alaska which recently adopted legislation (H.B. 101, a copy of which is contained in Appendix II of these materials) that will enforce spendthrift provisions in an irrevocable self-settled trust provided that certain conditions are met, including the requirements that a portion of the trust assets be invested in Alaska and administered by a "qualified person," defined to mean an Alaskan resident or a domestic corporation or banking organization.

A far more viable approach in jurisdictions that permit spouses to hold title to real property as tenants by the entirety is for the debtor to transfer individually owned property to the nondebtor spouse as tenants by the entirety. Unlike under state law, however, the bankruptcy trustee is permitted to sell the debtor's interest without the consent of the other spouse.\(^{25}\) However, once such a sale occurs, it is unclear whether the proceeds are distributed to only joint creditors or to all creditors.\(^{26}\) Finally, to further confuse the


\(^{23}\) See, e.g., In re Yuhas, 186 B.R. 381, 386 (Bankr. D.N.J. 1995).

\(^{24}\) See, e.g., Shurley v. Texas Commerce Bank-Austin, N.A. (In re Shurley), 115 F.3d 333 (5th Cir. 1997); see also In re Phillips, 206 B.R. 196 (Bankr. N.D. Cal. 1997) (assets transferred to self-settled trust are just as vulnerable to the claims of creditors as they were before they were transferred); Spenlinhauer v. Spencer Press, Inc. (In re Spenlinhauer), 195 B.R. 543 (D. Me. 1996) (holding that a spendthrift trust naming the settlor as beneficiary is invalid as against the present and future creditors of the settlor).

\(^{25}\) See Bankruptcy Code § 363(h) & (j); In re Hunter, 970 F.2d 299 (7th Cir. 1992). Cf. The Great Southern Co. v. Allard (In re Allard), 198 B.R. 715 (Bankr. N.D. Ill. 1996) (discussing, without ultimately resolving, the nature of the relationship between Illinois' tenancy by the entireties statute and the trustee's avoiding powers in bankruptcy).

\(^{26}\) Compare In re Himmelstein, 203 B.R. 1009, 1015 (Bankr. M.D. Fla. 1996) and In re Pepenella, 103 B.R. 299 (M.D. Fla. 1988), rev'd 79 B.R. 76 (Bankr. M.D. Fla. 1987); In re Oberlies, 94 B.R. 916 (Bankr. E.D. Mich. 1988) (bankruptcy law should not dilute the rights of joint creditors by making them share with other creditors that lacked the ability to receive distribution under state law) with In re Plans, 199 B.R. 211, 217 (Bankr. S.D. Fla. 1996); In re Cochrane, 178 B.R. 1011 (Bankr. D. Minn. 1995); In re Boyd, 121 B.R.
picture, recently, the First Circuit has held that "assuming a proper objection by a party in interest an entireties exemption is invalid ab initio to the extent there are joint creditors. Thereupon, as nonexempt property of the Chapter 7 estate, the entireties property becomes [fully] subject to administration."27 Thus, in some jurisdiction, use of entireties may result in total loss of the exemption.

The use of offshore trusts is particularly troubling and represents a far more dubious strategy than routine exemption planning of the sort discussed in this paper. Unlike a conversion in the form in which an asset is held, where the net value of the asset remains on the debtor's balance sheet, the transfer of assets to a trust involves a transfer to another entity and the separation of the asset from the estate. The author strongly discourages the use of this approach to the protection of assets from creditors as very likely illegal. At a minimum, debtors who engage in this tactic face the risk of global loss of discharge under §§ 727(a)(2) and (4).28 While there is some argument that there is no fraudulent conveyance problem as long as there are no present creditors at the time of transfer,29 since motivation in relation to future as well as present creditors is relevant to the analysis of fraudulent intent, insulation from liability is not clear even under those circumstances.30 These tactics also present serious ethical problems for the lawyer who participates in their design and implementation, a subject to which attention is turned next.

D. The Dilemma for Counsel

Both the House and Senate Reports accompanying the Bankruptcy Reform Act of 1978 provide that it is lawful for a debtor to take advantage of applicable exemptions by converting nonexempt property to exempt property in anticipation of bankruptcy.31

622 (Bankr. N.D. Fla. 1989) (property must be distributed to all creditors pursuant to § 726 without limitation to joint creditors).

27 Edmonston v. Murphy (In re Edmonston), 107 F.3d 74, 77 (1st Cir. 1997). But see In re Williams, 104 F.3d 688, 690 (4th Cir. 1997) ("debtor does not lose all benefits when joint creditor is present, but he does not benefit from it to the extent of joint claims.").

28 E.g., In re Colburn, 145 B.R. 851 (Bankr. E.D. Va. 1992) (barring debtor from discharge under § 727(a)(4) for failing to discharge his reversionary interest in an offshore trust).

29 The asset protection bar maintains that offshore asset protection trusts are not fraudulent transfers as long as, at the time the trust is established, the transferor is solvent, his current creditors are provided for, and he does not expect to incur other and future debt beyond his ability to pay. See, e.g., Krause, Fraudulent Transfers in 1 Asset Protection: Domestic and International Law and Tactics (Osborne ed.) ch. 2 § 2:21 (1995).

30 In In re Portnoy, 201 B.R. 685 (Bankr. S.D.N.Y. 1996), the court applied New York law to invalidate a Jersey Islands trust even though the debtor filed his bankruptcy case more than six years after establishing the trust; i.e., after the statute of limitations on fraudulent transfers had expired. The court found that the debtor was one of a class of beneficiaries of the trust, that the trustee retained discretion to distribute trust assets among beneficiaries, and that the debtor retained the power to remove the trustee at will.

31 The Reports provide:
Counsel, therefore, is faced with the difficult task of, on the one hand, advising the client of this opportunity to protect additional property, but, at the same time, cautioning against engaging in conduct that might later be characterized as a fraudulent and, therefore, result in the loss of the discharge as well as loss of the property. The absence of clear standards and uniform treatment of this question compounds the problem for counsel since it is impossible to predict with certainty when the conversion of assets will be regarded as a fraud on creditors or as grounds for disallowing exemptions (supra § II.B.). Counsel must also be mindful of his or her general ethical responsibilities as well as the specific ethical standards governing members of the bar.

1. Ethical and Professional Obligations

Needless to say, an attorney stands in a fiduciary relationship to the client and owes the client a duty of finest loyalty and a duty to maintain client confidences. Additionally, by professional standards, the attorney also has a duty to represent the client zealously within the limits of the law. In advising debtor's in connection with prebankruptcy planning activities, however, counsel needs to take into account several additional considerations which derive from the lawyer's position as an officer of the court and the ethical preclusions that govern the conduct of lawyers in their professional activities. To begin with, Rule 2.1 of the American Bar Association Model Rules of Professional Conduct (1984) provides that:

In representing a client, a lawyer...may refer not only to law but to other considerations such as moral, economic, social, and political factors, that may be relevant to the client's situation

Further, Model Rule 4.4 provides that:

In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay or burden a third party....

As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition....The practice is not fraudulent as to creditors and permits the debtor to make full use of the exemptions to which he is entitled under law.


33 Nearly 40 states have adopted all or significant parts of the ABA Model Rules. Kentucky is among these states. See KENTUCKY RULES OF PROFESSIONAL CONDUCT, SCR 3.310 (eff. Jan.1, 1990).
Of perhaps even greater concern are the specific ethical prohibitions regarding a lawyer’s participation in or perpetration of a fraud. Under the Model Rules, the emphasis is upon counseling clients who are or who intend to engage in conduct that is criminal or fraudulent. In particular, Model Rule 1.2(d) states that:

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law [Emphasis added].

This standard is more forgiving than the comparable provision in the Code of Professional Responsibility, DR 7-102(a)(7) which forbid counsel from assisting a client in the commission of “illegal” as well as “fraudulent” conduct. Nevertheless, Rule 1.2(d) presents a serious concern for counsel who counsel clients in asset protection planning.

If the lawyer determines that continued representation of the client would place the lawyer in violation of Model Rule 1.2(d), the lawyer must withdraw from the representation. Failure to withdraw may constitute “professional misconduct” within the meaning of Model Rule 8.4. It is far less clear whether the lawyer must also disclose the information. Model 1.6(a), which prohibits a lawyer from revealing client confidences except in instances involving as likelihood of imminent death or substantial bodily harm, suggests not.

2. Disqualification from Representation and Loss of Fees

In In re Prince, the defendant-law firm had represented the debtor, William Prince, and his spouse in an estate planning context and counseled the transfer of $600,000 in property from Mr. to Mrs. Prince. Subsequently, Mr. Prince filed for chapter 11 relief and the firm was appointed counsel without disclosing the prior representation. The court concluded that on these facts the firm labored under a conflict of interest that clearly prejudiced the estate inasmuch as the firm was not in a position to independently evaluate the property transaction between the Prince’s and its effect on the estate. Accordingly, because of the firm’s failure to disclose its involvement in the prebankruptcy planning, the court held that

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34 In those jurisdictions still operating under the earlier Model Code of Professional Responsibility, an analog to Rule 1.2(d) can be found in DR 7-102 (which prohibits a lawyer from assisting a client in the commission of conduct which the lawyer knows to be illegal or fraudulent).

35 See Model Rule 1.16(a). There may also be circumstances where the lawyer feels it necessary to withdraw from representation, even though withdrawal is not mandatory, provided that withdrawal can be accomplished without material adverse effect on the client’s interests. See Model Rule 1.16(b).

the firm was disqualified from representing the debtor-in-possession and was required to disgorge all fees previously received.37

3. Disbarment by the Bankruptcy Court

Bankruptcy courts have the inherent power to preclude attorneys who engage in repeated lapses of professional ethics from practicing before the court.38 Therefore, in addition to the risk of discipline under the Model Rules, an attorney who is found to have countenanced fraudulent conduct by her client faces censure directly from the court in the form of loss of privilege to practice before the court.

4. Sanctions

Rule 9011 requires an attorney to sign all pleadings and filings. Such signature constitutes a certificate that the attorney has read the document and that, to the best of the attorney’s knowledge and belief, after reasonable inquiry, the pleading is supported by existing law or a good faith argument for an extension, modification, or reversal of existing law. The rule prevents an attorney from filing any pleading for the purpose of delay, harassment, or to increase the cost of litigation. Unlike recently-amended Federal Rule 11, Rule 9011 still makes imposition of sanctions mandatory when a pleading is determined to have been signed in violation of Rule 9011. Even where Rule 9011 is not applicable, the bankruptcy court has the inherent power to discipline lawyers appearing before the court,39 as well as to impose sanctions under 28 U.S.C. § 192740 or pursuant to a finding of contempt.41

5. Liability to the Estate

Theoretically, if counsel for the debtor-in-possession is regarded as a fiduciary to the estate, counsel may also be answerable to the estate in damages for failure to reveal or prosecute prebankruptcy transactions deemed prejudicial to the estate or creditors a group.42 In general, the nature of bankruptcy law complicates questions of professional responsibility since, in large measure, those rules were developed in the context of a classic adversarial mode where their is no ambiguity over the question of to whom the lawyer’s duties are

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37 Id. at 360-61. The court also suggested that disbarment proceedings would have been appropriate had the actions been performed by a sole practitioner.


39 See In re Morz, 65 F.3d 1567 (11th Cir. 1995).

40 E.g., Knepper v. Skelhoff, 154 B.R. 75 (N.D. Ind. 1993).

41 Bankruptcy judges are generally considered to possess civil, albeit usually not criminal, contempt powers. See, e.g., Bartell, Contempt of the Bankruptcy Court--A New Look, 1996 U. Ill. L. Rev. 1.

42 See generally Everett v. Perez (In re Perez), 30 F.3d 1209 (9th Cir. 1994) (debtor-in-possession had fiduciary responsibility to the estate to propose a plan that complied with all of the confirmation requirements of § 1129, regardless of whether those issues were placed in dispute or not during confirmation).
owed. The bankruptcy process, while it includes aspects of litigation, is a much broader practice. For example, in chapter 11, counsel for the debtor in possession has responsibilities not only to the debtor but to creditors and other parties in interest as well.

6. Civil Liability

Traditionally courts have respected the right of an attorney to practice law without rendering himself or herself subject to liability for damages to non-clients. Moreover, it is well established that a violation of the Model Rules of Professional Conduct does not itself give rise to a cause of action nor does it create a presumption that a legal duty has been violated. In recent years, however, courts have increasingly been willing to entertain a variety of causes of action by aggrieved third party non-clients for actions committed during the course of the attorney’s representation of another party. This may include a direct claim for fraud or negligence, but in this context would be more likely to involve assertion of civil conspiracy claims or a charge of aiding and abetting the commission of a fraud. Often an individual who is planning to engage in fraudulent conduct will seek out the aid of his or her attorney to prepare the necessary transfer documents. While most civil claims against the lawyer are predicated on the lawyer’s knowledge of the client’s fraudulent purpose, “playing dumb” is equally fraught with peril. In short, it would be a mistake for counsel to not to make detailed inquiry into the reasons that the client is taking the proposed action and, if the client offers an lawful justification, to document the file accordingly.

7. The Ultimate Concern: Criminal Prosecution

In 1993, a proposed amendment to 18 U.S.C. § 152 would have added the “knowing fraudulent transfer or concealment of property in contemplation of bankruptcy” to the list of offenses constituting criminal bankruptcy fraud. Although that provision was never enacted, 18 U.S.C. § 157, added to the Code by the 1994 Act, raises the same possibility. It makes the filing of a bankruptcy petition as part of a scheme to defraud a criminal offense. Although it is difficult to imagine this provision being construed to cover prebankruptcy exemption planning, the language is arguably broad enough to reach such conduct if pushed to the limit. In that case, an attorney who counseled or participated in the transaction could also be found criminally responsible for aiding and abetting the commission of a bankruptcy crime. Additionally, 18 U.S.C. § 153, which applies to all

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45 Knowing and fraudulently concealing assets or making a false oath in a bankruptcy case are also crimes. See 18 U.S.C. § 152(1) & (2).

46 The legislative history to the 1994 Act states that the giving of a false statement or promise in connection with a bankruptcy proceeding would not be a violation of § 157 unless the act was part of a scheme to defraud. H.R. Rep. No. 835, 103d Cong., 2d Sess., 57-58 (1994).
officers of the court, makes the knowing and fraudulent appropriation of property in a bankruptcy case, or the secretion or destruction of any document belonging to the estate, a criminal offense.

8. Liability to the Client: The Other Side of the Coin

Although, as the foregoing illustrates, there is every reason to proceed conservatively in advising clients to take maximum advantage of available exemptions, given that some level of prebankruptcy planning is generally regarded as legitimate, if the lawyer is too conservative in advising the client about how to preserve assets, she risks liability to the client for malpractice. Thus, the lawyer must walk a perilous line separating her responsibilities to her client from her responsibilities to the court and the profession.

E. The Basic Standards: When Does Prudent Prebankruptcy Planning Become Fraud?

1. Acquisition of Exempt Property Beyond the Reasonable Needs of the Debtor

This approach, based on the supposed policy of the exemption laws to permit the debtor a fresh start but not a "head start," is illustrated by the bankruptcy court's decision in In re Reed. In the case, the debtor had sold nearly $50,000 of non-exempt assets and used the proceeds to reduce outstanding liens against his residence with the objective of increasing his homestead exemption in bankruptcy. Notwithstanding the admonition in the legislative history concerning the permissibility of prebankruptcy conversions to shield assets from creditors, the court concluded some limitation had to be imposed where the exemption at issue "reaches to infinity." Although the bankruptcy court's decision in Reed was affirmed by the Fifth Circuit, the court of appeals emphasized the rapid conversion of assets and the concealment of these transactions from creditors as evidence of actual intent to defraud rather than the size of the exemption claim. However, in the Eighth Circuit decision discussed supra § II.B., In re Tveten, in which it will be recalled that the debtor converted nearly all of his assets (totaling over $700,000) to exempt form, the Eighth

47 In Ayers v. Acuff (slip opinion) (C.A. Tenn. Oct. 25, 1984), a debtor sued an attorney for failure to claim exemptions. Although the complaint was dismissed, it was only because of the court's finding that the action was time barred. See also In re Collins, 19 B.R. 874 (Bankr. M.D. Fla. 1985) (suggestion of malpractice if available exemptions not claimed).


50 Reed, 11 B.R. at 688. Accord, In re Collins, 19 B.R. 874, 877 (Bankr. M.D. Fla. 1982); Zouhar, 10 B.R. at 157 ("there is a principle of too much; phrased colloquially, when a pig becomes a hog it is slaughtered.").

51 Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988).
Circuit stated that it would be a "perversion" of the purposes of the Code to permit the debtor to retain this amount of property free of the claims of his creditors. Recently, in In re Carletta, a bankruptcy court for the Northern District of New York cited Tveten approvingly for the proposition that the amount of nonexempt property converted to exempt property is relevant to a Code § 727(a) determination, although the court concluded that the conduct of the debtors in the case before it did not exceed reasonable prebankruptcy planning.

2. Acquisition of Exempt Property with the Intent of Placing Assets Beyond the Reach of Creditors

A few courts have suggested that the test for determining when discharge may be denied under section 727(a)(2) based on the conversion of non-exempt assets to exempt assets should focus on whether at least in some part the debtor's motivation for acquiring the exempt property was a desire to shield assets from creditors. This approach is difficult to defend in light of the legislative history and has not found wide support, particularly in more recent decisions. In fact, the general rule seems to be that someone who is insolvent may convert property to exempt form precisely for the purpose of placing that property beyond the reach of creditors.

3. Prebankruptcy Conversion of Property as Grounds for Denial of Discharge When There is Extrinsic Evidence of Fraud

The majority of cases, particularly among the circuit court opinions, take the view that neither the amount of assets claimed exempt nor evidence that the debtor was motivated by

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52 Id. at 876 (distinguishing an earlier decision of the court decided under the Act, Fosberg v. Security State Bank, 15 F.2d 499 (8th Cir. 1926)). While acknowledging that the scope of the debtor's exemption claim was determined purely by state law, the court justified its decision on the basis that "[a] debtor's right to discharge...unlike his right to an exemption, is determined by federal, not state, law." Id. at 674, citing, Reed, 700 F.2d at 991.

In a dissenting opinion, 848 F.2d at 877, Judge Arnold took the majority to task for usurping the prerogative of the legislative branch. As a result of the majority decision, Judge Arnold pointed up that debtors "will be unable to know in advance how far the federal courts will allow them to exercise their rights under state law." Id. at 879.


54 Id. at 263.

55 See, e.g., In re Ford, 53 Bankr. 444 (W.D. Va. 1984), aff'd sub nom. Ford v. Poston, 773 F.2d 52 (4th Cir. 1985); In re Schwingle, 15 B.R. 291 (W.D. Wis. 1981). See also infra Part II.H.3.a and accompanying text, applying a similar test for determining when prebankruptcy asset conversions may be grounds for disallowing the debtor's exemption claims.

56 Panuska v. Johnson (In re Johnson), 880 F.2d 78, 83 (8th Cir. 1989) (refusing to apply Tveten in the case of homestead claims absent evidence of extrinsic evidence of fraud unrelated to the amount of money involved). See also NCNB Texas Nat'l Bank v. Bowyer (In re Bowyer), 932 F.2d 1100 (5th Cir. 1991) (discussed infra notes 59-62 and accompanying text.)
a desire to protect those assets from creditors is relevant to when discharge may be denied based on the conversion of assets prior to bankruptcy. Recognizing the debtor's right to take full advantage of lawful exemptions, these courts hold that the discharge may only be denied when the debtor is shown to have committed some act or acts extrinsic to the conversion which hinder, delay, or defraud creditors.57 The Seventh Circuit, for example, applied this standard in *In re Smiley*, concluding that the bankruptcy court could reasonably have inferred from the debtor's concealing his intention to establish residency in another state with more liberal exemption laws—and misrepresenting to his creditors the extent of his equity in certain non-exempt assets—that the debtor had endeavored to at least hinder and delay creditors.58

However, in an *en banc* opinion on rehearing in *In re Bowyer*,59 the Fifth Circuit refused to apply *Smiley* in order to deny discharge to a debtor who had i) sold non-exempt assets to finance homestead repairs and improvements, and ii) withdrawn $24,000 in savings to pay down the mortgage on his homestead exempt residence, on the ground that these actions did not hinder or delay creditors.60 Instead, the court observed that the sale of assets occurred several months before the debtor decided to file bankruptcy, and that the use of non-exempt assets to increase the debtor's equity in his homestead constituted legitimate bankruptcy planning and was not sufficient to establish intent to defraud.61

**F. Indicia of "Intent to Defraud"**

While the courts have articulated different standards for gauging when the prebankruptcy conversion of assets may be grounds for denying discharge, in point of fact, these tests have more in common than not. Virtually all of the decisions discussed above, and others like

57 The circuit court decisions in both *Reed* and *Ford* based their decision on this ground rather than factors (respectively, the amount of assets involved and the debtor's motivation for converting assets to exempt form) emphasized in the lower court decisions. See also Marine Midland Business Loans, Inc. v. Carey (In re *Carey*), 938 F.2d 1073, 1077 (10th Cir. 1991); *Johnson*, 880 F.2d at 83; *In re Adlman*, 541 F.2d 999, 1004-05 (2d Cir. 1976) (under the former Act); Federal Land Bank of Omaha v. Ellingson (*In re Ellingson*), 63 B.R. 271 (Bankr. N.D. Iowa 1986).

58 *Smiley* v. First Nat'l Bank of Belleville, 864 F.2d 562, 568 (7th Cir. 1988) (because the language of the statute is disjunctive, evidence establishing a pattern of concealment and non-disclosure designed to hinder or delay creditors is alone sufficient to sustain an objection under § 727(a)(2) without additional proof of actual intent to defraud). See also McCormick v. Security State Bank, 822 F.2d 806 (8th Cir. 1987).

59 932 F.2d 1100 (5th Cir. 1991).

60 In the original panel decision, 916 F.2d 1056 (5th Cir. 1990), relying heavily on the Seventh Circuit's position in *Smiley*, the court concluded that the debtor's action went beyond allowable prebankruptcy planning and served as extrinsic evidence of an intent to hinder and delay creditors, even though they did not establish an intent to defraud them.

61 *Bowyer*, 932 F.2d at 1103. Regrettably, the court failed to elaborate on the distinction between "legitimate" and "illegitimate" prebankruptcy planning. The court also distinguished the instant case from *Reed* on its facts, observing that the debtor's conduct in *Reed* was "much more egregious." *Id.* at 1102 n.3.
them (see infra § II.G.), declare their adherence to the basic directive from Congress that
the practice of converting non-exempt property to exempt status even for the purpose of
evading creditor collection efforts is not itself fraudulent. Nevertheless, it is also clear from
these decisions that the court may infer the requisite intent necessary to satisfy section
727(a)(2) from actions attendant to the conversion of property, rather than truly extrinsic
acts that might alone justify denial of discharge. It is helpful, therefore, to cull from the
cases the factors which the courts have considered relevant in this regard. They include:

1. Recent change of residence to state with more liberal exemptions.

2. Concealment from creditors of the transactions in which exempt assets are acquired.

3. Decision to convert assets to exempt form made after or in connection with the
decision to file for bankruptcy relief.

4. Conversion occurs immediately after entry large judgment or in apparent
response to specific creditor collection efforts. It is helpful, therefore, to cull from the
cases the factors which the courts have considered relevant in this regard. They include:

5. New credit acquired in order to finance purchase of exempt assets.

6. Non-exempt goods purchased on credit with the intention of selling such goods
and acquiring exempt property with the proceeds.

7. Exempt assets acquired by debtor in contemplation of bankruptcy in excess the
"reasonable needs" of the debtor and the debtor's family.

8. Misrepresentations to creditors concerning the debtor's use and intended use of
assets.

9. Volume of assets converted unusually large both as a percentage of total assets
and in relation to claims against the estate.

10. Applicable state law provides for generous or even unlimited categories of
exempt property.

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62 See Devers v. Bank of Sheridan (In re Devers), 759 F.2d 751 (9th Cir. 1985).


64 See Smiley, 864 F.2d at 568 ("The unlimited homestead exemption...provides an incentive for debtors
to keep their creditors in the dark about their conversion activities."). But see Panuska v. Johnson (In re
Johnson), 880 F.2d 78, 82-83 (8th Cir. 1989) (in determining eligibility for discharge, federal courts should
respect the legislative judgment of the states regarding exemption limits and policies); In re Witwer, 148 B.R.
930, 941 (Bankr. C.D. Cal. 1992) (regardless of inequities that may result from use of unlimited exemption,
in the absence of a showing of inequitable conduct, the bankruptcy court cannot disallow a state exemption in
order to serve the bankruptcy policy of equitable distribution of the debtor’s property to creditors).
10. Applicable state law provides for generous or even unlimited categories of exempt property.\textsuperscript{64}

11. Conveyances of property made for less than fair return value.

The conduct described in paragraph 4 may also be challenged as a fraudulent conveyance under section 548(a),\textsuperscript{65} while conduct described in paragraphs 5 and 6 could separately give rise to a claim under section 523(a)(2) for non-dischargeability in favor of the defrauded creditor or seller.\textsuperscript{66}

\textbf{G. Select Other Cases}

The following is a list of citations to other recent decisions addressing this issue, with a brief statement of the holding in each case:

- **Gullickson v. Brown (In re Brown), 108 F.2d 1290 (10th Cir. 1997)** (denial of discharge refused where the only evidence of fraud was debtor's continued exercise of control over transferred asset, and the transfer, in the form of security interest, was granted in an arms-length transaction). The court in \textit{Brown} relied on its earlier holding in \textit{In re Carey}, 938 F.2d 1073, 1077 (10th Cir. 1991), in which the court held that desire to convert non-exempt assets to exempt status is alone insufficient to support an inference of fraud.

- **Reese v. Kulwin (In re Kulwin), 187 B.R. 341 (Bankr. D. Kan. 1995)** (discharge denied where, in the four months preceding bankruptcy, debtor converted virtually all of his nonexempt assets into exempt assets for the purpose of defeating the claim of a specific creditor). In addition, the court in \textit{Kulwin} noted that" "At the time of he filed bankruptcy, Kulwin did not face overwhelming debts or a lack of income or assets sufficient to pay his creditors. Instead, it appears that Kulwin targeted Reese's claim primarily, if not exclusively, for discharge and that his decision to file for protection under the Bankruptcy Code resulted from an unwillingness, rather than an inability to pay his debts."

\textsuperscript{64} \textit{See} Smiley, 864 F.2d at 568 ("The unlimited homestead exemption...provides an incentive for debtors to keep their creditors in the dark about their conversion activities."). \textit{But see} Panuska v. Johnson (\textit{In re Johnson}), 880 F.2d 78, 82-83 (8th Cir. 1989) (in determining eligibility for discharge, federal courts should respect the legislative judgment of the states regarding exemption limits and policies); \textit{In re Witwer}, 148 B.R. 930, 941 (Bankr. C.D. Cal. 1992) (regardless of inequities that may result from use of unlimited exemption, in the absence of a showing of inequitable conduct, the bankruptcy court cannot disallow a state exemption in order to serve the bankruptcy policy of equitable distribution of the debtor's property to creditors).

\textsuperscript{65} \textit{See infra} Part II.H.4 and accompanying text.

\textsuperscript{66} 11 U.S.C. § 523(a)(2) provides for the nondischargeability of debts determined to have been procured on the basis of fraud, fraudulent representations or false pretenses.
• Kapila v. Covino (In re Covino), 187 B.R. 773 (Bankr. S.D. Fla. 1995) (holding that if a debtor makes a transfer with a particular creditor in mind and has removed assets from the reach of the creditor, the debtor's discharge will be denied, but if the debtor is merely looking to her well-being, discharge will be granted).


• Clarendon National Insurance Company v. Barrett (In re Barrett), 156 B.R. 529 (Bankr. N.D. Tex. 1993) (where the record is devoid of sharp dealing or fraud, prebankruptcy planning cannot support an objection under section 727(a)(2)).

• Weissing v. Levine (In re Levine), 139 B.R. 551 (Bankr. M.D. Fla. 1992) (absent extrinsic evidence of debtor's intent to defraud, mere conversion of non-exempt property to exempt property is not fraudulent as to creditors).

• In re Hosek, 124 B.R. 239 (Bankr. W.D. Tex. 1991) (a state is free to declare as exempt such categories of property as it chooses, and the federal courts are not free to question such decisions).


• Thompson McKinnon Securities, Inc. v. Hiegel (In re Hiegel), 117 B.R. 655 (Bankr. D. Kan. 1990) (eve of bankruptcy conversion did not justify denial of discharge under either section 727(a)(2) or 727(a)(4)).

• Taunt v. Wojtala (In re Wojtala), 113 B.R. 332 (Bankr. E.D. Mich. 1990) (debor's transfer of property to exempt form in apparent response to aggressive creditor collection efforts created a strong presumption that the debtor's actions were undertaken with intent to delay or hinder creditors). The court in Wojtala also rejected the arguments that reliance on counsel is a defense to denial of discharge or that concealment of the transactions in question is a necessary element under section 727(a)(2).

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The Eighth Circuit in Tveten also held that reliance on an attorney's advice will not protect a debtor unless the reliance is reasonable. See also In re Dreyer, 127 F.2d 587, 597 (Bankr. N.D. Tex. 1991) (good faith, reasonable reliance on advice of counsel can constitute an excuse for wrongful transfer or concealment of property and will prevent denial of discharge).
H. Other Remedies

1. Dismissal of Case as a Substantial Abuse

In a chapter 7 liquidation case involving a debtor whose debts are primarily consumer debts, section 707(b) provides that the case may be dismissed by the court sua sponte or on motion of the U.S. trustee on the ground that it would constitute a substantial abuse of the provisions of the chapter to grant relief to the debtor. At least one bankruptcy court has suggested that section 707(b) may be used to defeat fraudulent bankruptcy planning.\(^\text{68}\)

2. Criminal Liability

In theory, prebankruptcy planning can give rise to prosecution under the Bankruptcy Crimes provisions of the Federal Criminal Code.\(^\text{69}\) Thus far, there are no reported prosecutions based on overly aggressive exemption planning alone, as distinguished from the outright concealment of assets or knowing making of a false oath.

3. Disallowance of Exemptions

Along with challenging the debtor’s entitlement to a discharge under section 727(a), the most common procedural device for attacking a prebankruptcy conversion of assets is to challenge the debtor’s entitlement to claim an exemption for the recently-acquired exempt property. The debtor’s right to a discharge must be determined by federal, not state, law. By contrast, except in a jurisdiction that has not opted out of the federal exemptions and where the debtor elects to use the federal exemptions, the scope of a debtor’s exemption claims are determined under state law.\(^\text{70}\) Therefore, some courts have quite properly taken the position that an exemption otherwise valid under state law may not be disallowed in bankruptcy regardless of whether the exempt asset was acquired in contemplation of filing.\(^\text{71}\)

Even under the former Act, however, where exemption issues were relegated strictly to state law, exemption claims were sometimes disallowed where the debtor’s acquisition of

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\(^{68}\) See In re Schwarb, 150 B.R. 470, 472 (Bankr. M.D. Fla. 1992). See also In re Higgenbotham, 111 B.R. 955, 964 (Bankr. N.D. Okl. 1990) (suggesting that misuse of exemptions may be grounds for dismissal under § 707(b)).

\(^{69}\) See supra Part II.E.6.

\(^{70}\) First Texas Sav. Ass'n v. Reed (In re Reed), 700 F.2d 986, 990-91 (5th Cir. 1983); In re Hosek 124 B.R. 239, 241 (Bankr. W.D. Tex. 1991) (federal courts are not free to question the decisions of the states relating to categories of exempt property).

\(^{71}\) See, e.g., In re Clements, 194 B.R. 923 (Bankr. M.D. Fla. 1996); In re Sumerell, 194 B.R. 818 (Bankr. E.D. Tenn. 1996) (stating that the court should exercise caution before utilizing its equitable powers to fashion a remedy for fraud that is not expressly authorized by the Code); Crews v. First Colony Life Ins. Co. (In re Barker), 168 B.R. 773 (Bankr. M.D. Fla. 1994); In re Hosek, 124 B.R. 239, 241 (Bankr. W.D. Tex. 1991) (asserting that the federal courts are not free to question decisions of states insofar as categories and entitlement to exemptions are concerned).
the exempt property was accompanied by fraudulent conduct and state law permitted disallowance of the exemption for fraud.72 Since the enactment of the Code, creditors have routinely challenged the practice of converting non-exempt property into exempt property on the eve of bankruptcy in the form of objections to the allowability of the debtor’s claimed exemptions as well as by objecting to discharge, sometimes supported by state law and sometimes not.73 In ruling on these objections, two basic standards have emerged.

a. Moving party must demonstrate extrinsic evidence of fraud

The traditional view, articulated by several panels from the Eighth Circuit,74 is that the exemption may be disallowed only when there is extrinsic evidence that the debtor acted with intent to defraud in converting non-exempt assets into exempt assets,75 a test very similar in formulation to the standard applied by many courts in determining when the prebankruptcy conversion of assets may be grounds for denial of discharge (supra § II. E.3.). The sort of factors necessary to find fraudulent use of an exemption include conduct designed to materially mislead or deceive creditors about the debtor’s financial situation, use of credit to purchase exempt property, and conveyances for less than fair consideration.76 On the other hand, because there is greater deference to state law in determining entitlement to specific exemptions than is the case with the granting or denial of discharge, if state law provides an absolute right to convert non-exempt property into certain categories of exempt assets, some courts hold that the bankruptcy court cannot later deny the exemption based on proof that the debtor engaged in the conduct with actual intent to defraud.77 By the same token, where state law explicitly speaks to the question (i.e.,

72 See, e.g., Kangas v. Robie, 264 F. 92 (8th Cir. 1920); In re White, 221 F. Supp. 64 (N.D. Cal. 1963); In re Martin, 217 F.2d 937 (D. Or. 1963).

73 Under Bankruptcy Rule 4003(a), the debtor must file a schedule of exempt property within 15 days after the commencement of a voluntary case. If no objection is filed, the property claimed as exempt is exempt: 11 U.S.C. § 522(l). Objections to claimed exemptions are governed by Bankruptcy Rule 4003(b), which requires that such objections be filed within 30 days following the first meeting of creditors. Under Bankruptcy Rule 4003(e), a party objecting to a homestead exemption claim bears the burden of proving that the property does not qualify for the exemption.


75 Armstrong, 931 F.2d at 1237. See also Peoples State Bank & Trust Co. v. Saylor (In re Saylor), 98 B.R. 542 (D. Kan 1989) (affirming bankruptcy court’s disallowance of debtor’s claim that life insurance policy was exempt after remand to establish the presence of sufficient indicia of extrinsic fraud); In re MacKey, 158 B.R. 509, 512 (Bankr. M.D. Fla. 1993) (although not fraudulent per se, if done with intent to defeat the interests of creditors, a prebankruptcy conversion of assets may be sufficient to warrant denial of the debtor’s claim of exemption).

76 See Johnson, 880 F.2d at 82; Mueller v. Redmond (In re Mueller), 71 B.R. 165, 168 (D. Kan. 1987), aff’d, 867 F.2d 568 (10th Cir. 1989).

77 See Smith v. Moody (In re Moody), 862 F.2d 1194, 1197-98 (5th Cir. 1989) (under Texas law, intent is irrelevant in determining the scope and amount of the homestead exemption). See also Tveten, 848 F.2d at
makes prebankruptcy asset conversions grounds for denial of exemption claims), the bankruptcy court would be obliged as well to apply the state law rule.\textsuperscript{78}

b. Fraud may be inferred solely from debtor's intent to place assets beyond the reach of creditors

In \textit{In re Schwarb},\textsuperscript{79} the bankruptcy court found that the debtors had engaged in a "systematic conversion of assets" following entry of a large judgment in favor of a creditor who had indicated its intent to forcefully pursue collection. In disallowing the debtors claimed exemptions, the court specifically acknowledged that it was departing from the rule that the conversion of non-exempt property to exempt property is not \textit{per se} fraudulent.\textsuperscript{80} Instead the court embraced a rule that the conversion of an asset into exempt form for the specific purpose of placing the asset out of the reach of creditors is itself sufficient to deprive a debtor of her right to claim the property as exempt.\textsuperscript{81} A similar approach can be found in \textit{In re Spoor-Weston, Inc.},\textsuperscript{82} where the court, following a lengthy discussion of the

\textsuperscript{78} See \textit{In re Ayre}, 158 B.R. 123 (Bankr. C.D. Ill. 1993) (applying an Illinois statute providing that property acquired within six months of bankruptcy should be presumed acquired in contemplation of bankruptcy and, thus, in fraud of creditors). Iowa has a similar, albeit more limited, restriction applicable to exempt payments from a pension, annuity, or similar plan to the extent the payments are attributable to contributions made within one year prior to bankruptcy. Iowa Code Ann. § 627.6(8)(e) (1994). In \textit{In re Phillips}, 1997 Bankr. LEXIS 249 (Bankr. N.D. Cal. 1997), the court construed the California law to deny an exemption for funds in a "private retirement plan" where the plan was designed and used for non-retirement purposes.

\textsuperscript{79} Id. at 473. In \textit{Weissing v. Levine (In re Levine)}, 139 B.R. 551, 553-54 (Bankr. M.D. Fla. 1992), an earlier decision also written by Judge Paskay, the court had held that the conversion of non-exempt property to exempt property could not be fraudulent \textit{per se} even when the purpose for the conversion of property was to place the property beyond the reach of creditors. \textit{See also In re Snape}, 172 B.R. 361 (Bankr. M.D. Fla. 1994) (same) \textit{In re Swecker}, 157 B.R. 694 (Bankr. M.D. Fla. 1993) (Bankr. M.D. Fla. 1993) (extrinsic evidence showing serious creditor collection pressure just prior to the conversion may warrant forfeiture of the exemption claim).

\textsuperscript{80} \textit{Schwarb}, 150 B.R. at 473. \textit{But see In re Elia}, 198 B.R. 588 (Bankr. D. Az. 1996) (observing that the fact that the debtor is insolvent at the time of conversion and intends to place assets beyond the reach of creditors does not necessarily lead to a finding of fraudulent intent); Ameritrust Nat'l Bank v. Davidson (\textit{In re Davidson}), 164 B.R. 782, 787 (Bankr. S.D. Fla. 1994) (holding that nothing within § 522 permits the court to deny an exemption because nonexempt property was converted to exempt property with the intent to hinder, delay, or defraud creditors); \textit{aff'd in part, rev'd in part}, 178 B.R. 544 (S.D. Fla. 1995); Crews v. Colony Life Ins. Co. (\textit{In re Barker}), 168 B.R. 773 (Bankr. M.D. Fla. 1994) (same). \textit{See also Kapila v. Beahm (In re Beahm)}, 179 B.R. 329, 334 n.6 (Bankr. S.D. Fla. 1995) (discussing the disagreement between \textit{Schwarb} and \textit{Barker}).

\textsuperscript{81} 139 B.R. 1009 (Bankr. N.D. Okl. 1992).
legislative history, concluded that the "conversion of assets outside of the usual course of business and on the eve of bankruptcy is wrong."83

Florida, because of its unlimited homestead exemption, coupled with a salubrious climate and an attractive environment for retirement, has always generated a disproportionate number of the reported decisions challenging a debtor’s prebankruptcy conversion of assets. Many of these cases have arisen in the context of a challenge to the debtor’s exemption claim for assets, including the homestead, acquired on the eve of, and allegedly in contemplation of, filing for bankruptcy relief. In an effort to control the perceived “abuse” of its generous homestead law, effective October 1, 1993, Florida amended its exemption statutes to provide that any conversion made with the intent to hinder, delay, or defraud a creditor is a “fraudulent” conversion.84 Because the federal bankruptcy courts are obliged, in opt-out jurisdictions, to follow state law in terms of the allowability of exemptions, the intended effect of the new statutory provision was to render the exemption nonallowable in bankruptcy in any case to which the statute pertains.85 However, in In re Miller,86 Judge Paskay held that the new statute could not operate as a limitation on or exception to the homestead exemption because that exemption is created by the Florida Constitution and, thus, is subject only to those exceptions expressly provided for by the Constitution.87 Nevertheless, the court in Miller did deny the debtor’s claimed exemption for the cash value of two life insurance policies acquired with the proceeds from the sale of nonexempt property on the ground that “the exemption created for annuities is a creature of the

83 Id. at 1015.

84 Fla. Stat. ch. 222.30 (1993), applied in In re Thomas, 172 B.R. 673, 674 (Bankr. M.D. Fla. 1994) (concluding that the debtors’ use, after consulting an attorney, of proceeds from the sale of a nonexempt automobile to pay down the mortgage on an exempt residence was a fraudulent conversion within the meaning of the statute). See also Fla. Stat. ch. 222.29 (1993) (providing that an exemption is not effective to the extent it results from a fraudulent transfer or conveyance).

85 Several other states have similar provisions in their statutory exemptions schemes. See e.g., Kan. Stat. Ann. § 40-414 (1993) (creating an exception to the exemption for life insurance policies where it can be shown that the debtor purchased the asset with the intent to defraud creditors); Tex. Prop. Code Ann. § 42.004 (Vernon 1984 and Supp. 1995) (affecting the use of nonexempt property to acquire exempt personal property). See also supra note 78. Some states’ exemption laws tie the amount of the allowable exemption to the “reasonable needs” of the debtor. See In re Esian, 181 B.R. 848, 850, 853 (Bankr. D.S.C. 1995) (describing the operation of the South Carolina exemption statute (S.C. Code Ann. § 15-41-30(11)(c) (1994)) limiting the exemption for payments made under a life insurance policy).


Legislature, it has no constitutional protection, and therefore, may be subject to other exceptions, specifically an exception related to the fraudulent transfer of non-exempt property into exempt property."\(^8\)

In *In re Wilbur*,\(^8\) Judge Proctor took a different approach than *Miller* to the issue of whether an otherwise valid Florida homestead claim can be disallowed upon a finding that the debtor converted the residence from a non-exempt status to an exempt status with the purpose of hindering, delaying, or defrauding creditors. Citing *In re Brown* and *In re Frederick*, the court determined that it retained authority, without relying on FLA. STAT. 220.30, to ensure that the exemption did not become the instrument of fraud. Thus, the court concluded that if prohibited intent can be shown by inference from extrinsic evidence—such as the timing of the conversion or attempts to conceal the transfers—the exemption may still be denied.\(^9\) Also, the Eleventh Circuit has ruled that where the debtors' claimed homestead exceeds the area limitation set forth in the Florida Constitution and is indivisible, sale by the trustee and apportionment of the proceeds between the estate and the debtor is appropriate and equitable.\(^1\)

c. An alternative approach: partial denial

The court in *Spoor-Weston*, as a remedy for the wrongful conversion of assets, granted the trustee an equitable lien on the debtors' homestead in an amount equal to the amount of the funds that the court determined had been wrongfully diverted from the estate in contemplation of bankruptcy.\(^2\) This approach has particular utility in filings by recently-arrived residents of states with unlimited exemptions for certain types of property. For example, in *In re Coplan*\(^3\) the debtor had engaged in the familiar practice of liquidating assets and relocating from a state with a limited homestead exemption, Wisconsin, to a state with an unlimited homestead exemption, Florida. The issue, according to the court, was whether, under all of the circumstances, the debtor's relocation to Florida, and purchase of a new residence in that state, "was for the specific purpose of shielding assets from creditors." Concluding that the behavior was so motivated by the fact, *inter alia*, that the filing occurred just after the one year anniversary of the move, the court denied the

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\(^8\) *Miller*, 188 B.R. at 308.


\(^10\) In the actual case, however, the court found that the trustee had not met the burden of establishing disallowance based on fraudulent conversion.

\(^1\) *Englander v. Mills* (*In re Englander*), 95 F.3d 1028 (11th Cir. 1996). Several states impose a size as well as a dollar value limitation on their homestead exemption. *See* Appendix I.

\(^2\) *Spoor-Weston*, 139 B.R. at 1016-17. *See also* Smiley v. First Nat'l Bank of Belleville (*In re Smiley*), 864 F.2d 562, 564 (7th Cir. 1989) (describing lower court action where debtors were relegated to exemptions under the laws of the state of their former residence rather than the jurisdiction where they had moved shortly before filing for bankruptcy).

\(^3\) 156 B.R. 88 (Bankr. M.D. Fla. 1993).
applicable Florida homestead exemption to the extent that it provided a benefit exceeding the homestead exemption to which the debtor would have been entitled under Wisconsin law.\textsuperscript{94}

In \textit{In re Bandkau},\textsuperscript{95} decided by the same judge that decided \textit{Coplan}, the debtor purchased a veterinary practice in return for cash and an $80,000 promissory note. Subsequently, bad blood developed between the buyer and the seller and, according to the court’s finding, the debtor set out upon a premeditated plan to defeat the seller’s claim under the note. This plan consisted of the liquidation of the debtor’s old homestead along with various other nonexempt assets, followed by the purchase of a new residence for $100,000, approximately $66,000 of which was paid in cash and the balance from the proceeds of a new mortgage. “Because the debtors used $54,114.22 of nonexempt assets in purchasing the home with the specific intent to place those assets out of reach of their only creditor, the right to exemption for that portion of the home ...is forfeit.”\textsuperscript{96} Thus, the court granted the debtors an exemption equal to 45.9\% of their home, leaving 54.1\% subject to administration.\textsuperscript{97} In addition, however, the court ordered that the first mortgage be satisfied out of the exempt portion of the homestead, effectively leaving the debtor with a negligible homestead claim. As in \textit{Coplan}, the remedy was fashioned whole-cloth without any basis in the Code, producing perhaps an equitable result on the facts of the particular decision but creating an unwieldy and potentially dangerous precedent for future cases.

4. Fraudulent Transfer Law as a Remedy for Conversion of Non-Exempt Assets

Section 548(a)(1) grants the trustee the power to avoid any transfers made with “intent to hinder, delay, or defraud creditors.” Section 548(a)(2) sets forth three sets of circumstances under which the trustee may avoid transfers made for less than “reasonably equivalent value.” Unlike a cause under section 548(a)(1), proof of actual intent to prejudice creditors is not required under section 548(a)(2). In either case, the transfer must occur within one year of filing to be vulnerable under section 548. However, by virtue of the trustee’s ability to exercise the rights of unsecured creditors under section 544(b), transfers considered

\textsuperscript{94} The Wisconsin homestead exemption had a limit of $40,000, whereas the Florida property had been purchased by the debtor for $228,000 in case, virtually all of which had been obtained from the sale of the debtor’s Wisconsin home. While the result in \textit{Coplan} may be appealing as an equitable accommodation of the contractual rights of creditors and the protections the Code endeavors to provide to debtors, by fashioning a remedy out of whole cloth the court produced an outcome that is difficult to support under the express directives of the Code.

\textsuperscript{95} 187 B.R. 373 (Bankr. M.D. Fla. 1995).

\textsuperscript{96} \textit{Id.} at 381. The balance of the cash paid at closing, some $11,929.37, came from the proceeds of the sale of the debtors’ prior homestead and, thus, retained their exempt character.

\textsuperscript{97} Although the court made no reference to the point, apparently the same division would apply to any post-closing appreciation or depreciation in value.
fraudulent under state law occurring more than one year before bankruptcy may also be recovered for the benefit of the estate. 98

Ordinarily, a transfer of exempt property cannot give rise to a fraudulent transfer action since creditors would have no legal right to look to those assets in the first place. 99 Thus, the conversion of one exempt asset into another cannot have the effect of delaying, hindering or defrauding creditors. 100 On the other hand, the transfer of assets from non-exempt to exempt form may constitute a fraudulent conveyance upon showing of evidence of actual intent to hinder, delay or defraud. 101 Theoretically, the trustee could simultaneously pursue actions to “recover” fraudulently transferred assets and to deny discharge. 102 A conversion of assets for less than fair return value can also be challenged without proof of actual wrongful intent under section 548(a)(2). 103

98 See, e.g., Dehmer Distrib. v. Temple, 826 F.2d 1463 (5th Cir. 1987).

99 For example, under the Uniform Fraudulent Transfers Act, § 1(12) defines a “transfer” as a “transfer of assets” and, in § 1(2), the definition of assets excludes exempt property. See also G. Glenn, FRAUDULENT CONVEYANCES AND PREFERENCES § 172 (Rev. ed. 1940). In a bankruptcy context, however, § 522(g) which precludes the debtor from exempting property recovered by the trustee under § 550 unless the transfer was not involuntary. The implication of this provision is that the trustee does have the power to avoid a transfer of exempt property either as a preference or a fraudulent conveyance. See, e.g., Kepler v. Weis (In re Weis), 92 B.R. 816, 820-21 ((Bankr. W.D. Wis. 1988).

100 See, e.g., In re Kimmel, 131 B.R. 223, 229 (Bankr. S.D. Fla. 1991) (use of exempt pension funds to purchase exempt insurance policy could not have the effect of hindering, delaying or defrauding creditors).

101 See, e.g., Govaert v. Strehlow (In re Strehlow), 84 B.R. 241, 245 (S.D. Fla. 1988) (insolvent debtor’s conversion of non-exempt property to exempt property held a fraudulent transfer under state law); Roemelmeyer v. Gefen (In re Gefen), 35 B.R. 368, 372 (S.D. Fla. 1984) (purchase of exempt property with exempt funds was a fraudulent transfer since debtor was aware of pending litigation at the time the transfer occurred); Shaia v. Meyer (In re Meyer), 1997 Bankr. LEXIS 410 (Bankr. E.D. Va. 1997) (trustee permitted to set aside as a fraudulent transfer a prepetition payment made by the debtor, in his individual capacity and with nonexempt funds, on a debt owed jointly by him and his spouse and secured by realty which they held as tenants by the entitle). See also In re Clements, 194 B.R. 923 (Bankr. M.D. Fla. 1996) (noting that § 548(a) may be available as a remedy in these circumstances). But see In re Miller, 113 B.R. 98, 104 (Bankr. D. Mass. 1990) (debtor’s availing himself of an exemption that state law makes available to him is not a fraudulent transfer since the very purpose of the homestead exemption is to put the property beyond the reach of creditors).

102 For an example of a case where the trustee did just that, see Rosen v. Bezner, 996 F.2d 1527, 1530 (3d Cir. 1993).

103 In re Spoor-Weston, Inc., 139 B.R. 1009, 1015 (Bankr. N.D. Okla. 1992) (indicating that one of the possible remedies for wrongful conversion of assets would be avoidance of the transfer involving the conversion of assets as a fraudulent transfer).
I. Possible Solutions and Ethical Considerations Revisited

Several possible solutions to the conversion issue have been proposed in the literature: 104

1. Make the federal exemptions mandatory for all bankruptcy debtors. 105 This would prevent debtors from "loading up" since all of the federal exemption have dollar limitations on categories of exempt property. See 11 U.S.C. § 522(d). It would also cease to make advantageous the move to a state with more generous exemptions in advance of filing. However, unless coupled with additional amendments to define the exemption solely in dollar value terms, rather than by exempt category as well, it would not eliminate the incentive to change the form in which assets are held before filing.

A copy of a proposal along these lines made by the author and Judge William Houston Brown to the National Bankruptcy Review Commission is attached as Appendix III to these materials. 106 The actual proposal recommended by the Consumer Bankruptcy Working Group of the Commission, which largely follows these recommendations, is also attached as an Appendix IV. However, in a late amendment, the floor on the homestead exemption was dropped from $30,000 to $20,000.

2. Retain the present approach of deferral to state law exemptions, but subject to federally-imposed floors and ceilings. The Bankruptcy Technical Corrections Act of 1996, which passed by the Senate but not acted on by the House before the adjournment of the 104th Congress, contained a variation of this approach in the form of a $500,000 cap on the homestead. Recently, Senator Kohl of Wisconsin has introduced new legislation (S. 540) which would cap the homestead at $100,000. In the author’s view, floors and ceilings, represents a second best solution. It is second best because it retains most of the shortcomings of the present system, principally in the absence of clear guidelines, without taking full advantages of the efficiency gains that would be achieved if, for example, the patchwork of state law was replaced with a single, mandatory list of uniform federal exemptions. The pending bill, like the one that was proposed last year, is also infirm in that it capped the

105 See Cowell, Note, The Debtor and Conversion of Nonexempt Assets to Exempt Assets on the Eve of Bankruptcy: Astute Bankruptcy Estate Planning or Fraud, 18 Cap. U. L. Rev. 567, 586-89 (1989). But see Kennedy, supra note 7, at 485 (concluding that "[f]or all the antiquarianism, diversity, and inadequacies of state exemption legislation, there seems to be no impelling need to impress a federal mold on the exemptions recognizable in bankruptcy").
106 For further detail see Brown, Political and Ethical Considerations of Exemption Limitations: The “Opt-Out” as Child of the First and Parent of the Second, 71 AM. BANKR. L.J. 221 (1997).
homestead, regardless of state law, without setting a corresponding minimum homestead amount tied to the fresh start aims of the bankruptcy law. The attached proposal on exemptions from the Consumer Bankruptcy Working Group of the Commission (Appendix IV) retains the floors and ceilings concept for the homestead exemption only.

3. Disallow a debtor's exemptions for assets acquired within 90 days of bankruptcy and while insolvent to the extent that such assets exceed the reasonable needs of the debtor and her family.\textsuperscript{107}

4. Treat any prebankruptcy conversion of property by an insolvent debtor in the same manner that the bankruptcy law treats other prebankruptcy transfers of property by insolvent debtors; i.e., as a preference.\textsuperscript{108} Like the previous suggestion, this approach suffers from the serious flaw that in operation it would almost certainly end up shielding the more sophisticated debtors with the savvy enough to plan in advance, while penalizing those less affluent debtors, most in need of exemption protection, but who lack routine access to counsel and who would in most cases not learn of the opportunity to do effective exemption planning until the exigencies of their situation rendered deferring filing a non-option.

5. Permit prebankruptcy conversions without regulation (except as to the dischargeability of particular debts incurred by fraud), but permit revocation of discharge to the extent that assets so acquired are “reconverted” to non-exempt form in the year following entry of the order of discharge. This would respond to the criticism that conversions in bankruptcy situations are more harmful than under state law because there is no remedy for creditors when and if assets are later reconverted into non-exempt form. The obvious problem with this approach is the monitoring and litigation costs associated in determining whether the debtor has acted in a manner that would give rise to a revocation proceeding.

6. Allow creditors to sell exempt property subject to the debtor's continued right of possession for life or some other limited period of time.\textsuperscript{109}

\textsuperscript{107} This proposal was originally made by Alan Resnick in his article, \textit{Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy}, 31 Rutgers L. Rev. 615, 651 (1979). A serious problem with this approach is that it would penalize the less sophisticated debtors who failed to seek counsel in advance of the time when financial pressures made immediate filing a necessity.

\textsuperscript{108} See Eisenberg, \textit{Bankruptcy Law in Perspective}, 28 UCLA L. Rev. 953, 993-97 (1981) (the presumption should be against conversion).

\textsuperscript{109} Vukowich, \textit{supra} note 7, at 793; Note, \textit{supra} note 105, at 225-26. One of several problems with this approach is that it ignores the effect of the limitation on the needs of the debtor's dependents.
Unquestionably, the most promising of these solutions is a mandatory schedule of uniform federal exemptions, which would eliminate wasteful litigation over asset conversion and debtor relocation. It also ensures that federal fresh start policy is applied consistently and rationally, rather than according to the vagaries of state law. It does not solve all problems. Issues regarding the character and value of assets claimed as exempt would remain. Nevertheless, federalization of exemption policy would be of enormous help to courts, counsel, creditors, and debtors alike.

Of course, any of these solutions requires some form of legislative action, an event not certain to occur. For the foreseeable future, therefore, it seems that the issue will continue to be adjudicated on a case-by-case basis, even though Code courts have failed to agree upon a consistent approach to be taken in these cases. This lack of uniformity and guidance promotes uncertainty, meaning that counsel must walk a fine line in advising clients between, on the one hand, making them aware of the opportunity for taking maximum advantage of exemptions available to them, and, on the other hand, making sure that they understand the risks involved, including denial of discharge, in engaging in “fraudulent” prebankruptcy planning.

In addition, counsel must be attentive at all times to the ethical standards and preclusions which govern the profession. Just as the absence of bright line tests presents problems for a debtor trying to decide how much property can be converted before she is in jeopardy under section 727(a)(2), so too does the lack of clear and definitive guidelines complicate the task for counsel in abiding by the ethical norms governing the profession and referred to in more detail above. Ultimately, it is the client who must decide how aggressive she intends to be in planning for bankruptcy, but if, in making that decision, the client exceeds what counsel regards as the permissible boundaries of legitimate prebankruptcy planning, the lawyer has an ethical duty and an obligation as an officer of the court not to countenance such behavior in the form of continuing representation. The problem, of course, is ascertaining the precise location of such boundaries, a task that Congress and the courts have complicated many fold by failing to provide clear and consistent standards and guidelines.

III. Recent Developments Concerning Exemptions

A. Waiver of Exemptions by Creditor Nonaction—herein of Taylor v. Freeland & Kronz

1. In General

In Taylor, 503 U.S. 638 (1992), the Supreme Court held that the failure to file a timely objection under Rule 4003(b) to a debtor’s exemption claim caused those exemptions

110 See supra § II.D.
to be allowed even though the exemptions were not otherwise proper. Since that case was
decided there have been a number of decisions seeking to flesh out the scope and limitations
in that ruling. Quite recently, the Sixth Circuit, in Rogers v. Laurain (In re Laurain), 113
F.3d 595 (6th Cir. 1997), held that not only must the trustee’s (or creditor’s) motion for
extension of time to file an objection be filed before the expiration of the 30-day period in
Rule 4003(b), but the court must act on the motion before the expiration of such deadline or
the exemption claim is allowed. The court based its holding on the explicit language in
Rule 4003(b) (which indeed is phrased somewhat differently from the language in the
comparable rules governing time for filing discharge objections and complaints objecting to
dischargeability under Rules 4004(b) and 4007(c)) and its conclusion that the time
limitations in Rule 4003(b) are jurisdictional. This ruling will inevitably place trustees and
creditors, who obviously cannot control when the court will act, in the unenviable position
of having to file blanket objections before the expiration of the 30-day period and sort out
the facts later.111

Recognizing these undesirable practical consequences, in a dissenting opinion in
Laurain, Judge Conti argued that Congress could not have intended the “nonsensical”
interpretation adopted by the majority of the court. 113 F.2d at 602. In Barbee v. Statner
(In re Statner), 1997 Bankr. LEXIS 1330 (Bankr. S.D. Fla.), the court adopted the reasoning
of Judge Conti, concluding, “to hold otherwise would be to create an undue hardship on
both trustees and the Court.” Nevertheless, the language in Rule 4003(b) is problematical.
Therefore, because the holding in Laurain will tend only to increase the cost and complexity
of consumer bankruptcy cases, the Rules Committee should consider an amendment to Rule
4003(b) to make clear that it is only the filing of the motion for extension of time, and not
entry of the order, which must occur within the 30-day window in order to avoid a waiver
of the right to object to exemption claims.

In a case tending to limit the holding in Taylor, the First Circuit held that Rule
4003(b) does not require the trustee to object to an exemption to which the debtor is fully
entitled. Williams v. Peyton (In re Williams), 104 F.3d 688 (1st Cir. 1997). In Williams,
the debtor listed as exempt on her schedules a parcel of property that she owned as a “tenant
by the entirety” with her husband. The trustee did not object. Thereafter when the trustee
sought to take possession of the property, the debtor filed a motion to compel abandonment

111 A rather good example of this strategy can be found in Spenler v. Siegel (In re Spenler), 1997 Bankr.
LEXIS 1488 (Bankr 9th Cir. 1997), in which the trustee filed an “objection” to the debtor’s list of property
claimed as exempt apparently for the purpose of conducting further discovery of the debtor. The bankruptcy
court disagreed, noting that “Customarily, you notice up a 2004 in a timely manner and request an extension
of time,” rather than file an objection without supporting documentation. Nevertheless, the court “deemed”
the trustee’s “objection” to be a request for additional time and granted the trustee an extension of time to file
an objection supported by appropriate documentary evidence. On appeal, the debtor argued that because a
proper objection was not filed within the 30-day period prescribed by Rule 4003(b), the time for objection
expired. The Appellate Panel disagreed on the basis that the purpose of Rule 4003(b) is to provide the debtor
with timely notice that the trustee objects to claimed exemptions and that the trustee’s purported “objection,”
which specifically referred to claimed exemptions in two IRAs, served to provide such notice even if treated
by the court as an request for extension of time. See also In re Young, 806 F.2d 1303, 1305 (5th Cir 1987).

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contending that the trustee had no right to sell the property for the benefit of any creditors. The court disagreed; noting that the exemption in § 522(b)(2)(B) for property held as a tenant by the entirety only applies to the extent such interest is exempt under state law. Because applicable local law in this case provided that entireties property is exempt only from the claims of individual, but not joint creditors, the trustee was free to administer the property for the benefit of joint creditors. The failure to object to the exemption claim within the time limitations of Rule 4003(b) did not, according to the court, affect the trustee’s rights because the debtor had never claimed the property as exempt from the claims of joint creditors. It bears noting that other decisions hold, assuming a timely objection under Rule 4003(b), that an entireties exemption is simply void to the extent there are joint creditors as to whom the exemption does not apply under state law. See Edmonston v. Murphy (In re Edmonston), 107 F.3d 74 (1st Cir. 1997).

The obligation to file an objection also depends on the existence of a proper claim by the debtor. Thus, where the debtor fails to file timely schedules, or later amends the schedules, the trustee is relieved of the duty to object until there is a list of property to be opposed under § 522(l) and Rule 4003(b). See Petit v. Fessenden, 80 F.3d 29, 32-33. (1st Cir. 1996); In re Doyle, 209 B.R. 897 (Bankr. N.D. Ill. 1997) (trustee given 30 days to object from the date that debtor amends schedules to describe individual items claimed as exempt with greater particularity); In re Harrel, 1997 Bankr. LEXIS 1043 (Bankr. S.D. Ga. 1997) (debtor could not claim an exemption based on amendment of his schedules, despite trustee’s failure to object, where the exemption is barred by § 522(g) regarding property fraudulent concealed and recovered by the trustee); In re Pugh, 195 B.R. 787 (Bankr. M.D. Fla. 1996), aff’d, 202 B.R. 792 (M.D. Fla. 1996). Also, where the debtor seeks to exclude, rather than exempt, property from the estate, Rule 4003(b) does not apply. Spenlinhauer v. Spencer Press, Inc. (In re Spenlinhauer, 195 B.R. 543) (D. Me. 1996), aff’d w/o op., 101 F.3d 106 (1st Cir. 1996) (debtor claimed one-third of interest in corpus of spendthrift trust excluded under § 541(c)(2).

2. Taylor in Chapter 13

In In re Graznow, 1997 WL 40471, (E.D. Mich. 1997), the debtor designated two securities accounts as exempt from inclusion in his bankruptcy estate. A creditor objected to confirmation on the basis that the exemptions were not allowable, and that, if the exempt property were included in the estate, the creditor would be entitled to full payment of its claim under § the confirmation standard in 1325(a)(4). The bankruptcy court refused to confirm the plan and the debtor appealed. On appeal, the district reversed, observing that several courts have extended the Taylor holding to chapter 13 cases. Therefore, since the plan objection was in substance an untimely objection to the debtor’s claimed exemption, the court concluded that consideration of that aspect of the confirmation objection was barred by Rule 4003(b). Along similar lines, in In re Ruggles, 210 B.R. 57 (Bankr. D. Vt. 1997), the bankruptcy court held that property that was exempted from the estate without a timely objection could not be considered in the liquidation analysis for purposes of determining if the plan met the best interests of creditors test under § 1325(a)(4).
Another case involving application of *Taylor* in chapter 13 is *In re Gamble*, 208 B.R. 598 (Bankr. S.D. Ga. 1997). In this case, the debtors claimed the equity in their residence exempt under the Illinois homestead law. Subsequently, the debtors sought and received authority to sell the property, the net proceeds from which were $6,731.22, which the court ordered held by the chapter 13 trustee until the conclusion of all payments called for by the debtors’ plan. The debtors filed a motion for turnover of these funds citing *Taylor* for the proposition that, no objection to their exemption claim having been filed, the property was not and could never become the property of the estate. Although the court agreed that the exempt character of the proceeds had been established, it stated that this did not resolve the remaining issue of the appropriate disposition of exempt property during the pendency of the chapter 13 case. As to this issue, the court found that while *Taylor* carved the exempt property out of the estate, it did not free it from the claims of prepetition creditors until the case is concluded. Therefore, the court ruled that the property should be held in suspense pending completion of payments under the debtors’ plan, with the proceeds to revest in the debtors at that time, but not earlier. As justification for this holding, the court stated: “Debtors have the right to dismiss a Chapter 13 case at any time. To hold exempt property revests in debtors at confirmation and allow unfettered use of property would, defacto or dejure, potentially result in property being placed beyond the reach of creditors prior to the time that debtors’ Chapter 13 plan is consummated by distribution of the monthly payments of debtor’s disposable income. To avoid this injustice,…the Code contemplates the possessory enjoyment of debtors’ exemptions be postponed, contingent on future payment.” Although the language of this holding can certainly be read to support a broader application, it appears that the court intended to limit the scope of its holding to exempt property that has been converted to *cash*. 208 B.R. 602 n.1. Without such a limitation (and perhaps even with it) this decision would pose a serious threat to the integrity of chapter 13, since there would be little incentive to select a repayment plan if the debtors were to be deprived of the use and enjoyment of their property during the three to five year duration of the plan.

Finally, in *In re Ferretti*, 203 B.R. 796 (Bankr. S.D. Fla. 1997), the debtor identified in his schedules as exempt property an “auto accident claim” valued at $1.00. Such property was not exempt as a matter of law, but no objection was filed. Thereafter, the debtor settled the auto accident claim for $70,000 and the trustee objected to the distribution of the net settlement proceeds to the debtor in excess of the $1.00 that had been claimed. Specifically, the trustee argued that *Taylor* should not apply in chapter 13, and that, in any event, even if it was too late to challenge the exemption, the court must still consider whether the property should be regarded as disposable income for purposes of §§ 1322 and 1325. In response, the court made the following determinations: (1) the entire settlement, and not just the $1.00 scheduled by the debtor, was exempt under the rationale of *Taylor*; (2) *Taylor* applies in chapter 13; and (3) despite contrary authority, the language of § 522(c) which protects exempt property from prepetition debts applies for purposes of defining disposable income under § 1325(b)(2).
3. Adjournment of the First Meeting

After Taylor, one technique that trustees have employed has been not to conclude the § 341(a) meeting, but rather to continue it generally. The object is to circumvent the strict 30-day bar date for filing objections to exemption claims relying on the language in Rule 4003(b) which states that the objection period terminates “30 days after the conclusion of the meeting of creditors.” The theory is that there is no need to apply for an extension of the objection period if it never expired. Rule 2003(e) states that the § 341(a) meeting may be “adjourned from time to time by announcement at the meeting of the adjourned date and time without further notice.” The case law on the validity of this approach is mixed.

In In re Levitt, 137 B.R. 881 (Bankr D. Mass. 1992), decided just prior to the Supreme Court’s decision in Taylor, the court held (relying on Rule 2003(e)) that unless the trustee orders a specific adjourned date and time within 30 days of the date on which the meeting is held, the meeting will be deemed to have concluded on the last meeting date. Id. at 883. Taking a somewhat different tact, in Petit v. Fessenden, 182 B.R. 59, 63 (D. Me. 1995), aff’d on other ground, 80 F.3d 29 (1st Cir. 1996), the district court ruled that in cases involving an indefinite continuance, the determination of whether or not the objection to the debtor’s exemption claim was timely filed depends on whether the time of filing the objection was “not unreasonable under the circumstances presented.”

Several other reported decisions permit a general continuance, although with some limitations on the trustee’s ability to act arbitrarily. In Bernard v. Coyne (In re Bernard), 40 F.3d 1028, 1031 (9th Cir. 1994), cert. denied, 115 S. Ct. 1695, the court upheld the trustee’s right to continue the creditors’ meeting if he believes that the purposes of the meeting have not been fulfilled. See also In re Havenac, 175 B.R. 920 (Bankr. N.D. Ohio 1994) (Rule 2003(e) impliedly authorizes general continuances). In In re DiGregorio, 187 B.R. 273 (Bankr. N.D. Ill. 1995), the court rejected the “bright line” approach in Levitt, but also refused to simply sanction general adjournments. Instead, the court put the burden on the debtor to move the court for an order concluding the meeting. Id. at 276. In In re Flynn, 200 B.R. 481 (Bankr. D. Mass. 1996), the court adopted the reasoning of the DiGregorio, but reserved the question of whether the debtor’s motion to strike the objection should be granted “only if the debtor has objected to the continuance and the adjournment is found to arbitrary, capricious or an abuse of discretion.” Id at 486.

4. Conversion

Does Taylor preclude an objection beyond the 30-day period where the case is converted from chapter 11 or 13 to chapter 7? Again the case law is in some disarray on this issue. In re Brown, 178 B.R. 722 (Bankr. E.D. Tenn. 1995), was initially filed as a chapter 11 case. The trustee failed to make timely objections to exemption claims and the case was subsequently converted to chapter 7. The trustee argued that the objection period should be revived upon conversion, but the court disagreed, following the rationale of In re Halbert, 146 B.R. 185 (Bankr. W.D. Tex. 1992), to the effect that once property leaves the estate as exempt, conversion does not restore it. In contrast to these authorities, in In re
Havenac, 175 B.R. 920 (Bankr. N.D. Ohio 1994), which also involved a conversion from chapter 11 to chapter 7, the court found that "the realities of bankruptcy administration militate in favor of finding a new objection period after the case is converted to chapter 7." Id. at 925. A contrary rule was described as an encouragement of "the potential for debtor abuse." Id. It bear noting, however, that in Havenac the U.S. Trustee had adjourned the § 341(a) meeting indefinitely prior to the conversion of the case.

The conversion problem is a significant one because, ordinarily, creditors in chapter 11, 12 and 13 proceedings focus on the proposed terms of repayment and the feasibility of the debtor’s plan, and not on exemptions. See, e.g., Alderman v. Martinson (In re Alderman), 195 B.R. 106, 109 (Bankr. 9th Cir. 1996) (observing that exemptions are of lesser importance in chapter 13 than chapter 7). Thus an individual, perhaps aware of this tendency to overlook exemptions, might set out to take advantage of the situation by filing under chapter 11 or 13, intending all along to convert as soon as the exemption objections window has closed. Of course, to counsel such behavior might raises ethical concerns for the lawyer, and a debtor who can be shown to have deliberately engaged in such a course of conduct risks sanctions and perhaps dismissal on bad faith grounds. Nonetheless, the better solution would be one that automatically reopens the objection window for a limited time after conversion. This would eliminate wasteful "precautionary" objections while the reorganization case is pending. Moreover, if the debtor is not attempting to claim improper exemptions, there is no harm to the debtor as well as a result of reopening the objection period.

5. Lien Avoidance

If an exemption claim, although improper, is deemed allowed because of the failure to timely object, can the debtor thereafter also avoid a judicial lien or nonpossessory, nonpurchase money security interest that impairs that "exemption" pursuant to § 522(f)(1)? Again, the cases are split. In In re Liston, 206 B.R. 235 (Bankr. W.D. Okla. 1997), the debtor included on her list of exempt property a computer and treadmill, neither of which was in fact exempt under applicable law. No objection was filed by the trustee or any creditor within the time required by Rule 4003(b). Thereafter, the debtor moved to avoid the lien of Beneficial Oklahoma, Inc. under § 522(f)(1)(B). Beneficial Oklahoma objected on the ground that the items were not exempt under applicable law. The court sustained the objection, ruling that a debtor who files a voluntary bankruptcy petition must meet the requirements of both § 522(b) and § 522(f)(1)(B) in order to avoid a creditor's security interest. More to the point, the court held that “a literal reading of § 522(f)(1)(B) leads to the conclusion that in order to avoid a lien under this section, it is not enough that the property is deemed exempt by operation of Rule 4003(b) and Taylor. Debtor must be entitled to exempt the property under § 522(b), and the property must fall within one or more of the categories described in § 522(f)(1)(B)(i), (ii), or (iii).” Id. at 237. The bankruptcy court in In re Franklin, 210 B.R. 560 (Bankr. N.D. Ill. 1997), reached a similar conclusion under § 522(f)(1)(A), noting that “whether an exemption arises by default under § 522(l) is not dispositive; the debtor must show a substantive entitlement to exemption under § 522(b).” See also Canelos v. Mignini (In re Canelos), 1997 212 B.R. 249 (Bankr.
D. Md. 1997) ("This Court holds that a creditor may contest the amount of an exemption for the first time in defending against a motion to avoid lien, not to attack the exemption itself, which is inviolate, but to contest the amount of the exemption for the purpose of limiting the amount of the lien to be avoided, pursuant to Section 522(f).").

By contrast, in In re Mollon, 205 B.R. 321 (Bankr. M.D. Fla. 1996), the court held that a creditor that had failed to challenge the debtor’s claim of exemption under Rule 4003(b) could not object to the debtor’s attempt to avoid a judicial lien against such property on the ground that the exemption claim was improper. Similarly, in The Great Southern Co. v. Allard, 202 B.R. 938 (N.D. Ill. 1996), the court stated that a creditor that had failed to assert a challenge to the exempt status of the debtor’s property in a timely manner could not avoid the “devastating effect” of Taylor by challenging avoidance of its judicial lien against such property based on the nonexempt status of the property. Finally, in In re Vasquez, 205 B.R. 136 (Bankr. N.D. Ill. 1997), the creditor attempted to block the debtor’s lien avoidance action on the basis that its claim was nondischargeable under § 523(a)(17). However, because the creditor had not timely objected to the debtor’s exemption claim in the property, the court found that it was too late to challenge the exemption in any form. Moreover, because debts falling within § 523(a)(17) are not among the types of nondischargeable debts from which exempt property is made liable under § 522(c)(1), the court also concluded that the creditor’s only recourse was to pursue an adversary proceeding to have its debt determined to be nondischargeable, but that regardless of the outcome in that action, the debtor’s right under § 522(f)(1)(A) to avoid the judicial lien securing that debt was unaffected. Id. at 139.

B. State Defined Limitations of Exemptions—herein of Moreland and § 522(c)

In Owen v. Owen, 500 U.S. 305 (1991), the Supreme Court ruled that the states cannot, by defining exempt property in such a way as to specifically exclude property encumbered by certain liens, “achieve a similar exclusion from the Bankruptcy Code’s lien avoidance provision [in § 522(f)].” Many people believed, at that juncture, that the Sixth Circuit’s decision in In re Dixon, 885 F.2d 327 (6th Cir. 1989) was no longer good authority. In Dixon, the court had ruled that under the Ohio homestead exemption statute—which by its terms only applies in execution situations—a judicial lien could not be deemed to impair the debtor’s exemption absent an attachment or other involuntary disposition of the property. However, in In re Moreland, 21 F.3d 102 (6th Cir. 1994), the court surprised the bar, ruling that Dixon was still good law. Specifically, the court held that although Owen reflected a policy against permitting the states to circumvent the federal lien avoidance provisions, it did “not hold that the states may impose no limits on lien avoidance in the context of impaired exemptions.” The court in Moreland proceeded to distinguish the Florida law under scrutiny in Owen from Ohio’s homestead exemption law, observing that operation of the Florida laws at issue would have permanently deprived the debtor of his homestead exemption. In contrast, the Ohio statute only deferred the time when and circumstances under which the exemption could be claimed. In light of this distinction, the court reasoned (without ever quite explaining its logic) that its earlier holding in Dixon, was still good authority. On the facts of Moreland, because no judicial sale was pending at the
time of the bankruptcy filing, the court ruled that there was simply no exemption to be impaired by the creditor’s judicial lien, and, therefore, reversed the orders of the bankruptcy and district courts granting the debtor’s motion to avoid the defendant’s judicial lien against her residence.

In a lengthy and typically well-reasoned decision, Judge Lee demonstrated why, in fact, the Ohio statute should properly be construed as making the exemption available on the date of bankruptcy, and not the later date of execution. In re Lynch, 187 B.R. 536, 548 (E.D. Ky. 1995). Lynch also articulates why the Ohio exemption statute does not, as the court contended in Moreland, merely postpone a debtor’s right to exemptions, and why, even if so interpreted, the statute is no less pernicious than the Florida statute struck down in Owen. Id. at 49. Moreland has been further cast into doubt by the 1994 amendments to § 522(f)(2) which set out a mathematical formula for determining the extent to which a lien impairs an exemption for purposes of § 522(f)(1). By focusing on the dollar amount of the exemption rather than the more ambiguous question of whether the property is itself exempt, the new definition of impairment negates the view that a judicial lien on property cannot impair an exemption where applicable state law only provides for an exemption when and if the property is the subject of an involuntary execution. New § 522(f)(2) underscores the point made in Owen that while state law identifies and quantifies the property the debtor may exempt in opt-out jurisdictions, the Code neither adopts nor is bound by any built-in limitations which the state imposes on the right to the exemption. See In re Davis, 105 F.3d 1017, 1022-23 (5th Cir. 1997); In re Miller, 198 B.R. 500 (Bankr. N.D. Ohio 1996) (holding, based on the legislative history to the Bankruptcy Reform Act of 1994, that it is evident that Moreland and Dixon were contrary to Congress’ intent); In re Jakubowski, 198 B.R. 262 (Bankr. N.D. Ohio 1996) (holding that Moreland and Dixon have been overruled by the 1994 Amendments). In effect, regardless of state law, the lien survives only if, at the time of the bankruptcy filing, the debtor’s property has sufficient value to satisfy all liens on the property, including the judicial lien, and, at the same time, to give effect to the full value of the debtor’s exemption in the property.112 But see In re Colston, 1997 Bankr. LEXIS 1647 (Bankr. S.D. Ohio 1997) (ruling that: “A change in the method of calculating impairment under § 522(f) does not affect the state law issue, and thus Dixon and Moreland still govern”).

One might predict, therefore, that, when next presented with the issue, the Sixth Circuit will finally see its way clear to overrule Dixon and Moreland. Disturbingly, however, occasional decisions from courts in other circuits giving effect to the content of state exemption law continue to creep up. A perfect example is the bankruptcy court’s decision in In re Fracasso, 210 B.R. 221 (Bankr. D. Mass. 1997). In this case, the debtor

112 But see Federal Dep. Ins. Corp. v. Finn (In re Finn), 211 B.R. 780 (Bankr. 1st Cir. 1997) (holding that underwater liens are not necessarily avoided in their entirety, but rather, only that portion of the lien that exceeds a debtor’s equity in the property, taking into account nonjudicial liens and the debtor’s exemptions, may be avoided).
claimed a homestead exemption for the equity in her residence. The amount of that equity exceeded the sum of unsecured claims against her. Under Massachusetts’s law, a homestead exemption is granted in the amount of $100,000, but acquisition of the homestead status requires the filing of a declaration with the county Registry of Deeds, and the statute makes the exemption ineffective against debts contracted prior to the recording of this declaration. As it happened, in this case, all of the debtor’s debts were incurred prior to the recording of her declaration of homestead. Thus, the trustee objected to the asserted exemption, claiming that the debtor’s residence was subject to administration.

The debtor contended that, pursuant to § 522(c), state created exceptions to state exemptions are prohibited. Parting with prior district precedent (In re Boucher, 203 B.R. 10 (Bankr. D. Mass. 1996), the court held that neither Owen nor § 522(c) restrict the right of the state, “as reserved to the state by Congress, to craft its Homestead Statute with an exception for prehomestead debts.” It should be noted, however, that in In re Whalen-Griffen, 206 B.R. 277 (D. Mass. 1997), the U.S. District Court for Massachusetts upheld the reasoning in Boucher, concluding that exempt property, whether exempted under state or federal law, can only be liable for the types of debt set forth on § 522(c).

C. Section 522(f)(3)

At the same time that Congress clarified the confusion over whether a lien impairs an exemption, by providing a statutory definition in § 522(f)(2), it also adopted § 522(f)(3), which represents the worst sort of special interest legislation. To make matters worse, it is couched in convoluted and obscure language that renders its application an exercise in pure guesswork. Section 522(f)(3) purports to place a $5,000 cap on the debtor’s ability to avoid the fixing of a lien that constitutes a nonpurchase money, nonpossessory security interest in the debtor’s tools of the trade, professional books, farm animals or crops. This limitation is only applicable when the requirements of both subparts (f)(3)(A) and (f)(3)(B) are met. To further confuse the issue, both of those subparts contain two alternatives, satisfaction of either of which will render that subpart applicable to a particular debtor. Subpart (A) requires that state law must either (1) permit the voluntary waiver of the right to claim federal exemptions; or (2) prohibit a debtor from claiming those exemptions. While (2) apparently is intended to refer to the states that have adopted opt-out legislation, it is not at all clear what (1) pertains to since no state permits a debtor to waive the § 522(d) exemptions and, in any event, such a waiver would be unenforceable under § 522(e). Presumably, then it can only be read to refer to circumstances where the state has not opted out and the debtor has elected her state exemptions. See In re Zimmel, 185 B.R. 786 (Bankr. D. Minn. 1995). One can hardly imagine, however, a more awkward way to express the idea. Subpart (B) applies where state law either (1) permits the debtor to claim an unlimited exemption, except to the extent that the debtor has permitted the fixing of a consensual lien on any
property; or (2) prohibits avoidance of a consensual lien on property. What does this mean??

In one of the few reported decisions to address § 522(f)(3), In re Ehlen, 202 B.R. 742 (Bankr. D. Wis. 1996), aff'd, 207 B.R. 179 (D. Wis. 1997), the debtors sought to avoid a lien against business and farm property in which they each claimed a $7,500 tools of the trade exemption under state law. Under the formula in § 522(f)(2), it was clear that the lien impaired to the full extent of the exemption, or $15,000. The creditor objected, however, on the ground that although its lien was nonpurchase money and nonpossessory, § 522(f)(3) limited the debtors from avoiding more than $10,000 of that lien. Despairing of attaching any sane meaning to the language of the statute, the court looked to the circumstances surrounding enactment of § 522(f)(3) in an effort to divine congressional intent. This inquiry revealed that many credit industry representatives were concerned by the Supreme Court's decision in Owen, which overruled prior Fifth Circuit precedent that had recognized state-created limitations on the ability of Texas and Louisiana debtors to avoid liens against small business and agricultural collateral. The first portion of subpart (B) was apparently aimed at Louisiana, which grants an unlimited exemption for debtors' tools of the trade, but excepts from that exemption property upon which the debtor has granted a consensual lien. The second portion of subpart (B) was apparently intended for the benefit of Texas lenders because Texas' $60,000 per family personal property exemption specifically prohibits avoidance of any lien against such property whether created by operation of law or a valid security interest in the property. In Ehlen, the court reasoned that the applicable Wisconsin statute bore no similarity to either the Texas or Louisiana statutes, and, therefore, refused to apply § 522(f)(3).

Assuming that subparagraphs (A) and (B) are both satisfied, and the collateral at issue consists of implements, professional books, tools of the trade, farm animals or crops, § 522(f)(3) provides that the debtor may not avoid a consensual lien, even though determined to impair an exemption, “to the extent that the value of such collateral exceeds $5,000.” The provision is nearly unintelligible and, not surprisingly therefore, replete with interpretive uncertainty. To begin with, does the $5,000 threshold apply to each item of qualifying collateral, each category of qualifying collateral, or all qualified collateral? Since the last sentence in subsection (f)(3) connects the various kinds of collateral with the inclusive conjunction “and,” the most rational conclusion is that the collateral is bundled for valuation purposes, as long as all such property is subject to the same security interest. However, early in the same paragraph a verbal distinction is drawn between the trade/professional collateral, on the one hand, and the farm collateral, on the other. Therefore, one might also reasonable infer that they are to be separated for valuation purposes so that the debtor can protect up to $5,000 in each type of collateral, even if all of the collateral is subject to a single creditor’s nonpossessory, nonpurchase money security interest. The issue is not as hypothetical as it might seem since although most nonfarmers are unlikely to both own and encumber both types of collateral, just the opposite is true for most farm borrowers. Further complicating the picture is the fact that the rationale for including farm collateral in the first place is unclear.
Doubtless, Congress’ aim in restricting application of subsection (f)(3) to property with a value in excess of a specified amount was to ensure that a minimum amount of collateral was “freed up” for the debtor’s fresh start, regardless of this restriction on lien avoidance. The problem is that by focusing on the dollar value of the collateral, rather than the amount of the liens or the exemptions, applying section 522(f) now requires controlling for multiple, inconsistent values, an approach calculated to create havoc in the courts. Consider, for example, a debtor who has granted a nonpossessory, nonpurchase money security interest in her exempt professional books, valued at $7,500. Assume that at filing the debt is $11,000 and that applicable state law provides a tools of the trade exemption for $7,500. It is apparent that under the formula in subsection (f)(2), the entire lien impairs and, therefore, can be avoided subject to the limitation in subsection (3). Subsection (3), in turn, preserves the lien to the extent that value of the property exceeds $5,000. But what does that mean?

Perhaps the most extreme view would be that since the value of the property exceeds $5,000, the requirement in subsection (3) is met and the entire lien survives. This construction hardly seems consistent with the articulated reason behind the limitation, but it is not entirely fanciful given the language employed. Another view might be that only $6,000 of the lien can be avoided, because that is the amount of the debt that exceeds the $5,000 threshold, but that conclusion ignores the fact that the value of the property not the amount of the claim controls. A somewhat related approach would be to permit avoidance only to the extent of $5,000, leaving $6,000 rather than $5,000 of the lien intact. Of course, in addition to having done nothing for the debtor, this technique relates the $5,000 to something other than the value of the property. A more sensible, but not immediately obvious, interpretation is that since the value of the property exceeds $5,000 by $2,500, the lien is only avoidable to the extent of $7,500, which is to say that $2,500 of the impairing lien is preserved. Thus, at least on these facts, the debtor exits bankruptcy with $5,000 of equity in the exempt property, which seems to be consistent with the compromise Congress struck with respect to this collateral when it simultaneously adopted subsections (f)(2) and (3).
A COMPILATION OF HOMESTEAD AND PERSONAL PROPERTY EXEMPTIONS IN THE 50 STATES, THE DISTRICT OF COLUMBIA, PUERTO RICO, AND THE VIRGIN ISLANDS
<table>
<thead>
<tr>
<th>STATE</th>
<th>OPTION¹</th>
<th>HOMESTEAD</th>
<th>PERSONAL PROPERTY²</th>
<th>MOTOR VEHICLE³</th>
<th>WAGES⁴</th>
<th>PRIVATE PENSION⁵</th>
</tr>
</thead>
<tbody>
<tr>
<td>FED.</td>
<td>§522d</td>
<td>15,000</td>
<td>8,400(s) / 1,000(g)⁶</td>
<td>2,400</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Ala.</td>
<td>S</td>
<td>5,000</td>
<td>3,000(g) / &quot;necc.&quot;(s)</td>
<td>??</td>
<td>F</td>
<td>no</td>
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<tr>
<td>Alask</td>
<td>unclear</td>
<td>54,000</td>
<td>4,000(s)</td>
<td>3,000</td>
<td>350 / wk</td>
<td>yes</td>
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<td>Ariz.</td>
<td>S</td>
<td>100,000</td>
<td>4,000(g) / 3,000(s)</td>
<td>1,500⁷</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Ark.</td>
<td>S</td>
<td>800⁸</td>
<td>500(g) / 800(s)⁹</td>
<td>1,200</td>
<td>25 / wk</td>
<td>yes</td>
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<tr>
<td>Cal.</td>
<td>S¹⁰</td>
<td>50,000¹¹</td>
<td>&quot;necc.&quot;(g)¹² / 5,000(s)</td>
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<td>F</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>15,000</td>
<td>necc.(g) / 1,800(s)</td>
<td>2,400</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Colo.</td>
<td>S</td>
<td>30,000</td>
<td>3,800(s)</td>
<td>1,000</td>
<td>F</td>
<td>yes</td>
</tr>
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<td>Conn.</td>
<td>B</td>
<td>75,000</td>
<td>&quot;necc.&quot;(s)</td>
<td>1,500</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Del.</td>
<td>S</td>
<td>-0-</td>
<td>5,000(g)</td>
<td>??</td>
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<td>no</td>
</tr>
<tr>
<td>D.C.</td>
<td>B</td>
<td>-0-¹³</td>
<td>700(g)¹⁴</td>
<td>500</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Fla.</td>
<td>S</td>
<td>Unlimited¹⁵</td>
<td>1,000(g)</td>
<td>1,000</td>
<td>100%</td>
<td>yes</td>
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<td>Ga.</td>
<td>S</td>
<td>5,000</td>
<td>3,900(g) / 500(s)¹⁶</td>
<td>1,000</td>
<td>F</td>
<td>yes¹⁷</td>
</tr>
<tr>
<td>Haw.</td>
<td>B</td>
<td>20,000¹⁸</td>
<td>&quot;necc.&quot;(g) / 1,000(s)</td>
<td>1,000</td>
<td>F</td>
<td>yes¹⁹</td>
</tr>
<tr>
<td>Idaho</td>
<td>S</td>
<td>50,000²⁰</td>
<td>4,000(g) / 1,850(s)²¹</td>
<td>1,500</td>
<td>F</td>
<td>yes²¹</td>
</tr>
<tr>
<td>Ill.</td>
<td>S</td>
<td>7,500</td>
<td>&quot;necc.&quot;(g)²²</td>
<td>1,200</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Ind.</td>
<td>S</td>
<td>7,500</td>
<td>4,100(s)²³</td>
<td>??</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Iowa</td>
<td>S</td>
<td>Unlimited</td>
<td>4,000(s)</td>
<td>5,000</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Kan.</td>
<td>S</td>
<td>Unlimited</td>
<td>&quot;necc.(g) / 1,000(s)</td>
<td>20,000</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Ky.</td>
<td>S</td>
<td>5,000²⁴</td>
<td>$4,000(g)</td>
<td>2,500</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>La.</td>
<td>S</td>
<td>15,000</td>
<td>5,000(g)</td>
<td>-0-</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Me.²⁵</td>
<td>S</td>
<td>12,500²⁶</td>
<td>6,000(s)</td>
<td>2,500</td>
<td>F</td>
<td>yes</td>
</tr>
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A-41
<table>
<thead>
<tr>
<th>STATE</th>
<th>OPTION</th>
<th>HOMESTEAD</th>
<th>PERSONAL PROPERTY</th>
<th>MOTOR VEHICLE</th>
<th>WAGES</th>
<th>PRIVATE PENSION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Md.</td>
<td>S</td>
<td>5,500</td>
<td>3,000(g) \ 500(s)</td>
<td>??</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Mass</td>
<td>B</td>
<td>100,000</td>
<td>3,775(g) \ 725(s)</td>
<td>700</td>
<td>125 / wk</td>
<td>yes</td>
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<tr>
<td>Mich.</td>
<td>B</td>
<td>3,500</td>
<td>1,000(g) \ 1000(s)</td>
<td>-0-</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Minn.</td>
<td>B</td>
<td>200,000</td>
<td>4,500(g)</td>
<td>2,000(^{39})</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Miss.</td>
<td>S</td>
<td>75,000(^{31})</td>
<td>10,000</td>
<td>??</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Mo.</td>
<td>S</td>
<td>8,000</td>
<td>1,000(g) \ 1,750(s)</td>
<td>1,000</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Mont.</td>
<td>S</td>
<td>40,000</td>
<td>4,500(s)</td>
<td>1,200</td>
<td>F</td>
<td>yes(^{33})</td>
</tr>
<tr>
<td>Neb.</td>
<td>S</td>
<td>10,000</td>
<td>1,500(g)(^{34})</td>
<td>-0-</td>
<td>100%(^{35})</td>
<td>yes</td>
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<tr>
<td>Nev.</td>
<td>S</td>
<td>125,000</td>
<td>4,500(g)</td>
<td>1,000</td>
<td>F</td>
<td>no</td>
</tr>
<tr>
<td>N.H.</td>
<td>S</td>
<td>30,000</td>
<td>4,300(g) \ 900(s)</td>
<td>4,000</td>
<td>F</td>
<td>no</td>
</tr>
<tr>
<td>N.J.</td>
<td>B</td>
<td>-0-</td>
<td>2,000(g)</td>
<td>-0-</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>N.M.</td>
<td>B</td>
<td>30,000(^{36})</td>
<td>500(g) \ 2,500(s)(^{37})</td>
<td>4,000</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>N.Y.</td>
<td>S</td>
<td>10,000</td>
<td>5,000(g)</td>
<td>2,400</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>N.C.</td>
<td>S</td>
<td>10,000</td>
<td>3,500(g)(^{38})</td>
<td>1,500(^{39})</td>
<td>100%(^{40})</td>
<td>no</td>
</tr>
<tr>
<td>N.D.</td>
<td>S</td>
<td>80,000(^{41})</td>
<td>2,500(g)(^{42})</td>
<td>1,200</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Ohio</td>
<td>S</td>
<td>5,000</td>
<td>2,000(s)</td>
<td>1,000</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Okla.</td>
<td>S</td>
<td>5,000(^{43})</td>
<td>4,000(g)</td>
<td>3,000</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Or.</td>
<td>S</td>
<td>25,000(^{44})</td>
<td>6,800(g) \ 1,000(s)</td>
<td>1,700</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Pa.</td>
<td>B</td>
<td>-0-</td>
<td>&quot;necc.&quot;(g) \ 400(s)</td>
<td>-0-</td>
<td>100%(^{45})</td>
<td>yes</td>
</tr>
<tr>
<td>P.R.</td>
<td>B</td>
<td>1,500</td>
<td>650(g)&quot;necc.&quot;(s)</td>
<td>-0-</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>R.I.</td>
<td>B</td>
<td>-0-</td>
<td>1,300(g) \ 100(s)</td>
<td>-0-</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>S.C.</td>
<td>S</td>
<td>5,000</td>
<td>2,500(g) \ 500(s)(^{46})</td>
<td>1,200</td>
<td>100%</td>
<td>no</td>
</tr>
<tr>
<td>S.D.</td>
<td>S</td>
<td>unlimited</td>
<td>4,000(g)(^{47})</td>
<td>-0-</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Tenn.</td>
<td>S</td>
<td>5,000(^{48})</td>
<td>4,000(g) \ misc.(s)</td>
<td>??</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Texas</td>
<td>B</td>
<td>unlimited(^{49})</td>
<td>30,000(g)(^{50})</td>
<td>51</td>
<td>100%</td>
<td>yes</td>
</tr>
<tr>
<td>STATE</td>
<td>OPTION</td>
<td>HOMESTEAD</td>
<td>PERSONAL PROPERTY</td>
<td>MOTOR VEHICLE</td>
<td>WAGES</td>
<td>PRIVATE PENSION</td>
</tr>
<tr>
<td>--------</td>
<td>--------</td>
<td>------------</td>
<td>-----------------------</td>
<td>---------------</td>
<td>-------</td>
<td>----------------</td>
</tr>
<tr>
<td>Utah</td>
<td>S</td>
<td>8,000$^{52}$</td>
<td>&quot;necc.&quot; (g) $\backslash 1,500(s)$</td>
<td>1,500</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Vt.</td>
<td>B</td>
<td>30,000</td>
<td>2,500(g) $\backslash$ misc. (s)</td>
<td>2,500</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>V.I.</td>
<td>B</td>
<td>30,000</td>
<td>&quot;necc.&quot; (g)</td>
<td>-0-</td>
<td>F</td>
<td>no</td>
</tr>
<tr>
<td>Va.</td>
<td>S</td>
<td>5,000$^{53}$</td>
<td>5,000 (g) $\backslash$ 6,000(s)</td>
<td>2,000$^{44}$</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Wash.</td>
<td>B</td>
<td>30,000$^{55}$</td>
<td>3,700(g) $\backslash$ 1,500(s)</td>
<td>2,500</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>W.Va.</td>
<td>S</td>
<td>7,500</td>
<td>1,000(g) $\backslash$ 500(s)</td>
<td>1,200</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Wis.</td>
<td>B</td>
<td>40,000</td>
<td>5,000(g)</td>
<td>1,200</td>
<td>F</td>
<td>yes</td>
</tr>
<tr>
<td>Wyo.</td>
<td>S</td>
<td>10,000 per occupant</td>
<td>3,000(g)$^{56}$</td>
<td>2,000</td>
<td>F</td>
<td>yes</td>
</tr>
</tbody>
</table>

1. (S)tate or (B)oth 11 U.S.C. §522(d) or state’s exemption scheme.

2. The category "Personal Property" varies dramatically between the states. This chart represents the author’s best effort to compare each state’s treatment of exemptions in this area. For consistency, "Personal Property" includes typical household items appearing in several state schemes including: personal wearing apparel, family books, pictures, a sewing machine, military uniforms, and various quantities and varieties of livestock. Where a state provides an exemption in dollar amount only, or specifies that the exemption is (g)enerally applicable to these types of typical household items "(g)" appears. Where a state (s)pecifies what items are to be exempt "(s)" appears with the total dollar amount of (s)pecified items.

3. Virtually all states provide exemptions for motor vehicles used as tools of the trade. In order to make this column more meaningful, the only reference is to non-tool of the trade vehicle exemptions. The "??" symbol indicates that the state does not provide a specific vehicle exemption, but it may be implied from the state’s general personal property exemption.

4. (F)ormula used to determine the amount of wages exempt.

5. Virtually all states exempt pensions for public or civil service. The pension column therefore indicates only whether privately funded pensions are at all exempt.

6. Federal Exemption Scheme provides for additional personal property exemptions up to $7,500 of un-used homestead.
7. Upon request the court may increase the exemption for injuries or disabilities. The exemption may also be increased to $550/wk where the debtor is the sole support of the household.

8. If an Arizona debtor is "maimed or crippled" the motor vehicle exemption increases from $1,500 to $4,000.

9. If married, an Arkansas debtor may increase the homestead exemption from $800 to $1,250 plus $2,500 of land.

10. California makes available two alternative sets of exemptions in bankruptcy cases.

11. Amount depends on category of debtor -- $50K, $75K (family), or $100k ("poor" & over 55yrs; over 65; or disabled.)

12. Debtor may exempt ordinary and necessary household items however proceeds from execution sale of items of extraordinary value are exempt in the amount determined by the court to be sufficient to purchase ordinary and necessary replacement.

13. Escrow deposits for residential condominiums are exempt in D.C.


15. Floridians may exempt their homestead with no value limit. Up to 1\2 acre inside municipalities and 160 acres outside.

16. No individual item (g)enerally exempted may exceed $400. Debtor may apply un-used homestead to personal property.

17. Georgia private pensions are only exempt to the extent necessary for debtor's and dependents' support.

18. Hawaii debtors over 60 yrs or disabled may increase homestead exemption from $20,000 to $60,000.

19. Contributions made more than 3 years prior to bankruptcy are exempt in Hawaii.

20. Includes unimproved lots upon which homestead is to be built.

21. Up to $350/mo in annuity payments are exempt.

22. Illinois Debtors may exempt the certificate of title to motor and sail boats over 12 feet in length.

23. Provided that the total homestead and personal property exemption does not exceed $10,000.
24. Kentucky debtors may exempt $1,000 for any personal or real property. The $4,000 listed under "Personal Property" includes this $1,000 instead of counting it under homestead.

25. On consumer credit sales or supervised loans, if the amount financed is $2,000 or less and the creditor has possession of the collateral, the consumer and any surety are not liable for any deficiency. Me. Rev. Stat. Ann. tit. 9-A, § 5-103.

26. Maine debtors over 60 yrs. or disabled may exempt $60,000 for homestead.

27. Massachusetts debtors 65 yrs or disabled may increase homestead exemption to $150,000. Also $200/mo. rent is exempt in lieu of homestead exemption.


30. Disabled Minnesota debtors may exempt a motor vehicle valued up to $32,000 if it has been modified at a cost of at least $1,500 to accommodate a physical disability.

31. Mississippi debtors over 60 yrs. may also

32. Plus $250 additional for each unmarried dependent child under 18.

33. Amounts in excess of $350/mo. are subject to garnishment unless a court finds them necessary for support.

34. Debtors without a homestead may exempt $2,500.

35. Heads of household may exempt 100% wages. Others may exempt wages under a formula.

36. Jointly owned properties entitles each owner to $30,000 exemption.

37. Plus additional $2,000 for debtors without a homestead.

38. Debtor may exempt an additional sum not to exceed $3,000 for dependents at a rate of $750 per dependent.

39. Except if purchased within 90 days of bankruptcy.

40. Up to 100% is necessary to support family.
41. Debtors without homesteads in North Dakota may exempt $7,500.

42. Heads of household may exempt $5,000(g)

43. Outside a municipality, there is no dollar limit but the homestead may not exceed 160 acres.

44. $33,00 if two debtors are members of same household.

45. If in hands of employer.

46. Plus $1,000 for debtors without a homestead.

47. South Dakota offers debtors three choices: $4,000(g) -OR- $1,250 in farming tools, $200 in books & musical instruments, $200 in household furnishings, various livestock and one year’s feed for them. Debtor’s who are not heads of households may exempt $2,000.

48. Joint Debtors may exempt $7,500 in a shared home in Tennessee.

49. In Texas, no mortgage, trust deed, or other lien on the homestead shall ever be valid except for a debt described in Tex. Const. art. 16 §50 which essentially prohibits liens against homesteads for anything other than purchase-money-related-liens i.e. home improvements, re-finance, partition of entirety. It has come to this author’s attention that Texas is currently contemplating a constitutional amendment to increase the scope of authorized liens against homesteaded property in that state.

50. $60,000(g) for a family.

51. A motor vehicle may be exempted as part of the overall $30,000 personal property exemption for each adult family member.

52. In Utah the homestead exemption is increased by $2,000 for a spouse and $500 for each other dependent.

53. In Virginia, $5,000 for any property is exempt plus $500 for each dependent. Virginia also provides that profits derived from the homestead property are exempt subject to certain liens.

54. Up to $2,000 of Virginia’s $5,000(g) exemption may be for a motor vehicle unless used as a tool of the trade.

55. or the value of the homestead, whichever is less.

56. No item is exempt from purchase money debt.
ALASKA HOUSE BILL 101

An act relating to certain irrevocable transfers in trust, to the jurisdiction governing a trust, to challenges to trusts or property transfers in trust, to the validity of trust interests, and to transfers of certain trust interests

Signed into law April 3, 1997
Effective Immediately
HOUSE BILL NO. 101
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTIETH LEGISLATURE - FIRST SESSION
BY REPRESENTATIVES VEZEY, Bunde
Introduced: 1/31/97
Referred: Labor and Commerce

A BILL
FOR AN ACT ENTITLED
"An Act relating to certain irrevocable transfers in trust, to the jurisdiction governing a trust, to challenges to trusts or property transfers in trust, to the validity of trust interests, and to transfers of certain trust interests; and providing for an effective date."

BE IT ENACTED BY THE STATE OF ALASKA:

* Section 1. AS 13.12.205 (2) is amended to read:

(2) property transferred in any of the following forms by the decedent during marriage:

(A) an irrevocable transfer, including an irrevocable transfer in trust with a transfer restriction under AS 34.40.110 (a), in which the decedent retained the right to the possession or enjoyment of, or to the income from, the property, if and to the extent the decedent's right terminated at or continued beyond the decedent's death; the amount included is the value of the fraction of the property to which the decedent's right related, to the extent the fraction of the property passed outside probate to or for the benefit of a person other than the decedent's estate or surviving spouse;

(B) a transfer in which the decedent created a power over the income or property, exercisable by the decedent alone or in conjunction with another person, or exercisable by a nonadverse party, to or for the benefit of the decedent, the decedent's creditors, the decedent's estate, or creditors of the decedent's estate; the amount included with respect to a power over property is the value of the property subject to the power, and the amount included with respect to a power over income is the value of the property that produces or produced the income, to the extent the power in either case was exercisable at the decedent's death to or for the benefit of a person other than the decedent's surviving spouse or to the extent the property passed at the decedent's death, by exercise, release, lapse, default, or otherwise, to or for the benefit of a person other than the decedent's estate or surviving spouse; if the power is a power over both income and property and the preceding provision defining the amount included produces different amounts, the amount included is the greater amount; and

* Sec. 2. AS 13.36.035 (a) is amended to read:

(a) The court has exclusive jurisdiction of proceedings initiated by interested parties concerning the
(a) The court has exclusive jurisdiction of proceedings initiated by interested parties concerning the internal affairs of trusts, including trusts covered by (c) of this section. Except as provided in (c) and (d) of this section, proceedings that [PROCEEDINGS WHICH] may be maintained under this section are those concerning the administration and distribution of trusts, the declaration of rights, and the determination of other matters involving trustees and beneficiaries of trusts. These include [, BUT ARE NOT LIMITED TO,] proceedings to

(1) appoint or remove a trustee;

(2) review trustees' fees and to review and settle interim or final accounts;

(3) ascertain beneficiaries, determine any question arising in the administration or distribution of any trust including questions of construction of trust instruments, instruct trustees, and determine the existence or nonexistence of any immunity, power, privilege, duty, or right; and

(4) release registration of a trust.

* Sec. 3. AS 13.36.035 is amended by adding new subsections to read:

(c) A provision that the laws of this state govern the validity, construction, and administration of the trust and that the trust is subject to the jurisdiction of this state is valid, effective, and conclusive for the trust if

(1) some or all of the trust assets are deposited in this state and are being administered by a qualified person; in this paragraph, "deposited in this state" includes being held in a checking account, time deposit, certificate of deposit, brokerage account, trust company fiduciary account, or other similar account or deposit that is located in this state;

(2) a trustee is a qualified person who is designated as a trustee under the governing instrument or by a court having jurisdiction over the trust;

(3) the powers of the trustee identified under (2) of this subsection include or are limited to

(A) maintaining records for the trust on an exclusive basis or a nonexclusive basis; and

(B) preparing or arranging for the preparation of, on an exclusive basis or a nonexclusive basis, an income tax return that must be filed by the trust; and

(4) part or all of the administration occurs in this state, including physically maintaining trust records in this state.

(d) The validity, construction, and administration of a trust with a state jurisdiction provision are determined by the laws of this state, including the

(1) capacity of the settlor;

(2) powers, obligations, liabilities, and rights of the trustees and the appointment and removal of the trustees; and

(3) existence and extent of powers, conferred or retained, including a trustee's discretionary powers, the powers retained by a beneficiary of the trust, and the validity of the exercise of a power.

(e) In (d) of this section, "settlor" means a person who transfers property in trust; "settlor" includes a person who furnishes the property transferred to a trust even if the trust is created by another person.

* Sec. 4. AS 13.36.045 (a) is amended to read:

(a) The court will not, over the objection of a party, entertain proceedings under AS 13.36.035 involving a trust registered or having its principal place of administration in another state, unless
a trust registered or having its principal place of administration in another state, unless

(1) all appropriate parties could not be bound by litigation in the courts of the state where the trust is registered or has its principal place of administration; [OR]

(2) the interests of justice otherwise would seriously be impaired; or

(3) the trust satisfies AS 13.36.035 (c).

* Sec. 5. AS 13.36 is amended by adding new sections to read:

Sec. 13.36.310. Challenges to trusts. Except as provided in AS 34.40.110, a trust that is covered by AS 13.36.035 (c) or that is otherwise governed by the laws of this state, or a property transfer to a trust that is covered by AS 13.36.035 (c) or that is otherwise governed by the laws of this state, is not void, voidable, liable to be set aside, defective in any fashion, or questionable as to the settlor's capacity, on the grounds that the trust or transfer avoids or defeats a right, claim, or interest conferred by law on a person by reason of a personal or business relationship with the settlor or by way of a marital or similar right. In this section, "settlor" means a person who transfers property in trust; "settlor" includes a person who furnishes the property transferred to a trust even if the trust is created by another person.

Sec. 13.36.390. Definitions. In AS 13.36,

(1) "qualified person" means

(A) an individual who, except for brief intervals, military service, attendance at an educational or training institution, or for absences for good cause shown, resides in this state, whose true and permanent home is in this state, who does not have a present intention of moving from this state, and who has the intention of returning to this state when away;

(B) a trust company that is organized under AS 06.25 and that has its principal place of business in this state; or

(C) a bank that is organized under AS 06.05, or a national banking association that is organized under 12 U.S.C. 21 - 216d, if the bank or national banking association possesses and exercises trust powers and has its principal place of business in this state;

(2) "state jurisdiction provision" means a provision that the laws of this state govern the validity, construction, and administration of a trust and that the trust is subject to the jurisdiction of this state.

* Sec. 6. AS 34.27.050 (a) is amended to read:

(a) A nonvested property interest is invalid unless

(1) when the interest is created, it is certain to vest or terminate no later than 21 years after the death of an individual then alive; [OR]

(2) the interest either vests or terminates within 90 years after its creation; or

(3) the interest is in a trust and all or part of the income or principal of the trust may be distributed, in the discretion of the trustee, to a person who is living when the trust is created.

* Sec. 7. AS 34.40.010 is amended to read:

Sec. 34.40.010. Invalidity generally. Except as provided in AS 34.40.110, a conveyance or assignment, in writing or otherwise, of an estate or interest in land, or in goods, or things in action, or of rents or profits issuing from them or a charge upon land, goods, or things in action, or upon the rents or profits from them, made with the intent to hinder, delay, or defraud creditors or other persons of their lawful suits, damages, forfeitures, debts, or demands, or a bond or other evidence of debt given, action
lawful suits, damages, forfeitures, debts, or demands, or a bond or other evidence of debt given, action commenced, decree or judgment suffered, with the like intent, as against the persons so hindered, delayed, or defrauded is void. * Sec. 8. AS 34.40.110 is repealed and reenacted to read:

Sec. 34.40.110. Restricting transfers of trust interests. (a) A person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. In this subsection,

(1) "property" includes real property, personal property, and interests in real or personal property;

(2) "transfer" means any form of transfer, including deed, conveyance, or assignment.

(b) If a trust contains a transfer restriction allowed under (a) of this section, the transfer restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor, or another person from satisfying a claim out of the beneficiary's interest in the trust, unless the

(1) transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons under AS 34.40.010;

(2) trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; in this paragraph, "revoke or terminate" does not include a power to veto a distribution from the trust, a testamentary special power of appointment or similar power, or the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor;

(3) trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor; or

(4) at the time of the transfer, the settlor is in default by 30 or more days of making a payment due under a support judgment or order for a child of the settlor.

(c) The satisfaction of a claim under (b)(1) - (4) of this section is limited to that part of the trust to which (b)(1) - (4) of this section applies.

(d) Notwithstanding a provision in the trust instrument to the contrary, when a distribution is declared by and payable from a trust, the child support enforcement agency established under AS 25.27 may enforce the support obligations of a beneficiary, including a trust settlor who is a beneficiary, of the trust against the portion of the distribution to which the beneficiary is entitled.

(e) In this section, "settlor" means a person who transfers real property, personal property, or an interest in real or personal property, in trust.

* Sec. 9. This Act does not apply to a trust unless the trust is created on or after the effective date of this Act.

* Sec. 10. This Act takes effect immediately under AS 01.10.070 (c).

HB0101

CSHB 101(L&C)

CS FOR HOUSE BILL NO. 101(L&C)

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTIETH LEGISLATURE - FIRST SESSION
A BILL
FOR AN ACT ENTITLED

"An Act relating to certain irrevocable transfers in trust, to the jurisdiction governing a trust, to challenges to trusts or property transfers in trust, to the validity of trust interests, and to transfers of certain trust interests; and providing for an effective date."

BE IT ENACTED BY THE STATE OF ALASKA:

* Section 1. AS 13.12.205 (2) is amended to read:

(2) property transferred in any of the following forms by the decedent during marriage:

(A) an irrevocable transfer, including an irrevocable transfer in trust with a transfer restriction under AS 34.40.110 (a), in which the decedent retained the right to the possession or enjoyment of, or to the income from, the property, if and to the extent the decedent's right terminated at or continued beyond the decedent's death; the amount included is the value of the fraction of the property to which the decedent's right related, to the extent the fraction of the property passed outside probate to or for the benefit of a person other than the decedent's estate or surviving spouse;

(B) a transfer in which the decedent created a power over the income or property, exercisable by the decedent alone or in conjunction with another person, or exercisable by a nonadverse party, to or for the benefit of the decedent, the decedent's creditors, the decedent's estate, or creditors of the decedent's estate; the amount included with respect to a power over property is the value of the property subject to the power, and the amount included with respect to a power over income is the value of the property that produces or produced the income, to the extent the power in either case was exercisable at the decedent's death to or for the benefit of a person other than the decedent's surviving spouse or to the extent the property passed at the decedent's death, by exercise, release, lapse, default, or otherwise, to or for the benefit of a person other than the decedent's estate or surviving spouse; if the power is a power over both income and property and the preceding provision defining the amount included produces different amounts, the amount included is the greater amount; and

* Sec. 2. AS 13.36.035 (a) is amended to read:

(a) The court has exclusive jurisdiction of proceedings initiated by interested parties concerning the internal affairs of trusts, including trusts covered by (c) of this section. Except as provided in (c) and (d) of this section, proceedings that [PROCEEDINGS WHICH] may be maintained under this section are those concerning the administration and distribution of trusts, the declaration of rights and the determination of other matters involving trustees and beneficiaries of trusts. These include [BUT ARE NOT LIMITED TO] proceedings to

(1) appoint or remove a trustee;

(2) review trustees' fees and to review and settle interim or final accounts;

(3) ascertain beneficiaries, determine any question arising in the administration or distribution of any trust including questions of construction of trust instruments, instruct trustees, and determine the
trust including questions of construction of trust instruments, instruct trustees, and determine the existence or nonexistence of any immunity, power, privilege, duty, or right; and

(4) release registration of a trust.

* Sec. 3. AS 13.36.035 is amended by adding new subsections to read:

(c) A provision that the laws of this state govern the validity, construction, and administration of the trust and that the trust is subject to the jurisdiction of this state is valid, effective, and conclusive for the trust if

(1) some or all of the trust assets are deposited in this state and are being administered by a qualified person; in this paragraph, "deposited in this state" includes being held in a checking account, time deposit, certificate of deposit, brokerage account, trust company fiduciary account, or other similar account or deposit that is located in this state;

(2) a trustee is a qualified person who is designated as a trustee under the governing instrument or by a court having jurisdiction over the trust;

(3) the powers of the trustee identified under (2) of this subsection include or are limited to

(A) maintaining records for the trust on an exclusive basis or a nonexclusive basis; and

(B) preparing or arranging for the preparation of, on an exclusive basis or a nonexclusive basis, an income tax return that must be filed by the trust; and

(4) part or all of the administration occurs in this state, including physically maintaining trust records in this state.

(d) The validity, construction, and administration of a trust with a state jurisdiction provision are determined by the laws of this state, including the

(1) capacity of the settlor;

(2) powers, obligations, liabilities, and rights of the trustees and the appointment and removal of the trustees; and

(3) existence and extent of powers, conferred or retained, including a trustee's discretionary powers, the powers retained by a beneficiary of the trust, and the validity of the exercise of a power.

(e) In (d) of this section, "settlor" means a person who transfers property in trust; "settlor" includes a person who furnishes the property transferred to a trust even if the trust is created by another person.

* Sec. 4. AS 13.36.045 (a) is amended to read:

(a) The court will not, over the objection of a party, entertain proceedings under AS 13.36.035 involving a trust registered or having its principal place of administration in another state, unless

(1) all appropriate parties could not be bound by litigation in the courts of the state where the trust is registered or has its principal place of administration; [OR]

(2) the interests of justice otherwise would seriously be impaired; or

(3) the trust satisfies AS 13.36.035 (c).

* Sec. 5. AS 13.36 is amended by adding new sections to read:

Sec. 13.36.310. Challenges to trusts. Except as provided in AS 34.40.110, a trust that is covered by AS 13.36.035 (c) or that is otherwise governed by the laws of this state, or a property transfer to a trust that
13.36.035 (c) or that is otherwise governed by the laws of this state, or a property transfer to a trust that is covered by AS 13.36.035 (c) or that is otherwise governed by the laws of this state, is not void, voidable, liable to be set aside, defective in any fashion, or questionable as to the settlor's capacity, on the grounds that the trust or transfer avoids or defeats a right, claim, or interest conferred by law on a person by reason of a personal or business relationship with the settlor or by way of a marital or similar right. In this section, "settlor" means a person who transfers property in trust; "settlor" includes a person who furnishes the property transferred to a trust even if the trust is created by another person.


(1) "qualified person" means

(A) an individual who, except for brief intervals, military service, attendance at an educational or training institution, or for absences for good cause shown, resides in this state, whose true and permanent home is in this state, who does not have a present intention of moving from this state, and who has the intention of returning to this state when away;

(B) a trust company that is organized under AS 06.25 and that has its principal place of business in this state; or

(C) a bank that is organized under AS 06.05, or a national banking association that is organized under 12 U.S.C. 21 - 216d, if the bank or national banking association possesses and exercises trust powers and has its principal place of business in this state;

(2) "state jurisdiction provision" means a provision that the laws of this state govern the validity, construction, and administration of a trust and that the trust is subject to the jurisdiction of this state.

* Sec. 6. AS 34.27.050 (a) is amended to read:

(a) A nonvested property interest is invalid unless

(1) when the interest is created, it is certain to vest or terminate no later than 21 years after the death of an individual then alive; [OR]

(2) the interest either vests or terminates within 90 years after its creation; or

(3) the interest is in a trust and all or part of the income or principal of the trust may be distributed, in the discretion of the trustee, to a person who is living when the trust is created.

* Sec. 7. AS 34.40.010 is amended to read:

Sec. 34.40.110. Restricting transfers of trust interests. (a) A person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. In this subsection,

(1) "property" includes real property, personal property, and interests in real or personal property;

(2) "transfer" means any form of transfer, including deed, conveyance, or assignment.
(b) If a trust contains a transfer restriction allowed under (a) of this section, the transfer restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor, or another person from satisfying a claim out of the beneficiary's interest in the trust, unless the

(1) transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons under AS 34.40.010;

(2) trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; in this paragraph, "revoke or terminate" does not include a power to veto a distribution from the trust, a testamentary special power of appointment or similar power, or the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor;

(3) trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor; or

(4) at the time of the transfer, the settlor is in default by 30 or more days of making a payment due under a support judgment or order for a child of the settlor.

(c) The satisfaction of a claim under (b)(1) - (4) of this section is limited to that part of the trust to which (b)(1) - (4) of this section applies.

(d) Notwithstanding a provision in the trust instrument to the contrary, when a distribution is declared by and payable from a trust, the child support enforcement agency established under AS 25.27 may enforce the support obligations of a beneficiary, including a trust settlor who is a beneficiary, of the trust against the portion of the distribution to which the beneficiary is entitled.

(e) A person may not bring an action with respect to a claim allowed under (b)(1) of this section if the person

(1) is a creditor when the trust is created unless the action is brought within the later of

(A) four years after the transfer is made; or

(B) one year after the transfer is or reasonably could have been discovered by the person; or

(2) becomes a creditor subsequent to the transfer unless the action is brought within four years after the transfer is made.

(f) In this section, "settlor" means a person who transfers real property, personal property, or an interest in real or personal property, in trust.

* Sec. 9. This Act does not apply to a trust unless the trust is created on or after the effective date of this Act.

* Sec. 10. This Act takes effect immediately under AS 01.10.070 (c).
PROPOSAL FOR REFORM OF BANKRUPTCY EXEMPTIONS

Prepared by

Hon. William H. Brown
Judge, United States Bankruptcy Court
Western District of Tennessee

and

Lawrence Ponoroff
Professor
Tulane University School of Law
January 3, 1997

Elizabeth Warren
Leo E. Gottlieb Professor of Law
Harvard Law School
Cambridge, Massachusetts 02138

Re: Bankruptcy Exemption Policy

Dear Professor Warren:

As you know, we both have urged the National Bankruptcy Review Commission to adopt in its final report a recommendation that Congress eliminate the present "opt-out" and "election" arrangements in § 522(b) of the Bankruptcy Code in favor of a single list of mandatory, uniform bankruptcy exemptions. The justification for this position includes recognition that the fresh start in bankruptcy is a matter of federal, not state, concern. It is also premised on our observation that the present approach to exemption policy has introduced an enormous level of uncertainty into the consumer bankruptcy system. That uncertainty has eroded public confidence in the system, increased the costs of administering bankruptcy cases, and, in many cases, undermined the ability of the system to afford effective relief to debtors and creditors alike. These points are developed in much greater detail in the papers we each have authored for publication in the American Bankruptcy Law Journal, copies of which have previously been made available to the Commission.

Up until this time, in the interest of seeing if we could achieve consensus on the principle that federal bankruptcy exemptions are preferable to state law deferral, we have deliberately refrained from venturing any opinions concerning the dollar levels at which the uniform federal exemptions ought to be set under the Bankruptcy Code. You have, however, asked that we give you our collective thoughts on just that issue to provide a basis for further discussion and deliberation in both the Consumer Bankruptcy Working Group and, eventually, at the full Commission level. This letter is a response to that request. We will begin by sharing with you a few guiding principles that influenced our specific recommendations:

First, with respect to most categories of property, we believe that the exemption ought to be stated in a single, lump-sum cash value allowance rather than by particular type of property. This would have the benefit of eliminating any incentive to change the form in which assets are held prior to filing a bankruptcy case, and also would allow individual
debtors to protect those assets most essential to their fresh start in a manner that
parentalistic, predetermined categories, limited by individual dollar maximums, could not.
This approach also would permit important regional differences to be reflected in national
exemption policy. For example, it would allow the Alaskan fisherman to protect his
fishing license and the Minnesota homeowner to protect her snowblower—items that
would be difficult (albeit not impossible) to protect under the present bankruptcy
exemption scheme contained in § 522(d) of the Code.

Second. and operating as a qualification on the first principle, we believe that the
homestead, certain special categories of personalty (such as prescribed medical aids and
appliances) and income, as distinguished from asset, exemptions should each be treated
separately. This is generally consistent with the pattern now found in the § 522(d)
exemptions as well as the exemption laws of most states. We also believe that the
underlying policy reflected in current § 522(d)(5) should be retained in order to avoid
unfair discrimination against non-homeowning debtors.

Third. while we are less concerned than some about the potential for a uniform system of
federal exemptions to operate unfairly because of regional differences in cost of living, we
believe that the problem would be adequately addressed by adjusting the exemption levels
by regional CPI in much the same manner that § 104(b) of the Code now adjusts aggregate
exemption levels every three years based on national CPI. If the Commission were to
adopt that approach, you should consider the specific dollar amounts referenced below as
the base to which the CPI adjustments could be made.

Fourth, we should mention that in formulating our proposal regarding mandatory federal
bankruptcy exemptions we were to some extent influenced by a desire to simplify for
courts and litigants the operation of § 522(f) concerning avoidance of liens impairing
exemptions. Thus, these proposals would obviate the need for the current limitation on
the debtor’s avoiding power under § 522(f)(3), and also eliminate the continuing confusion
in the case law over the extent to which the states can control the definition of when a lien
impairs an exemption after the Supreme Court’s decision in Owen v. Owen, 500 U.S. 305

Finally, in setting specific dollar amounts, our bias was to select levels that were more-or-
less on the high side of “average” among the states. That effort was complicated, of
course, by the wide variation among the states, but our thinking was that, on the one hand,
keeping the federal bankruptcy exemptions within range of most states would minimize the
threat that uniform exemptions would increase the absolute number of bankruptcy case
filings, voluntary and involuntary. On the other hand, we believe that the high-end is
appropriate because specific federal policies, particularly fresh start, obviously are
implicated in a bankruptcy case in a way that simply is not the case in routine state
collection actions.
Against the backdrop of this conceptual framework, our preliminary suggestions for the Commission’s consideration follow:

1. **Homestead** We recommend an individual homestead exemption, applicable also to an interest by the debtor as a tenant by the entirety or joint tenant, of $40,000 (more than twice the current level) for debtors with no dependents. Like the proposal offered by the first National Bankruptcy Review Commission, however, we think this number should be adjusted upward by $3,000 to $5,000 for each dependent supported by the debtor to a maximum of $55,000. While we recognize that this number may seem high to some (and perhaps low to others), in point of fact few debtors are likely to have this much equity, over and above the sum of nonavoidable liens, in their home. However, we think the ability to retain one’s regular dwelling, or at least have the downpayment to purchase something almost comparable, is an important pragmatic and psychological component of the fresh start. By the same token, the level is more than low enough to prevent the kinds of abuses that have caught the attention of the popular press. Finally, we would note that we see no particularly compelling reason to limit, by acreage, the size of the homestead that can be exempted so long as the aggregate dollar limitation is not exceeded.

2. **Tangible Personal Property** We recommend a single lump sum cash allowance of $15,000 for tangible personal property of any kind (including cash and deposit accounts) to be selected by the debtor at the time of filing. Note that a debtor would have to use this exemption to preserve the cash value of an unmatured life insurance policy—presently exempt without limitation under the Code—as well as to exclude from administration any motor vehicle. We also intend that this “bushel-basket” exemption might include property rights represented by an symbolic or essential writing, such as stock certificates and other types of negotiable instruments.

3. **Additional Exemption for Unused Homestead** We urge continuation of the approach taken in current § 522(d)(5) of the Code to allow up to one-half of the unused amount of the homestead exemption to be applied by the debtor to any other property interest. real or personal. While this provision would primarily be aimed at the non-homeowning debtor, as under present law, it would not be so limited. However, because of the recommendation regarding a lump sum allowance for personality there would be no need to retain the the $800 wildcard unrelated to use of the homestead amount.
4. **Special Kinds of Personality** We recommend an unlimited exemption for prescribed health aids and durable medical appliances more-or-less along the lines of current § 522(d)(9) of the Code. We also believe that a "burial plot" exemption of some sort may be justified, not to exceed a specified amount.

5. **Income Exemptions** We recommend continuation of the income-based exemptions in current § 522(d)(10) & (11), subject to the following modifications. We propose a significant increase, if not elimination, of any dollar limitation on a payment in respect of a personal injury claim. The current limitation is $15,000. See § 522(d)(11)(D). In addition, note that the exemption for a payment under a stock bonus, pension, profitsharing, etc. plan may need to be reworked as a combination asset/income exemption depending on whether the Commission decides to recommend that Congress overrule *Patterson v. Shumate*, 504 U.S. 753 (1992) (essentially excluding the corpus of most retirement plans from the property of the estate). In that event, a portion of the debtor's interest in or rights under such a plan may require independent exemption protection in order to make the exemption for payments under the plan meaningful. In addition, even if the *Patterson* exclusion is continued, because of uncertainty as to the scope of that decision as it relates to non-ERISA and other kinds of plans, a separate exemption for rights under a retirement or similar benefit plan may be appropriate, even if potentially redundant in some cases.

We would reiterate that we propose these exemptions as a "closed" system in bankruptcy cases, in lieu of both state and other non-bankruptcy federal exemptions. As under current law, however, in a joint case each debtor would be entitled to his/her own exemptions. Of course, there would no longer be any issue over the question of "stacking" state and federal exemptions, now precluded by § 522(b) of the Code.

We wish to stress that the above proposals are very preliminary in nature, probably still incomplete to some extent, and certainly in need of further refinement before amenable to adoption in final form. We hope that they do provide a basis for further discussion and study of this important issue.

Sincerely,

William H. Brown  
U.S. Bankruptcy Judge  
Western District of Tennessee

Lawrence Ponoroff  
Professor of Law
CONSUMER BANKRUPTCY PROPOSAL REGARDING UNIFORM FEDERAL BANKRUPTCY EXEMPTIONS

NATIONAL BANKRUPTCY REVIEW COMMISSION

Memorandum of April 11, 1997

A - 63
Memorandum

Re: Expanded Proposal on Uniform Federal Exemptions

To: All Commissioners
Advisors, National Bankruptcy Review Commission
Staff, National Bankruptcy Review Commission
Interested Persons

From: Elizabeth Warren, Reporter, NBRC
Melissa Jacoby, Staff Attorney, NBRC

Date: April 11, 1997

Re: Expanded Proposal on Uniform Federal Exemptions

The National Bankruptcy Review Commission has discussed the possibility of recommending changes in the structure of property exemptions since the issue was raised during its day-long session on consumer bankruptcy in May 1996. Following two meetings devoted specifically to the subject of exemptions, the Consumer Bankruptcy Working Group circulated a draft outline of a proposal for uniform federal exemptions and invited feedback from all those interested in the consumer bankruptcy system. At its meeting in February, the Commission tentatively endorsed the approach taken in that outline. This expanded draft has been developed on the basis of the discussion at the meeting of all Commissioners and the comments received from a wide audience.

The Working Group gratefully acknowledges the help of many attorneys, judges and other parties who participated in the Working Group meetings or who submitted written comments. Professor Lawrence Ponoroff and The Honorable William Brown have been especially generous in giving their time to help develop the initial discussion papers on property exemptions.

Outline of Proposed Changes to Section 522

No Opt Out

A consumer debtor who has filed a petition for relief under the Bankruptcy Code should be allowed to exempt property as provided in section 522 of the Code. Subsection (b)(1) and (2) of section 522 should be repealed.

The Exemptions
Homestead Property

The debtor should be able to exempt the debtor’s aggregate interest as a fee owner, a joint tenant, or a tenant by the entirety, in real property or personal property that the debtor or a dependent of the debtor uses as a residence in the amount determined by the laws of the state in which the debtor resides, but not less than $25,000/ $30,000/$40,000 and not more than $100,000. Subsection (m) should be revised to reflect that all exemptions except for the homestead exemption shall apply separately to each debtor in a joint case.

Rights to Receive Benefits and Payments

All funds held directly or indirectly in a trust that is exempt from federal income tax pursuant to sections 408 or 501(a) of the Internal Revenue Code should be exempt.

Rights to receive future payments, e.g., social security benefits, life insurance, should be exempt, and the debtor’s right to receive an award under a crime victim’s reparations law or payment for a personal bodily injury claim of the debtor or her dependent should be exempt.

All Other Property

With respect to property of the estate not otherwise exempt by the provisions listed above, a debtor should be permitted to retain up to $25,000 in value in any form. A debtor who claims no homestead exemption should be permitted to exempt an additional $15,000 of property in any form.

All professionally-prescribed medical devices and health aids necessary for the health and maintenance of the debtor or a dependent of the debtor should be exempt.

Background and Reasons for the Change

In virtually every collection scheme involving individual debtors, the law reserves some property for the debtor and puts it beyond the reach of creditor collection activities. [FN: The historical antecedents of this approach are well established. According to one commentator, Roman law provided property exemptions to maintain an adequate tax flow: “The public interest was thought to be serviced by those early exemptions because destitute persons were unlikely to pay taxes or produce wealth that could be taxed.” William J. Woodward, “Exemptions, Opting Out, and Bankruptcy Reform,” 43 Ohio St. L. J. 335, 337 (1982). See also Joseph McKnight, “Protection of the Family Home from Seizure By Creditors: The Sources and Evolution of a Legal Principle,” 86 S.W. Hist. L. Q. 364 (1983) (Tracing history of Texas exemptions). The homestead exemption meant family preservation. “The Nebraska Homestead,” 3 Neb. Bull. No. 2 112 (1924).] Whether the creditor collects under state law or federal law, no debtor can be stripped of all property and reduced to destitution.

The policy reasons underlying exemption laws are basic. Debtors cannot go to the workplace without clothes, nor can they do their jobs without the tools of their trade. Early exemptions for personal property protected plows and cattle. In a society of farmers, craftspeople, artisans, and other entrepreneurs, protection for farm machinery and tools was protection of the debtor’s future ability to earn. As more people became wage earners, exemption laws dealt less with the tools needed to earn a living and more with the need to exempt future wages in order to assure the worker’s incentive to continue to work, to work longer hours or under more adverse conditions, and to be a productive, tax-paying member of society. Protecting property so that each person can be a productive member of society, able to earn a living and to avoid becoming a public charge, has been the mainstay of this country’s exemption laws. Creditors are not permitted to eliminate either the ability or the incentive to earn. The laws exempt money saved for retirements to encourage all citizens to make adequate provisions rather than risk becoming public charges in their post-employment years. Similarly, laws shield disability payments so the government need not supplement its grants to provide a basic standard of living for its disabled citizens.

Another rationale underlies exemption policy. Some items of property, such as clothes or household goods, have little resale value for creditors who would seize and liquidate the property to satisfy an outstanding debt. Although the items would yield little when sold, loss of the property would be...
devastating for the debtor. For some types of property, such as bedding and dishes, replacement costs would far exceed the value gained by the creditor. For other items, such as family pictures or heirlooms, no replacement is possible. In such circumstances, property seizure enhances leverage, not economic recovery. Hence, exemptions often protect personal property that is not directly necessary to earn a living. [FN: See, e.g., Ala. Code §6-10-6 (exempting family portraits or pictures).]

Brief History of Exemption Laws In Bankruptcy

Congressional authorization to establish uniform laws of bankruptcy is drawn from the Constitution, but there were no bankruptcy laws in place for most of the Nineteenth Century. Each of the three short-lived acts predating the Bankruptcy Act of 1898 provided federal bankruptcy exemptions. The Bankruptcy Act of 1800 established exemptions for necessary apparel, bedding, and a percentage of the estate keyed to the amount of creditor distributions. [FN: Charles Jordan Tabb, "The History of the Bankruptcy Laws in the United States," 3 Am. Bankr. Inst. L. Rev. 5, 14 (1995).] Having a slightly different focus, the Bankruptcy Act of 1841 offered a wider range of exemptions. It protected more clothing, household goods, and other "necessaries" worth up to $300. The Bankruptcy Act of 1867 exempted even more items within these categories of property, and also reflected contemporary events by exempting military arms, uniforms, and equipment. More significantly, this Act permitted debtors to avail themselves of the state law exemptions as well. Altogether, federal bankruptcy laws were in force fewer than seventeen years. For the remainder of the century, state laws filled the gaps to protect property deemed essential from creditor process. [FN: See Paul Goodman, "The Emergence of Homestead Exemption in the United States: Accommodation and Resistance to the Market Revolution, 1840-1880," 80 J. Am. Hist. 470 (Sept 1993) (recounting history of state homestead exemptions).]

Unlike its predecessors, the Bankruptcy Act of 1898 did not provide a set of federal bankruptcy exemptions and relied on state exemptions. [FN: Nonbankruptcy federal exemptions also were available. For a list of currently applicable nonbankruptcy federal exemptions, see 14 Collier on Bankruptcy at Fed-1 - Fed-16 (Rev. 15th Ed. 1996).] Thus, one's right to retain property in a federal bankruptcy proceeding would depend on the exemption laws of each of the states. The Supreme Court in Hanover National Bank v. Moyses [FN: 186 U.S. 181 (1902). This case was brought by a creditor challenging the constitutionality of the system, noting its apparent lack of uniformity despite the constitutional mandate to establish "uniform laws of bankruptcy."] upheld the constitutionality of the 1898 Act, declaring that the scheme yielded "geographical uniformity." [FN: The court's reasoning partly was derived from two decisions upholding the constitutionality of the 1867 Act. In re Beckerford, 3 F. Cas. 26 (C.C.D. Mo. 1870) (state exemptions variety did not compromise uniformity requirement, for creditors in any state only were entitled to receive distribution from available portion of debtors' assets); In re Deckert, 7 F. Cas. 334 (C.C.E.D. Va. 1874) (rejecting attack to law on basis of geographical diversity). Hanover, in turn, has been used for subsequent challenges to the 1978 Code.]

As the Bankruptcy Act weathered the evolution of debtor-creditor relations throughout the Twentieth Century, the goals of the consumer bankruptcy system, particularly the goal of providing a fresh start, matured and diverged more sharply from those of state law creditor collection statutes. Reliance on state law exemptions, geared toward a different end, became increasingly unsatisfactory for bankruptcy purposes. [FN: See Woodward, supra note 1, at 340.] Although it is important that exemptions not be overly generous, grossly insufficient state exemptions were inconsistent with rehabilitating failing families and encouraging work and self-sufficiency. The problems of relying on state laws were compounded by the fact that many state exemption laws had become outdated, so that once-adequate exemptions were laughable in a modern economy.

Mindful of these concerns, in its 1973 Report the Commission on the Bankruptcy Laws of the United States proposed that Congress enact a set of uniform federal exemptions. [FN: Report of the Commission on the Bankruptcy Laws of the United States, Part I, 170 (1973).] To that end, the 1973 Commission provided a draft statute with exemptions that conceivably would be appropriate for bankruptcy purposes. The Commission sought to eliminate both the excessively generous and exceedingly miserly exemptions. It also specifically aimed to reduce litigation over exemptions. Taking a slightly different approach, the National Conference of Bankruptcy Judges recommended federal bankruptcy exemptions but proposed that all debtors be permitted to choose between the state exemptions and those to be found in the new bankruptcy statute. [FN: H.R. 32, 94th Cong., 1st Sess. (1975); S. 235, 94th Cong., 1st Sess. (1975).]
During the debates over what became the 1978 Code, Congress considered proposals for uniform federal exemptions. The House endorsed the NCBJ approach and thus would have permitted debtors in bankruptcy to choose between federal and state exemptions. The Senate, however, preferred exclusive use of state exemptions. Late in the process, Congress adopted a provision that offered a slate of federal exemptions but also allowed states to "opt out," precluding their residents from using federal exemptions when they filed for bankruptcy. [FN: Lawrence Ponoroff & F. Stephen Knippenberg, "Debtors Who Convert their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?" 70 N.Y.U. L. Rev. 235, 254 (1995).] The provision permitted debtors in non-opt-out states to elect either the state or the federal exemptions. Subsequent amendments to section 522 clarified some issues and adjusted the amounts of the federal exemptions, [FN: Several matters were clarified in the Bankruptcy Amendments and Federal Judges Act of 1984. For example, it resolved the question of whether debtors filing jointly could "stack" federal and state exemptions by having one filer pick the state exemptions while the other picked the federal exemptions. In addition, Congress reduced the size of the "pourover exemption." The 1994 Amendments doubled the amounts of the federal exemptions, essentially raising the exemptions "floor" in the non-opt-out states.] but the fundamental structure of the exemptions system did not change.

Implications of the Current System

Although little public debate centered on this part of the new Code when initially enacted, the exemption provisions subsequently have provoked much commentary and have yielded a large body of conflicting case law. The compromise measure in section 522 has been described as a failure to "define, enact, and effect a fresh start policy in bankruptcy." [FN: See e.g., James B. Haines, Jr., "Section 522's Opt-Out Clause: Debtors' Bankruptcy Exemptions In a Sorry State," 1983 Ariz. St. L. J. 1, 9.] Litigants have attacked the provision as lacking the uniformity required by the Constitution, as an impermissibly broad delegation of power to state legislatures, and as a violation of the Supremacy Clause. As is self-evident, the opt-out clause has survived such challenges. [FN: See e.g., In re Storer, 58 F.3d 1125 (6th Cir. 1995) (opt out does not violate 5th Amendment due process or equal protection rights); In re Sullivan, 680 F.2d 1131 (7th Cir. 1982) (rejecting impermissible delegation argument), cert. denied, 459 U.S. 992 (1982). But see Judith Schenck Koffler, "The Bankruptcy Clause and Exemption Laws: A Reexamination of the Doctrine of Geographic Uniformity," 58 N.Y.U. L. Rev. 22 (1983).] While bankruptcy law purportedly controls the claiming, safeguarding, and sometimes entitlement to exemptions, the incomplete delegation of exemption law and policy has caused confusion, requiring reconciliation of state and federal laws. [FN: See In re Davis, 95-1112, 1997 WL 20734 (5th Cir. Feb. 12, 1997) (Bankruptcy Code exception to scope of exemption superseded state homestead protection from levy).]

As a result, the bankruptcy exemption system is a complex structure in which variation is the norm. In all of the bankruptcy cases in the majority of states that have opted out of the federally-provided bankruptcy exemptions, the federal exemptions in section 522(d) are simply inapplicable, leaving the determination of post-petition property to the various state schemes. [FN: See Appendix A for the states that have opted out.] In "debtor's choice" states that have not opted out of the federal exemption scheme, debtors can choose either federal or state exemptions to protect the greatest amount of value. In cases involving joint debtors, each spouse can claim a separate set of exempt property, effectively doubling up on some exemptions. If exemption laws reflected regional variations, such as protection of farmland in farm regions or higher homestead exemptions when houses were more expensive, the state law variations might be sensible. Instead, however, the disparities often have little rhyme or reason. No regional cost variation explains why California has very generous exemption laws while New York does not. Kansas permits its citizens to exempt up to $20,000 in a vehicle while Michigan exempts only $1,000 and Nebraska has no automobile exemption at all. [FN: In Nebraska, any equity in an automobile can be exempted only within the $1500 wildcard exemption or as a "tool of the trade." Oliver B. Pollak, David G. Hicks, "'Please Sir, I Want Some More,' - Loopholes, Austerity and the Cost of Living - Nebraska Exemption Policy Revisited," 73 Neb. L. Rev. 298, 312 (1994). Note, "Bankruptcy Exemptions: A Full Circle back to the Act of 1800?" 53 Cornell L. Rev. 663, 669 (1967-68) (discussing exemptions for fishing and oyster equipment and unpaid milk proceeds).] Moreover, some states predicate the right to use an exemption in bankruptcy on filing deeds of exemption in advance, which can be traps for the unwary. [FN: See 1 Ginsberg & Martin on Bankruptcy §6.01[D][3], 6-9 (1997) (citations omitted). In re Wing, 55 B.R. 91 (Bankr. D. Col. 1985) (permitting dismissal and refiling to comply with homestead deed filing requirement). The 1973 Commission also was concerned about the loss of state exemptions through mistake or inadvertence. Commission Report, supra note 9, at 171.]

Several significant repercussions flow from this system. First, the system does not deal fairly with its users -- debtors or creditors. Depending on the comparative benefits of the state exemptions, parties are
affected adversely. Some states have more restrictive exemptions than the federal exemptions, while others give much wider latitude to debtors to exclude property from their creditors' reach. Although there has been significant revision in state exemption statutes since 1978, state exemption laws tend to have some archaic remains. [FN: See generally, Haines, supra note at 13, at 10.] Some states had more generous exemptions in actual dollars in the mid-Nineteenth Century than other states do now. As a result, debtors with roughly equivalent economic profiles and similar property receive vastly dissimilar treatment through the federal bankruptcy system. Their creditors face the same disparities when they operate within multiple jurisdictions.

In addition, in its deference to state law exemptions, the current system multiplies the opportunities for forum shopping and pre-bankruptcy asset conversion without authorizing or proscribing these activities or even establishing whether state or federal laws should be controlling. [FN: See, e.g., Ponoroff & Knippenberg, supra note 11. Alan N. Resnick, "Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy," 31 Rutgers L. Rev. 615 (1978).] According to most commentators, Congress intended that the system permit debtors to maximize the use of exemptions. [FN: See, e.g., Lynn M. LoPucki, "The Death of Liability," 106 Yale L.J. 1. 32 (1996) ("Congress was concerned with equity between those already judgment proof and those who sought to become so on the eve of bankruptcy.").] The legislative history of the Bankruptcy Code of 1978 suggests that prebankruptcy asset conversion was not intended to be prohibited, for it was not fraudulent to make full use of exemptions to which he is entitled under the law. H.R. Rep 595 95th Cong. 1st Sess. 1977, etc. see Brown, p. 82. However, this type of prebankruptcy planning has not been met with uniform acceptance and has been the subject of much litigation and discussion. Ponoroff & Knippenberg, supra note 11.] Case law development has not yielded coherent rules on what constitutes appropriate prebankruptcy planning, sometimes leading to decisions holding that debtors have overreached in their efforts to maximize the value of their exemptions. [FN: See In re Reed, 700 F.2d 986 (5th Cir. 1983) (affirming lower court's denial of discharge under section 727 for transferring property less than two weeks before bankruptcy to maximize homestead exemption); In re Smiley, 864 F.2d 562 (7th Cir. 1989) (denying discharge after debtor originally residing in Illinois encumbered assets to buy home in state with unlimited homestead exemption, even though court already had limited debtors' homestead to $7,500, the Illinois exemption). In re Tveten, 848 F.2d 871 (8th Cir. 1988) (applying Minnesota exemption law, denying discharge to doctor with $19 million in debts for prebankruptcy planning). Judge Arnold's dissent in Tveten criticized the majority's attempt to legislate where the legislature had not: "A debtor's right to make full use of statutory exemptions is fundamental to bankruptcy law." Id. But see In re Johnson, 880 F.2d 78 (8th Cir. 1989) (under similar facts to Tveten, upheld district court and bankruptcy court's approval of discharge); In re Hanson, 848 F.2d 866 (8th Cir. 1988) (applying North Dakota exemption law, finding that debtor's prebankruptcy planning was not fraudulent behavior); In re Sholdan, 96-1836, 1997 WL 190286 (8th Cir. March 13, 1997) (findings that debtor intended to hinder and delay by prebankruptcy conversion are not sufficient under Minnesota law without evidence that debtor intended to defraud); See also In re Coplan, 156 B.R. 88 (Bankr. M.D. Fla. 1993) (after debtor transferred homestead from Wisconsin to Florida, permitted debtor to take only Wisconsin exemption amount). See generally Ponoroff & Knippenberg, supra note 11.] As a consequence, some debtors unwittingly risk losing entitlement to exemptions, having transactions unwound, or losing their discharges altogether, while others engage in similar behavior and successfully protect substantial sums of property.

The enhanced opportunities for prebankruptcy planning activity also have generated a problematic onslaught of attacks on the integrity of the bankruptcy system in the context of high-visibility debtors. People with no other familiarity with the bankruptcy system can cite celebrities who have shielded ample assets in an expensive homestead in certain states, a behavior that has become attributable to the bankruptcy system. [FN: See, e.g., Sandra Ward, "Bailing Out: Bankruptcy, Once a Disgrace, Has Become As American as the Fourth of July," Barron's, at 17 (July 17, 1996); David Barstow, "In Florida, Simpson May Find a Financial Haven," St. Petersburg Times, October 19, 1995 ("Were Simpson to move to Florida and file for bankruptcy, creditors couldn't touch his home, no matter how lavish, bankruptcy lawyers say. Conceivably, Simpson could sell Brentwood, sell his New York apartment, sell his Bentley and sink his money into a spread of up to 160 acres of prime Florida real estate, declare bankruptcy a week later, and all of it would be untouchable.")]. These events yield public outrage. This reaction may, in fact, stem from the perception that a celebrity debtor seems too wealthy to discharge her debts in bankruptcy, not because a debtor exercised her legal right to take full advantage of exemptions. Regardless of the cause, this fact pattern invokes calls for the constriction of the availability of bankruptcy relief. Many of the suggested restrictions would have a serious adverse impact on the majority of debtors who truly are in financial distress, but would do little to curb the activities of those dealing with substantial assets, who can find other means to shield their assets through the variety of state law exemptions.

The bankruptcy system was designed to deal with the consequences of financial failure and to reorganize the honest but unfortunate debtor, a fundamental tenet that should be reflected in a national bankruptcy...
policy. Until the bankruptcy system sets its own carefully balanced exemption policy, the integrity of the system remains at risk, with serious repercussions for all debtors and creditors.

No Opt Out: Why Bankruptcy Warrants Its Own Set of Exemptions

Exemption policy is a fundamental component of consumer bankruptcy. [FN: See, e.g., Vern Countryman, "For a New Exemption Policy in Bankruptcy," 14 Rutgers L. Rev. 678 (1960); Frank R. Kennedy, "Limitation of Exemptions in Bankruptcy," 45 Iowa L. Rev. 445 (1960); Ponoroff & Knippenberg, supra note 11.] Exemptions, along with the discharge, are so central to bankruptcy that they are not waivable, [FN: See Thomas H. Jackson, "The Fresh-Start Policy in Bankruptcy Law," 98 Harv. L. Rev. 1393 (1985). "In order to justify nonwaivability, it must be shown that individuals systematically misjudge (or ignore) their own interests and that this bias leads them to consume too much and save too little. I will also argue that societal intervention in the decisions of individuals to consume credit may be justified by the negative effects that those decisions may have on third parties." Id., at 1045. Some states permit their citizens to waive exemptions. See, e.g., Ga. Code Ann. §44-13-41.] and yet current exemption policy is channeled away from bankruptcy policy-makers toward a variety of state legislatures. Some states that have opted out have enacted sets of exemptions designed exclusively for bankruptcy. [FN: See, e.g., Del. Code Ann. tit. 10 §4913.] Exemptions certainly have important roles in state law. Variations among states in approaches to exemptions could be related to distinctions in other collection laws and state exemptions may be more or less generous depending on other policy judgments the state has made about local debt collection powers.

Nothing in a bankruptcy proposal for uniform federal exemptions usurps the power or the influence of the states in integrating their exemption laws with their other collection laws. For the debtors who remain under the jurisdiction state law and for the creditors who pursue their rights through state law, state exemptions still would apply. For debtors who want the protection and unique attributes of federal law, such as the automatic stay and the discharge, it is appropriate to require adherence to federal exemptions. Such exemptions can be crafted in light of the particular policies and special features of bankruptcy law.

The Benefits of a Lump Sum Property Exemption

This proposal is premised on the belief that it is well within Congress’ province to set a uniform standard of how much property should be retained through bankruptcy. The essential attributes of applicable exemptions are equally relevant to all debtors who come through the bankruptcy system, regardless of their domiciles. Debtors’ economic profiles are strikingly similar throughout the country, [FN: Teresa A. Sullivan, Elizabeth Warren, & Jay Lawrence Westbrook, "The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts," 17 Harv. J. L. Pub. Pol’y 801 (1994).] warranting roughly equal entitlement to exemptions. To this end, the Commission’s proposal provides a lump sum property exemption that can be used for many different kinds of necessary items. The advantages to this approach are manifold.

Equality of treatment depends in part on uniformity in the applicable laws, but, as a practical matter, parity in outcomes cannot be accomplished without considering the variety among debtors and creditors. Specific property needs may be vastly different, both inter- and intra-region. The Commission has heard repeatedly that there are great differences in local conditions that should not be coaxed into a uniform mold by a rigid federal statute. [FN: See, e.g., Henry E. Hildebrand, III, "Uniformity Meets Reality," 15 Am. Bankr. Inst. J. 16, 17 (1996) (characterizing consumer bankruptcy debates before Commission.)] Indeed, in determining the parameters of the exemptions, no legislature -- federal or state -- can know exactly what types of property would optimally facilitate the rehabilitation of a debtor. The variety in cultures, trades, and climate yields diversity that makes it inappropriate to predetermine overly-specific categories of property.

Recognition of this tremendous nationwide variety can be accomplished through a single system with sufficient internal flexibility to accommodate regional, local, and idiosyncratic needs. By permitting debtors to determine what property they will keep within very broad outlines, this approach vitiates the need for policy-makers to presuppose what assets look like for debtors in bankruptcy. Debtors are in a superior position to know what items are most essential to their own fresh starts. [FN: "Only an individual can accurately measure the difference between the value he places on an asset and the market price." Jackson, supra note 25,
at 1439, "Society could formulate a relatively short list of assets considered vital to the typical individual 's well being . . . There is another option that might better reflect the individual 's subjective belief about his needs for various assets in the future. Society could allow the debtor to exempt a specific amount (say, $25,000 worth) of existing assets (over and above human capital and, perhaps, wage substitutes) and leave the individual to decide which of his existing assets to exempt." Id., at 1435, citing Countryman, supra note 24, at 746.] Narrow and inflexible categories prevent the kind of efficiency that the debtors' own decision-making adds to the process. The bankruptcy system and its users are best served by setting a level of property exemption that is fair and reasonable to both debtors and creditors in light of the goals of the bankruptcy system, without delineating each piece of property that will be instrumental for the reorganization of each debtor. "While the debtor would still 'pay' for discharge (by turning over unprotected assets), his ability to shelter the ones precious to him would reduce the debtor's (without increasing the creditor's) cost of discharge." [FN: Jackson, supra note 25, at 1434, n. 134.]

The lump sum approach also is superior in its actual implementation. Such an approach would decrease litigation over whether property qualifies for a certain exemption. [FN: See, e.g., In re Johnson, 14 B.R. 14 (Bankr. W.D. Ky. 1981) ("Is a bus a bus, or is it a car?"); In re Hall, 169 B.R. 732 (Bankr. N.D. Okla. 1994) (denying debtor 's attempt to claim tractor-lawnmower as "household furniture ").] The need to forum shop and pre-plan for bankruptcy would be sharply curtailed by the limitation of regional disparity and the broad, blunt categorization of exemptions. The issue of pre-exemption planning -- by which the carefully-advised debtor preserves large amounts of property while his poorly-advised counterpart loses similar property -- would become largely irrelevant. Time consuming questions relating to the exemption of the proceeds of otherwise exempt property no longer will be at issue. [FN: See, e.g., In re Williams, 171 B.R. 451 (D. N.H. 1994) (upholding exemption of workers compensation benefits that were converted to another use).] By taking these issues off the table, the lump sum exemption would provide flexibility and equitable results for all debtors and their creditors.

There is an additional benefit to the lump sum property exemption. In preventing further tears in the social fabric, it is equally important to discourage the practice of using items of little economic value, but tremendous idiosyncratic value, to wield undue leverage. Outside of bankruptcy, a creditor might gain advantage by threatening to levy on a piece of personal property that is nearly worthless but is not among the specifically-enumerated categories of exempt property. This type of activity, which has no place in a collective bankruptcy proceeding, ceases under this proposal. If an item has nominal liquidation value, and is exempted in the allowable cash value lump sum exemption, the inquiry ends.

The proposal recommends setting the lump sum exemption at $25,000 worth of property in any form. The $25,000 cap represents only a slight increase over the amount of capped property one presently can exempt under section 522(d). [FN: Adding together the present section 522(d) exemptions yields a total of $21,700. This includes the exemptions for a motor vehicle ($2,400), household items ($8,000, none of which to exceed $400), jewelry ($1,000), wildcard ($800), professional tools ($1,500), and accrued dividend or interest in unmatured life insurance contract ($8,000. The homestead equalization exemption would be doubled over its current maximum allowable amount but would be available in fewer cases, e.g., when there was no home equity to be exempted at all.] At the same time, by imposing a value cap at $25,000, the proposal would prevent specific property exemptions from being exploited in ways not originally contemplated by state legislatures. Thus, for example, a debtor would no longer be able to keep a race horse worth six figures under an exemption protecting "one horse" from levy. [FN: See, e.g., In re Freedlander, 93 B.R. 446 (Bankr. E.D. Va. 1988) (Virginia exemption statute that permitted exemption of horse for agricultural purposes included race horse potentially worth $640,000).] The petition date is the relevant date for property valuation.

The proposal would carve out only one specific personal property exemption: professionally prescribed health aids for a debtor or dependent would be exempt independently and without limitation. Items falling into this category can be exceedingly expensive. A family's need for professionally prescribed health aids is in addition to, and not in place of, other types of property. It would be antithetical to the rehabilitative goals of bankruptcy, and generally contrary to public policy, to require a debtor to choose between retaining household goods, tools of the trade, and a wheelchair for a disabled child. Similarly, a prescribed health aid should not become an object of leverage for general creditors.
The Homestead Exemption

Throughout the Twentieth Century, governmental entities have created incentives and have employed various means to enable families to become homeowners. For most Americans, a home not only provides family shelter but it is also the most significant and valuable financial asset they will own. [FN: U.S. Department of Commerce, Bureau of the Census, 1990 Housing Highlights Financial Facts, Table 1 State and Regional Ranking by Median Home Value: 1970-1990 (June 1992).] American families hold a substantial proportion of their net worth in their homes. Once a person becomes a homeowner, the person is likely to remain a homeowner through retirement; the vast majority of Americans over the age of fifty live in their own homes. [FN: Data from the Consumer Bankruptcy Project, Phase II, 1991, reported in Teresa A. Sullivan, Elizabeth Warren, Jay Lawrence Westbrook, The Fragile Middle Class (forthcoming).]

For many Americans, home equity is a form of long-term savings and an informal retirement plan. To the extent that families make this long-term investment to provide for their future needs rather than spending their incomes on consumable goods, governmental policy generally favors that choice.

Nonetheless, home ownership, in itself, is neither an insurance policy against financial distress nor a badge of solvency. Homeowners tend to be more financially secure than renters, but they are not immune from economic troubles or the need for bankruptcy. Rather, homeowners represent almost one half of bankruptcy filers. [FN: Id.] The great majority of homes held by debtors in bankruptcy are encumbered by at least one mortgage, and often two or three.

To promote debtor rehabilitation and to advance other governmental policies, there is adequate cause to establish exclusive homestead exemption policies for bankruptcy. At the same time, states traditionally have had an especially strong interest in the homestead and the rights related thereto. The modern conception of a homestead exemption has been present for over one hundred years, and its roots run deeper. Some states, such as Florida, Texas, and Oklahoma, provide homestead protection in their state constitutions.

Not all states are equally protective, either in terms of the value or the scope of the exemption, and they have taken divergent views on the importance of sheltering a homestead. Homeowners in some states are not entitled to the homestead exemption, while others enjoy nearly unlimited homesteads, and there are multiple variations in between these two extremes. [FN: See Appendix A.] The variations have led to both national ridicule [FN: See, e.g., Larry Rohter, "Rich Debtors Find Shelter Under a Populist Florida Law," N.Y. Times, July 25, 1993.] and the efforts of debtors to find both literal and figurative shelter in generous states.

The differences among the states are difficult to justify on grounds other than historical artifact. Little else could explain the fact that the Nebraska Territory had a more generous exemption in 1883 than Arkansas does in 1997. [FN: Goodman, supra note 4, at 472. The Nebraska Territory provided a $2000 exemption, as compared with Arkansas’ current $800 single/$1250 married homestead exemption. Ark. Code Ann. §16-66-210.] A comparison of state homestead exemptions and the relative cost of living in those states reveals that state homestead exemptions do not reflect a relative cost of living assessment. For example, in 1991, Rhode Island had the fifth highest median home value in the country and yet had a homestead exemption of zero; conversely, Iowa had the third lowest home value in the nation and had an unlimited homestead exemption. [FN: U.S. Department of Commerce, Bureau of the Census, 1990 Housing Highlights Financial Facts, Table 1 State and Regional Ranking by Median Home Value: 1970-1990 (June 1992).] More significantly, because state exemption laws generally do not take into account the vast intrastate variations in the cost of living, they may not, in fact, address local needs at all. [FN: See, e.g., Raymond C. Marier, Note, "Bankruptcy Exemptions: A Full Circle Back to the Act of 1800?" 53 Cornell L. Rev. 663, 682 (1967-68) (implying that states contain many economically distinct regions, giving rise to greater impetus for national solution).] Housing costs in upstate New York and Manhattan, for example, differ greatly, but they are equally subject to a single state exemption.

Thus, while it is extremely important to give deference to the states’ longstanding interest in setting the parameters of homestead protection, the bankruptcy system’s recognition of the homestead exemptions must reflect other factors. Providing no homestead exemption at all is flatly inconsistent with the fresh start goal of the bankruptcy system, the numerous federal policies promoting home ownership (e.g., federally insured mortgages, tax deductibility of interest on home mortgages), and the prevalent and widely-accepted use of the home as a long-term savings plan. At the same time, permitting unlimited homestead exemptions plainly violates bankruptcy’s goal to liquidate and ratably distribute assets...
among the creditors when a debtor seeks a personal discharge from all outstanding debts.

To reconcile state law interest in the homestead with bankruptcy policy considerations, the Commission’s proposal treats homestead exemptions differently than other property exemptions. The proposal would permit state law to determine the character of property to which a homestead exemption would attach. In addition, state law would determine the amount of the homestead exemption, within a permissible range.

A variety of factors are relevant in determining the appropriate floor, such as the number of states with exemptions at that level, a comparison of the proposed floor with the current federal exemption, policy reasons for protecting the homestead, and the level of flexibility that the system affords for families to enhance homestead exemptions. At the last Commission meeting when this proposal initially was endorsed, the Commission was working with a $40,000 floor, but expressed interest in setting the level that was most justifiable considering the above-listed factors. For purposes of this discussion, three possible alternatives are explored: $40,000, $30,000, and $25,000. In many of the opt-out states with homestead exemptions lower than the floor, it is undisputed that the homestead exemption floor using any of these options would be more generous than what currently is available. While some might be concerned about the implications of more generous exemptions in bankruptcy, empirical evidence generally refutes the assertion that larger exemptions, or more liberal bankruptcy laws generally, directly have caused increases in bankruptcy filings. [FN: See, e.g., Ian Domowitz and Thomas L. Eovaldi, "The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy," 2 J. L. & Econ. 803, 805 (1993) ("Code cannot be established as the cause of any major increase in the number of nonbusiness bankruptcies"); Kim J. Kowalewski, "Personal Bankruptcy: Theory and Evidence," Federal Reserve Bank of Cleveland Economic Review 1-29 (1982); Charles A. Luckett "Personal Bankruptcy" (1988); Teresa A. Sullivan, Elizabeth Warren, Jay Lawrence Westbrook, As We Forgive Our Debtors; Bankruptcy and Consumer Credit in America (1989). But see Richard L. Peterson and Kiyomi Aoki, "Bankruptcy Filings Before and After Implementation of the Bankruptcy Reform Law," Journal of Economics and Business 95-105 (1984).]

It is important to remember that a homestead exemption protects only the debtor's equity in a home. Notwithstanding the fact that home values might be quite high, most debtors have encumbered their homes with large mortgages, so that the amount they need to protect is quite modest. The median home equity for homeowners in bankruptcy is far below this amount. [FN: The median equity is $5,500. Sullivan, Warren & Westbrook, Fragile Middle Class, supra note 36.] Under any of the three scenarios, not many homeowners in bankruptcy will have equity that meets or exceeds the floor. On the other hand, setting the floor any lower would discriminate against elderly homeowners and frustrate their savings efforts, because they are more likely to have built up a greater portion of equity than their younger counterparts who have greater earning potential ahead. The floor must reflect the fact that the homestead is both a physical shelter and a long-term savings device.

Some states vary their exemptions by marital status, number of occupants or dependents, age of debtors, and location of homestead. To simplify the comparison of the proposed floors with the presently applicable exemptions, this discussion will presume that the debtors are jointly-filing spouses under sixty years of age with two dependent children and reside in a non-rural area.

The first draft of the Commission's proposal recommended a $40,000 floor. Approximately nineteen states have exemptions of $40,000 or more for a family of four, and it would increase the exemption for the remainder. [FN: See Appendix A.] This floor would provide $10,000 more in potential homestead protection for joint filers and $25,000 more for single filers than the current federal exemption. Although some people have suggested that exempting $40,000 of equity is an insufficient floor for rural areas, other commentators have suggested that it is unnecessarily generous.

On the other end of the spectrum, if the floor were set at $25,000, twenty-five states would be above the floor for the paradigm family. Although this floor would raise the exemption by $10,000 for single filers, joint filers would get less protection than they currently receive under the federal exemptions.

For the aforementioned family of four, twenty-five states also have homestead exemptions at or above $30,000. Thus, this floor is consistent with a large proportion of the state exemptions while it also comports with the federal homestead exemption currently available for joint filers. [FN: However, this floor
would be equally applicable whether the debtor filed singly or jointly. The same would be true for the ceiling.] Although twenty five states and the District of Columbia have homestead exemptions of less than $30,000 for a family of four, six states with the most meager homestead exemptions have not opted out of the federal exemptions. Thus, assuming that homeowner debtors in these states generally choose the federal exemptions, this functionally brings the number of states with bankruptcy homestead exemptions at or above $30,000 to thirty-one.

To a certain extent, any of these three floors would narrow the tremendously wide gap in treatment of economically similar debtors in states with disparate views of the homestead and brings their treatment into accordance with the bankruptcy system’s view of the role of the homestead in the reorganization of a debtor. The level that is chosen should reflect the use of the home as a savings and retirement plan and should make bankruptcy policy consistent with other federal policies promoting home ownership.

Quite a few states allow debtors to exempt over $100,000 in home equity or impose no monetary cap on the homestead. [FN: See Appendix A.] The $100,000 ceiling would restrict the homestead exemption in some states, freeing more property for creditors in cases involving high-asset consumer debtors. Individuals with ample means still might use homesteads to judgment-proof themselves outside of bankruptcy, but they would forfeit this ability once they sought the benefits of federal bankruptcy relief. Although some have argued that a $100,000 cap on exemptions is needlessly high, the cap is consistent with legislation introduced by Senator Herbert Kohl (D-WI) in the U.S. Senate in 1995 during the 104th Congress, and is significantly lower than the proposed cap of $500,000 in S.1559 that passed in the Senate and was referred to the House Committee on the Judiciary in 1996. [FN: Bankruptcy Abuse Reform Act of 1995, S. 769; Bankruptcy Technical Corrections Act of 1996, S. 1559, §28.] The majority of states do not have such high homestead exemptions, and thus a $100,000 cap would be an issue in only a few states. Even in those states, it still would represent a significant restriction on the bankruptcy exemption currently permitted.

Although they are capped, the exemption provisions allow some flexibility for debtors: for the debtor who needs to exempt an additional $10,000 or so of equity beyond the homestead exemption, that debtor might choose to use part of the lump sum exemption to do so. Thus, debtors who are willing to strip down their other assets and make them available to their creditors may protect a somewhat larger homestead than they could otherwise.

The floor-and-ceiling approach is a compromise that preserves some of the state variation while it narrows the range of differences to eliminate the most serious concerns about unprotected and overprotected homeowners.

Homestead Exemption Based on Households

In some states, a standard homestead exemption applies equally to single people and married couples, while in other states the homestead is available for each debtor as a separate claim. Some states provide enhanced exemptions for a married couple, and still others give slight increases for dependents. The present set of federal exemptions provides each individual debtor a homestead exemption of $15,000, but gives $30,000 to a married couple filing jointly.

The need for a homestead may be based more on the formation of a household than on whether one or two adults live in the home. Single parents or widows or widowers may need a homestead exemption that is as large as if they lived with spouses. [FN: In some cases applying state law, widows get no protection at all. See In re Henry, 91-41972 (Bankr. D. Neb. Jan. 15, 1996), cited in Pollak & Hicks, supra note 17, at 330 n. 218.] This proposal recognizes that fact by recommending that the homestead floor and ceiling apply equally to a debtor filing singly or to jointly-filing debtors. The property exemption would apply to the interest of either the single debtor or the married couple without distinction. As a result, it would not permit a married couple to "stack" exemptions, thereby doubling the amount available that would have been available to a single filer. If a husband and wife filed separately, each could claim a $30,000 exemption in the homestead; in such cases, however, the calculation of the exemption, coming immediately after applicable mortgages, would protect the same $30,000 in value in the home. Neither bankruptcy defers to or accounts for the other bankruptcy. If the couple files jointly, the exemption would remain the same.
This would not change the states’ ability to enhance the amount of an exemption based on family size within the federal floor and ceiling.

**Homestead Equalization Exemption**

Similar in principle to the current section 522(d)(5), a homestead equalization exemption of $15,000 would reduce discrimination against debtors who rent their residences. It also would provide some balance for the one quarter of homeowner debtors who have no equity in their homes at all. [FN: Sullivan, Warren & Westbrook, Fragile Middle Class, supra note 36.] Because some non-homeowners use other means for long-term savings, this equalization provision permits them to reserve necessary value free from creditor attachment.

Without a homestead equalization exemption, economic discrepancies among homeowners and non-homeowners would be exacerbated. The effort to rehabilitate all debtors, not just homeowners, would be undercut.

Establishing the appropriate homestead equalization amount can depend on a number of factors. Because saving a home is not at issue, the attendant concerns over the larger costs and social implications of forcing a family to move and the variations in valuation are not present. Originally, this proposal contemplated a homestead equalization bonus of half the amount of the unused homestead exemption, but this calculation would invoke needless confusion in conjunction with the floor and ceiling approach to homestead exemptions. In addition, the bonus would have protected a disproportionately high amount of personal property for debtors whose state laws otherwise would have entitled them to a $100,000 homestead exemption. There is little justification for variation of this exemption among debtors in different jurisdictions, making a uniform equalization amount appropriate.

**Retirement and Pension Funds**

Few would refute the sound reasons to protect pension and retirement plans from the reach of creditors. According to the Federal Reserve, families in all economic sectors report increased retirement savings. [FN: “Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances,” 83 Federal Reserve Bulletin at 5, 10 (January/February 1997).] Retirement funds are the largest single type of financial asset held by American families, constituting over 25% of the financial assets held by families in 1995, and the percentage of families in almost every demographic group holding retirement accounts grew between 1992 and 1995. [FN: Id.]

Although Americans, and more particularly debtors in bankruptcy, invest significantly less money in retirement funds than they put into homes, [FN: Ownership of non-home assets, such as stocks, mutual funds, rental property or a business, vehicles, other real estate, IRAs and KEOGH plans, etc. each comprised 7% or less of total assets. Bureau of the Census, Statistical Brief, Household Wealth and Asset Ownership: 1991.] public policy demands that people not be discouraged from saving for their later non-income producing years when they otherwise might become a drain on the public fisc. [FN: This rationale has motivated some state legislatures, such as that of Massachusetts, to grant a larger homestead exemption for citizens past retirement age. Mass. Gen. Laws. Ann. ch. 188 §1A.] Far from signifying excessive wealth, retirement funds have become a middle-class necessity, especially in light of the diminishing adequacy of social security funds and other deferred benefits. Similar to the considerations regarding the homestead, bankruptcy should not discourage what other federal policies and common sense encourage.

Protection of retirement fund contributions should not be boundless. It would be improper to permit a debtor to make extraordinary contributions in contemplation of bankruptcy, only to withdraw these monies after receiving discharge from all debt. Retirement funds should not become a vehicle for clever debtors to hide money temporarily in contemplation of bankruptcy. The means of controlling debtors’ retirement fund exemptions vary at present. Current federal exemptions rely on subjective judicial determinations of what would be "reasonably necessary" for that debtor to support herself and dependents, similar to some state law exemptions. [FN: For example, in Ohio, IRA and KEOGH plans are exempt when necessary for support. Nebraska has a similar limitation on profit sharing plans. Missouri imposes the same requirement, assuming the plan met applicable tax restrictions, as do Iowa and Georgia.] This fact-based test can lead
to excessive litigation or intrusive and time-consuming inquiries. [FN: For example, some courts go through the following analysis to determine whether a retirement fund is reasonably necessary for the Debtor's support: (1) Debtor's present and anticipated living expenses; (2) Debtor's present and anticipated income from all sources; (3) Age of the debtor and dependents; (4) Health of the debtor and dependents; (5) Debtor's ability to work and earn a living; (6) Debtor's job skills, training and education; (7) Debtor's other assets, including exempt assets; (8) Liquidity of other assets; (9) Debtor's ability to save for retirement; (10) Special needs of the debtor and dependents; (11) Debtor's financial obligations, e.g., alimony or support payments. In Re Flygstad 56 B.R. 884, 890 (Bankr. N.D. Iowa 1997.)] States have employed myriad other methods to determine the extent to which retirement funds should be exempt. Some state laws effectively exclude certain types of plans from the bankruptcy estate, i.e., if they qualify as spendthrift trusts, or exempt plan contributions that are federal tax-protected, while other states exempt pension fund contributions only in limited circumstances, such as for public employees. [FN: Some examples include Indiana, District of Columbia, Nevada, Rhode Island, Delaware, and New Jersey. 14 Collier on Bankruptcy (Rev. 15th Ed. 1996.) Some states employ look-back periods and apply special rules for eve-of-bankruptcy contributions, [FN: For example, Alaska law provides that tax qualified plans are exempt, excluding contributions made 120 days prior to bankruptcy. Likewise, otherwise exempt contributions made within a year of the bankruptcy filing are non-exempt in Louisiana and Mississippi. In Montana, tax qualified stock plans are exempt except for contributions made within 1 year of bankruptcy in excess of 15% of debtor's income for that year. Id.] while others impose specific monetary caps. [FN: E.g., In re Bashak, 96-1423, 1997 WL 50616 (3d Cir. February 10, 1997) (Pennsylvania restricted to $15,000 per year in certain employer sponsored plan contributions). Other states with monetary limitations, either in total or on yearly contributions, include Vermont, North Dakota, South Dakota, and Idaho. 14 Collier on Bankruptcy (Rev. 15th Ed. 1996.)]

This proposal does not contemplate making any significant policy shifts in this area. Pension plans containing anti-alienation provisions would continue to be excluded from property of the estate altogether. [FN: Patterson v. Shumate, 1125 S. Ct. 2242 (1992). The Supreme Court found that pension plan assets in a qualified pension plan with an anti-alienation provision were not includable in the debtor's bankruptcy estate pursuant to the plain language of the Bankruptcy Code and ERISA; the plan's anti-alienation provision was a "restriction on transfer enforceable under applicable nonbankruptcy law." under section 541(c)(2). Approximately thirty-seven states have exemptions applicable to ERISA-regulated pensions. See Collier on Bankruptcy at CasHi-37 (Rev. 15th Ed. 1996.) At the same time, the Commission declines to promote disparate treatment of various types of pension plans, yielding less protection to those who were not savvy planners or whose employers do not offer them the "right" plans. Nor does the Commission wish to provide more retirement protection for the citizens of one state than for the citizens of another. A uniform approach to retirement funds, with as little change to upset past retirement planning, seems appropriate.

The proposal relies on the federal tax restrictions for plans that are not otherwise subject to anti-alienation provisions, making retirement funds exempt property in bankruptcy so long as they are exempt under federal tax laws as well. By exempting all funds held indirectly or directly in a trust that are exempt under sections 408 or 501(a) of the Internal Revenue Code, the debtor would be able to protect self-employed KEOGH plans and individual defined benefit plans, as well as other plans that have federal tax protection. This permits the bankruptcy laws to employ the developed supervision of the Internal Revenue Code to evaluate what kinds of plans and what kinds of contributions are encouraged as a matter of public policy. Because these provisions limit the amount of contributions in a single year, a debtor would not be able to make an extraordinary contribution to shield assets temporarily from creditors. The integrity of the system would be best served by this limitation that precludes exemption of excessive and improper contributions.

Rights to Payments

Certain rights to payment are especially important to the rehabilitation of a debtor in bankruptcy. They consistently have been declared outside the reach of creditors under federal bankruptcy law. The current policies are endorsed by the Commission's proposal. Future wages would not be property of the estate. [FN: 11 U.S.C. §541(a)(6). "This reservation of future earnings exclusively and inalienably to the debtor is the 'fresh start' that has been a driving tradition of American bankruptcy law. The system provides a fresh start at least partly because of the difficulty of denying it. Debtors who could neither pay nor discharge their debts might adopt a judgment-proof lifestyle, adopt a new identity, or join the underground economy. Both debtor and creditor might spend considerable efforts on a struggle that yielded less for the creditor than it cost the system in the aggregate." LoPucki, supra note 21.] Debtors would continue to be able to exempt unmatured life insurance contracts, [FN: 11 U.S.C. §522(d)(7).] although cash value would have to be exempted under the $25,000 lump sum exemption. The debtor also would retain the right to receive undistributed and unaccumulated social security, unemployment compensation, public assistance, veterans' benefits, and disability, illness or unemployment benefits. [A - 76]
In addition, the right to receive a crime victim’s reparation award or a personal injury award would be exempt. Although the current federal exemptions provision caps personal injury award entitlements at $15,000, many states do not impose such a limitation. There is little evidence that this type of exemption is a likely or frequent subject of scrutiny or abuse and little justification for the cap.

Competing Considerations

If uniform bankruptcy exemptions were more restrictive than state law exemptions, creditors might develop a greater interest in bringing more involuntary consumer bankruptcy cases. To prevent a creditor from filing an involuntary petition simply to deny the debtor the protection of state exemption laws, it might be necessary to make a slight adjustment to the standard for involuntary petitions against consumer debtors: an involuntary petition would require a showing that the filing was not made solely for the purpose of entitling the creditor to a less generous federal exemption. Only a handful of involuntary petitions are filed against consumers under the current system, which means that the predicted impact of this change would be minimal.

An argument has been made that nothing, including this proposal, can stop pre-bankruptcy planning. This proposal vitiates most of the need for the conversion of assets from one form to another because the proposal does not establish multiple categories of personal property that will be necessary to a debtor’s fresh start. It also would take away the main tools: categories of property with no value limits. While it would be possible to enhance exemptions by converting some assets from personalty to a homestead, the floor and cap on the homestead exemption reduce the impetus to purchase homesteads solely in anticipation of bankruptcy. Because the safeguards against excessive exemptions are accomplished through the caps identified here, there is no need to put further restrictions on pre-bankruptcy planning, and the statute could make explicit that a debtor may transfer property to take advantage of the exemptions identified here. Such a provision would eliminate unnecessary litigation and clarify the law for debtors who are unsure about how much help they can receive in arranging their financial affairs.

Of course, any pre-bankruptcy planning that runs afoul of other laws, such as fraudulent conveyance provisions, would remain voidable in bankruptcy.

Some believe that this proposal does not go far enough in establishing a federal exemption policy because it does not provide a uniform homestead exemption. In so doing, this proposal does not resolve all of the difficulties in applying state property laws to a federal bankruptcy proceeding. Some critics argue that each state legislature is better suited to determine the appropriate level of exemptions for their citizens in the context of the federal bankruptcy system and that this proposal does not take regional differences sufficiently into account. For many of the reasons already discussed, this proposal does not adopt that view. Exemptions in bankruptcy involve somewhat different considerations than exemptions in state law collection actions, demanding a greater need for uniformity and more considered choices that focus on the discharge and fresh start. These reasons may justify centralized policy choices. State law exemptions cannot be said, as a whole, to be based on the cost of living relative to other states. State law exemptions also do not address the very significant intrastate distinctions that often overshadow interstate distinctions. If there is true concern about disparities in cost of living that Congress ultimately decides must be taken into account, then regional adjustments could be made to the federal exemptions, which would provide more parity than ceding responsibility for exemption policy to the states.

Appendix A

State Homestead Exemptions Order of Value As Applicable to Joint Debtors Under Sixty Years of Age with Two Dependents in Non-Rural Region [FN: The amounts listed generally do not include "wildcard " exemptions that may be applicable to real property. The acreage limitations imposed in some states also have not been listed. Although reasonable efforts have been expended to ensure the accuracy of this information, consultation with selected state statutes and several secondary sources sometimes provided ambiguous or conflicting accounts of the amounts of the exemptions.]
<table>
<thead>
<tr>
<th>State</th>
<th>Exemption</th>
<th>Opt-Out?</th>
</tr>
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<tbody>
<tr>
<td>Florida</td>
<td>Unlimited $ Amount</td>
<td>Yes</td>
</tr>
<tr>
<td>Iowa</td>
<td>Unlimited $ Amount</td>
<td>Yes</td>
</tr>
<tr>
<td>Kansas</td>
<td>Unlimited $ Amount</td>
<td>Yes</td>
</tr>
<tr>
<td>South Dakota</td>
<td>Unlimited $ Amount</td>
<td>Yes</td>
</tr>
<tr>
<td>Texas</td>
<td>Unlimited $ Amount</td>
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<tr>
<td>Minnesota</td>
<td>$200,000</td>
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<td>Nevada</td>
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</tr>
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<td>Yes</td>
</tr>
<tr>
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<td>No</td>
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<tr>
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<td>$80,000</td>
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<tr>
<td>California</td>
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</tr>
<tr>
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</tr>
<tr>
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<td>Yes</td>
</tr>
<tr>
<td>New Mexico</td>
<td>$60,000 ($30,000 per joint tenant)</td>
<td>No</td>
</tr>
<tr>
<td>Alaska</td>
<td>$54,000</td>
<td>Ambiguous/Probably Yes</td>
</tr>
<tr>
<td>Idaho</td>
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</tr>
<tr>
<td>Wisconsin</td>
<td>$40,000</td>
<td>No</td>
</tr>
<tr>
<td>Wyoming</td>
<td>$40,000 ($10,000 per &quot;occupant&quot;)</td>
<td>Yes</td>
</tr>
<tr>
<td>Oregon</td>
<td>$33,000</td>
<td>Yes</td>
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<tr>
<td>Colorado</td>
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<td>Yes</td>
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<tr>
<td>Hawaii</td>
<td>$30,000</td>
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</tr>
<tr>
<td>New Hampshire</td>
<td>$30,000</td>
<td>No</td>
</tr>
<tr>
<td>Vermont</td>
<td>$30,000</td>
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</tr>
<tr>
<td>Washington</td>
<td>$30,000</td>
<td>No</td>
</tr>
<tr>
<td>Indiana</td>
<td>$15,000 ($7,500 per debtor)</td>
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</tr>
<tr>
<td>Louisiana</td>
<td>$15,000</td>
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</tr>
<tr>
<td>Maine</td>
<td>$12,500</td>
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</tr>
<tr>
<td>Utah</td>
<td>$11,000 (w/ spouse and dependents)</td>
<td>Yes</td>
</tr>
<tr>
<td>State</td>
<td>Amount</td>
<td>Exemption</td>
</tr>
<tr>
<td>-------------------</td>
<td>--------</td>
<td>-----------</td>
</tr>
<tr>
<td>Alabama</td>
<td>$10,000 ($5,000 per debtor)</td>
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</tr>
<tr>
<td>Georgia</td>
<td>$10,000 ($5,000 per debtor)</td>
<td>Yes</td>
</tr>
<tr>
<td>Nebraska</td>
<td>$10,000</td>
<td>Yes</td>
</tr>
<tr>
<td>New York</td>
<td>$10,000</td>
<td>Yes</td>
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<tr>
<td>North Carolina</td>
<td>$10,000</td>
<td>Yes</td>
</tr>
<tr>
<td>South Carolina</td>
<td>$10,000 (if co-owners)</td>
<td>Yes</td>
</tr>
<tr>
<td>Missouri</td>
<td>$8,000</td>
<td>Yes</td>
</tr>
<tr>
<td>Illinois</td>
<td>$7,500</td>
<td>Yes</td>
</tr>
<tr>
<td>Tennessee</td>
<td>$7,500</td>
<td>Yes</td>
</tr>
<tr>
<td>West Virginia</td>
<td>$7,500</td>
<td>Yes</td>
</tr>
<tr>
<td>Virginia</td>
<td>$6,500 (with 3 dependents; can be used for personal property too)</td>
<td>Yes</td>
</tr>
<tr>
<td>Kentucky</td>
<td>$5,000</td>
<td>Yes</td>
</tr>
<tr>
<td>Ohio</td>
<td>$5,000</td>
<td>Yes</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>$5,000 (unlimited for rural)</td>
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</tr>
<tr>
<td>Michigan</td>
<td>$3,500</td>
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</tr>
<tr>
<td>Arkansas</td>
<td>$2,500</td>
<td>No</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>None (except condo escrow deposits)</td>
<td>No</td>
</tr>
<tr>
<td>Delaware</td>
<td>None (but provides $10,000 lump sum exemption that may be applicable)</td>
<td>Yes</td>
</tr>
<tr>
<td>Maryland</td>
<td>None (but provides $5,500 wildcard exemption for property of any kind)</td>
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<td>No Homestead Exemption</td>
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<tr>
<td>Pennsylvania</td>
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</tr>
<tr>
<td>Rhode Island</td>
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</table>
SEMINOLE TRIBE OF FLORIDA vs. FLORIDA

AND ITS IMPACT IN BANKRUPTCY CASES

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SECTION B
SEMINOLE TRIBE OF FLORIDA vs. FLORIDA
AND ITS IMPACT IN BANKRUPTCY CASES

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SECTION B
United States Constitution, 11th Amendment

The Judicial Power of the United States shall not be construed to extend to any writ 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.

Seminole Tribe of Florida, Petitioner,

v.

Florida et al.

No. 94-12.

Supreme Court of the United States

116 S.Ct. 1114 (1996)

Chief Justice REHNQUIST delivered the opinion of the Court. *

The Indian Gaming Regulatory Act provides that an Indian tribe may conduct certain gaming activities only in conformance with a valid compact between the tribe and the State in which the gaming activities are located.... The Act, passed by Congress under the Indian Commerce Clause, U.S. Const., Art. I, § 8, cl. 3, imposes upon the States a duty to negotiate in good faith with an Indian tribe toward the formation of a compact, ... and authorizes a tribe to bring suit in federal court against a State in order to compel performance of that duty.... We hold that notwithstanding Congress' clear intent to abrogate the States' sovereign immunity, the Indian Commerce Clause does not grant Congress that power, and therefore ... [the statute] cannot grant jurisdiction over a State that does not consent to be sued....

I

Congress passed the Indian Gaming Regulatory Act in 1988 in order to provide a statutory basis for the operation and regulation of gaming by Indian tribes....

In September 1991, the Seminole Tribe of Indians, petitioner, sued the State of Florida

* A substantial portion of the majority opinion and almost all of the dissenting opinions have been omitted. — Ed.
and its Governor, Lawton Chiles, respondents. Invoking jurisdiction under 25 U.S.C. § 2710(d)(7)(A), as well as 28 U.S.C. §§ 1331 and 1362, petitioner alleged that respondents had "refused to enter into any negotiation for inclusion of [certain gaming activities] in a tribal-state compact," thereby violating the "requirement of good faith negotiation" contained in § 2710(d)(3). Petitioner's Complaint ¶ 24, see App. 18. Respondents moved to dismiss the complaint, arguing that the suit violated the State's sovereign immunity from suit in federal court. The District Court denied respondents' motion, 801 F.Supp. 655 (S.D.Fla.1992), and the respondents took an interlocutory appeal of that decision....

The Court of Appeals for the Eleventh Circuit reversed the decision of the District Court, holding that the Eleventh Amendment barred petitioner's suit against respondents. 11 F.3d 1016 (1994). The court agreed with the District Court that Congress in § 2710(d)(7) intended to abrogate the States' sovereign immunity, and also agreed that the Act had been passed pursuant to Congress' power under the Indian Commerce Clause, U.S. Const., Art. I, § 8, cl. 3. The court disagreed with the District Court, however, that the Indian Commerce Clause grants Congress the power to abrogate a State's Eleventh Amendment immunity from suit, and concluded therefore that it had no jurisdiction over petitioner's suit against Florida....

Petitioner sought our review of the Eleventh Circuit's decision, and we granted certiorari, 513 U.S. ----, 115 S.Ct. 932, 130 L.Ed.2d 878 (1995), in order to consider two questions: (1) Does the Eleventh Amendment prevent Congress from authorizing suits by Indian tribes against States for prospective injunctive relief to enforce legislation enacted pursuant to the Indian Commerce Clause?; and (2) Does the doctrine of Ex parte Young permit suits against a State's governor for prospective injunctive relief to enforce the good faith bargaining requirement of the Act? We answer the first question in the affirmative, the second in the negative, and we therefore affirm the Eleventh Circuit's dismissal of petitioner's suit.

The Eleventh Amendment provides:

"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."

Although the text of the Amendment would appear to restrict only the Article III diversity jurisdiction of the federal courts, "we have understood the Eleventh Amendment to stand not so much for what it says, but for the presupposition ... which it confirms." Blatchford v. Native Village of Noatak, 501 U.S. 775, 779, 111 S.Ct. 2578, 2581, 115 L.Ed.2d 686 (1991). That presupposition, first observed over a century ago in Hans v. Louisiana, 134 U.S. 1, 10 S.Ct. 504, 33 L.Ed. 842 (1890), has two parts: first, that each State is a sovereign entity in our federal system; and second, that "'[i]t is inherent in the nature of sovereignty not to be amenable to the suit of an individual without its consent.' " Id., at 13, 10 S.Ct., at 506 (emphasis deleted),

B - 2
quoting The Federalist No. 81, p. 487 (C. Rossiter ed. 1961) (A. Hamilton). See also Puerto Rico Aqueduct and Sewer Authority, supra, at 146 ("The Amendment is rooted in a recognition that the States, although a union, maintain certain attributes of sovereignty, including sovereign immunity"). For over a century we have reaffirmed that federal jurisdiction over suits against unconsenting States "was not contemplated by the Constitution when establishing the judicial power of the United States." Hans, supra, at 15, 10 S.Ct., at 507.

Here, petitioner has sued the State of Florida and it is undisputed that Florida has not consented to the suit. See Blatchford, supra, at 782, 111 S.Ct., at 2582 (States by entering into the Constitution did not consent to suit by Indian tribes). Petitioner nevertheless contends that its suit is not barred by state sovereign immunity. First, it argues that Congress through the Act abrogated the States' sovereign immunity. Alternatively, petitioner maintains that its suit against the Governor may go forward under Ex parte Young, supra. We consider each of those arguments in turn.

II

Petitioner argues that Congress through the Act abrogated the States' immunity from suit.

In order to determine whether Congress has abrogated the States' sovereign immunity, we ask two questions: first, whether Congress has "unequivocally expressed its intent to abrogate the immunity," Green v. Mansour, 474 U.S. 64, 68, 106 S.Ct. 423, 426, 88 L.Ed.2d 371 (1985); and second, whether Congress has acted "pursuant to a valid exercise of power." Ibid.

A

Congress' intent to abrogate the States' immunity from suit must be obvious from "a clear legislative statement." Blatchford, 501 U.S., at 786, 111 S.Ct., at 2584. This rule arises from a recognition of the important role played by the Eleventh Amendment and the broader principles that it reflects. See Atascadero State Hospital v. Scanlon, 473 U.S. 234, 238-239, 105 S.Ct. 3142, 3145-3146, 87 L.Ed.2d 171 (1985); Quern v. Jordan, 440 U.S. 332, 345, 99 S.Ct. 1139, 1147, 59 L.Ed.2d 358 (1979). In Atascadero, we held that "[a] general authorization for suit in federal court is not the kind of unequivocal statutory language sufficient to abrogate the Eleventh Amendment." 473 U.S., at 246, 105 S.Ct., at 3149; see also Blatchford, supra, at 786, n. 4, 111 S.Ct., at 2585, n. 4 ("The fact that Congress grants jurisdiction to hear a claim does not suffice to show Congress has abrogated all defenses to that claim") (emphases deleted). Rather, as we said in Dellmuth v. Muth, 491 U.S. 223, 109 S.Ct. 2397, 105 L.Ed.2d 181 (1989), "To temper Congress' acknowledged powers of abrogation with due concern for the Eleventh Amendment's role as an essential component of our constitutional structure, we have applied a simple but stringent test: 'Congress may abrogate the States' constitutionally secured immunity from suit in federal court only by making its intention unmistakably clear in the language of the statute.'" Id., at
227-228, 109 S.Ct., at 2399-2400....

Here, we agree with the parties, with the Eleventh Circuit in the decision below, 11 F.3d, at 1024, and with virtually every other court that has confronted the question that Congress has in § 2710(d)(7) provided an "unmistakably clear" statement of its intent to abrogate....

B

Having concluded that Congress clearly intended to abrogate the States' sovereign immunity through § 2710(d)(7), we turn now to consider whether the Act was passed "pursuant to a valid exercise of power." Green v. Mansour, 474 U.S., at 68, 106 S.Ct., at 425-426. Before we address that question here, however, we think it necessary first to define the scope of our inquiry.

Petitioner suggests that one consideration weighing in favor of finding the power to abrogate here is that the Act authorizes only prospective injunctive relief rather than retroactive monetary relief. But we have often made it clear that the relief sought by a plaintiff suing a State is irrelevant to the question whether the suit is barred by the Eleventh Amendment. See, e.g., Cory v. White, 457 U.S. 85, 90, 102 S.Ct. 2325, 2329, 72 L.Ed.2d 694 (1982) ("It would be a novel proposition indeed that the Eleventh Amendment does not bar a suit to enjoin the State itself simply because no money judgment is sought"). We think it follows a fortiori from this proposition that the type of relief sought is irrelevant to whether Congress has power to abrogate States' immunity. The Eleventh Amendment does not exist solely in order to "prevent federal court judgments that must be paid out of a State's treasury," Hess v. Port Authority Trans-Hudson Corporation, 513 U.S. ----, 115 S.Ct. 394, 404, 130 L.Ed.2d 245 (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," Puerto Rico Aqueduct and Sewer Authority, 506 U.S., at 146, 113 S.Ct., at 689 (internal quotation marks omitted)....

Thus our inquiry into whether Congress has the power to abrogate unilaterally the States' immunity from suit is narrowly focused on one question: Was the Act in question passed pursuant to a constitutional provision granting Congress the power to abrogate? See, e.g., Fitzpatrick v. Bitzer, 427 U.S. 445, 452-456, 96 S.Ct. 2666, 2669-2671, 49 L.Ed.2d 614 (1976). Previously, in conducting that inquiry, we have found authority to abrogate under only two provisions of the Constitution. In Fitzpatrick, we recognized that the Fourteenth Amendment, by expanding federal power at the expense of state autonomy, had fundamentally altered the balance of state and federal power struck by the Constitution. Id., at 455, 96 S.Ct., at 2671. We noted that § 1 of the Fourteenth Amendment contained prohibitions expressly directed at the States and that § 5 of the Amendment expressly provided that "The Congress shall have the power to enforce, by appropriate legislation, the provisions of this article." See id., at 453, 96 S.Ct., at 2670 (internal quotation marks omitted). We held that through the Fourteenth Amendment, federal power extended to intrude upon the province of the Eleventh Amendment and therefore
that § 5 of the Fourteenth Amendment allowed Congress to abrogate the immunity from suit guaranteed by that Amendment.

In only one other case has congressional abrogation of the States' Eleventh Amendment immunity been upheld. In Pennsylvania v. Union Gas Co., 491 U.S. 1, 109 S.Ct. 2273, 105 L.Ed.2d 1 (1989), a plurality of the Court found that the Interstate Commerce Clause, Art. I, § 8, cl. 3, granted Congress the power to abrogate state sovereign immunity, stating that the power to regulate interstate commerce would be "incomplete without the authority to render States liable in damages." Union Gas, 491 U.S., at 19-20, 109 S.Ct., at 2284. Justice White added the fifth vote necessary to the result in that case, but wrote separately in order to express that he "[di]d not agree with much of [the plurality's] reasoning." Id., at 57, 109 S.Ct., at 2296 (White, J., concurring in judgment in part and dissenting in part).

In arguing that Congress through the Act abrogated the States' sovereign immunity, petitioner does not challenge the Eleventh Circuit's conclusion that the Act was passed pursuant to neither the Fourteenth Amendment nor the Interstate Commerce Clause. Instead, accepting the lower court's conclusion that the Act was passed pursuant to Congress' power under the Indian Commerce Clause, petitioner now asks us to consider whether that clause grants Congress the power to abrogate the States' sovereign immunity.

Petitioner begins with the plurality decision in Union Gas and contends that "[t]here is no principled basis for finding that congressional power under the Indian Commerce Clause is less than that conferred by the Interstate Commerce Clause." Brief for Petitioner 17. Noting that the Union Gas plurality found the power to abrogate from the "plenary" character of the grant of authority over interstate commerce, petitioner emphasizes that the Interstate Commerce Clause leaves the States with some power to regulate, see, e.g., West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 114 S.Ct. 2205, 129 L.Ed.2d 157 (1994), whereas the Indian Commerce Clause makes "Indian relations ... the exclusive province of federal law." County of Oneida v. Oneida Indian Nation of N.Y., 470 U.S. 226, 234, 105 S.Ct. 1245, 1251, 84 L.Ed.2d 169 (1985). Contending that the Indian Commerce Clause vests the Federal Government with "the duty of protect[ing]" the tribes from "local ill feeling" and "the people of the States," United States v. Kagama, 118 U.S. 375, 383-384, 6 S.Ct. 1109, 1113-1114, 30 L.Ed. 228 (1886), petitioner argues that the abrogation power is necessary "to protect the tribes from state action denying federally guaranteed rights." Brief for Petitioner 20....

Following the rationale of the Union Gas plurality, our inquiry is limited to determining whether the Indian Commerce Clause, like the Interstate Commerce Clause, is a grant of authority to the Federal Government at the expense of the States. The answer to that question is obvious. If anything, the Indian Commerce Clause accomplishes a greater transfer of power from the States to the Federal Government than does the Interstate Commerce Clause. This is clear enough from the fact that the States still exercise some authority over interstate trade but have been divested of virtually all authority over Indian commerce and Indian tribes. Under the
rationale of Union Gas, if the States' partial cession of authority over a particular area includes cession of the immunity from suit, then their virtually total cession of authority over a different area must also include cession of the immunity from suit. See Union Gas, supra, at 42, 109 S.Ct., at 2303 (SCALIA, J., joined by REHNQUIST, C.J., and O'CONNOR and KENNEDY, JJ., dissenting) ("[i]f the Article I commerce power enables abrogation of state sovereign immunity, so do all the other Article I powers"); see Ponca Tribe of Oklahoma v. Oklahoma, 37 F.3d 1422, 1428 (C.A.10 1994) (Indian Commerce Clause grants power to abrogate), cert. pending, No. 94-1029; Cheyenne River Sioux Tribe v. South Dakota, 3 F.3d 273, 281 (C.A.8 1993) (same); cf. Chavez v. Arte Publico Press, 59 F.3d 539, 546-547 (C.A.5 1995) (After Union Gas, Copyright Clause, U.S. Const., Art. I, § 8, cl. 8, must grant Congress power to abrogate). We agree with the petitioner that the plurality opinion in Union Gas allows no principled distinction in favor of the States to be drawn between the Indian Commerce Clause and the Interstate Commerce Clause.

Respondents argue, however, that we need not conclude that the Indian Commerce Clause grants the power to abrogate the States' sovereign immunity. Instead, they contend that if we find the rationale of the Union Gas plurality to extend to the Indian Commerce Clause, then "Union Gas should be reconsidered and overruled." Brief for Respondents 25. Generally, the principle of stare decisis, and the interests that it serves, viz., "the evenhanded, predictable, and consistent development of legal principles, ... reliance on judicial decisions, and ... the actual and perceived integrity of the judicial process," Payne v. Tennessee, 501 U.S. 808, 827, 111 S.Ct. 2597, 2609, 115 L.Ed.2d 720 (1991), counsel strongly against reconsideration of our precedent. Nevertheless, we always have treated stare decisis as a "principle of policy," Helvering v. Hallock, 309 U.S. 106, 119, 60 S.Ct. 444, 451, 84 L.Ed. 604 (1940), and not as an "inexorable command," Payne, 501 U.S., at 828, 111 S.Ct., at 2609. "[W]hen governing decisions are unworkable or are badly reasoned, 'this Court has never felt constrained to follow precedent.' " Id., at 827, 111 S.Ct., at 2609 (quoting Smith v. Allwright, 321 U.S. 649, 665, 64 S.Ct. 757, 765, 88 L.Ed. 987 (1944)). Our willingness to reconsider our earlier decisions has been "particularly true in constitutional cases, because in such cases 'correction through legislative action is practically impossible.' " Payne, supra, at 828, 111 S.Ct., at 2600, (quoting Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 407, 52 S.Ct. 443, 447, 76 L.Ed. 815 (1932) (Brandeis, J., dissenting)).

The Court in Union Gas reached a result without an expressed rationale agreed upon by a majority of the Court. We have already seen that Justice Brennan's opinion received the support of only three other Justices. See Union Gas, 491 U.S., at 5, 109 S.Ct., at 2275-2276 (MARSHALL, BLACKMUN, and STEVENS, JJ., joined Justice BRENNAN). Of the other five, Justice WHITE, who provided the fifth vote for the result, wrote separately in order to indicate his disagreement with the majority's rationale, id., at 57, 109 S.Ct., at 2296 (WHITE, J., concurring in judgment and dissenting in part), and four Justices joined together in a dissent that rejected the plurality's rationale. Id., at 35-45, 109 S.Ct., at 2298-2304 (SCALIA, J., dissenting, joined by REHNQUIST, C.J., and O'CONNOR and KENNEDY, JJ.). Since it was issued, Union Gas has created confusion among the lower courts that have sought to understand and
apply the deeply fractured decision. See, e.g., Chavez v. Arte Publico Press, supra, at 543-545 ("Justice White's concurrence must be taken on its face to disavow" the plurality's theory); 11 F.3d, at 1027 (Justice White's "vague concurrence renders the continuing validity of Union Gas in doubt").

The plurality's rationale also deviated sharply from our established federalism jurisprudence and essentially eviscerated our decision in Hans. See Union Gas, supra, at 36, 109 S.Ct., at 2299 ("If Hans means only that federal-question suits for money damages against the States cannot be brought in federal court unless Congress clearly says so, it means nothing at all") (SCALIA, J., dissenting). It was well established in 1989 when Union Gas was decided that the Eleventh Amendment stood for the constitutional principle that state sovereign immunity limited the federal courts' jurisdiction under Article III. The text of the Amendment itself is clear enough on this point: "The Judicial power of the United States shall not be construed to extend to any suit...." And our decisions since Hans had been equally clear that the Eleventh Amendment reflects "the fundamental principle of sovereign immunity [that] limits the grant of judicial authority in Article III," Pennhurst State School and Hospital v. Halderman, 465 U.S. 89, 97-98, 104 S.Ct. 900, 906, 79 L.Ed.2d 67 (1984); see Union Gas, supra, at 38, 109 S.Ct., at 2301, ("'[T]he entire judicial power granted by the Constitution does not embrace authority to entertain a suit brought by private parties against a State without consent given ...'" (SCALIA, J., dissenting) (quoting Ex parte New York, 256 U.S. 490, 497, 41 S.Ct. 588, 589, 65 L.Ed. 1057 (1921)); see also cases cited at n. 7, supra. As the dissent in Union Gas recognized, the plurality's conclusion—that Congress could under Article I expand the scope of the federal courts' jurisdiction under Article III—"contradict[ed] our unvarying approach to Article III as setting forth the exclusive catalog of permissible federal court jurisdiction." Union Gas, 491 U.S., at 39, 109 S.Ct., at 2301....

In the five years since it was decided, Union Gas has proven to be a solitary departure from established law. See Puerto Rico Aqueduct and Sewer Authority v. Metcalf & Eddy, Inc., 506 U.S. 139, 113 S.Ct. 684, 121 L.Ed.2d 605 (1993). Reconsidering the decision in Union Gas, we conclude that none of the policies underlying stare decisis require our continuing adherence to its holding. The decision has, since its issuance, been of questionable precedential value, largely because a majority of the Court expressly disagreed with the rationale of the plurality. See Nichols v. United States, 511 U.S. 738, ---, 114 S.Ct. 2121, 1927, 128 L.Ed.2d 745 (1994) (the "degree of confusion following a splintered decision ... is itself a reason for reexamining that decision"). The case involved the interpretation of the Constitution and therefore may be altered only by constitutional amendment or revision by this Court. Finally, both the result in Union Gas and the plurality's rationale depart from our established understanding of the Eleventh Amendment and undermine the accepted function of Article III. We feel bound to conclude that Union Gas was wrongly decided and that it should be, and now is, overruled.

The dissent makes no effort to defend the decision in Union Gas, see post at 1145, but nonetheless would find congressional power to abrogate in this case. Contending that our
decision is a novel extension of the Eleventh Amendment, the dissent chides us for "attend[ing]" to dicta. We adhere in this case, however, not to mere obiter dicta, but rather to the well-established rationale upon which the Court based the results of its earlier decisions. When an opinion issues for the Court, it is not only the result but also those portions of the opinion necessary to that result by which we are bound. Cf. Burnham v. Superior Court of Cal., County of Marin, 495 U.S. 604, 613, 110 S.Ct. 2105, 2112, 109 L.Ed.2d 631 (1990) (exclusive basis of a judgment is not dicta) (plurality); Allegheny County v. American Civil Liberties Union, Greater Pittsburgh Chapter, 492 U.S. 573, 668, 109 S.Ct. 3086, 3141, 106 L.Ed.2d 472 (1989) ("As a general rule, the principle of stare decisis directs us to adhere not only to the holdings of our prior cases, but also to their explications of the governing rules of law.") (KENNEDY, J., concurring and dissenting); Sheet Metal Workers v. EEOC, 478 U.S. 421, 490, 106 S.Ct. 3019, 3057, 92 L.Ed.2d 344 (1986) ("Although technically dicta, ... an important part of the Court's rationale for the result that it reach[es] ... is entitled to greater weight ...") (O'CONNOR, J., concurring). For over a century, we have grounded our decisions in the oft-repeated understanding of state sovereign immunity as an essential part of the Eleventh Amendment. In Principality of Monaco v. Mississippi, 292 U.S. 313, 54 S.Ct. 745, 78 L.Ed. 1282 (1934), the Court held that the Eleventh Amendment barred a suit brought against a State by a foreign state. Chief Justice Hughes wrote for a unanimous Court:

"[N]either the literal sweep of the words of Clause one of § 2 of Article III, nor the absence of restriction in the letter of the Eleventh Amendment, permits the conclusion that in all controversies of the sort described in Clause one, and omitted from the words of the Eleventh Amendment, a State may be sued without her consent. Thus Clause one specifically provides that the judicial power shall extend 'to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority.' But, although a case may arise under the Constitution and laws of the United States, the judicial power does not extend to it if the suit is sought to be prosecuted against a State, without her consent, by one of her own citizens...."

"Manifestly, we cannot rest with a mere literal application of the words of § 2 of Article III, or assume that the letter of the Eleventh Amendment exhausts the restrictions upon suits against non-consenting States. Behind the words of the constitutional provisions are postulates which limit and control. There is the essential postulate that the controversies, as contemplated, shall be found to be of a justiciable character. There is also the postulate that States of the Union, still possessing attributes of sovereignty, shall be immune from suits, without their consent, save where there has been a 'surrender of this immunity in the plan of the convention.'"

Id., at 321-323, 54 S.Ct., at 747-748 (citations and footnote omitted); see id. at 329-330, 54 S.Ct., at 750-751; see also Pennhurst, 465 U.S., at 98, 104 S.Ct., at 906-907 ("In short, the
principle of sovereign immunity is a constitutional limitation on the federal judicial power established in Art. III"); Ex parte New York, 256 U.S., at 497, 41 S.Ct., at 589 ("[T]he entire judicial power granted by the Constitution does not embrace authority to entertain a suit brought by private parties against a State without consent given ... "). It is true that we have not had occasion previously to apply established Eleventh Amendment principles to the question whether Congress has the power to abrogate state sovereign immunity (save in Union Gas). But consideration of that question must proceed with fidelity to this century-old doctrine.

The dissent, to the contrary, disregards our case law in favor of a theory cobbled together from law review articles and its own version of historical events. The dissent cites not a single decision since Hans (other than Union Gas) that supports its view of state sovereign immunity, instead relying upon the now-discredited decision in Chisholm v. Georgia, 2 Dall. 419, 1 L.Ed. 440 (1793). See, e.g., post, at ---- n. 47. Its undocumented and highly speculative extralegal explanation of the decision in Hans is a disservice to the Court's traditional method of adjudication. See post, at 1154-1156.

The dissent mischaracterizes the Hans opinion. That decision found its roots not solely in the common law of England, but in the much more fundamental "jurisprudence in all civilized nations." Hans, 134 U.S., at 17, 10 S.Ct., at 508, quoting Beers v. Arkansas, 20 How. 527, 529, 15 L.Ed. 991 (1858); see also The Federalist No. 81, p. 487 (C. Rossiter ed. 1961) (A. Hamilton) (sovereign immunity "is the general sense and the general practice of mankind"). The dissent's proposition that the common law of England, where adopted by the States, was open to change by the legislature, is wholly unexceptionable and largely beside the point: that common law provided the substantive rules of law rather than jurisdiction. Cf. Monaco, supra, at 323, 54 S.Ct., at 748 (state sovereign immunity, like the requirement that there be a "justiciable" controversy, is a constitutionally grounded limit on federal jurisdiction). It also is noteworthy that the principle of state sovereign immunity stands distinct from other principles of the common law in that only the former prompted a specific constitutional amendment.

Hans—with a much closer vantage point than the dissent—recognized that the decision in Chisholm was contrary to the well-understood meaning of the Constitution. The dissent's conclusion that the decision in Chisholm was "reasonable," post, at 1148, certainly would have struck the Framers of the Eleventh Amendment as quite odd: that decision created "such a shock of surprise that the Eleventh Amendment was at once proposed and adopted." Monaco, supra, at 323, 54 S.Ct., at 749. The dissent's lengthy analysis of the text of the Eleventh Amendment is directed at a straw man—we long have recognized that blind reliance upon the text of the Eleventh Amendment is "to strain the Constitution and the law to a construction never imagined or dreamed of." Monaco, 292 U.S., at 326, 54 S.Ct., at 749, quoting Hans, 134 U.S., at 15, 10 S.Ct., at 507. The text dealt in terms only with the problem presented by the decision in Chisholm; in light of the fact that the federal courts did not have federal question jurisdiction at the time the Amendment was passed (and would not have it until 1875), it seems unlikely that much thought was given to the prospect of federal question jurisdiction over the States.
That same consideration causes the dissent's criticism of the views of Marshall, Madison, and Hamilton to ring hollow. The dissent cites statements made by those three influential Framers, the most natural reading of which would preclude all federal jurisdiction over an unconsenting State. Struggling against this reading, however, the dissent finds significant the absence of any contention that sovereign immunity would affect the new federal-question jurisdiction. Post, at 1165-1169. But the lack of any statute vesting general federal question jurisdiction in the federal courts until much later makes the dissent's demand for greater specificity about a then-dormant jurisdiction overly exacting.

In putting forward a new theory of state sovereign immunity, the dissent develops its own vision of the political system created by the Framers, concluding with the statement that "[t]he Framer's principal objectives in rejecting English theories of unitary sovereignty ... would have been impeded if a new concept of sovereign immunity had taken its place in federal question cases, and would have been substantially thwarted if that new immunity had been held untouchable by any congressional effort to abrogate it." [FN14] Post, at 1172. This sweeping statement ignores the fact that the Nation survived for nearly two centuries without the question of the existence of such power ever being presented to this Court. And Congress itself waited nearly a century before even conferring federal question jurisdiction on the lower federal courts. [FN15]

FN14. This argument wholly disregards other methods of ensuring the States' compliance with federal law: the Federal Government can bring suit in federal court against a State, see, e.g., United States v. Texas, 143 U.S. 621, 644-645, 12 S.Ct. 488, 493, 36 L.Ed. 285 (1892) (finding such power necessary to the "permanence of the Union"); an individual can bring suit against a state officer in order to ensure that the officer's conduct is in compliance with federal law, see, e.g., Ex parte Young, 209 U.S. 123, 28 S.Ct. 441, 52 L.Ed. 714 (1908); and this Court is empowered to review a question of federal law arising from a state court decision where a State has consented to suit, see, e.g., Cohens v. Virginia, 6 Wheat. 264, 5 L.Ed. 257 (1821).

FN15. Justice STEVENS, in his dissenting opinion, makes two points that merit separate response. First, he contends that no distinction may be drawn between state sovereign immunity and the immunity enjoyed by state and federal officials. But even assuming that the latter has no constitutional foundation, the distinction is clear: the Constitution specifically recognizes the States as sovereign entities, while government officials enjoy no such constitutional recognition. Second, Justice STEVENS' criticizes our prior decisions applying the "clear statement rule," suggesting that they were based upon an understanding that Article I allowed Congress to abrogate state sovereign immunity. His criticism, however, ignores the fact that many of those cases arose in the context of a statute passed under the Fourteenth Amendment, where Congress' authority to abrogate is undisputed. See, e.g., Quern v. Jordan, 440 U.S. 332, 99 S.Ct. 1139, 59 L.Ed.2d 358 (1979). And a more fundamental flaw of the criticism is its failure to recognize that both
the doctrine requiring avoidance of constitutional questions, and principles of federalism, require us always to apply the clear statement rule before we consider the constitutional question whether Congress has the power to abrogate.

In overruling Union Gas today, we reconfirm that the background principle of state sovereign immunity embodied in the Eleventh Amendment is not so ephemeral as to dissipate when the subject of the suit is an area, like the regulation of Indian commerce, that is under the exclusive control of the Federal Government. 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. [FN16] 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. Petitioner's suit against the State of Florida must be dismissed for a lack of jurisdiction.

FN16. Justice STEVENS understands our opinion to prohibit federal jurisdiction over suits to enforce the bankruptcy, copyright, and antitrust laws against the States. He notes that federal jurisdiction over those statutory schemes is exclusive, and therefore concludes that there is "no remedy" for state violations of those federal statutes....

That conclusion is exaggerated both in its substance and in its significance. First, Justice STEVENS' statement is misleadingly overbroad. We have already seen that several avenues remain open for ensuring state compliance with federal law.... Most notably, an individual may obtain injunctive relief under Ex parte Young in order to remedy a state officer's ongoing violation of federal law....

Contrary to the implication of Justice STEVENS' conclusion, 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 statutory schemes; in the decision of this Court that Justice STEVENS cites (and somehow labels "incompatible" with our decision here), we specifically reserved the question whether the Eleventh Amendment would allow a suit to enforce the antitrust laws against a State. See Goldfarb v. Virginia State Bar, 421 U.S. 773, 792 n. 22, 95 S.Ct. 2004, 2015 n. 22, 44 L.Ed.2d 572 (1975). Although the copyright and bankruptcy laws have existed practically since our nation's inception, and the antitrust laws have been in force for over a century, there is no established tradition in the lower federal courts of allowing enforcement of those federal statutes against the States. Notably, both Court of Appeals decisions cited by Justice STEVENS were issued last year and were based upon Union Gas. See Chavez v. Arte Publico Press, 59 F.3d 539 (C.A.5 1995); Matter of Merchants Grain, Inc., 59 F.3d 630 (C.A.7 1995). Indeed, while the Court of Appeals in Chavez allowed the suit against the State to go forward, it expressly recognized that its holding was unprecedented. See Chavez, 59 F.3d at 546 ("we are aware of no case that specifically holds that laws passed pursuant to the Copyright Clause can abrogate state
immunity")....

It is so ordered.

Justice STEVENS, dissenting.

This case is about power—the power of the Congress of the United States to create a private federal cause of action against a State, or its Governor, for the violation of a federal right. In Chisholm v. Georgia, 2 Dall. 419, 1 L.Ed. 440 (1793), the entire Court—including Justice Iredell whose dissent provided the blueprint for the Eleventh Amendment—assumed that Congress had such power. In Hans v. Louisiana, 134 U.S. 1, 10 S.Ct. 504, 33 L.Ed. 842 (1890)—a case the Court purports to follow today—the Court again assumed that Congress had such power. In Fitzpatrick v. Bitzer, 427 U.S. 445, 96 S.Ct. 2666, 49 L.Ed.2d 614 (1976), and Pennsylvania v. Union Gas Co., 491 U.S. 1, 24, 109 S.Ct. 2273, 2287, 105 L.Ed.2d 1 (1989) (STEVENS, J., concurring), the Court squarely held that Congress has such power. In a series of cases beginning with Atascadero State Hospital v. Scanlon, 473 U.S. 234, 238-239, 105 S.Ct. 3142, 3145-3146, 87 L.Ed.2d 171 (1985), the Court formulated a special "clear statement rule" to determine whether specific Acts of Congress contained an effective exercise of that power. Nevertheless, in a sharp break with the past, today the Court holds that with the narrow and illogical exception of statutes enacted pursuant to the Enforcement Clause of the Fourteenth Amendment, Congress has no such power.

The importance of the majority's decision to overrule the Court's holding in Pennsylvania v. Union Gas Co. cannot be overstated. 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. [FN1]

FN1. See, e.g., Pennsylvania v. Union Gas Co., 491 U.S. 1, 109 S.Ct. 2273, 105 L.Ed.2d 1 (1989) (holding that a federal court may order a State to pay clean-up costs pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980); In re Merchants Grain, Inc., 59 F.3d 630 (C.A.7 1995) (holding that the Eleventh Amendment does not bar a bankruptcy court from issuing a money judgment against a State under the Bankruptcy Code); Chavez v. Arte Publico Press, 59 F.3d 539 (C.A.5 1995) (holding that a state university could be sued in federal court for infringing an author's copyright). The conclusion that suits against States may not be brought in federal court is also incompatible with our cases concluding that state entities may be sued for antitrust violations. See, e.g., Goldfarb v. Virginia State Bar, 421 U.S. 773, 791-792, 95 S.Ct. 2004, 2015-2016, 44 L.Ed.2d 572 (1975).
As federal courts have exclusive jurisdiction over cases arising under these federal laws, the majority's conclusion that the Eleventh Amendment shields States from being sued under them in federal court suggests that persons harmed by state violations of federal copyright, bankruptcy, and antitrust laws have no remedy. See Harris & Kenny, Eleventh Amendment Jurisprudence After Atascadero: The Coming Clash With Antitrust, Copyright, and Other Causes of Action Over Which the Federal Courts Have Exclusive Jurisdiction, 37 Emory L.J. 645 (1988).

There may be room for debate over whether, in light of the Eleventh Amendment, Congress has the power to ensure that such a cause of action may be enforced in federal court by a citizen of another State or a foreign citizen. There can be no serious debate, however, over whether Congress has the power to ensure that such a cause of action may be brought by a citizen of the State being sued. Congress' authority in that regard is clear....
SEMINOLE TRIBE OF FLORIDA v. FLORIDA:
ISSUES/QUESTIONS:

I. The 11th Amendment:
   A. Bars suits against nonconsenting states in federal court
   B. Is a constitutional limitation on subject matter of jurisdiction of federal courts
   C. Exclusions:
      1. Suits which seek prospective injunctive relief--Ex Parte Young, 209 U.S. 123 (1908)
      2. Federal court can have jurisdiction if Congress has validly abrogated sovereign immunity or state has waived it

II. Congress' power to abrogate a state's sovereign immunity--§5 of 14th Amendment--intent must be "unmistakenly clear in language of statute".
   A. Former §106(a) unconstitutional because intent to abrogate unclear
   C. Seminole Tribe of Florida v. Florida, 116 S.Ct. 1114 (1996)--Congress cannot use Article I powers to abrogate 11th Amendment immunity and therefore, §106(a)'s purported abrogation per Article I (and not §5 of 14th A) is not constitutional. In re Tri-City Turf Club, Inc., 30 B.C.D. 81 (Bkrtcy E.D. Ky. 1996)

III. The Seminole Decision
   A. The facts--it's not a bankruptcy case. Gaming Act (federal law) authorized Indian tribes to bring suit against state in federal court to force a "compact" (and good faith negotiations) regarding gaming activities within the state.
   B. The holding--11th Amendment prevents Congress, pursuant to Article I, from subjecting nonconsenting states to suits by private parties in federal court--provision in Gaming Act which permitted such a suit was unconstitutional.
      1. Majority read 11th Amendment as a limitation on judicial power conferred in Article III
      2. Dissent--common-law doctrine subject to congressional override
IV. **Seminole** Impact on Section 106 (11 U.S.C. § 106)

A. §106 undisturbed as to:

1. All governmental units (11 U.S.C. §101(27)) other than states

2. §106 validly waives suit against federal government, foreign governments, counties and municipal agencies


B. §106 unconstitutional as to suits against unconsenting states in federal court which appear to be authorized by Article I. Prohibition exists irregardless of:

1. Remedy sought

2. Jurisdictional basis of suit

3. Which Article I power is being exercised

C. Effect of invalidity—Inequality—only states have this special protection—undermines bankruptcy of a single forum for all claims/issues

1. Immunity only exists in federal court suits—not in state court

2. Immunity is only for a non-consenting state

3. Immunity does not always extend to state officials

4. No immunity for suits against states by federal officials

V. Remedies Alive

A. Bankruptcy Courts have non-exclusive jurisdiction over suits which arise in, under or relate to title 11 cases (28 U.S.C. § 1334); therefore, state courts have concurrent jurisdiction.

1. Issues: longer to try?, less convenient?, less (any?) expertise in bankruptcy?, bias against debtors?

2. Does state have to consent?

   a. If not, Congress can create a federal remedy against states in state court, i.e., create federal remedies against non-consenting states; see Hilton v. South Carolina Public Railroad Commission, 502 U.S. 197 (1991)
b. §106 can be read to be a congressional act creating a federal remedy against state if brought in state court; i.e., a clear statement by Congress of intent to impose monetary liability on states.

3. Cf. In re: Wilkerson (Bank One, Lexington v. Mark Wayne Wilkerson), Case No. 93-10015(1)(7), Adv. No. 96-1020 (Bkrtcy. W.D. Ky. 1996) (Stay violation action couched in terms of malicious prosecution which was removed to bankruptcy court is remanded in deference to plaintiff's choice of state law remedies)

VI. Consent/Waiver--11th Amendment "shield" only applies to non-consenting states

1. Consent to suit in state court is not consent to suit in federal court

2. 11th Amendment cannot be waived by inaction--can be raised for first time on appeal because of subject matter jurisdiction (but see, State of Maryland v. Antonelli Creditors' Liquidating Trust, 1997 W.L. 523681 (4th Cir. (Md.)); Cf. In re: Kish, 1997WL 4719.11 (D.N.J.) (no jurisdiction over nondischargeability action against state agency even though state agency appeared in the adversary proceeding, sought and received summary judgment).

3. Recoupment--11th Amendment waived to offset state's claim made in federal court arising out of same event. See e.g., In re: Koehler, 30 B.C.D. 176 (Bkrtcy. D. Minn. 1997)

A. Asserted in defensive posture

B. No affirmative recovery

C. Cf. 11 U.S.C. § 106(b)--permits affirmative recovery

D. Cf. 11 U.S.C. § 106(c)--not limited to same event/transaction

4. Filing proof of claim--constructive consent? (state is deemed to consent to suit in federal court if it voluntarily engages in some activity that Congress has said could lead to liability of state in federal court, i.e., § 106(b) and (c))

a. Is filing a proof of claim really a voluntary act?

1. Bar date

2. No other forum

5. Filing Proof of Claim--immunity waived as to compulsory counterclaims?
a. How "related" do claims have to be? -- FRCP 13(a) standard?


6. Who has the authority to waive 11th Amendment Immunity, i.e., does the state agency/actor which filed the Proof of Claim or entered the appearance have the authority to effectuate a waiver? Compare, In the Matter of Midland Mechanical Contractors, Inc., 200 B.R. 453 (Bkrtcy. N.D. Ga. 1996) with In re: Headrick, 200 B.R. 963 (Bkrtcy. S.D. Ga. 1996).

7. Suit against state officials (instead of the state)

a. No suit against state actor is his/her "official capacity" as it will impose damages on the state agency he/she represents

b. Ex parte Young exception: suits against state officials for prospective relief

1. But Seminole's holding against the governor for injunctive relief was barred. 116 S.Ct. 1114, 1133 (Gaming Act allowed limited liability against the state and the Court concluded that Congress did not intend to impose greater liability on the state actor)

2. Can a trustee seek injunctive against state tax collector to prevent collection of discharged taxes? Remedial scheme in Bankruptcy Code is much broader than that in the Gaming Act--Seminole's result can be distinguished (or did the Supreme Court intend to abrogate entire Ex parte Young exception?). See e.g., In the Matter of Guiding Light Corp., (Bkrtcy E.D. La. 1997).

3. Application to discharge order? confirmation order?
DISCUSSION HYPOTHETICALS

1.

Debtor's confirmed Chapter 11 plan provides that substantially all of Debtor's property must be transferred to Trust for liquidation as rapidly as market conditions will allow. State wishes to impose real estate transfer taxes on all transfers from Debtor to the trust and from the trust to subsequent purchasers. Accordingly, State files suit in state court against both the trust and purchasers to recover unpaid transfer and recording fees. Trust removes this action to the U.S. District Court.

Trust next moves to dismiss State's claims, arguing that the imposition of all taxes is prohibited both by statute and by the express terms of the confirmed reorganization plan. At this point, State, relying on Seminole, argues that it is not bound by the terms of the confirmed plan and requests that the litigation be remanded to state court. Assume that State had notice of, and did not participate in, the confirmation hearing. Assume also that the terms of the plan are authorized by §1123(c)(6) as an "appropriate provision" and/or §1146(c), How should the court rule? Cf. State of Maryland v. Antonelli Liquidating Trust, 123 F.3d 777 (4th Cir. 1997).

2.

Following the commencement of Chapter 13 Proceedings, State decertifies Debtor as a DBE (disadvantaged business enterprise) with special eligibility to bid on state highway projects. Debtor's Attorney believes that the state action violates both §525(a) and §362(a)(3). Do you agree? If Attorney is right, what type of legal action is appropriate? Cf. Wyoming Dept. of Transportation v. Straight (In re Straight), 209 B.R. 540 (D.C.D.Wyo. 1997).

3.

Following the receipt of a Chapter 7 discharge, Debtor sought restoration of her driver's license which had been suspended after her failure to (1) pay motor vehicle surcharges for an alcohol related conviction under state law and (2) fines for other municipal offenses. The driving license was restored but the Department of Motor Vehicles (DMV) has continued to demand payment of the surcharges. Debtor now seeks (1) a declaratory judgment that her insurance surcharges are discharged, (2) a declaratory judgment that the post-discharge collection attempts violated §524 and the discharge injunction, (3) an injunction prohibiting any further collection activity by either the DMV, the administrator of the state-created insurance fund, or the municipalities. What relief, if any, if appropriate? Cf. Kish v. Verniero (In re Kish), 212 B.R. 808 (D.C.D.N.J., 1997).

4.

Trustee commences an adversary proceeding seeking to avoid the allegedly preferential payment of state income taxes within 90 days of bankruptcy. While State has not filed a claim for these taxes, it has filed a claim for unpaid sales and withholding taxes. State moves for dismissal, arguing that the preference action is barred by the 11th Amendment. Trustee responds that State has waived its immunity by filing its proof of claim. What result? Cf. Schlossberg v. State of Maryland (In re Creative Goldsmiths of Washington, D.C., Inc.), 119 F.3d 1140 (4th Cir. 1997).
5.

Review the facts of Hypothetical #1. Assume that the District Court has granted State's motion to remand the litigation to state court. Debtor would like to discourage State from assessing taxes on future sales by Trust. Any suggestions concerning strategy?
ADDITIONAL READING:

Patricia Barsalou, Defining the Limits of Federal Court Jurisdiction Over States in Bankruptcy Court, 28 St. Mary's L.J. 575 (1997).


CASE LAW:

1. Matter of Estate of Fernandez, --- F.3d ----, 1997 WL 570353 (5th Cir. (La.), Sep 15, 1997) (No. 96-31013, 97-30529)


10. 9th Ave Remedial Group, 962 F.Supp 131


17. In re Crispo, 1997 WL 258482 (Bankr. S.D. N.Y., May 13, 1997) (No. 96 B 42570 (JLG), 97/8164A


23. In re Kobler, 204 B.R. 210


THE THEORY, REALITY AND PRAGMATISM OF CORPORATE GOVERNANCE IN BANKRUPTCY REORGANIZATIONS

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SECTION C
# THE THEORY, REALITY AND PRAGMATISM OF CORPORATE GOVERNANCE IN BANKRUPTCY

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SECTION C
I. INTRODUCTION

Governing a corporation during a Chapter 11 reorganization presents a special case of the age old problem of the separation of ownership and control. Critics of Chapter 11 have long pointed to the insulation provided by the automatic stay to managers of the business as one of the causes of bankruptcy inefficiency. Protected from the normal contractual and market forces that restrain the behavior of managers of healthy companies, managers of firms in bankruptcy, the harshest critics charge, use delay and other strategies to enrich themselves and the shareholders at the expense of the firm's creditors.

These charges echo those leveled in corporate law debates about the responsiveness of managers to the concerns of shareholders and, more recently, about the behavior of...
corporate managers of companies involved in leveraged buyouts. Disputes over the constituencies that managers should serve and the efficacy of such institutional controls as fiduciary duties, contract, and the market in controlling managers behavior continue unabated, resulting in a rich literature of corporate governance that accounts for a wide range of views. Drawing from this literature, many bankruptcy scholars have turned their attention to the unique corporate governance problems that Chapter 11 raises. By examining the economic principles underlying the non-bankruptcy governance structure, these commentators have propounded theories that seek to align the Chapter 11 governance structure with its non-bankruptcy counterpart.

As compelling as such theories may seem outside of bankruptcy, they tend to fall apart in the context of a Chapter 11. The financial reverses precipitating the filing, the need to attend to the day to day business problems and the desire for a speedy and inexpensive resolution of the problems often render the bankruptcy governance structure ineffective, resulting in a free-for-all in which strategic behavior is the order of the day. This specter is more likely in small bankruptcies where the creditors have so little at stake that the traditional methods of control — creditors’ committees, motions to convert to Chapter 7 or to appoint a Chapter 11 trustee, termination of debtor exclusivity and the like — are impractical. In many cases, there is no one with the time and the incentive to assure that managers are not milking the case for their own benefit.

Bankruptcy lawyers and judges are a pragmatic lot, however. Status conferences, expedited procedures in small bankruptcies, the judicious use of examiners and, perhaps most importantly, control over the fees awarded debtor’s attorneys are pragmatic responses to the difficulties inherent in governing a corporation undergoing a Chapter 11 reorganization. In addition, the recent report of the National Bankruptcy Review

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Further complicating questions of bankruptcy governance, however, is the fact that governance questions are inextricably bound up in broader policy question regarding the goals Chapter 11 should seek to promote. Leaving managers in control of reorganizing businesses not only benefits the managers and the shareholders, it may also provide indirect benefits to such non-investor constituencies as employees, customers, suppliers and the surrounding community. To the extent the Chapter 11 process introduces delay in the ultimate liquidation of businesses without a realistic chance of reorganization, the benefits are shared by these stakeholders. Thus a governance system that errs in favor of attempting reorganization may be justifiable as a means through which redistributions from creditors to these stakeholders might be effected.

We are far from a consensus on the appropriate goals underlying Chapter 11. In general, we seem to expect that the process of rehabilitation will serve both the goals of maximizing the value of the business assets, thereby maximizing creditors’ returns, and restoring businesses to health so that they can continue to provide benefits to employees and other non-investor stakeholders. The problem is that meeting these two goals is often impossible when liquidation is the choice that maximizes the value of the business assets. This conflict, coupled with the usual lack of clarity regarding the likelihood that the business does have a positive going concern value, forces us to choose between a governance system that is biased in favor of liquidation and one that is biased in favor of reorganization.

This paper addresses the financial economic theories of corporate governance and isolates some of the principles underlying the non-bankruptcy corporate governance structure that bear on the problem of corporate governance in Chapter 11. Having established those theories as a basis for discussion, the paper then examines the practical limitations on the bankruptcy process resulting from creditor indifference and a lack of consensus regarding the goals of Chapter 11. The paper next examines some of the ways courts have responded to the intractable problems of running a Chapter 11 debtor focusing on their use of case management techniques, examiners and control over attorney’s fees. The paper concludes with a discussion of the National Bankruptcy Review Commission Report and Recommendations, discussing both the Commission’s practical governance recommendations and the Report’s evidence of a continued tension over the appropriate goals of Chapter 11.

II. THE THEORY OF BANKRUPTCY GOVERNANCE

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6 BANKRUPTCY THE NEXT 20 YEARS: NATIONAL BANKRUPTCY REVIEW COMMISSION FINAL REPORT (October 20, 1997) available at <http://www.nbrc.gov> (hereinafter, “NBRC REPORT”). The first 45 pages of the Report contains more than 170 recommendations. These recommendations will be referred to as “NRBC RECOMMENDATIONS.”
In its broadest sense, the term "corporate governance" refers to the regulation of decision making within the firm. Economic theory views the corporation as the central party to a set of contracts among providers of inputs to production. Corporate managers monitor compliance with these contracts and make decisions that fall within the inevitable gaps in the contracts. Thus at this high level of generality, the basic principle of corporate governance is simply that managers control most of the decisions that are not the subject of explicit contract.

It is here that the analysis starts to get interesting. Managers monitor the contractual relationships that comprise the firm but they themselves are in a contract relationship with the firm and, therefore must themselves be monitored. This observation raises two fundamental questions. First, who is in the best position to monitor managers — that is for whom do managers work? Second, how should that group accomplish and enforce its monitoring role? Passing familiarity with corporate law provides the commonplace answers. Managers owe their allegiance to the shareholders of the firm who effectuate their monitoring through their right to remove managers and through their enforcement of managers' fiduciary duties. This section examines the reasons underlying these two propositions and then looks at the effect the bankruptcy process has on those rationales.

A. The Non-Bankruptcy Corporate Governance Structure

The non-bankruptcy corporate governance structure is designed to resolve conflicts between the participants in the firm. The most basic of these conflicts arise from the differences in incentives that emerge once a corporation divides the claims to its assets between debt and equity. Issuing debt divides the claims on earnings and assets between fixed and residual claimants. Creditors trade a claim to the business' upside potential for a fixed, priority claim on the assets and the income stream. After the interest rate on the debt is fixed, creditors prefer that the corporation avoid projects that increase the risk of the

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7 The seminal paper on this "nexis of contracts" theory is Jensen and Meckling, supra note 3.

8 If parties could account for all contingencies in their contracts there would be no need for discretion. It is because contracting is costly that managers must exercise discretion over some corporate decisions. See Oliver Williamson, Corporate Governance, 93 Yale L.J. 1197, 1199 (1984) ("Matters would be vastly simplified if firms were small and if contracts between the corporation and each of its constituencies satisfied the paradigm of contracting within discrete markets, where each exchange can accurately be described as 'sharp in by clear agreement; sharp out by clear performance'.").


income stream since they bear some of the risk of failure but receive none of the higher returns. Shareholders, on the other hand, prefer projects that increase the risk of the corporation because they will capture all of the higher returns and are protected on the downside by the limited liability doctrine.  

Managers play a central role in the mediation of this conflict. Their control over the selection of business projects enables them to choose between satisfying the shareholders' appetite for risk and observing the creditor's distaste for such projects. The non-bankruptcy corporate governance structure is designed to provide a mixture of contractual, market and fiduciary constraints on managers' choices. The following discussion examines this structure and the economic principles supporting it in an effort to illuminate the tensions and principles underlying the bankruptcy governance structure.

1. Managerial Allegiance

The differences in their respective claims on corporate income create inherent conflicts between creditors and shareholders. Thus, the question of managerial allegiance is of more than theoretical interest. The existing law provides an allocation of control and allegiance that forms the backdrop against which participants in capital markets develop expectations and negotiate contracts. As a general rule creditors derive their protection against managerial and shareholder opportunism solely through contract. Shareholders have protections that are less specific but occasionally more powerful than those granted the creditors.  

Historically, the allocation of control rights is most likely due to the differences in the legal source of claims of shareholders and creditors. Characterized as the true owners of the corporate enterprise, shareholders lay claim to the equitable principles that underlie trust law. Since credit claims arise from contract, there is little room for a fiduciary analysis.

12 This allocation of control rights has been the subject of substantial scholarly criticism. Commentators have questioned the wisdom of the shareholder wealth maximization principle that underlies the rules that direct managers to resolve conflicts between the interests of shareholders and creditors in favor of the shareholders. See Rutheford B. Campbell, Jr. Corporate Fiduciary Principles for the Post-Contractarian Era, 23 FLA. STATE L. REV. 561, 599-606 (1996); Bratton, supra note 4, at 149-151; McDaniel, supra note 11, at 265-309.
13 See Harvey R. Miller Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent And Insolvent Corporations, 23 Seton Hall 1467, 1473 (1993) (hereinafter, “Corporate Governance”) (“This relationship of trust between directors and the corporation and its stockholders ‘springs from the fact that directors have the control and guidance of corporate business affairs and property and hence of the property interests of the
Economic analysis of the firm provides an alternative explanation that better illuminates the special problems involved in translating general principles of corporate governance into the bankruptcy forum.

In the solvent corporation the allocation to shareholders of control rights and managerial allegiance is justified by the status of shareholders as the residual claimants on the corporation's cash flow. So long as the corporation is solvent, business decisions made by managers directly affect the income of the shareholders. Shareholders stand to gain or lose depending on the efficacy of the managers. Thus, shareholders stand in the best economic position to monitor the decisions of managers. They have the most to gain or lose by managerial decisions.\(^{14}\)

The beauty of this simple explanation of the managerial allegiance aspect of corporate governance is that it also provides an explanation of ways in which managerial allegiance shifts when the corporation becomes insolvent. In a growing number of cases, courts hold that managerial allegiance must shift to the creditors when the corporation approaches insolvency.\(^{15}\) Upon insolvency, the residual claims of the shareholders become economically worthless.\(^{16}\) Creditors who will go unpaid in the event of complete financial failure now occupy the position of residual owners. Thus it is not surprising that managerial allegiance should depend upon the fortunes of the business.

2. Enforcement of Control Rights

Of course, it is one thing to require managers to pursue the business of the firm for the benefit of the shareholders but quite another to put such a guiding principle into practice. Again, passing familiarity with corporate law provides the commonplace methods of

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\(^{16}\) Although the bankruptcy system may provide shareholders with holdup value. See infra notes 76-81 and accompanying text.
enforcing managers allegiance to the shareholders. Shareholders may enforce manager's fiduciary duties through derivative suits and retain the ability to oust managers through voting rights. But, while shareholder voting rights and fiduciary duties may constrain managerial behavior in the most egregious circumstances these methods are unlikely to be effective in completely assuring managerial allegiance. In addition, these methods are inadequate to assure creditors that managers will not take actions that result in insolvency of the firm. To get a complete vision of the governance structure, therefore, one has to further examine the role of contract and the market in policing managers and mediating conflicts between creditors and shareholders.

The limitations of the fiduciary duty principle as a method of policing managerial misconduct are well known. The principle subsumes two related axioms. First, managers owe shareholders a duty of undivided loyalty. The duty of loyalty assures shareholders that managers will exercise their discretion free from the taint of self dealing. Second, managers owe shareholders a duty of care and diligence. In theory, these axioms should be sufficient to enforce shareholder's expectations of managerial allegiance. In practice, however, the business judgement rule limits the efficacy of the fiduciary principle in all but the most obvious cases of conflict.\(^\text{17}\)

The limitations on the fiduciary principle relegate it to a secondary role in the corporate governance structure – effective in checking only the most egregious conflicts and management failures. The non-bankruptcy governance structure places relatively more reliance on the shareholder’s contractual right to remove managers. Voting rights operate as the basic governance mechanism by giving shareholders the ability to replace managers who, through miscalculation, bad judgment, or shirking, have failed to maximize the value of the firm.\(^\text{18}\) Again, however, shareholder voting rights may provide less than complete protection against managerial misbehavior. This is particularly problematic in large firms. The wide dispersion of shares necessitated by investors’ desire for diversification\(^\text{19}\) often results in individual shareholders having too little at stake to justify their monitoring managers to assure that they are doing a good job. This, coupled with managerial control over the proxy

\(^{17}\) See Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director’s Duty of Independence*, 67 TEX. L. REV. 1351, 1361-62 (1989) (“Courts accord near-complete deference to corporate decisions untainted by interest...”). Easterbrook and Fischel provide an explanation of the business judgement rule that highlights the likelihood that a negligence standard would result in managerial risk aversion that would be inconsistent with the goal of shareholder wealth maximization. EASTERBROOK AND FISCHEL, supra note 14, at 98-100.

\(^{18}\) Easterbrook and Fischel characterize shareholder voting rights as the second most distinctive feature (after limited liability) of corporate law. Id. at 63.

apparatus, enables managers to control the outcome of corporate elections.\textsuperscript{20}

This problem leaves the market as the ultimate backstop against the limitations inherent in the fiduciary principle and shareholder voting rights. Given that the difficulty with voting rights is the wide dispersion of shareholders with each holding small claims, transactions that aggregate voting power in the hands of larger investors provide a remedy.\textsuperscript{21} This is the typical justification for the merger and acquisition activity that became so rampant in the 1980's.\textsuperscript{22}

As noted above, when a corporation is solvent, creditors do not enjoy a claim to managerial allegiance enforced through the fiduciary duty principle or through voting rights.\textsuperscript{23} Creditors do, however, need protection against actions that decrease the creditworthiness of their borrower.\textsuperscript{24} Thus a complete view of corporate governance must consider the contractual limitations on managerial conduct that are inherent in the firm's credit relationships.\textsuperscript{25} Consider first the firm's long term credit relationships. Such relationships are governed by contracts that often provide detailed protection against specific managerial actions that unduly increase the risk of the enterprise. These covenants strike a negotiated balance in the creditor/shareholder conflict. Actions that violate the covenants result in default and a consequent withdrawal of capital from the firm. In the absence of bankruptcy, such a withdrawal of capital would likely result in the replacement of the managers.\textsuperscript{26}

Short term lenders may also exercise a form of control over the behavior of managers. While short term credit contracts do not usually contain the detailed covenants characteristic of longer term debt, the revolving nature of these arrangements can be a significant constraint. Managers who take actions that unduly increase the risk of the business may find their sources of short term credit drying up which in turn can result in a cash flow crisis that triggers defaults in other credit arrangements.


\textsuperscript{23} Creditors may be granted voting rights, seeDEL. GEN. CORP. LAW § 221, so this is more a matter of practice than an immutable corporate law rule.

\textsuperscript{24} See, e.g. Campbell, supra note 12, at 599-606.


\textsuperscript{26} Id. at 1084-85.
3. Summary: An Integrated Corporate Governance Structure

As illustrated above, corporate governance is accomplished through a complex but integrated structure of contract, market and fiduciary principles. Each element of the structure complements the others resulting in a system that attempts to mediate conflict between shareholders and creditors and that binds managers to behave in the interests of the stakeholders. The corporate governance system is also sensitive to the financial condition of the firm. During solvency, the system vests discretionary authority in managers and relegates creditors to the position of contracting parties. As the corporation begins to approach insolvency, the creditors' contractual controls become effective to grant them a larger voice in the management of the firm. Finally, when the firm reaches insolvency, creditors contracts grant them more direct authority over managers and corporate law requires managers to shift their allegiance from the shareholders to the creditors.

B. Translating Corporate Governance Principles to the Bankruptcy Forum.

In theory, general principles of corporate governance should work well in the bankruptcy context. Both inside and outside of Chapter 11 governance issues present the basic problem of how to regulate the behavior of managers who might have an incentive to take actions that are not in the interest of their constituents. This requires some method of determining who those constituents are and a system to bind the managers to pursue the interests of those constituents. Abstracting from the sense of urgency and heightened emotions of the participants, the basic decisions confronted in a bankruptcy case are not all that different from decisions encountered in running a solvent corporation. While some components of the non-bankruptcy system require adjustment to accommodate the particular needs of a collective judicial proceeding, the basic theory remains applicable inside bankruptcy.

1. Evaluating Business Decisions in Chapter 11

Governance in the reorganization context requires a decision-making structure capable of handling problems ranging from the mundane day-to-day decisions involved in running a firm to the basic liquidation/reorganization decisions that lie at the very heart of a Chapter 11 case. While the Code provides detailed standards for reaching such decisions, at bottom, these decisions should be judged by the standard applicable to all businesses. Most business analysts agree that the quality of decisions big or small is a function of the expected cost of the decision compared to the present value of the expected return from that decision. At first blush, this proposition appears unremarkable and unlikely to be particularly controversial. On further examination, however, the proposition raises two important points about business decision-making generally and its applicability to the reorganization context.

The first of these points is the fact that our general standard for business decisions
says absolutely nothing about who should reap the gains or bear the losses of the decision. Thus this standard adopts the goal of allocative efficiency which does not account for the distributional consequences of a particular decision. To the extent one sees the purpose of the reorganization process as the maximization of the value of the business assets, the fact that a decision is being made in the bankruptcy context is irrelevant. All that insolvency does is change the beneficiaries of business decisions.

The second of these points is that decisions can be evaluated only on the basis of expected costs and expected returns. Business decisions of all sorts entail possibilities of gain and risks of loss. The fact that a loss instead of a gain materialized in a given case does not mean that the decision resulting in that loss was, at the time the decision was made, objectively wrong. Perhaps more importantly, decisions inside bankruptcy or out, involve such a wide array of competing possibilities and probabilities that it makes little sense to discuss business decisions in terms of their "correctness." Instead, the focus must be on the process through which such decisions are made — the governance structure. This proposition underlies the business judgment rule. Courts recognizing the complexity of business decisions and their inherently subjective qualities require nothing more than that the decision maker be free of obvious conflict and be well informed about the consequences of the decision.

2. Adjusting The Governance Structure to Account for the Special Needs of the Bankruptcy Process

Of course, one cannot simply apply the non-bankruptcy governance structure in bankruptcy cases. The automatic stay and the need to deter strategic uses of the structure in an effort to achieve favorable treatment require that the structure be adjusted to account for the particular needs of the reorganization process. The automatic stay deprives creditors' of their contractual controls over managers by prohibiting them from withdrawing capital from the business. Shareholder meetings called in an effort to displace managers who are thought to have failed to protect adequately shareholder interests must be scrutinized closely.

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27 The effect of the relaxation of this assumption is considered infra notes 71-82 and accompanying text.

28 See EASTERBROOK AND FISCHEL, supra note 14, at 98 ("To observe that things turned out poorly ex post, perhaps because of competitors' reactions, or regulations, or changes in interest rates or consumers' fickleness, is not to know that the decision was wrong ex ante.").

29 Id. at 98-100. See also Palmier, supra note 17, at 1373.

30 Id. at 1361.


to assure that they are not simply delay tactics. Market discipline is not likely to be of much use. Markets for the securities of small bankrupt firms are likely to be thin. Even in those situations in which an active market exists, managers are unlikely to respond to the market when they are fighting for the very existence of the business.

This leaves the fiduciary principle as the sole surviving element of the non-bankruptcy corporate governance structure. Courts often note that the debtor in possession is a fiduciary. Moreover, because the corporation is usually insolvent in bankruptcy, that fiduciary duty extends to the creditors of the business. But, as noted above, the fiduciary principle works only as a backstop to the contractual and market components of the non-bankruptcy governance structure. The difficulty in evaluating business decisions leads courts to abstain from directly examining the quality of business decisions. Instead, outside of bankruptcy, the fiduciary principle is limited to an examination of obvious conflicts and egregious failures on the part of managers. Thus, the fiduciary principle alone cannot be expected to provide an answer to the difficult problems involved in governing a bankrupt entity.

The Chapter 11 process is not without its own governance structure, however. The judicial controls over the entire process provide a replacement for the contractual and market controls that exist outside of Chapter 11. The court’s authority to appoint a trustee, end debtor exclusivity, or convert or dismiss a case can all be thought of as elements of the

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33 See In re Johns-Manville Corp., 52 B.R. 879 (Bankr. S.D.N.Y. 1985), aff’d, 60 B.R. 842 (S.D.N.Y. 1986), rev’d, 801 F.2d 60 (2d Cir. 1986), on remand, 66 B.R. 517 (Bankr. S.D.N.Y. 1986). In Manville, the bankruptcy court issued an injunction prohibiting a shareholders’ meeting at the instance of the debtor’s management and several creditor constituencies. The bankruptcy court found that the express purpose of the meeting would be to replace the existing board with one that would be more sympathetic to shareholders’ interests. The district court affirmed but the Second Circuit reversed stating that enjoining the meeting would require a showing that the Equity Committee was acting in bad faith by showing a “willingness to risk rehabilitation altogether to win a larger share for equity. 801 F.2d at 60. The Second Circuit did, however note that if Manville were insolvent, “denial of the right to call a meeting would likely be proper . . .” Id. at 65, n.6. On remand, the bankruptcy court supplemented its findings to include the required showing and again entered the injunction. 66 B.R. at 542. The Manville case, as well as other cases addressing this issue are thoroughly discussed in Michael A. Gerber, The Election of Directors and Chapter 11: The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever, 53 BROOK. L. REV. 295, 321-41 (1987).

34 The business judgement standard governs the courts review of managements’ decisions in bankruptcy as well. See Frost, Running the Asylum, supra note 5, at 120. The fiduciary principle is further limited as a tool of bankruptcy governance by the fact that managers duties run to both the creditors and the shareholders. See infra notes 84-86 and accompanying text.


reorganization governance structure. In addition, the Code requires judicial approval of
specific managerial decisions that can have the effect of prolonging or shortening the case.\textsuperscript{38} Creditor committees\textsuperscript{39} supplement this structure by assuring that widely dispersed creditors
have a representative with enough at stake to justify the costs of monitoring the debtor and
participating in bankruptcy decision-making.\textsuperscript{40}

While this governance structure is facially complete, it provides a less than
satisfactory substitute for the contract and market controls that are eliminated by the filing
of a bankruptcy petition.\textsuperscript{41} Outside of bankruptcy, managers are beholden to a group of
claimants that has actual money at stake in the business decision under consideration. This
economic incentive is non-existent in a Chapter 11 since the ultimate decision-maker is the

\textsuperscript{38} 11 U.S.C. § 363(b) (1994). Elsewhere I have analyzed the limitations of these elements of
the bankruptcy governance structure. \textit{See} Frost, \textit{Running the Asylum, supra} note 5, at 120-29.

\textsuperscript{39} 11 U.S.C. § 1102(a)(1) (1994) requires the appointment of a creditors committee in every
case. In practice, however, creditors' committees are appointed in only about 15% of all cases. \textit{See}
\textit{NBRC REPORT, supra} note 6, at 642, \textit{citing} \textit{SUMMARY BY CIRCUIT OF CREDITOR
COMMITTEE DATA, EXECUTIVE OFFICE OF UNITED STATES TRUSTEES} (February 21,
1996).

\textsuperscript{40} These collective action problems are similar to those facing shareholders in large, publically
held firms. \textit{See} \textit{supra} note 19 and accompanying text.

\textsuperscript{41} Dissatisfaction with the bankruptcy governance structure is at the heart of the many calls
for reform of Chapter 11. Much of the reform literature seems to be concerned with managers' use
of the inadequate controls over them to prolong the bankruptcy case, benefitting shareholders and
themselves at the expense of creditors. Many of these reform proposals call for market resolutions
to the problems of financial distress in an effort to preclude this type of behavior. \textit{See}, \textit{e.g.}, David
A. Skeel, Jr., \textit{Rethinking the Line Between Corporate Law and Bankruptcy Law}, 72 \textit{TEX. L. REV.} 471
(1994); Michael Bradley & Michael Rosenzweig., \textit{supra} note 2; Robert K. Rasmussen, \textit{Debtor's
Choice: A Menu Approach to Corporate Bankruptcy}, 71 \textit{TEX. L. REV.} 51 (1992); Barry E. Adler,
Bankruptcy and Risk Allocation, 77 \textit{CORNELL L. REV.} 459 (1992); Barry E. Adler, \textit{Financial and
Political Theories of American Corporate Bankruptcy}, 45 \textit{STAN. L. REV.} 311 (1993); Philippe
Aghion, et al., \textit{The Economics of Bankruptcy Reform}, 8 \textit{J. LAW, ECON. & ORG.} 523 (1992); Lucian
Arve Bebchuk, \textit{A New Approach to Corporate Reorganizations}, 101 \textit{HARV. L. REV.} 775 (1988);
Douglas G. Baird, \textit{The Uneasy Case for Corporate Reorganizations}, 15 \textit{J. LEG. STUD.} 127 (1986);
Mark J. Roe, \textit{Bankruptcy and Debt: A New Model for Corporate Reorganization}, 83 \textit{COLUM. L.
REV.} 527 (1983).

It seems fairly clear that these proposals are unlikely to garner support, however. Thus the
challenge is to work within the existing structure in an effort to improve corporate governance in
Chapter 11. Several commentators have suggested ways in which the general principles of corporate
governance might be further incorporated in Chapter 11 to improve results in Chapter 11. \textit{See}
authorities cited \textit{supra} note 5.
bankruptcy judge.\textsuperscript{42} In addition, the bankruptcy judge can only act on information and transactions that are presented to her. Managers' informational advantages coupled with their control over the initiation of business decisions may allow them to manipulate the decision-making apparatus to their benefit.\textsuperscript{43}

But, by incorporating the economic principles underlying the non-bankruptcy governance structure, we can improve the performance of the reorganization process. Elsewhere I have suggested one potential solution.\textsuperscript{44} When evaluating a particular decision, bankruptcy judges should attempt to discover the views of the group that stands at the margin of solvency — the economic residual claimants. This approach recognizes the fact that insolvency shifts the residual interest in business decisions from the shareholders to the creditors and is therefore consistent with non-bankruptcy decisions that extend fiduciary duties to creditors when the company approaches insolvency. This economic shift in the residual interest places creditors in the position of gaining or losing from the business decision. From a process perspective, this group of investors is likely to hold the correct incentives to make decisions that maximize the value of the corporation's assets.

This solution is subject to a conceptual difficulty. The accurate use of this method requires an answer to the very question that bankruptcy resolves — the value of the business assets. If the value of the business assets were readily ascertainable, there would be no need for a judicially supervised reorganization process. New claims to the assets could be generated automatically by an application of the absolute priority rule. It is therefore the vagaries of business valuation that create the need for the reorganization process.\textsuperscript{45}

This problem presents an insurmountable obstacle to the full realization of such a theoretically neat solution. But residual claim analysis may still provide a means through which we can improve bankruptcy decision-making. Even in cases in which valuation

\textsuperscript{42} In the words of the Seventh Circuit:

[S]elf interest concentrates the mind, and people who must back their beliefs with their purses are more likely to assess . . . value . . . accurately than are people who simply seek to make an argument. Astute investors survive in competition; those who do not understand the value of assets are pushed aside. There is no similar process of natural selection among expert witnesses and bankruptcy judges.\textsuperscript{46}

\textit{In re Central Ice Cream Co.}, 836 F.2d 1068, 1072-73n.3 (7th Cir. 1987).

\textsuperscript{43} See Barry L. Zaretzky, \textit{Trustees and Examiners in Chapter 11}, 44 S.C.L. REV. 907, 914 (1993) ("Although the Code requires that a court approve various business decisions made by the debtor-in-possession, the debtor maintains the ability to determine, to a considerable extent, which issues are placed before the court.")

\textsuperscript{44} See Frost, \textit{Running the Asylum}, supra note 5, at 135-38.

\textsuperscript{45} Id. at 137. Note also that valuation probably also requires an evaluation of the business decision itself leading to circularity in the decision-making process.
difficulties preclude a precise location of the residual claimants, bankruptcy judges may be able to identify claimants that certainly are not residual claimants. For example, in cases in which the corporation is hopelessly insolvent, the judge may discount the claims of shareholders who have nothing at stake in the decision under consideration. Similarly in evaluating the views of a senior creditor secured by collateral with a liquidation value far in excess of the creditor’s claim, the bankruptcy judge should pay little heed to arguments that the business decision at issue should be decided in a way that would shorten the case. Thus while residual claim analysis cannot provide a clear rule of decision, it can be used to evaluate competing positions. Rather than simply ask whether a proposed business decision is correct, this approach asks the judge to take account of the incentives of those advocating or contesting the decision.46

3. An Example of Residual Claim Analysis: Litigation Settlements

One category of cases that courts occasionally examine under this rubric consists of cases in which the principal asset of the estate is a lawsuit. The Seventh Circuit opinion in Matter of Central Ice Cream47 provides the best example. In Central Ice Cream, the court considered three appeals regarding the district courts decisions on sanctions and attorneys fees. The heart of the case was the trustee’s handling of a suit by the debtor against McDonald’s Corp. Central Ice Cream had won a $52 million verdict against McDonald’s. Pending the trial courts decision on the verdict, McDonald’s offered Central Ice Cream $15.5 million to settle the case. The bankruptcy judge approved this settlement over the objection of the shareholders.48

After attorney’s fees, the settlement provided more than enough money to pay all of Central Ice Cream’s creditors. The bankruptcy court approved the settlement stating, “To seek a greater return for the shareholders at risk to the creditors would be most unfair.”49 While not called upon to overturn the bankruptcy court’s approval of the settlement, Judge Easterbrook’s opinion seemed to differ with the bankruptcy court regarding the appropriate resolution of the conflict:

Central Ice Cream had assets sufficient to pay all creditors. This made the shareholders the residual claimants; each additional dollar would go to them. It is true, as the bankruptcy judge wrote, that spurning the settlement would expose the creditors to risk, but this parallels the risk creditors face outside of the bankruptcy process as firms try to maximize the expected value of the

46 Id.
47 836 F.2d 1068 (7th Cir. 1987).
48 The true status of the objecting parties was an issue in the case. The court noted that these objecting parties held more than 300% of the common stock of the debtor. Id. at 1069.
enterprise.\textsuperscript{50}

The court also noted that while creditors outside of bankruptcy are not entitled to challenge the corporation's decisions, inside of bankruptcy they may do so because "they are (presumed to be) the principally affected persons, the new residual claimants."\textsuperscript{51}

The Central Ice Cream case is unusual, not only because the court presumed that the debtor was solvent, but also because the court so explicitly adopted an analysis focusing on the desires of the residual claimants. Other courts have considered settlement offers using a similar analysis, however. In In re Bowman,\textsuperscript{52} for example, a Chapter 7 debtor sought to convert her\textsuperscript{53} case to a Chapter 11 so that she could pursue litigation that the Chapter 7 trustee proposed to settle. The $500,000 settlement offer was sufficient to cover nondischargeable tax claims but was likely insufficient to provide a distribution to the debtor.\textsuperscript{54} The court noted that the evaluation of a settlement offer in the context of an insolvent Chapter 7 estate is straightforward because the creditors take precedence. In a Chapter 11 case or in a case in which there is a potential that the estate is solvent, however, the court stated that the evaluation becomes more difficult.\textsuperscript{55}

In making this more difficult analysis, the court adopted the approach of the bankruptcy court in the Central Ice Cream case without discussing Judge Easterbrook's analysis. The court stated:

If creditors could be paid to a certainty, regardless of the outcome of litigation, there might be a strong argument for a debtor to proceed. In the instant case, however, there is no guaranty, just a potential for a larger sum of money that will only benefit the Debtor. The creditors do not benefit from pursuing the litigation further, although they have most of the risk. The creditors may receive less than they would with the settlement, but there is no chance that they would receive more than they are owed. It would distort the bankruptcy process to permit the Debtor to shift the risk of loss to the creditors while retaining all the potential benefit for herself, particularly over the objections

\textsuperscript{50} Id. at 1072.
\textsuperscript{51} Id. at 1073.
\textsuperscript{52} 181 B.R. 836 (Bankr. D. Md. 1995).
\textsuperscript{53} The fact that Bowman involved an individual debtor does not change the analysis. In this situation, the debtor occupies a role similar to that of a shareholder of a corporate debtor. In a subsequent opinion, the court rejected the debtor's claim that the suit was exempt. In re Bowman, 1996 Bankr. LEXIS 925; 78 A.F.T.R.2d (P-H) 5890 (Bankr. D. Md. 1996).
\textsuperscript{54} Id. at 840.
\textsuperscript{55} Id. at 844.
of creditors.\textsuperscript{56}  
Thus, the court in \textit{Bowman}, like the bankruptcy court in \textit{Central Ice Cream}, was unwilling to find that the continued pursuit of the litigation would not place creditor recoveries at risk.  

\textit{In re Speilfogel},\textsuperscript{57} involved another individual debtor, this time in Chapter 11. The Chapter 11 trustee proposed to enter into a global settlement to which the debtor objected. The court distinguished \textit{Bowman} stating that that case involved an insolvent debtor in a Chapter 7.\textsuperscript{58} Instead, citing the Seventh Circuit opinion in \textit{Central Ice Cream}, the court searched the record for some indication that the trustee had considered the interests of the debtor in the residuary interest in the settlement. Finding no such consideration, the court proceeded to “balance the equities” rejecting the settlement because “The court believes that if the litigation proceeds, the creditors will ultimately receive a substantial portion, if not 100\%, of their claims, whereas if the settlement is approved, the Debtor will receive nothing and lose any possibility of a residual distribution.”\textsuperscript{59}

Both \textit{Bowman} and the bankruptcy court’s opinion in \textit{Central Ice Cream} illustrate both the residual claim analysis and the limitations of that approach. In both cases, the continued prosecution of the litigation would not only potentially benefit the stockholders but also would expose creditors to a risk of loss. The results in those cases show a sensitivity to the fact that the stockholders might not truly be the residual claimants. The question of who occupies that position turns on an analysis of the position of the creditors in the worst case scenario. If the debtor’s rejection of the settlement creates a non-trivial chance of creditor losses, the process must account for their views.

Judge Easterbrook’s opinion in \textit{Central Ice Cream} recognized the difficult valuation problems that inhere in his approach but suggested an alternative approach to the problem. The opinion suggests that the risk to the creditors could be eliminated by putting the firm up for sale with a $15.5 million reserve price. If the settlement amount were less than the expected value of rejecting the settlement, the market (or perhaps the objecting shareholders) would recognize the value

\textsuperscript{56} \textit{Id.} The court also considered the ability of Bowman as debtor in possession to act as a fiduciary for the estate, concluding that the conflict between her interests and the interests of her creditors could not be reconciled. \textit{Id.} at 845. Accordingly, the court granted the debtor’s motion to convert but immediately granted the motion of the IRS to reconvert the case to Chapter 7. The court also authorized the trustee to accept the settlement. \textit{Id.} at 848.

\textsuperscript{57} 211 B.R. 133 (Bankr. E.D.N.Y. 1997).

\textsuperscript{58} \textit{Id.} at 144-45. This reading of the \textit{Bowman} arguably renders it consistent with the Seventh Circuit opinion in \textit{Central Ice Cream}, but the reading in contestable. The \textit{Bowman} made no specific finding that the debtor was insolvent. Instead, the court simply noted that the settlement would result in a substantial payment to the creditors and that, while success in the litigation might result in a recovery for the debtor, all of the risk of loss would be born by the creditors. 181 B.R. at 844.

\textsuperscript{59} 211 B.R. at 146-47.
4. Summary: An Integrated Bankruptcy Governance Structure

Because the bankruptcy process addresses the unique problems arising from financial disaster, the non-bankruptcy governance structure cannot simply be transferred into the bankruptcy context. Nonetheless Chapter 11 sets out its own structure that, when supplemented by the residual claim approach to decision-making, appears calculated to achieve results that would be obtained outside of bankruptcy. This integrated structure replaces the non-bankruptcy contractual and market controls over managerial behavior with creditor representation and judicial oversight. Creditors' committees composed of large claimants and represented by counsel and other professionals, have both the wherewithal and the incentive to monitor managerial behavior. The Code’s requirement that managers obtain judicial approval of significant transactions and the Code provisions allowing the court to appoint a trustee or examiner, or to convert or dismiss a case, provide ample opportunities to test managerial competence and loyalty.

Of course, the bankruptcy governance process generates controversies. Creditors’ committees may not be fully representative of the broad array of their constituents. Managers and members of creditors’ committees may take actions that violate their fiduciary duties to estates and their members. The point here is not that the process is self executing and inevitably correct, but instead that the process seems calculated to isolate such problems and to respond to them in a rational way.

III. The Reality of Bankruptcy Governance

Unfortunately, this well intentioned and theoretically complete approach to governance in Chapter 11 unravels in many (perhaps most) cases. One of the principle culprits in this unraveling is the collective action problem facing widely dispersed creditors each holding small claims. Because small creditors have so little at stake in the bankruptcy process, they often adopt a posture of rational indifference toward the debtor, its management and the bankruptcy case. Another problem which is easy to overlook is the possibility that a strict application of the bankruptcy governance structure may conflict with perceived normative commitments that underlie the Bankruptcy Code. This section addresses these two practical limitations on the ability of the bankruptcy governance structure to police adequately the behavior of managers of the debtor.

A. Creditor Indifference

\[^{60}\] Id. at n.3.
Recent studies of large Chapter 11 cases have provided some cause for optimism that the governance structure established by the Code actually works to police management behavior. Several studies of large cases have provided evidence that bank creditors often are successful in ousting incumbent management.61 In the most detailed of these studies, LoPucki and Whitford concluded that the management's loyalty to creditors or shareholders was "clearly a function of the company's solvency. The managements of solvent companies never aligned with creditors, while the managements of insolvent companies did so frequently."62 Thus, while Chapter 11 may not provide the best and cheapest means of governing an insolvent firm, one cannot say that managers are universally well entrenched.

In contrast, the few studies of small business bankruptcies tell a tale of virtual management autonomy.63 In his 1983 study of small business bankruptcies, LoPucki concluded that "the debtors studied were able to continue in complete control of their businesses while they were under the jurisdiction of the court."64 This problem is exacerbated by the fact that in terms of numbers of cases, small cases far outweigh the cases involving large, publically held debtors,65 and the fact that the vast majority of such cases do not result in a confirmed plan.66

One of the difficulties with small business bankruptcies is that the procedures set out in Chapter 11 are too costly and cumbersome to provide an effective reorganization framework for these cases.67 While the governance difficulties encountered in these cases

62 Lynn M. LoPucki and William C. Whitford, supra note 5, at 75.
64 LoPucki, Debtor in Full Control I, supra note 64, at 120-21.
65 See NBRC REPORT, supra note 6, at 632 (concluding that defining small business bankruptcies as involving debtors with debtor less than $5,000,000 would include within that definition 85% of all of the Chapter 11 cases filed).
66 See NBRC REPORT, supra note 6, at 610-11 citing studies that indicate that as few as 10-12% of all Chapter 11 cases result in an effective reorganization.
67 NBRC REPORT, supra note 6, at 614-15, quoting Hon. Alexander L. Paskay & Frances Pilaro Wolstenholme, Chapter 11: A Growing Cash Cow: Some Thoughts on How to Rein in the System, 1 AM. BANKR. INST. L. REV. 331 (1993) ("It takes no elaborate empirical study to justify the conclusion that the problems facing a publicly held corporation facing a mass-tort problem, are quite removed from a "mom-pop" corporation running a shoe repair shop . . .").
may to some extent be related to this problem, there is another important element that distinguishes small from large Chapter 11 cases. In small cases, creditors are unlikely to have an interest in closely monitoring managers. The size of their claims and the remote chance that they will receive anything close to a full payout on their claims, limit individual creditors’ incentive to take an active interest in the case. In the vast majority of cases it is difficult to find creditors with enough at stake in the case to be willing to serve on a creditors’ committee. Studies indicate that creditors’ committees are formed only in around 15% of all Chapter 11 cases.

This lack of creditor participation leaves the course of the reorganization to the debtor’s management and to the secured creditors (if any). The views of the vast middle — who are likely to occupy the position of the residual claimants in the case — are likely to be effectively silenced in the process. In cases in which there is no significant secured creditor, the lack of a committee creates the conditions necessary for managerial entrenchment and delay.

B. The Connection Between Bankruptcy Policy and Governance

Apart from the cases involving claim settlement, there has been no trend in the reported decisions to adopt a residual claim approach to governance questions in Chapter 11. Of course, that does not mean that courts are insensitive to the solvency or lack thereof in the cases that they confront. There is every reason to believe that bankruptcy judges have always looked to the incentives that might underlie various claimants positions -- even if they do not memorialize that examination in their written opinions. Still, the lack of an explicit use of such an approach outside of the settlement context requires an explanation. As the

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68 The court in In re Bayou Self, 73 B.R. 682 (Bankr. W.D. Louisiana) recognized this problem in the following passage:

In most Chapter 11 cases, particularly the smaller ones, creditors, particularly unsecured creditors, are inactive. The debtor’s obligations are so spread among a multitude of creditors that frequently no creditor, or creditors’ committee if there is one, has a sufficient stake to pursue its interests. Yet, the creditors collectively over a number of cases can sustain substantial and needless losses if measures are not taken to insure that prompt efforts are taken to rehabilitate the debtor, if possible.

Id. at 683.

69 In addition, unsecured creditors likely recognize that the benefits of any special interest that they take in the case will have to be shared with other unsecured creditors. This creates a classic free-rider problem that results in inadequate monitoring of the managers actions. See Skeel, supra note 5, at 520-22.

70 See NBRC REPORT, supra note 6, at 642, citing SUMMARY BY CIRCUIT OF CREDITOR COMMITTEE DATA, EXECUTIVE OFFICE OF UNITED STATES TRUSTEES (February 21, 1996).
following discussion suggests, one reason for the absence of such analysis may be found by examining the complex normative commitments underlying Chapter 11.

In addition to the practical problems resulting from creditor indifference, one of the principal difficulties in applying general principles of corporate governance in the reorganization context is the lack of a clear consensus regarding the goals of the bankruptcy process. For example, general governance principles dictate that the views of shareholders regarding the viability of the business enterprise be devalued in most cases. Shareholders of a hopelessly insolvent enterprise put nothing at risk in the business decision to reorganize rather than liquidate. Since it is probably a safe empirical assumption that most bankruptcies involve hopelessly insolvent enterprises, it is tempting to go one step further and suggest that shareholders be completely disabled from participating in the Chapter 11 case. It is possible that a blanket rule that prohibited shareholders from participating in any Chapter 11 distribution would eliminate the holdup power shareholders exercise in the case. While such an approach might create difficulties retaining the continued involvement of shareholders who are critical to the viability of the business, it may well be that the losses from reorganizations that fail for lack of continued management involvement would be more than offset by the gains from improved governance.

Commentators have advocated such proposals, but none have garnered widespread support. Perhaps one of the reasons for this lack of support is suspicion regarding the claimed efficiency gains of such proposals. A more fundamental reason is our national ambivalence regarding the purposes of Chapter 11. As a general matter, we see Chapter 11 as a means of maximizing creditor recovery through the preservation of going concern value. At the same time, Chapter 11 is hailed as a method of preserving jobs and communities that are affected by financial failure. These goals are sometimes complimentary; but, perhaps

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71 See Skeel, supra note 5, at 510-13 (suggesting that shareholders be disabled from holding elections during Chapter 11 and proposing a relaxed “for cause” standard that would enable creditors to replace the board of directors in more cases); Lynn M. LoPucki & William C. Whitford, Preemptive Cram Down, 65 AM. BANKR. L.J. 625, 633 (1991) (proposing a “preemptive cramdown” that would extinguish the claims of a class upon a showing that claims of the senior classes clearly exceed the value of the debtor).

72 Various proposals for the repeal or radical reform of the process would create such a result. The simplest such proposal, first suggested by Douglas Baird, is the repeal of the reorganization provisions of Chapter 11 and the use of Chapter 7 to conduct an auction for the business as a going concern. The proceeds from the auction could then be distributed among the claimants in accordance with the absolute priority rule. Baird, supra note 41. The auction would end equity’s participation in the case if the proceeds were insufficient to satisfy all of the claims.

73 The legislative history of the Bankruptcy Code states, "The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders." See H. REP. NO. 595, 95th Cong. 2d Sess. 220, reprinted in 1978 U.S.C.C.A.N., pp.
more often, they are directly conflicting.

When a company has real going concern value — that is when the value of the company as an operating entity exceeds the liquidation value of the company — the goals of preserving jobs and communities and maximizing creditor values are entirely consonant. To the extent that the reorganization process keeps firms together that should be kept together everyone benefits.74 Where the asset values that might be achieved in an orderly liquidation exceed those of the firm as a going concern, however, the interests of the creditors and those of the non-creditor stakeholders of the firm diverge.75 Of course, if we could be certain regarding going concern value or the lack thereof, the conflict would present a straightforward policy question that would be ripe for debate and resolution. But in the real world of uncertainty, the system does not explicitly resolve the conflict and ambivalence reigns.

This ambivalence manifests itself in the reorganization governance structure. The continued participation of managers in the running the corporation creates a bias in favor of reorganization.76 Shareholders and managers of insolvent companies have every reason to desire an attempt at reorganization regardless of the efficiency of such an attempt.77 The bias inures not only to the benefit of the shareholders and managers but also to the benefit of other corporate stakeholders. Employees, suppliers and the surrounding community benefit


74 Warren, Imperfect World, supra note 73, at 354-56.
77 See LoPucki & Whitford, Corporate Governance, supra note 5, at 685 ("The holders of underwater claims and interests often have reason to oppose liquidation until the distributions to them under the reorganization plan have been fixed); see also Laura Lin, Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors, 46 Vand. L. Rev. 1485, 1496 (1993) ("Shareholders [of an insolvent firm] are highly motivated to overinvest in risky projects and to under-invest in stable ones. Shareholders are also likely to delay liquidation, even if this strategy causes further loss to the firm.").
from the continued operation of the debtor as well as from the possibility (albeit remote) of a turnaround in the business fortunes.

While the Code does not explicitly take account of these stakeholder interests, the structural bias in favor of reorganization may reflect a normative commitment that goes beyond that of efficiency. Recall that the standard for judging business decisions set out above is neutral regarding the distributional effect of the decision. In that economic analysis, business decisions are judged against a value maximizing standard. Distributional concerns such as the effect of the decision on non-creditor stakeholders find no place in such an analysis.

Thus, the simple economic model of bankruptcy governance fails to capture what is really going on in bankruptcy cases. Rather than focusing solely on value maximization, there is a complex array of considerations including, perhaps first and foremost, a desire to maximize for creditor recovery, but also including a general sense that every corporate debtor deserves at least a chance at reorganization — if not for the sake of the corporation itself, at least for the sake of the corporations dependents. Regardless of the desirability of this policy, the normative commitments underlying the approach seem to be reflected in the Code and therefore have a real effect on the governance structure.

This observation also provides an explanation for the use of residual claim analysis in the litigation settlement cases and its absence in courts’ analysis of other types of issues. In the abstract, the question of whether to settle litigation is no different from the decision to continue an attempt at reorganization, to invest in a new plant or any other economic decision. A decision to forego a settlement offer represents an investment of the settlement proceeds in the litigation. A litigant seeking to maximize his or her wealth will reject a settlement only if the present value of the expected returns from the litigation exceed the present value of the settlement offer. The settlement cases generally do not implicate any concerns about non-investor stakeholders in the business, however. Thus the residual claim approach provides a way in which the court may analyze the settlement offer to the end of maximizing the value of the estate without concern over how the decision might affect those interests.

In sum, the principal effect of the complex normative commitments underlying

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79 The company could strike oil. The point here is not that companies often strike oil during a reorganization, however. Instead it is that the possibility of some huge business success, however remote, is of value to the stakeholders.

80 See supra note 27 and accompanying text.

81 I have stated elsewhere that I find this more expansive view of the reorganization process flawed. See Frost, *Redistributive Policies*, supra note 75, at 112-38.

82 See supra notes 47-60 and accompanying text.
Chapter 11 is to make impossible the distillation of bankruptcy governance to a single principle. The competing concerns the bankruptcy process addresses create conflicts that cannot be resolved by a simple rule of decision. Instead, bankruptcy governance involves a flexible structure that includes the allocation of responsibility for conflict resolution coupled with a respect for local customs and judicial attitudes. The structure is adaptable—changing to meet the facts of the situation at hand. It is also pragmatic—responding to problems using the resources at hand.

IV. THE PRAGMATISM OF BANKRUPTCY GOVERNANCE

Expanding the range of constituencies, the interests of whom the bankruptcy system must consider, exacerbates the governance problems inherent in Chapter 11. Reconsider the question of fiduciary duties. To the extent that the Chapter 11 process is intended to benefit the shareholders of the company as well as the creditors, one cannot take too literally the notion that fiduciary duties should benefit creditors when the corporation is insolvent. Shareholders are also worthy of managers' consideration. The need to serve two masters with conflicting interests require that managers strike some balance between the two. 83 One commentator has suggested that the underlying principle of bankruptcy governance is that the debtor-in-possession may, and perhaps must, 84 make an effort to reorganize the debtor (notwithstanding the contrary desires of the creditors) unless that attempt appears to be

83 While a conflict of obligation creates an uncomfortable legal environment that lacks clarity, the officers, directors, and managers of the DIP owe obligations of care, honesty, and reason to both the creditors of the bankrupt and its owners. The DIP thus operates in an inherent conflict. The DIP's obligation is to resolve that conflict in a reasoned, balanced and honest manner.

Raymond T. Nimmer and Richard B. Feinberg, Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity, 6 BANKR. DEV. J. 1, 33 (1989). Professor Campbell points out that outside the bankruptcy context managers often represent "multiple masters, including majority common shareholders, minority common shareholders and preferred shareholders. See Campbell, supra note 12, at 593.

84 Congress intended to make it clear that, even if insolvency may render the shareholders' continued economic interests in the corporation problematical, shareholders nevertheless retain their ownership interest. Therefore, it would be anomalous to interpret the Bankruptcy Code to mean that once a corporation is insolvent directors no longer owe any fiduciary duty to shareholders.

Miller, Corporate Governance, supra note 13, at 1495.
hopeless. 85 While this principle appears to provide a standard against which managerial actions might be judged, in practice, the idea, standing alone grants managers broad discretion that is very difficult to limit. 86

As noted above, 87 outside of bankruptcy, the fiduciary principle is but a component of a broader governance structure that includes contract and market elements. The special problems addressed by bankruptcy require that the contract and market elements of the non-bankruptcy structure be curtailed. In addition, the expansion of the scope of beneficiaries to whom managers owe duties of care and loyalty further weaken the fiduciary principle as a means of control over managerial misbehavior. Our normative commitments preclude an approach to the supervision of management that focuses simply on the interests and desires of the residual claimants to the assets. Add in a dash of rational disinterest from a widely dispersed creditor body and you have a recipe for nearly unfettered discretion by possibly opportunistic managers.

Of course, one must not forget that bankruptcy decisions take place in the context of a judicial proceeding. Bankruptcy judges serve as the ultimate defense against managerial self-aggrandizement. Most important decisions require judicial approval. 88 Bankruptcy judges have the power to displace managers through the appointment of a trustee. 89 They can declare futile an attempt to reorganize through their authority to convert or dismiss the case. 90 They can move cases along by shortening (or refusing to extend) the exclusivity period. 91 But their ability completely to control the case is subject to an inherent limitation caused by the very source of their authority. Bankruptcy judges are judges and thus are by nature limited to a judicial role. They decide disputes that are brought before them, they can act only on the information submitted to them. They are required to be above the fray, not in the middle of it.

85 Miller, Corporate Governance, supra note 13, at 1496 ("[I]t seems that when the financial condition of a corporation is "hopelessly" insolvent, such that there is little or no chance that stockholders would have any equity interest in the corporation, a debtor's directors no longer have any duty to pursue actions that may prejudice the debtor, its business, and the interests of senior classes.").

86 This problem has plagued advocates of corporate constituency statutes that enable managers to consider the interests of non-shareholder constituencies in responding to takeover attempts. See Campbell, supra note 12, at 622 ("Constituency statutes ... provide an obfuscation opportunity that facilitates [managerial opportunism]").

87 See supra note 17 and accompanying text.


Notwithstanding this limitation, bankruptcy judges have devised ways in which managerial discretion might be checked. Judges have taken a more active role in case administration. They have made use of examiners and mediators in an effort to resolve conflicts over plan development. Perhaps more significantly — at least to debtor’s counsel — courts have placed some of the burden on the attorneys involved in the case to monitor the actions of managers and to exercise some control over the reorganization process. The following discussion addresses these methods and some of the problems that they create.

A. **Case Management**

Bankruptcy judges have shown a remarkable creativity in developing case management techniques that preserve their role as impartial adjudicators while insuring that Chapter 11 cases do not languish. These solutions range from the systematic application of a “fast track” procedural system for small Chapter 11’s to the ad hoc use of status conferences and scheduling orders and sua sponte hearings designed to move parties swiftly toward the resolution of the case.

In 1987, Judge Thomas Small of the Eastern District of North Carolina introduced a fast track procedure for small bankruptcy cases. The approach involves an accelerated schedule for the filing of the plan, and conditional approval of the disclosure statement with the court approving both the plan and the disclosure statement in one hearing. If the debtor fails to comply with the deadlines, the Bankruptcy Administrator files a motion requiring the debtor in possession to show cause why the case should not be dismissed. Other Judges have followed Judge Small’s lead in instituting fast track procedures.

While the fast track system is widely touted as a method of reducing the costs of Chapter 11 thus making reorganization available to small debtors, the approach also has significant governance benefits. Managers recognizing that a day of reckoning is close at hand will have less incentive to delay the case in hopes of a turnaround in the debtor’s business fortunes. The data regarding fast track procedures certainly shows that the procedure moves cases through Chapter 11 more quickly. A study of Chapter 11 cases before and after Judge Mund of the Central District of California instituted a fast track procedure show substantial reduction in the median time to confirmation (24.1%), conversion...
(44.1%), dismissal (53.5%) and the total days in Chapter 11 (45.4%).

We cannot always equate acceleration of the process with improved governance. Managers still retain information and initiation advantages that allow them to continue to exercise wide discretion. But, the fast track procedures do reduce the ability of managers to use delay to perpetuate their employment and to extract concessions from creditors. The stricter requirements of the fast track procedures provide creditors with some assurance that there will be an outside limit to the delay they will experience.

The 1994 amendments to the Bankruptcy Code added provisions that permit a business with debts under $2 million to elect fast track treatment. These provisions limit the exclusivity period to 100 days and require that all plans be filed within 160 days. An increase in the 100 day period requires that the debtor show that the need for an increase is "caused by circumstances for which the debtor should not be held accountable." In addition to the limitation on the exclusivity period, the small business amendments allow the disclosure hearing to be combined with the confirmation hearing and grant the court discretion to dispense with the requirement that a creditors' committee be appointed.

As an approach to corporate governance, the 1994 statutory incorporation of the fast track approach leaves much to be desired, however. While the small business definition captures a majority of Chapter 11 cases, small business treatment is only applicable to those debtors who elect such treatment. The procedures adopted by Judge Small and Judge Mund are not so limited. Neither approach employs a dollar limitation. Instead, the Judges base their decision regarding fast track status on their own experience with

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101 Statistics compiled by the NBRC indicate that 72% of all debtors fall within the $2 million debt limitation. NBRC REPORT, supra note 6, at 630-31.
102 See 11 U.S.C. § 1121(e) (1994) The only real incentives to elect such treatment are the streamlined procedures for approval of the disclosure statement and the elimination of the mandatory creditors committee. These incentives are likely to be inadequate to ensure a widespread election of small business treatment for two reasons. First the combination of the disclosure statement and plan approval processes may serve only to compress the time within which the debtor is expected to confirm a plan. Second, statistics indicate that creditors' committees are rarely appointed in small bankruptcies without regard to the mandatory language of 11 U.S.C. § 1102(a). See supra note 70.
bankruptcy cases.103  

In addition to this structural approach to case management, the 1994 amendments explicitly grant bankruptcy judges the authority, on their own motion or on the motion of a party in interest, to hold a status conference and to enter detailed scheduling orders.104 Judge Fenning of the Central District of California recently authored an article in which she noted: Two kinds of chapter 11 cases come through the bankruptcy judge's door: Debtors that may be able to confirm a plan, and those that are hopeless. The two types call for different case management approaches. The problem is telling them apart at the beginning of the case. No simple litmus test is available, but most experienced bankruptcy judges find it relatively easy to sort about 90 percent of all chapter 11 cases into those two categories after just one or two hearings.105 Judge Fenning believes that early status conferences provide a method through which she can identify “zombie cases” and terminate them quickly.106 In a similar vein, Judge Clark of the Western District of Texas has written of the practice of judges in Texas to enter scheduling orders that respond to motions for relief from the automatic stay in single asset real estate cases.107 These orders require the debtor to achieve confirmation of a plan by a date certain or face foreclosure or case dismissal.108 One potential concern with this more active role for bankruptcy judges is that it may conflict with their role as impartial adjudicators.109 The 1978 Code went to some lengths to remove bankruptcy judges from the day-to-day administration of cases.110 Prior to the

103 Bufford, supra note 96, at 99; Small, supra note 92, at 307. Judge Small also seeks the recommendation of the Bankruptcy Administrator. Id.

104 11 U.S.C Sec. 105(d) (1994). Many judges held conferences and entered such orders before the enactment of the statutory authorization. Of course, one benefit of the explicit authority of the court to enter into detailed scheduling orders validates one of the key components of the fast track approach.


106 Judge Fenning also suggests that Bankruptcy Judges should use their authority to mediate fundamental disputes in an effort to arrive at a consensual plan. Id. at 36-37.


108 Id. At 191-92.

109 See John D. Ayer, How to Think About Bankruptcy Ethics, 60 AM. BANKR. L.J. 355, 397 (1986) (“The extent to which a judge may, in fact, act sua sponte is a measure of how much he is a participant, and how much a mere decider of issues.”).

110 See Id. (“It seems clear that a dominant purpose of the 1978 Code was to reduce the judge’s sua sponte role.”); see also, Harvey R. Miller, The Changing Face of Chapter 11: A
enactment of the Code, bankruptcy judges took an active role in supervising and administering cases — two roles that the Congress believed placed the judge in an "untenable position of conflict that compromises his impartiality as an arbiter of bankruptcy disputes."111

Active case management is a far cry from the administrative duties formerly placed on bankruptcy judges, however.112 Federal and state judges have increasingly taken an active role in managing cases to assure that they move toward completion.113 Also, as one commentator has pointed out,114 Congress evidenced an intent to provide judges more latitude in controlling cases by adding language to Section 105 in 1986 making explicit the authority of bankruptcy judges to issue sua sponte orders.115

This change has increased substantially the ability of bankruptcy judges to actively manage cases. Prior to the 1986 amendments, Section 1112(b) allowed only a "party in interest" to move for a conversion or dismissal of a Chapter 11 case. The legislative history surrounding the enactment of the Bankruptcy Code shows that the restriction of Section 1112(b) to parties in interest was a conscious choice on the part of the Code's drafters that

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111 H. REP. NO. 595, 95th Cong. 2d Sess. 89.

112 Of particular concern was the bankruptcy judges’ involvement in the appointment and supervision of trustees who were involved as litigants in the cases. See Miller, Changing Face, supra note 110, at 434.

113 See, e.g., MANUAL FOR COMPLEX LITIGATION THIRD, at 14-15 (1995) (characterizing effective judicial management as active, substantive, timely, continuing, firm but fair, and carefully prepared). The Fifth Circuit has drawn a similar analogy:

We do not believe, however, that Congress thereby intended to relieve the bankruptcy judge of the responsibility of managing the cases before him in such a way as to promote the objective and goals of the Bankruptcy Code. Our conclusion in this respect is strengthened by the fact that the bankruptcy court is an adjunct of the district court. District court judges function under Fed.R.Civ.P. 16 with full power and responsibility to manage their cases and with the directive to move their cases in such a way as to promote fairness to the parties and judicial economy.


114 Miller, Changing Face, supra note 110, at 435-36.

115 See 11 U.S.C. Section 105(a) (1986) (“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.”) This language was added by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986; Pub. Law 99-554 Section 203.
evidenced their concern with "excessive judicial entanglement in administrative matters". This history, coupled with the plain meaning of Section 1112(b) led most courts considering the question to conclude that they were without the power to dismiss or convert cases sua sponte unless there was a showing that the case was filed with an "intent to abuse the judicial process with a hope of delaying creditors."  

The 1986 amendment to Section 105(a) frees bankruptcy courts from the constraints imposed by Section 1112. The legislative history is sparse, however, Senator Hatch’s statement in support of the amendment indicates that the change was intended to allow bankruptcy judges more latitude in managing their cases. As further support for a more active bankruptcy judiciary, several cases have cited the admonition of the Fifth Circuit in In re Timbers of Inwood Forest Associates Ltd.: 

Early and ongoing judicial management of Chapter 11 cases is essential if the Chapter 11 process is to survive and if the goals of reorganizability on the one hand, and creditor protection, on the other, are to be achieved. In almost all cases the key to avoiding excessive administrative costs, which are borne by the unsecured creditors, as well as excessive interest expense, which is borne by all creditors, is early and stringent judicial management of the case. The court’s opinion in In re Tax Shop provides an example of such judicial 

116 In re Gusam Restaurant Corp., 727 F.2d. 274, 277 (2d Cir. 1984). The Gusam opinion collects the legislative history underlying Section 1112(b) as originally enacted. Id. at 276-77; see also, In re Moog, 774 F.2d. 1073, 1076 (11th Cir. 1985).  

117 See, Gusam, 737 F.2d at 277, see also, In re Warner, 30 B.R. 528 (9th Cir. B.A.P.1983).  

118 See Moog, 774 F.2d at 1076-77 (collecting cases).  


120 "This bill also allows a bankruptcy court to take any action on its own, or to make any necessary determination to prevent an abuse of process and to help expedite a case in a proper and justified manner. 132 Cong. Rec. 28610 (October 3, 1986) (statement of Senator Hatch) (emphasis added).  

121 808 F.2d at 373-74. See In re Tax Shop, 173 B.R. at 608 (quoting Timbers); In re Public Service Company of New Hampshire, 84 B.R. 1, 2 (Bankr. D.N.H. 1988) (same); In re Bayou Self, Inc., 73 B.R. at 684 (same); In re Daily Corp., 72 B.R. at 494 (same). See also, Miller, Changing Face, supra note 110, at 435.  

122 173 B.R. 605.
management in the context of a fast track case. In *Tax Shop*, the court refused to reinstate a case that he had dismissed for debtor’s failure to comply with his fast track scheduling order. As in many small cases, the creditors showed no interest in the case.\textsuperscript{123} *Tax Shop* illustrates the efficacy of the sua sponte motion for dismissal for these small cases.

*In re Great American Pyramid Joint Venture*,\textsuperscript{124} provides an example of the use of a sua sponte order in a more complex case. *Great American Pyramid* involved the Chapter 11 cases of six entities that were involved in the development of an entertainment and sports arena (in the shape of pyramid) in Memphis. Despite the involvement of creditors and other parties in interest, the court issued a sua sponte order to show cause why the cases should not be converted or dismissed.\textsuperscript{125} Before the hearing was held on the court’s order, the City and County filed their own Section 1112(b) motions.\textsuperscript{126} While it is difficult to determine what would have happened absent the court’s order, it is likely that the order had the effect of spurring the creditors to action.\textsuperscript{127}

This case illustrates one of the benefits of a sua sponte order. Motions to dismiss or convert require the debtor to provide some evidence of the likelihood of a reorganization. They provide a means through which the reality of the debtors efforts to reorganize might be examined. Making such a determination can be a complex undertaking, however, and creditors may be reluctant to bring a Section 1112(b) motion prematurely. Sua sponte orders might act as a form of judicial signal to the parties in interest that the judge would be receptive to a Section 1112 motion which might in turn overcome creditor reluctance and place the issue squarely before the judge.

Short of outright dismissal, several bankruptcy courts have used their authority under Section 105(a) to order the appointment of a bankruptcy trustee. In *In re Bibo*\textsuperscript{128} the Ninth Circuit approved the bankruptcy court’s use of its sua sponte authority to appoint a trustee when, on a motion to approve management fees, the court found documentation that established a kickback scheme involving a principal of the debtor.\textsuperscript{129} The Ninth Circuit held that “[t]he statute plainly gives the bankruptcy judge authority to appoint a trustee sua

\textsuperscript{123} The court held a status conference at which no creditors appeared, *Id.* at 606, and held a show cause hearing that no one attended. *Id* at 607.

\textsuperscript{124} 144 B.R. 780.

\textsuperscript{125} *Id.* at 782.

\textsuperscript{126} *Id.* at n.2.

\textsuperscript{127} The court converted 5 of the 6 cases under consideration and placed the remaining case on a “fast track” *Id.* at 794.

\textsuperscript{128} 76 F.3d 256 (9th Cir. 1996)

\textsuperscript{129} *Id.* at 257.
sponte,"\textsuperscript{130} and further held that the evidence established cause to appoint a trustee.\textsuperscript{131} Finally the ninth circuit rejected the principal’s claim that the bankruptcy court denied him due process by denying him a continuance prior to the hearing on the court’s motion.\textsuperscript{132} The Ninth Circuit held that the notice and hearing the principal received were “appropriate in the circumstances” given the clear evidence of fraud and the consequent threat to the estate.\textsuperscript{133}

Of course, such judicial management techniques only have the effect of enabling the judge to consider the substantive issues involved in the case. They provide no indication of how to resolve those problems. In \textit{Great American Pyramid}, the court recognized the difficult substantive issues as it framed the issue:

Query, what is a reasonable breathing spell and fair opportunity for a chapter 11 debtor to seek rehabilitation before pulling the reorganization plug? The ultimate questions for judicial determination here, considering the realities of these case administrations at this time, is whether reorganization is now visionary only or hopeless and whether liquidation or dismissal is the only appropriate solution under the existing circumstances?\textsuperscript{134}

Case administration provides no answer to this dilemma and our ambivalence over the purposes of Chapter 11 precludes an easy answer.

This observation points up one of the principal dangers of active judicial case management. While status conferences, fast track procedures and sua sponte orders may be efficacious means of framing issues and assuring that management is not using the protection of Chapter 11 merely to perpetuate itself in office, quick resolution of bankruptcy cases should not be an end in and of itself. Take for example the decision in \textit{In re Petit}.\textsuperscript{135} Petit involved an individual Chapter 11 debtor whose principal asset was a cause of action against

\textsuperscript{130} \textit{Id.} at 258.

\textsuperscript{131} \textit{Id.}

\textsuperscript{132} Upon the bankruptcy court’s discovery of the documentation and examination of one witness, the court granted a short recess so that the principal could consult with counsel for the debtor. \textit{Id.} at 257. After consulting with counsel, the debtor requested a continuance. The court denied the request, stating:

I want someone to take over all the assets of the debtor today. I do not want Mr. Fukutomi or Ms. Fukutomi to have access to any of the assets of this estate hereinafter from the moment they walk out the door until all this case is resolved one way or another.

\textit{Id.}


\textsuperscript{134} \textit{Id.} at 789.

\textsuperscript{135} 189 B.R. 227.
Key Bank. All of the counts in the complaint had been dismissed or disposed of through summary judgment against the debtor. One count remained on appeal, however, and at least one expert testified that the debtor's damages were in excess of $30 million.\(^{136}\) Despite the fact that the debtor, the creditors, the trustee and the U.S. Trustee believed that the issue on appeal should keep the reorganization alive,\(^{137}\) the court sua sponte converted the case to a Chapter 7.\(^{138}\)

It is difficult to tell from the opinion precisely why the Petit court was determined to convert the case in the face of opposition from every constituency. The court indicates its belief that the debtor may have duped the creditors by holding out the possibility of such a large return.\(^{139}\) This reading of the case is cause for concern. To the extent bankruptcy courts use judicial case management to substitute their judgement for that of the interested parties, they may step beyond the bounds of impartial decision-maker and into the role of active participant in the case.\(^{140}\)

The court's opinion in *Matter of Mother Hubbard*\(^{41}\) is an example of the sensitivity required when a bankruptcy court is exercising its authority to act sua sponte. In *Mother Hubbard*, the president and sole shareholder of the debtor proposed a plan that sought to contribute a late filed unsecured claim as new value.\(^{142}\) After denying the president's motion to deem the claim timely filed and after permitting an unsecured creditor to file a competing plan, the court considered sua sponte whether to hold a hearing to consider the appointment of a Chapter 11 trustee.\(^{143}\) In its discussion of the issue, the court noted the danger of involvement with administrative matters and stated its belief that the impetus for such a motion must come from the record.\(^{144}\) While the court expressed its concern regarding the

\(^{136}\) *Id.* at 228.

\(^{137}\) *Id.*

\(^{138}\) *Id.* at 229.

\(^{139}\) *Id.* at 227 ("It is a fact of life, however that while there is no statutory requirement that creditors be realistic or reasonable in their expectations of success, the Court does not enjoy such latitude and neither may we permit the Debtor to fantasize indefinitely.").

\(^{140}\) It is possible that the courts decision might be justified on the grounds that the Chapter 11 process could achieve nothing that a could not be achieved more expeditiously in a Chapter 7. If this were the case, considerations of judicial economy coupled with a lack of benefit from judicial efforts might warrant conversion. The opinion is devoid of such analysis, however.


\(^{142}\) *Id.* at 191.

\(^{143}\) *Id.* at 196-197.

\(^{144}\) *Id.* at 197 ("This judge also strongly believes it is improper to sua sponte raise such an issue unless persuasive evidence comes to the court's attention on the record which may lead to a conclusion that cause exists or an abuse of process is occurring.")
goals and motives of the debtor's president and sole shareholder, it noted that the unsecured creditor, who was also the proponent of a competing plan, and the creditor's committee had "sufficient incentive to monitor the Debtor's business (and [the president's] business judgment)." Accordingly, the court declined to order a hearing but admonished the president regarding the conduct of the business during the confirmation process and invited parties in interest with knowledge of facts constituting cause to file a motion.

In sum, while case management alone cannot provide substantive solutions to the complex questions presented in a Chapter 11 case, it can assure the parties that the court will address the question in a timely manner. A necessary prerequisite to improved governance in Chapter 11 is a system that periodically frames the issues for the ultimate decision-maker. As studies of small business reorganizations have found, small bankruptcy cases often leave managers in full control of the process because creditors have little incentive to become actively involved in the cases. Active case management can provide a counterbalance to the control managers assert over these cases.

B. Flexible Use of Examiners

Even with active case management, bankruptcy judges suffer an informational disadvantage vis-a-vis managers which impairs the ability of the bankruptcy governance structure to provide adequate checks on managers. The case load of bankruptcy judges is ever increasing as new bankruptcy filings reach record heights. The resulting time limitations, coupled with the limits of the adjudicative role allow managers to restrict the information available to the parties and the judge.

Of course, the Code requires that managers provide some information to the other participants in the case. The Code requires the debtor in possession to file periodic reports and summaries of operation of the business with the court, the United States trustee, and taxing entities and to respond to requests for information by parties in interest. In addition, creditor’s committees, in those cases in which they are appointed, are charged with consulting with the debtor in possession concerning the administration of the case and

145 Id.
146 Id. ("Van Zoeren shall act in accordance with his fiduciary obligations, as contrasted to his personal desires, to assure a 'level playing field' is maintained until the conclusion of the confirmation hearings on the competing plans.")
147 Id. at 198.
148 See supra notes 61-70 and accompanying text.
149 Total bankruptcy filings reached a record high of 1,178,555 in 1996. 1997 BANKRUPTCY YEARBOOK AND ALMANAC 32 (1997). Thus even though the Chapter 11 caseload is about half of the peak years 1985-86 and 1990-93, Id., the bankruptcy system is strained.
investigating the debtor and its management.\footnote{151}{11 U.S.C. §§ 1103(c) (1994).}

While these provisions assure that the debtor's managers are subject to broad oversight, they may be inadequate to highlight more subtle information that managers hold about the prospects for reorganization. Only involvement in the day-to-day operations of the debtor will provide the detail required to make an accurate assessment of those prospects. In addition, the acquisition of knowledge about alternatives to reorganization, requires that one take the initiative to explore those alternatives. While an active creditors' committee in a large case, may take that initiative,\footnote{152}{Even in large cases, the creditors committee may be at a severe disadvantage. Zaretsky questioned the ability of creditors committees to control the management of the debtor: [A] committee is not involved in the day-to-day operations of the debtor and is often in the position of responding to initiatives generated by the debtor. Its information comes primarily form the debtor and may reflect the debtor's sometimes unduly optimiststic assessments. Accordingly, a committee usually cannot set the direction of the business or the tone of the operations. Zaretsky, supra note 43, at 914.} in smaller cases, there may be no one to do so but the judge who, of course, must look to managers for suggestions.

Commentators have suggested that courts make flexible use of the provisions of Chapter 11 allowing the court to appoint an examiner to counteract this difficulty.\footnote{153}{Id. at 940-61; Frost, Running the Asylum, supra note 5, at 132. Professor Adams has proposed the more radical solution under which the debtor in possession would share decision-making authority with prepetition managers. See Adams, supra note 5, at 620-23.} Traditionally, examiners have been appointed in cases in which there has been some need to investigate the pre-bankruptcy conduct of the firm managers or shareholders. But, in several large cases, courts have charged examiners with mediating disputes, bringing suits and operating the debtor's business.\footnote{154}{See Zaretsky, supra note 43, at 940-61 (discussing the various uses to which courts have put examiners).} Courts could also use examiners to provide the court an unbiased review of specific decisions thus alleviating, somewhat, the information monopoly held by the managers.\footnote{155}{Id. at 955 ("[S]ome bankruptcy courts have employed examiners as the 'eyes and ears' of the court....").}

Section 1104 provides the necessary authority for such a flexible use of examiners. The statute authorizes the court to appoint an examiner to "conduct such investigation as is appropriate" if the appointment is in the best interests of the creditors, equity holders and other interests in the estate.\footnote{156}{11 U.S.C. § 1104(c) appears to require the court to appoint an examiner when the debtor's debts exceed $5 million. Several courts have denied appointment of examiners in such cases, C - 34}
investigation that seems to require that there be some allegation of fraud, dishonesty, or incompetence, but the provision makes clear that the list is illustrative only.\textsuperscript{157}

A few courts have made use of this flexible authority, typically coupling specific informational charges with a general charge to mediate the case. For example, the court charge to the examiner in the Apex Oil Company Chapter 11 included taking, "any necessary and appropriate actions in furtherance of assisting the Court and parties in bringing these proceedings to a just, prompt and economic disposition."\textsuperscript{158} This broad charge required the examiner to undertake, for example, extensive monitoring of the debtor's efforts to stabilize its business post-petition;\textsuperscript{159} mediation of a number of disputes;\textsuperscript{160} and an investigation into the good faith of asset purchasers for purposes of Section 363(m).\textsuperscript{161}

The court in \textit{In re Public Service of New Hampshire}\textsuperscript{162} appointed an examiner to resolve a somewhat more specific problem. The parties in \textit{Public Service} had reached a difficult point in negotiations that revolved around the arcana of utility rate making. In addition to the desirability of a third party mediator, the court noted that it needed assistance "in understanding some of the rather arcane concepts employed in the utility rate-setting regulatory world in order to properly perform its duties."\textsuperscript{163}

Finally, in \textit{In re Big Rivers Electric Cooperative},\textsuperscript{164} the court appointed an examiner specifically to address allegations that the management was violating its fiduciary duty to maximize the value of the estate regarding a long term lease of substantially all of its generating assets.\textsuperscript{165} The examiner's investigation revealed the existence of a "No Shopping" clause in the lease and concluded that the debtor had "failed to develop bids submitted by

\textsuperscript{157} 11 U.S.C. § 102(3) ("includes" and including are not limiting). \textit{In re Public Service Company of New Hampshire}, 99 B.R. 177, 182 (Bankr. D.N.H. 1989) ("The Debtor's strict interpretation of "examiner" as merely an investigator of fraud and other irregularities is unwarranted.").


\textsuperscript{159} Id. at 238

\textsuperscript{160} Id. at 241.

\textsuperscript{161} Id. at 241.


\textsuperscript{163} Id. at 182.


\textsuperscript{165} Id. at 7-9.
parties other than [the proposed lessee].” The court, noting its duty to maximize the value of the estate as well as the duty of the debtor to do the same, subsequently ordered an auction of the assets resulting in a binding commitment for $50 million more than offered by the original proposed lessee. Thus, through the use of an examiner, the court was able to penetrate the informational monopoly held by management. The combination of the investigative functions of the examiner with a mediation function provides governance benefits in addition to the expected economies associated with alternative dispute resolution. The requirement that the examiner/mediator file a report with the court may deter managers or shareholders from taking strategic positions in the negotiations simply to delay the ultimate resolution of the case. In addition, involvement in the negotiations may provide the examiner an opportunity to obtain information about the prospects of the business and the managers’ operation of the business that would not otherwise come to light.

Of course, examiners are not without costs and the economics of many small cases will not support the luxury of third party involvement. Thus, it is not surprising that most of the reported cases in which courts have used examiners as described here have involved large debtors with active creditors’ committees and complex issues. But, if the task of the examiner is narrowly defined to the investigation of the viability of the enterprise or the desirability of a particular course of action, the court may keep the costs in check. In addition, examiners need not be bankruptcy professionals. If the examiner’s task is to evaluate a business decision, the analysis might be most appropriately accomplished by someone knowledgeable in the field.

In addition to cost, the flexible use of examiners may give rise to concerns regarding the adjudicative function of the bankruptcy judge. To the extent bankruptcy judges use examiners as a surrogate judge with the ability to achieve results that they themselves might

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166 Id. at 16.
167 Id. at 47.
168 Id. at 24.
169 Id. at 27.
170 The requirement that the examiner file a report may, however, impair the ability to reach a settlement because the parties cannot be assured that their communications with the examiner will remain confidential. Mabey, Tabb, and Dizengoff note that, “an examiner as mediator is not classic mediation. Rather, the examiner is clothed with judicial authority....” Ralph R. Mabey, et. al., Expanding the Reach of Alternative Dispute Resolution in Bankruptcy: The Legal and Practical Bases for the Use of Mediation and the Other Forms of ADR, 46 S.C.L. REV. 1259 (1995). Thus, the use of an examiner as an “investigative mediator” may involve a tradeoff between governance and ADR benefits.
172 See NBRC REPORT, supra note 6, at 658 (discussing the Licensed Insolvency Officer concept used in the United Kingdom in which accountants are used to administer insolvency cases).
be prohibited from accomplishing, their role as impartial adjudicators of disputes might be called into question. As noted above, the Bankruptcy Code was intended to relieve bankruptcy judges from the duty of administering cases in an effort to assure that the judges could exercise their adjudicative powers free from any appearance of partiality. To this end, Bankruptcy Rule 9003 prohibits ex parte communication by an examiner unless otherwise authorized by applicable law. This prohibition assures that the judge remains above the fray as an adjudicator of facts developed through the normal operation of the adversary system.

C. Attorney Compensation

One way that bankruptcy judges have found to improve governance is to look to the professionals already involved in the case for assistance in policing managers. In large reorganizations, this burden is shared by the wide range of professionals employed by the debtor in possession, the committees, and other significant creditors. In smaller cases, which are marked by the absence of committee and large creditor involvement, a large share of the governance burden often rests with the attorney for the debtor in possession. In what is doubtless an alarming trend for bankruptcy debtor’s counsel, bankruptcy courts have increasingly used their authority over fee applications as a method of policing managerial and shareholder behavior in Chapter 11 cases.

Outside of bankruptcy, the Model Rules of Professional Conduct enjoin attorneys retained by “organizations” (including corporations) to remember that they represent “the organization acting as through its duly authorized constituents” and require that conflicts between their client and the individuals running the client (including the person who signs the attorney’s check) are to be resolved in favor of the client. The Model Rules provide

173 See notes 109-111, supra, and accompanying text.
174 FED. R. BANKR. PROC. 9003(a). In Big Rivers, the court held that its earlier uncontested final order authorizing ex parte communications by the examiner constituted “applicable law” for purposes of Rule 9003(a). 1997 Bankr. Lexis 1368, 41-42. In addition, the court held that the failure to object to the order rendered subsequent motions to disqualify the judge and to remove the examiner untimely. Id. at 29-36.
175 See supra notes 39-40 and accompanying text.
176 MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13.
177 If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the
some guidance to attorneys regarding the appropriate response to actions by corporate officers and employees that the lawyer believes are not in the best interest of the corporation — including, as a last resort, resignation from the relationship.\textsuperscript{178}

While corporate representation sometimes results in some discomfort for attorneys, the ethical obligations of an attorney representing the debtor in possession\textsuperscript{179} present difficulties that go well beyond those facing corporate lawyers outside of the bankruptcy or insolvency context. The attorney’s obligation to the “estate” requires more vigilance than is required of corporate attorneys outside of bankruptcy.\textsuperscript{180} In bankruptcy, as one court put it, “the duty to advise the client [the DIP] goes beyond responding to the client’s request for advice. It requires an active concern for the interests of the estate and its beneficiaries.”\textsuperscript{181} This enhanced obligation, coupled with the role of DIP counsel as an officer of the court, ensures that the attorney is at the center of Chapter 11 governance controversies. Not only do attorney’s fiduciary obligations extend to all who are interested in the estate, the attorney has a duty to preserve the integrity of the bankruptcy process.\textsuperscript{182} The obligation of DIP counsel includes the duty to “carefully monitor each case and encourage conversion or dismissal without delay when it becomes apparent that reorganization is no longer feasible or that wrongdoing is taking place.”\textsuperscript{183} Not only must the DIP counsel be vigilant in advising the DIP’s managers regarding their fiduciary obligations, DIP counsel has an affirmative duty to inform the court of the managers’ lapses.\textsuperscript{184}

Of course these enhanced duties create what Jay Westbrook has referred to as “unavoidable conflicts inherent in the representation of DIPs.”\textsuperscript{185} The essence of this conflict

\textbf{organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization.}

\textbf{MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(b).}

\textsuperscript{178} MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(c).

\textsuperscript{179} Counsel for the debtor in possession is herein referred to as “DIP Counsel.” This reference is used to draw attention to the fact that the attorney technically represents an entity that has duties to the estate. Neither the Code nor courts are scrupulous about the distinction between the debtor and the debtor in possession because, when a Chapter 11 trustee has not been appointed, there is no distinction. 11 U.S.C. § 1101(1) (1994).

\textsuperscript{180} See Ayer, supra note 109, at 387-90.

\textsuperscript{181} In re Wilde Horse Enter., Inc., 136 B.R. 830, 840 (Bankr. C.D. Calif. 1991).

\textsuperscript{182} In re JLM, Inc., 210 B.R. 19, 26 (2d Cir. BAP 1997)

\textsuperscript{183} In re Pacific Forest Ind., Inc., 95 B.R. 740, 744 (Bankr. C.D. Calif. 1989).

\textsuperscript{184} In re JLM, Inc. 210 B.R. at 26 (collecting cases).

\textsuperscript{185} Jay Lawrence Westbrook, Fees and Inherent Conflicts of Interest, 1 AM. BANKR. INST. L. REV. 287 (1993). See also, C. R. Bowles and Nancy B. Rapoport, Has the DIP’s Attorney Become the Ultimate Creditor’s Lawyer in Bankruptcy Reorganization Cases, 5 AM. BANKR. INST.
lies in the divergence of incentives held by the various participants in the case. Because the shareholders and managers are likely to have interests that differ radically from those of the creditors, a conflict is unavoidable. The DIP's attorney is therefore thrust into the eye of the storm and must avoid the urge to view the shareholders and managers as her principal constituency.\textsuperscript{186}

By far the most notorious case addressing these inherent conflicts is \textit{In re Kendavis Ind. Int'l, Inc.}\textsuperscript{187} \textit{Kendavis} involved a large reorganization in which the creditors' committee and certain individual creditors moved for a disgorgement of fees paid to DIP counsel (Locke, Purnell, Boren, Laney and Healey).\textsuperscript{188} The gravamen of the movants' allegations was that Locke Purnell represented both the DIP and its controlling shareholders (the Davis family) and had taken actions designed to benefit only the Davis family.\textsuperscript{189} The court noted that correspondence among Locke Purnell, the Davis family and other professionals involved in the case indicated that the Davis family believed that Locke Purnell represented them.\textsuperscript{190} In addition the court looked to the actions of Locke Purnell during the proceeding.\textsuperscript{191} The

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{186} "It is to insure [the] integrity of the bankruptcy process where, by definition, a debtor in possession is not disinterested, that counsel for the debtor in possession must be disinterested, free of any adverse entanglements which could cloud its judgment respecting what is best for the estate." \textit{In re JLM, Inc.} 210 B.R. at 26.
\item \textsuperscript{187} 91 B.R. 742 (Bankr. N.D. Tex. 1988); \textit{See also}, Diamond Lumber, Inc. v. Unsecured Creditors' Comm. Of Diamond Lumber, Inc. (Bankr. N.D. Tex. 1988); \textit{In re Chapel Gate Apts. Ltd.} 64 B.R. 569 (Bankr. N.D. Tex. 1986). Westbrook refers to all of these cases as the Kendavis trio of cases. Westbrook, \textit{supra} note 185 at 290.
\item \textsuperscript{188} \textit{In re Kendavis}, 91 B.R. at 744.
\item \textsuperscript{189} \textit{Id.} at 745-46.
\item \textsuperscript{190} \textit{Id.} at 750-51. One of these items clearly demonstrates the nature of the conflict. One of the family members wrote "As Barb [apparently a member of Locke Purnell] continues to repeat and everyone agrees there is no shareholder equity — so we've got nothing to loose [sic]— The banks have it all on the line now — not us." \textit{Id.} at 763.
\item \textsuperscript{191} \textit{Id.} at 749-751. Specifically, the court examined the Debtor's new value plan finding that it was unconfirmable because it did not propose a substantial contribution, \textit{Id.} at 749, and Locke Purnell's vigorous opposition to the Committee's plan which called for 100% payment to all non-bank and non-insider creditors. \textit{Id.} at 750.
\end{enumerate}
\end{footnotesize}
court stated that the activities of Locke Purnell “were designed to further the interest interests
of the Davis family” and concluded that the totality of the evidence could lead only to the
conclusion that Locke Purnell represented the interests of the Davis family. The court
awarded Locke Purnell only $2,000,000 of the $4,000,000 in fees previously awarded — requiring
disgorgement of the balance.

In the course of the Kendavis decision, the court engaged in a detailed analysis of
conflicts of interest in the bankruptcy process. The court set the stage for this broader
inquiry by stating that the case “demonstrates the problems inherent in a popular theory
regarding representation of Debtors in bankruptcy, the concept of the ‘potential’ conflict of
interest . . . .” In its discussion, the court noted that the history and statutory language of
the disinterestedness requirement of Section 327 creates no room for allowing
representation of multiple entities in one or a series of related cases on the basis that the
conflicts created are only “potential.” The court’s broad holding is that “whenever counsel
for a debtor corporation has any agreement, express or implied, with management or a
director of the debtor, or with a shareholder, or with any control party, to protect the interest
of that party, counsel holds a conflict.”

Courts considering similar situations often note the difficulties that a rigid
interpretation of the disinterestedness requirement would create, usually concluding that the
Kendavis result should be limited to egregious conflicts such as those considered in that
case. For example, the court in In re Howell approved counsel for the debtor’s

192 Id. at 752.
193 Id. at 751.
194 Id. at 762-3. See 11 U.S.C. § 328(c) (1994) (allowing the court to deny allowence of compensation if “at any time during such professional person’s employment . . . , such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate . . . .” In addition the court ordered disgorgement of a $500,000 retainer that had been paid to Locke Purnell by a related Debtor but that had not been disclosed to the court. Id. See 11 U.S.C. § 329(a) (1994) (requiring attorneys to file a statement of compensation paid or agreed to be paid).
195 Id. at 744.
196 11 U.S.C. § 327(a) (1994) requires that professionals employed by the trustee not “hold or represent an interest adverse to the estate” and that such persons be “disinterested.” 11 U.S.C. § 101(14)(E) (1994) further defines disinterested person as a person who, “does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders . . . .”
197 In re Kendavis, 91 B.R. at 752-57.
198 Id. at 754.
199 See, e.g., In re Spanjer Bros., Inc., 191 B.R. 738, 754 (Bankr. N.D. Ill. 1996) (noting lack of evidence that the DIP’s attorney represented management, directors, or shareholders); In re Office Products of America, 136 B.R. 983, 988 (Bankr. W.D. Tex. 1992) (limiting application of Kendavis
application for compensation even though the attorney represented the bankruptcy estates of both a closely held corporation (a beauty school) and its individual shareholders. The court distinguished *Kendavis* on its facts citing the egregious nature of the Kendavis attorney’s behavior. The court also rejected the reasoning of the *Kendavis* court, applying instead a potential conflicts analysis. Ultimately, the court in *Howell* concluded that “The unity of interest and interdependence that exists between the debtors and the school exemplify the ‘mom & pop’ nature of the present situation so that Archer’s dual representation was both economically reasonable and legally appropriate.” Thus the cost of separate counsel may be one factor that limits strict adherence to the disinterestedness analysis.

The court in *In re Office Products of America, Inc.* provided another rational for limiting the holding of *Kendavis* to its facts. In *OPA* the trustee, joined by creditors and an unofficial creditors’ committee, objected to the fee application of counsel for the DIP (“Gresham Davis”). Among their arguments was that Gresham Davis represented the interests of OPA’s management in fighting a reconversion of the case to Chapter 7. Upon a review of the detail of the fee application, the court agreed that “at some point in the representation, the interests of the officers and directors of OPA may have become elevated over those of the estate.” In particular, the court focused on the fact that management’s proposed plan of reorganization “could redound only to the benefit of the owners of the enterprise and not to its creditors . . .” The court refused, however, to find a conflict based solely on the fact that management had proposed a cramdown plan benefitting only the shareholders:

There are serious policy ramifications to such a holding . . . which auger against deciding the case on that basis. The cramdown provisions of the Code are an expression of congressional intent regarding the importance of reorganization values even in the face of considerable creditor opposition, provided those creditors interests are appropriately protected.

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200 Id.
201 Id. at 271.
202 Id. at 271-72.
203 Id. at 272. *See also, In re Roberts*, 75 B.R. 402, (D. Utah 1987) (citing client’s choice of counsel and the economic realities as reasons to permit joint representation).
204 136 B.R. 983.
205 Id. at 986.
206 Id.
207 Id.
208 Id.
The court also noted that a strict application of *Kendavis* would create an inevitable *in terrorem* effect that would discourage competent counsel from accepting responsibility for such cases in the first place and from diligently discharging their duties.\(^{209}\)

Thus the widespread use of the principles enunciated in *Kendavis* is subject to the cost and normative concerns that limit the effectiveness of the bankruptcy governance structure. In small cases, courts are reluctant to find that dual representation constitutes a *per se* disqualification on the basis of disinterestedness. In addition, courts are averse to holding that DIP counsel’s actions which benefit managers and shareholders of the debtor necessarily should be taken as an indication that the attorney has abandoned her broader duty to the estate in favor of a particular group.

This is not to say, however, that attorney’s compensation plays no role in the bankruptcy governance structure. In contrast to the fairly broad approach taken in the disinterestedness cases, courts are increasingly examining attorney’s fees and governance issues in a somewhat more targeted way by examining how the work provided a benefit to the estate as is required under Section 330(a)(3)(C).\(^{210}\) These cases require attorneys to exercise independent judgment regarding the continued viability of a debtor or to risk losing their fees for work done beyond the point at which the reorganization appears to be hopeless.\(^{211}\)

*In re OPA*\(^{212}\) provides an example of this approach. In this case, after concluding that the DIP counsel’s actions did not warrant a finding of disinterestedness,\(^{213}\) the court went on to consider whether the firm’s efforts to avoid a reconversion of the case provided a benefit to the estate.\(^{214}\) Again, the court noted that the plan of reorganization filed by the debtor in an effort to avoid conversion of the case was unconfirmable,\(^{215}\) and stated that the fee detail

\(^{209}\) *Id.* at 988.

\(^{210}\) 11 U.S.C. § 330(a)(3)(C) (1994) directs the court in reviewing a fee application to consider, among other things, “whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title.” In addition, 11 U.S.C. § 330(a)(4)(A)(ii) (1994) prohibits the court from allowing compensation for services that were “reasonably likely to benefit the debtor’s estate” or that were not “necessary to the administration of the estate.”

Section 330 was substantially rewritten in the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994). In large part the change appears simply to codify the lodestar method of determining attorney’s fees used by many bankruptcy courts.

\(^{211}\) “Chapter 11 cases which lack viable chances of reorganization may place the fees of counsel at risk.” *In re Offield*, 128 B.R. 548, 550 (Bankr. W.D. Mo. 1991).

\(^{212}\) 136 B.R. 983.

\(^{213}\) *See* notes 187-209 *supra*, and accompanying text.

\(^{214}\) 136 B.R. at 988-91.

\(^{215}\) *Id.* at 990.
filed in the case suggested "that there was a point in time when the debtor knew or should have known that pursuit of [the] plan flew in the face of [the plan confirmation standards] ...." The court concluded that "[a]t that point, the services of the counsel were no longer necessary." The court denied allowance of the DIP counsel’s request for $10,315.00 in fees that related to the plan stating that that work “served primarily to maintain then-current management in control of the enterprise, at significant risk to the creditor body.”

In Rubner & Kutner, P.C. v. U.S. Trustee (In re Lederman Ent., Inc.), the Tenth Circuit made clear that in evaluating fee applications, benefit to the estate is a threshold concern which the court must determine before conducting any review into the reasonableness of the attorney’s fees. Lederman involved an appeal of a bankruptcy court order disallowing the DIP counsel fees related to plan confirmation and disclosure. The bankruptcy court held that the debtor’s petition was not filed in good faith and, therefore, that the work did not benefit the estate. The firm appealed the order arguing that the bankruptcy court erred in treating lack of benefit to the estate as a basis for denial of all fees related to particular work. Instead, the firm argued, benefit to the estate is merely a factor that the court should consider in determining the amount of the fees. The Lederman court also rejected the firm’s argument that the bankruptcy court’s denial of compensation amounted to punishment for the debtor’s decision to file the petition, citing a number of cases in which courts have denied fees for work completed when it is obvious that there is no reasonable prospect for a successful reorganization.

216 Id. at 990-91.
217 Id.
218 Id. at 991.
219 997 F.2d 1321 (10th Cir. 1993).
220 Id. at 1323.
221 Id. at 1322.
222 Id. at 1323. The firm also appealed the bankruptcy court’s reduction of its fees based on inadequate information in the fee application. The district court found that the bankruptcy court erred in imposing a 20% across the board reduction in the fees, and remanded the case for a recalculation of fees. In re Lederman, 143 B.R. 772, 775 (D. Colo. 1992). The district court affirmed the portion of the bankruptcy court’s opinion reducing the fees for lack of benefit to the estate, however. Id.
223 Id. at 1323-24 (collecting cases). See also, In re Ogden Modulars, Inc., 207 B.R. 198 (Bankr. E.D. Mo. 1997) (denying fees of attorney for opposing the revocation of an order of confirmation); In re Parke Imperial Canton, Ltd., 1995 Bankr. LEXIS 1259 (Bankr. N.D. Ohio 1995) (reducing fees related to the preparation of unconfirmable plan and disclosure statement and appeal of confirmation of creditor plan); In re Mfle Corp., 172 B.R. 854 (Bankr. W.D. Tex. 1994) (disallowing all compensation and requiring disgorgement of retainer where counsel filed plan with little chance of confirmation and failed to disclose compensation and conflicts of interest); In re Automobile Warranty Corp. 138 B.R. 72 (Bankr. D. Colo. 1991) (fees disallowed for preparation
Not all courts have followed the lead of cases such as Lederman and OPA. These two cases place the DIP counsel into a unique role. Normally when representing a corporation, an attorney is entitled to look to the corporation’s management for direction regarding business judgements. The comments to Rule 1.13 of the Model Rules of Professional Conduct evidence this traditional allocation of authority:

When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer’s province. However, different considerations arise when the lawyer knows that the organization may be substantially injured by action of a constituent that is in violation of law.224

The court in In re Spanjer Bros., Inc.225 cited this commentary in its consideration of a creditors’ committee’s challenge to DIP counsels fees incurred in its unsuccessful opposition to the committee’s motion for the appointment of a trustee.226 The court noted that the debtor’s management’s opposition to the motion was not a violation of law and therefore it was DIP counsel’s duty to follow the instructions of management and defend against the committee’s motion.227

Of course, one cannot take the Model Rules standard of illegality too literally in the bankruptcy context. It is not illegal to take actions such as filing plans that violate absolute priority, appealing confirmation orders or opposing conversion, yet taking such actions may place DIP counsel at risk of losing his fees if the court determines that the actions did not benefit the estate. Cases in which courts deny fees on this basis revolve around the fuzzy standards imposed by the fiduciary principle, not some hard-edged notion of illegality. Still cases such as Spanjer remind us that in examining those fiduciary standards, the Code requires the DIP and thus its counsel to represent all of the interests in the estate — not just those creditors seeking a quick liquidation.

224 MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.13 comment. Professor Ayer has noted that such bar pronouncements of the ethical obligations of attorneys are based on a litigation model and on a model of negotiation that includes a basic supposition that a lawyer is a person who tries a case. Ayer, supra note 109, at 378-84. He further points out that bankruptcy does not fit within the models represented by the Code of Professional Responsibility or the Model Rules. Id. at 392.


226 Id. at 751-52.

227 Id. at 752.
Casco Northern Bank, N.A. v. DN Associates (In re DN Associates) makes clear that this broad duty plays an important role in the determination of fee disputes. The court rejected a creditor’s argument that DIP’s counsel represented interests that were materially adverse to the estate. The creditor argued that the counsel’s opposition to the creditor’s plan and the proposal of three plans under which the limited partners would retain an interest in the reorganized debtor warranted a disallowance of fees. The court quoted the bankruptcy court with approval stating that:

[i]t would be unfortunate if courts, looking only at plan provisions removed from context, concluded as a matter of law that a conflict of interest existed whenever a debtor and its counsel, in the face of creditor opposition, pursued a reorganization strategy that, while providing for creditors in a fashion consistent with Chapter 11 priorities, sought to adjust the rights and relations of parties-in-interest so that the interests of equity interest holders could be preserved." The interests of the equity holders in preserving their interests also carried over to the courts analysis of how the work benefitted the estate. The court approved the bankruptcy court’s analysis of the intangible benefits the plans provided. Among these benefits was the attempt to protect “all interested parties, including creditors and debtor’s investors” and the constructive competition that arose among the plans.

The ability of debtors to retain counsel willing to undertake such an expansive role naturally is impaired by the risk that the court will deny fees to attorneys who err in favor of managers and shareholders. In In re Garrison Liquors, the court noted that a rule that penalized attorneys for a failed reorganization efforts “would not merely chill the enthusiasm for debtors’ representation but would prejudice the bankruptcy system itself by promoting the filing of liquidation cases rather than reorganizations.” In somewhat stronger language, the court in In re City Mattress rejected the notion that attorneys should act as watchdog over the viability of the reorganization, noting that “[l]egal services are the lifeblood of a debtor in reorganization.” The court seemed to reject the benefit to the estate standard, substituting instead a good faith requirement stating, “To the extent that a Chapter 11 Debtor

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228 3 F.3d 512 (1st Cir. 1993).
230 Id.
231 Id.
233 Id. at 564. See also, In re James Contracting Group, 120 B.R. 868, 873 (Bankr. N.D. Ohio 1990) (“counsel should not be penalized for merely for the lack of a successful reorganization”).
235 Id. at 26.
is incapable of reorganization, the Trustee’s Office may move for conversion or dismissal. So long as the debtor is permitted to continue in Chapter 11, however, this court will not penalize counsel for its good-faith representation.” 236

These cautionary notes notwithstanding, the trend seems to be to treat DIP counsel as a critical component of the Chapter 11 governance system. The unique nature of debtor practice requires the attorney to monitor continually not only the legal aspects of the case but also the business decisions made by the management. This unique status arises not only from the broad fiduciary duties owed by the DIP, and thus by DIP counsel, but also from purely pragmatic considerations. As the court in In re Pacific Forest Industries, Inc. 237 so aptly pointed out, the governance structure that Congress envisioned for the Code does not work in a world of ever increasing filings. 238 The courts and the U.S. Trustee’s office are hopelessly overburdened 239 and thus the process must turn to DIP counsel as the one person who is familiar with both the debtor and the practical constraints on the reorganization process. 240

D. Summary: Making the Best of a Bad Situation

Bankruptcy courts have shown a remarkable resourcefulness in responding to the problem of governing managerial behavior within a legislative framework that is theoretically sound but practically unworkable. 241 Through active case management, courts have placed outside limits on the ability of managers and shareholders to delay the ultimate demise of hopeless debtors. Courts have successfully used examiners to overcome managers’ informational advantages and to assist in plan negotiations. Finally, through their control over fee awards, courts have conscripted attorneys for DIP’s into a governance role. Each

236 Id. The City Mattress case did not, however, involve a challenge to the DIP counsel’s fees based on lack of benefit. Instead, the case considered the U.S. Trustees challenge to an application for interim compensation.


238 Id. at 743-44.

239 Cf. NBRC RECOMMENDATIONS, supra note 6, at 26 (expanding the role of the United States Trustee in small business reorganizations).

240 In Pacific Forest Industries, the court examined DIP counsel referred to as an application to sequester his attorneys fees. The plan called for the monthly payment of attorney’s fees which the DIP counsel would place in his client trust account pending court approval of his fee application. Id. at 741. The attorney argued that DIP attorneys should not be forced to finance the case and risk losing their fees if the reorganization failed. Id. The court noted that the risk of non-payment provided the attorney an incentive to monitor the DIP and to assure that the assets were not wasted in a futile attempt at reorganization and denied the application. Id. at 743.

241 Clark, supra note 107, at 200.
of these methods are subject to difficulties that limit their effectiveness, however. The nature of the judicial role may be inconsistent with some forms of case management. This problem, combined with concerns over costs, limit the widespread creative use of examiners. The need to attract high quality attorneys to debtors practice, coupled with the inherent conflicts such a practice entails, causes courts to be reluctant to rely too heavily on DIP counsel. On balance, however, these approaches seem to be reasonably calculated to respond to the intractable problems native to the reorganization process.

V. THE BANKRUPTCY REVIEW COMMISSION REPORT: PRAGMATISM MEETS POLICY

Appointed under the Bankruptcy Reform Act of 1994, the National Bankruptcy Review Commission, has recently completed an exhaustive study of all aspects of the bankruptcy process. The Commission's 1,000 page report includes more than 170 recommendations covering the entire range of bankruptcy problems from individual bankruptcies to large corporate reorganizations. Although, the Commission chose not to draft an all-encompassing bankruptcy reform bill, perhaps reducing the likelihood of prompt legislative consideration, it is likely that the report will dominate discussions of bankruptcy policy for years to come.

While, the Commission's report recommended a number of changes to Chapter 11, by far the most significant proposals for changes in the reorganization governance structure attempt to address the unique problems of small business reorganizations. As noted above, small business cases not only dominate Chapter 11, but also present unique problems that have led some commentators to question the wisdom of including large and small cases under the same statutory framework. The Commission noted two fundamental problems relating to small business Chapter 11's. First, some of Chapter 11's requirements are so

243 The Commission's Report was presented to Congress, the President and the Chief Justice on October 20, 1997.
244 See supra notes 61-70 and accompanying text.
245 The commission estimated that approximately 85% of Chapter 11 filings would fall within the $5,000,000 debt limit that the recommendations use to define "small business." See supra note 65.
costly and cumbersome that relief under the chapter is out of reach for some businesses wishing to reorganize.\textsuperscript{247} Thus, the Commission recommendations included proposals to streamline some of Chapter 11's procedures for these cases. Second, the Commission noted that the majority of small businesses seeking relief have no reasonable likelihood of rehabilitation.\textsuperscript{248} With respect to this latter category of cases, the Commission attempted to craft rules to identify more quickly hopeless debtors and to move them out of the reorganization process.

Solutions to these two problems create a tension, however. Provisions that are designed to eliminate those cases languishing in Chapter 11 without hope of reorganization will necessarily increase the cost of the process.\textsuperscript{249} Conversely, cost cutting and simplification measures carry the risk of reducing the effectiveness of the governance structure. The Commission report appears sensitive to this tension — generally erring on the side of improved governance.\textsuperscript{250}

A. The Small Business Proposals

The small business proposals attack the problem of governing these cases from two directions. First, the proposals provide standards regarding the DIP's conduct of both the case and the underlying business. These proposals provide shortened deadlines for both plan filing and confirmation and provide that the failure of the debtor to comply with either the deadlines or a number of other requirements constitute cause for dismissal, conversion or the appointment of a trustee. Second, the proposals enhance oversight of the debtor in possession and the conduct of the case. The proposals expand the reporting requirements, require the court to conduct status conferences and increase the role of the U.S. Trustee's

\textsuperscript{247} NBRC REPORT, \textit{supra} note 6, at 614.

\textsuperscript{248} Id. at 609.

\textsuperscript{249} See NBRC REPORT, \textit{supra} note 6, at 640 (noting the additional cost and burden of proposed reporting requirements)

\textsuperscript{250} The principal cost cutting measures will likely have little effect on the governance structure. Piggybacking off of the existing provisions on small business bankruptcies, the proposals eliminate the mandatory appointment of creditors' committees for a larger number of cases. \textit{See} 11 U.S.C. § 1102(a)(1) (1994). This provision is likely to have a negligible effect on bankruptcy governance since creditors' committees are currently appointed in only around 15% of all Chapter 11 cases. The other cost cutting measure is the proposal to simplify the disclosure requirements by allowing the use of form disclosure statements and allowing courts the discretion to combine the hearing on approval of the disclosure statement with the confirmation hearing. The commission noted that small cases cannot support the fees required to draft the elaborate disclosure statements required under current law. NBRC REPORT, \textit{supra} note 6, at 637. It is therefore likely that simplifying the disclosure statement requirements will result in better disclosure than is currently available.
office in overseeing the case. The following discussion examines these approaches in more detail.

1. Standards of Conduct

The heart of the standards of conduct governing small business reorganizations is the Commission’s proposal to amend Section 1112(b). The proposal provides particularized benchmarks for the conduct of the business and the Chapter 11 case and shifts the burden to the debtor to show its entitlement to continue in Chapter 11 if the benchmarks are not met. Among the benchmarks are failure to maintain insurance or to pay taxes or bankruptcy fees or charges, continued loss to or diminution of the estate, failure to file reports in the case or to attend Section 341 meetings or Rule 2004 examinations or to comply with the U.S. Trustee’s reasonable requests for meetings or information. The DIP’s failure to meet these benchmarks constitutes cause for dismissal, conversion or the appointment of a trustee. The proposed revisions to Section 1112 represent the Commission’s attempt both to add teeth to the Code’s procedural requirements and to identify objective factors that have a high correlation with a likelihood of a failed reorganization.

Where cause is established, the burden shifts to the debtor to show an entitlement to continue in Chapter 11. Not only must the debtor show that it is more likely than not that a plan will be confirmed within the time set by the court, but if the cause was an act or omission of the debtor, the debtor must show a reasonable justification for the act or omission and must cure the problem within 30 days, or less if the court so orders. The Commission’s Report explains that the intent of this proposal is to adopt a burden of proof “halfway between existing Chapter 11 practice and the burden of proof imposed on nondebtor litigants seeking injunctive relief against creditor action.” The proposals continue to place the burden on the party seeking dismissal or conversion until the debtor fails to meet one of the benchmarks. At that point, the burden shift to the debtor to show a likelihood of success.

In addition to the proposed changes to Section 1112, the Commission has recommended shortened deadlines for filing and confirming a plan of reorganization. Under

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251 It is unclear from the text of the recommendations for revision of Section 1112 whether the proposal is intended to apply only to small business reorganizations. The proposal itself recommends a replacement for 1112(b) which appears to apply to all Chapter 11 cases. NBRC RECOMMENDATIONS, supra note 6, at 30-31. The report’s discussion of the proposal makes several references to small business cases, however. NBRC REPORT, supra note 6, at 652-56.

252 NBRC RECOMMENDATIONS, supra note 6, at 31.
253 NBRC REPORT, supra note 6, at 653.
254 NBRC RECOMMENDATIONS, supra note 6, at 30.
255 NBRC REPORT, supra note 6, at 652-63.
the proposal, all plans and disclosure statements must be filed within 90 days and a plan must be confirmed within 150 days. The proposal would permit extensions only if the hearing is conducted and ruled upon within the deadline and only if the debtor proves "by a preponderance of the evidence that it is more likely than not to confirm a plan of reorganization within a reasonable time." The proposal includes a requirement that the U.S. Trustee actively participate in the extension hearing and requires the court to set a new deadline at the time the extension is granted. While the Commission Report justifies this requirement as a cost saving measure that is beneficial to the debtor, it is perhaps more appropriately viewed as providing assurance to the creditors that there will be an outside limit on managers ability to maintain control over the business in Chapter 11.

2. Oversight

Of course, these standards would be ineffective to counteract the control of managers in cases in which no one raises the debtor's failure to meet the standards. Thus, as a complement to the standards, the Commission's recommendations combine enhanced powers of the U.S. Trustees and a requirement that the court hold at least one "on the record" scheduling conference with increased debtor reporting requirements to provide a structure of debtor oversight. These provisions represent the Commission's effort to counteract the governance problems associated with creditor apathy in small Chapter 11 cases.

The centerpiece of the Commission's oversight proposal is their enhancement of the role of the U.S. Trustee. The proposals require the U.S. trustee to conduct an initial debtor interview ("IDI") soon after the initiation of the case. The purpose of the IDI is two-fold. First the IDI is intended to provide debtor education. The proposal requires the U.S. Trustee to inform the debtor of its reporting and other obligations under the Code. Second, the IDI allows the U.S. Trustee to begin learning about the debtor's business and likely prospects for reorganization. In addition to the IDI, the U.S. Trustee is given the authority to visit the debtor's business premises to examine the debtor's books and records. Finally, and perhaps most significantly, the proposals require the U.S. Trustee to review and monitor cases with a view toward identifying those cases in which the debtor's prospects appear hopeless and...

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256 The recommendation retains the exclusivity period for the entire 90 days but allows the court to lift exclusivity. NBRC RECOMMENDATIONS, supra note 6, at 28.
257 Id. at 29.
258 Id.
259 Id.
260 NBRC RECOMMENDATIONS, supra note 6, at 29. The court may dispense with the scheduling conference if the debtor and the U.S. Trustee present an agreed scheduling order to the court for approval on notice and a hearing. Id. The proposals contemplate that, in most cases, such an order will be agreed to at the initial debtor interview. See note 261, infra and accompanying text.
to move for relief under Section 1112 where material grounds exist.\textsuperscript{261}

The Commission's proposed enhancements to the Chapter 11 reporting requirements are conceptual rather than specific. The proposal calls for Advisory Committee on Bankruptcy Rules to develop nationwide standards for small business reporting that achieve a balance between reasonably complete information and affordability and simplicity. Elaborating on what constitutes reasonably complete information, the proposal states that the reporting requirements should, at a minimum include information regarding profitability, including projections of receipts and disbursements and a comparison of actual versus projected results, and information regarding the debtor's compliance with the Code's requirements and tax obligations.\textsuperscript{262}

B. Evaluation of the Commission's Proposals

The Commission's proposals obviously draw heavily from the positive experiences of bankruptcy judges who have used active case management techniques in an effort to reduce the delay and consequent waste of assets in small business cases. The oversight function of the U.S. Trustee responds directly to the creditor indifference problem that many commentators have identified in these cases. In addition, the shortened deadlines for plan filing and confirmation coupled with the changes in the substantive standards for dismissal or conversion provide creditor with some assurance that some outside limits are placed on both the length and the breadth of managerial discretion. Overall then, the recommendations represent a positive step toward improved governance in Chapter 11.

This conclusion is subject to a few caveats, however. The Commission's general proposals regarding Chapter 11 may limit somewhat the effectiveness of the small business proposals. By a 5-4 vote, the Commission proposed the codification of the new value

\textsuperscript{261} NBRC RECOMMENDATIONS, \textit{supra} note 6, at 32.

\textsuperscript{262} NBRC RECOMMENDATIONS, \textit{supra} note 6, at 26-27.
exception (corollary?)\textsuperscript{263} to the absolute priority rule\textsuperscript{264} in all cases, big and small.\textsuperscript{265} The effect of this proposal on the governance concerns discussed here is somewhat indirect but may be substantial.\textsuperscript{266} Both the substantive and oversight aspects of the small business proposals have as their goal, the identification of cases in which a confirmed plan is unlikely. The effort, of course, is to eliminate the ability of managers and shareholders to use the delays inherent in Chapter 11 to remain in control and perhaps to extract concessions from the creditors.\textsuperscript{267} Small business debtors may remain in Chapter 11 beyond the deadlines only upon a showing that it is more likely than not that they will confirm a plan within a reasonable time. To the extent that the new value rule makes it easier to propose a confirmable plan, the deadlines may lose some of their effectiveness.\textsuperscript{268}

\textsuperscript{263} Whether the new value rule is an exception or corollary to the absolute priority rule turns on the appropriate interpretation of 11 U.S.C. Sec. 1129(b)(2)(B) which provides that, in a cramdown plan, junior classes may not “receive or retain under the plan \textit{on account of such junior claim or interest} any property” (emphasis added) unless senior classes are paid in full. The correct characterization may also turn on which side of the new value debate one finds him or herself. \textit{Compare}, NBRC REPORT, supra note 6, at 104 (discussing the Commissions recommendation to codify the new value “corollary”) with Hon. Edith H. Jones, \textit{Dissent from Certain Commission Recommendations on General Issues in Chapter 11}, at 19, \textit{published in NBRC REPORT: VIEWS OF THE INDIVIDUAL COMMISSIONERS}, available at <http://www.nbrc.gov/report/24commvi.pdf> (hereinafter, \textit{Chapter 11 Dissent}) (discussing the Commissions proposal to codify a new value “exception”).

\textsuperscript{264} NBRC RECOMMENDATIONS, supra note 6, at 24.

\textsuperscript{265} In fact, the Report makes specific reference to the needs of “mom and pop” businesses in its new value discussion. \textit{See} NBRC REPORT, supra note 6, at 564.

\textsuperscript{266} The proposal does, however, include a provision terminating the debtor’s exclusive right to propose a plan on motion by a party in interest when the debtor moves to confirm a non-consensual new value plan. NBRC RECOMMENDATIONS, supra note 6, at 24. This aspect of the proposal ameliorates somewhat the imbalance created by granting the debtor an exclusive option to propose such a plan. NBRC REPORT, supra note 6, at 562. The lifting of exclusivity may not be sufficient, however, to counteract the negotiating leverage created by the ability to delay the case by proposing a new value plan and the informational advantage held by the debtor’s management. \textit{See} Jones, \textit{Chapter 11 Dissent}, supra note 263, at 24-27 (pointing out the inadequate protection provided by competing plans).

\textsuperscript{267} The Commission Report recognizes the concern that the ability of equity to propose a new value plan may create additional opportunities for equity to exercise “hold-out leverage,” but concludes that “in the context of the widely held publically traded debtor, this proposal is unlikely to change negotiating positions based on hold-out powers.” NBRC REPORT, supra note 6, at 565. The report does not respond to this concern in the context of smaller cases.

\textsuperscript{268} \textit{See} Jones, \textit{Chapter 11 Dissent}, supra note 263, at 28 (arguing that the proposal undercuts the small business proposals). Judge Jones also argues that the proposal does not include the
In addition it may be that the proposals do not go far enough in resolving the governance problems in small business cases. In its deliberations over how oversight should be conducted, the Commission considered and rejected proposals to require the appointment of an independent business expert to examine the viability of the business and to oversee the debtor’s management. Critics of this approach cited the duplication of functions already served by the courts, U.S. Trustees and panel trustees, the likelihood that such agents would be perceived as “stereotypical government bureaucrats” and the cost of such professionals. In the end the Commission decided to allocate this function to the U.S. Trustees.

The Report’s discussion of this decision provides an unsatisfactory explanation. Duplication is a function of the allocation of authority. Presumably, the presence of an independent monitoring agent would alleviate the governance burden placed on others in the process. Furthermore, it is unclear what problems are created by a perception that the monitor is a bureaucrat. Even if such a perception would create difficulties, it unlikely that the perception of a monitoring agent as a “stereotypical government bureaucrat” is reduced by the allocation of oversight authority to a governmental entity.

The Commission’s reference to the cost of an additional professional in the small business proposals raises what is perhaps the most disturbing aspect of the small business proposals. While the Report uses cost as a means of justifying its decision not to use an independent monitoring agency, the report is nearly devoid of any discussion of the likely cost of the expanded duties allocated to the U.S. Trustee. The only reference to the cost of expanding the duties of the U.S. Trustee is a brief passage expressing concern over whether Congress will appropriate the necessary funds for the U.S. Trustee to fulfill its new role.

Of course, inadequate funding would cripple the oversight provisions. The problem with the Commission’s approach to the cost issue is more fundamental, however. Increasing oversight comes only at a cost — no matter whether the role is assigned to a governmental or private entity. It may be that the U.S. Trustee can perform this role more efficiently than can a private monitoring agent, but the Report provides no evidence that this is true. Aside from the relative efficiency of government versus private monitors is the question of who should bear the cost of oversight. By assigning the oversight role to the U.S. Trustee, the proposal places this burden on the government, creating an additional subsidy for the

requirements for new value contributions set out in Case v. Los Angeles Lumber, 308 U.S. 106 (1939) and may overrule the Supreme Court’s holding in Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988). Id. at 23. These deficiencies would make it even easier to confirm a new value plan.

269 NBRC REPORT, supra note 6, at 658. The Report refers to the success of such an approach in the United Kingdom. Id.

270 Id. at 658-59.

271 In addition, the Report’s reference to a duplication of the panel trustee’s function is somewhat mystifying.

272 Id. at 657.
reorganization process. Such a subsidy may be defensible in light of the public benefits of the reorganization process. At a minimum, however, the question raises substantial policy issues that the Report’s treatment of the cost issue obscures.

C. The Bankruptcy Commission Proposals and the Continued Debate over the Goals of Chapter 11

Like most of the Recommendations, the small business proposals are not entirely free of controversy. Two of the Commissioners dissented from the small business proposals noting that “the Commission's Recommendation sets up a requirement-laden, inflexible program aimed primarily at removing cases from the system that cannot confirm plans in the limited time permitted.” The dissent cites the benefits of Chapter 11 to employees, customers and suppliers and taxing authorities and argues that the proposals would make those benefits more difficult to achieve. In its conclusion, the dissent states quite clearly the deep-seated policy issues that the proposals raise:

The Recommendation thus reveals an unmistakable sense that it is not the failing business lingering aimlessly in Chapter 11 that is the target so much as it is Chapter 11 itself. If that is the message of the Recommendation, then a more fundamental debate about Chapter 11 must be resolved—or at least the clear policy choices identified—before large scale case management proposals can be realistically considered.

These Commissioners’ comments illustrate a point made earlier. There exists no clear consensus regarding the appropriate goals of Chapter 11. This lack of consensus surfaces elsewhere in the Report and the dissents. In her dissent from the Chapter 11 proposals, Judge Jones complained that the majority’s proposals included a number of unstated assumptions that include debtor’s need for added negotiating leverage and control and that there are too few cases with confirmed plans. She further expressed concern that there was a lack of attention paid to “concrete proposals to get the creditors paid more quickly and certainly.” Sharply divided votes on proposals such as the new value recommendation may simply reflect differences of opinion regarding the

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274 See Id. at 2-3.

275 Id. at 3.

276 See notes 71-82, supra and accompanying text.

277 Jones, Chapter 11 Dissent, supra note 263, at 5.

278 Id. at 6.
appropriate means to an agreed end. It is more likely, however, that the differing views reflect a more fundamental disagreement on the appropriate ends.

A common refrain in discussions of Chapter 11 is that it is intended to rehabilitate businesses "for the benefit of both debtors and creditors [and] to preserve jobs and other ties within communities."279 Successful reorganizations can do both. But this well worn maxim obscures an important fact - the goals of benefitting creditor and saving jobs and ties within communities conflict anytime the business has a liquidation value that exceeds its value as a going concern.280 These are the cases that present the most fundamental policy questions regarding the goals of Chapter 11. The Commission report shows that the resolution of such questions will continue to undergird the debate over bankruptcy reform.

VI. CONCLUSION

In theory, the problem of controlling managerial behavior in Chapter 11 presents no real challenge. Chapter 11 provides a structure of investor representation and judicial oversight that facially addresses the governance problems inherent in running an insolvent corporation. By looking to the principles of financial economics that support and illuminate the non-bankruptcy governance structure, analysts have developed a number of suggestions regarding ways to apply non-bankruptcy governance principles in Chapter 11 to assure that managerial decisions maximize the value of the business assets.

The theoretical solutions to governance problems in Chapter 11 do not provide answers in the real world, however. Small bankruptcies present unique governance problems that arise from the fact that creditors do not individually have enough at stake to justify monitoring the debtor's management and challenging actions that do not maximize the value of the debtor's assets. The most fundamental of such actions relate to efforts to continue an attempt at reorganization that appears, to an objective observer, to be hopeless. The delay in liquidation places creditor recoveries at risk in an effort that may only benefit shareholders and managers. Bankruptcy courts have developed three somewhat related approaches to combat managerial autonomy in these cases. Through active case management, the flexible use of examiners and control over the fees of the DIP counsel, some courts have attempted to counteract managerial autonomy. The National Bankruptcy Review Commission has incorporated some of these approaches in its proposals for reform of the provisions governing small business bankruptcies.

But lurking under the surface of the both the cases and the Commission's Report is a more fundamental problem — a lack of consensus regarding the goals of Chapter 11. Everyone can agree on what we want bankruptcy to do — it should rehabilitate companies in order to maximize creditor returns, preserve jobs and assure continuing support for

279 NBRC REPORT, supra note 6, at 566-67.
280 See supra note 75, and accompanying text.
communities surrounding the business. Sometimes Chapter 11 can do this but most of the time it cannot. The question is not whether we should save the businesses that can be saved and quickly liquidate the rest, however. It is instead a question of in which direction the process should err. Since our approach to governance will necessarily have an effect on the direction of error, it is unlikely that a fully functioning governance structure will emerge until this fundamental question is answered.
DISCHARGE
AND
DISCHARGEABILITY LITIGATION

Supreme Court and Circuit Court Opinions Published Through 9/5/97
Selected District Court and Bankruptcy Court Opinions Published Through 12/25/96

Hon. Keith M. Lundin
United States Bankruptcy Judge
Middle District of Tennessee
Special thanks to Sharron Lane, Law Clerk for the United States Bankruptcy Court, Middle District of Tennessee, for much assistance in the preparation of these materials.
# DISCHARGE AND DISCHARGEABILITY LITIGATION

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SECTION D
DISCHARGE AND DISCHARGEABILITY LITIGATION

I. COMMENCEMENT, TIMING AND PROCEDURE

A. Commencement


   In re Catron, 186 B.R. 194, 196-97 (Bankr. E.D. Va. 1995) (adversary proceeding must be filed before court can declare debt nondischargeable. Consent order in stay litigation agreeing to nondischargeability after deadline for filing complaint has no preclusive effect where debtor did not fraudulently induce creditor to forfeit right to file dischargeability complaint.).

B. Timing and extensions of time

1. Section 523(a)(2), (4) or (6) complaint must be filed no later than 60 days after the first date set for the meeting of creditors. 11 U.S.C. § 523(c); Fed. R. Bankr. P. 4007(c).

   In re Dawson, 185 B.R. 406 (Bankr. D.R.I. 1993) (preconversion objection to confirmation of Chapter 13 plan alleging misappropriation of probate funds and requesting that judgment be declared nondischargeable under § 523(a)(4) constitutes amendable dischargeability complaint).

2. Sixty days from meeting of creditors at which debtor was present, 60 days from date first set, or 60 days from date of continued meeting?

   Datson v. Cote (In re Datson), 197 B.R. 1 (D. Me. 1996) (The bar date for filing dischargeability complaints is not tolled because the meeting of creditors is continued. “[T]he sixty-day period starts running on the first date set for the creditors’ meeting, regardless of when the meeting is actually held. If the meeting of the creditors is rescheduled or if a creditor anticipates that the meeting of creditors will not be held during the sixty-day period, then the proper remedy is for the creditor to request an extension before the expiration of the bar date pursuant to Rule 4004(a) and Rule 4007(c).”)

   Peerless Ins. Co. v. Miller (In re Miller), 182 B.R. 507 (Bankr. S.D. Ohio 1995) (given ambiguous wording of Rule 4007(c), 60 day period runs from date meeting of creditors actually held, not first date set; court cautions majority view is otherwise and Sixth Circuit has not ruled on issue).

3. Cause for extension of time

   In re Amezaga, 192 B.R. 37 (Bankr. D. P.R. 1996) (absent bad faith, extensions of time under Rule 4004(b) should be granted liberally. An allegation of need for discovery constitutes sufficient cause. Court may grant the extension without a hearing. The phrase “after hearing on notice” in Rule 4004(b) is
similar to “after notice and a hearing” and “clearly different from the statutory provisions stating that the Court ‘shall hold a hearing.’")

4. Party in interest must seek extension of time before original deadline expires

Brady v. McAllister (In re Brady), 101 F.3d 1165 (6th Cir. 1996) (chapter 7 trustee has standing to extend deadline for all creditors to file § 523 complaints. Trustee timely filed motion to “extend the date for filing non-discharge complaints.” The trustee’s motion was granted by order that provided “that the Trustee . . . shall, on behalf of the estate and all unsecured or undersecured creditors of the estate, have through and including October 21, 1992 in which to file non-dischargeability complaints . . .” After original complaint deadline but before October 21, a creditor filed a complaint under § 523(a)(2) & (a)(4). The debtor argued that the complaint was untimely, and that the chapter 7 trustee did not have standing to move to extend the time for all creditors. Sixth Circuit found that the motion and order extending time were “somewhat ambiguous,” but the court would not contradict the bankruptcy court’s interpretation of its own order. “Party in interest” under Fed. R. Bankr. P. 4007(c) includes a trustee. To “depriv[e] the trustee standing to secure additional time for creditors to file nondischargeability complaints could undermine the efficient administration of bankruptcy proceedings. . . .” That the chapter 7 trustee could not file a complaint on his own behalf “does not preclude the ability to request additional time to file such a complaint.” Trustee, as representative of the estate, has an economic interest in obtaining the extensions because “nondischargeable debts do share in the estate distributions pro rata with dischargeable debts of the same class.”

In re Farmer, 786 F.2d 618 (4th Cir. 1986) ("party in interest" does not have the same meaning in Fed. R. Bankr. P. 4004(b) and 4007(c). Because Chapter 7 trustee could not bring a complaint under § 523, trustee is not a party in interest to seek an extension of time under 4007(c). Granting of trustee’s Fed. R. Bankr. P. 4007(c) motion to extend time did not extend the period for creditors to file complaints under § 523. Chapter 7 trustee is a party in interest to seek an extension of time under Fed. R. Bankr. P. 4004(b) because trustee has standing to object to discharge under § 727.)


Marshall v. Demos (In re Demos), 57 F.3d 1037 (11th Cir. 1995) (bankruptcy court order, extending the time for filing discharge and dischargeability complaints, on joint motion of trustee and debtor, extended time for all parties in interest. The motion invoked the court’s equitable powers under 11 U.S.C. § 105, not Fed. R. Bankr. P. 4004. Motion stressed the numerous creditors and sought an extension for both discharge and dischargeability complaints. Order extending time was reasonably relied upon as an extension of deadlines for all creditors.)
5. Effects of clerk’s office notice and administrative mistakes

Wilzig v. Lopez (In re Lopez), 192 B.R. 539 (B.A.P. 9th Cir. 1996) (clerks’ office mailed two notices setting different deadlines for the filing of dischargeability complaints. The first purported to reschedule a meeting of creditors previously set, however, no prior notice had issued. The second notice set the date for the meeting of creditors and the date by which dischargeability complaints had to be filed. Plaintiff filed its complaint within date set in second notice. “To be effective, a notice which announces the
running of a time period must do so clearly. . . . Parties are entitled to be notified in clear and unambiguous terms of deadlines, particularly when they are critical. . . . A notice cannot be said to be ‘reasonably calculated’ to afford interested parties an opportunity to protect legal rights where its factual premise is not readily discernible and is misleading.” “[W]here the court misleads a creditor regarding the deadline for filing complaints, a bankruptcy court may employ its equitable powers under § 105(a) to hold a complaint timely filed.”

6. Can timeliness of complaint be waived?

Compare European Am. Bank v. Benedict (In re Benedict), 90 F.3d 50 (2d Cir. 1996) (time period for filing dischargeability complaints under Fed. R. Bankr. P. 4007(c) is not jurisdictional and can be waived by debtor. “The Supreme Court has stated that ‘[s]tatutory filing deadlines are generally subject to the defenses of waiver, estoppel, and equitable tolling.’ . . . There is nothing in the Bankruptcy Code that persuades us to hold that Rule 4007(c) is any different from a statutory provision that imposes a filing deadline. Nor do we perceive that there is a controlling policy goal that would be served by holding that Rule 4007(c) is jurisdiction.” Debtor waived her right to challenge a late filed § 523 complaint because she agreed in a reaffirmation agreement executed after the deadline for dischargeability complaints that if she rescinded the agreement, the creditor could still file a complaint under § 523), with State Bank of India v. Chalasani (In re Chalasani), 92 F.3d 1300 (2d Cir. 1996) (Fed. R. Bankr. P. 4004 creates “an inflexible and mandatory rule, one not subject to a court’s discretion. . . . The interest of finality, advanced by the deadline, furthers an important policy goal in bankruptcy law, that is, that a debtor should obtain a fresh start in life and an opportunity to move ahead free of financial distress as quickly as possible. . . . After the deadline passes, it is too late for any party to object to discharge in an ongoing adversary proceeding or to seek to intervene to raise an objection to discharge in another proceeding. . . . Hence, under § 727 an objection must be made within 60 days or not at all.”).

C. Statutes of limitations

Lee-Benner v. Gergely (In re Gergely), 110 F.3d 1448, ___ (9th Cir. 1997) (that state statute of limitations for fraud expired is not fatal of § 523(a)(2)(A) action where plaintiff has a state court judgment. “[T]he expiration of a state statute of limitations on fraud actions does not affect an action for nondischargeability if there is a valid judgment. . . . The state limitations period for fraud actions is irrelevant to the dischargeability of an established debt.” The plaintiff claimed that the debtor, an obstetrician, misrepresented the need for amniocentesis and then performed the procedure negligently resulting in the plaintiff being born blinded in one eye. Three years before bankruptcy, the child obtained a nonfraud judgment for $780,282. The child’s argument that fraudulent misrepresentation of the need for amniocentesis was actionable under § 523(a)(2)(A) was not barred by the state statute of limitations for fraud, citing In re McKendry, 40 F.3d 331 (10th Cir. 1994).)

Perdue v. Cantrell (In re Cantrell), 88 F.3d 344 (5th Cir. 1996) (bankruptcy court properly dismissed complaint under §§ 523(a)(2) and 727(a)(2)(A) because no
prosecutable claim existed. Statute of limitations had run prior to plaintiffs' state court complaint, thus plaintiff had no prosecutable claim in the bankruptcy case.)

Resolution Trust Corp. v. McKendry (In re McKendry), 40 F.3d 331 (10th Cir. 1994) ("[T]he question of the dischargeability of [a] debt under the Bankruptcy Code is a distinct issue governed solely by the limitations periods established by bankruptcy law." The "debt," on the other hand, is a creature of nonbankruptcy law, and is governed by applicable state or other federal statutes of limitation. If an action on the "debt" is not brought within the applicable limitations period, the debt cannot be established, and the issue of dischargeability is academic. Mortgage deficiency judgment containing no finding of fraud is a debt that may be nondischargeable under § 523(c) notwithstanding that state statute of limitations for fraud expired long before filing of bankruptcy case.). Accord Kaleta v. Sokolow, 183 B.R. 639, 642 (M.D. Ala. 1995).

Lee-Bennett v. Gergely (In re Gergely), 186 B.R. 951 (B.A.P. 9th Cir. 1995) (declining to follow McKendry, 40 F.3d 331 (10th Cir. 1994), statute of limitations bars dischargeability action where plaintiff obtained state court judgment for medical malpractice, but raised intentional tort theories of liability for the first time in dischargeability complaint filed years after the state statute of limitations expired for such actions).

G.W. White & Son, Inc. v. Tripp (In re Tripp), 189 B.R. 29 (Bankr. N.D.N.Y. 1995) (where the only issue before the court is dischargeability under § 523(a), and no request is made for judgment on debt, the defense that the statutory limitation period for maintaining an action has lapsed is misplaced. “[State statute of limitations creates a material issue in an action based on Code § 523(a)(6) only if it defines the existence of the Debtor’s role as a fiduciary.”)

D. Service of process

1. Delayed service of summons

Broitman v. Kirkland (In re Kirkland), 86 F.3d 172 (10th Cir. 1996) (bankruptcy court did not abuse its discretion in dismissing a dischargeability complaint that was served one day beyond time limit set forth in Fed. R. Civ. P. 4(j). Failure to serve the summons and complaint within 120 days is excused only for "good cause." "Good cause" is not equivalent to "excusable neglect" under Fed. R. Bankr. P. 9006(b)(1), thus the flexible test adopted by the Supreme Court in Pioneer is not applicable. "Good cause" is construed narrowly. Mere inadvertence or neglect do not constitute "good cause." Pro se plaintiffs stated no legitimate reason for belief that they had an additional day to complete service; neither mistake of counsel nor ignorance of the rules suffice.)

Artificial Intelligence Corp. v. Casey (In re Casey), 193 B.R. 942 (Bankr. S.D. Cal. 1996) (Under Fed. R. Bankr. P. 7004 a complaint shall be dismissed if not served within 120 days "if the party to provide service cannot show good cause why such service was not made within that period. The good cause must be connected with the failure to serve timely. The meaning of good cause is unaffected by the intervention of a time bar that will preclude refiling,
notwithstanding that the dismissal is nominally without prejudice." Plaintiff's tactical delay of service beyond 120 days was fatal to the complaint where failure to serve was not due to debtor's misconduct or any inability on plaintiff's part to complete service.)

Mrochek v. Oppean (In re Oppean), 189 B.R. 616 (Bankr. E.D. Va. 1995) ("If a plaintiff is not diligent and fails to serve the complaint, the case shall be dismissed without prejudice unless plaintiff demonstrates good cause not to dismiss the action. . . . ['T]he . . . burden of establishing good cause . . . is a difficult one to meet;' . . . Once plaintiff fails to establish good cause, dismissal is mandatory, and plaintiff must refile. . . . Upon refileing, plaintiff is subject to all time defenses even if the effect of dismissal 'is to bar plaintiff's claim.')

Mazzone v. Osebach (In re Osebach), 187 B.R. 92 (Bankr. E.D.N.Y. 1995) (complaint dismissed with prejudice due to plaintiff's failure to serve summons and complaint within 120 days. Statute of limitations expired after suit filed.)

E. Amending complaint after filing deadline

1. Allowing amendment

Schwager v. Fallas (In re Schwager), 121 F.3d 177, 186 (5th Cir. 1997) (bankruptcy court appropriately exercised discretion under Bankruptcy Rule 7015 to permit amendment of § 523(a)(4) complaint after 60 day deadline. "The amended complaint did not allege new grounds for finding the 1989 judgment debt nondischargeable, but merely added specific facts consistent with the nondischargeability grounds advanced in their original complaint.")

Beasley v. Adams (In re Adams), 200 B.R. 630 (N.D. Ill. 1996) (applying Rule 7015 standards, amendment to add § 523(a)(15) cause of action relates back to time of filing complaint asserting only § 523(a)(5) because both actions arise out of the same settlement agreement or divorce decree. Original § 523(a)(5) complaint was filed before 60-day bar date. Amendment to add § 523(a)(15) came after bar date. "Sections 523(a)(5) and (a)(15) are, . . . 'merely alternate theories for an objecting ex-spouse to establish a debt as nondischargeable.' . . . Which of these alternate theories applies depends upon whether the debt is in the nature of alimony, maintenance or support; or in the nature of a property settlement. This is a factual determination that the bankruptcy judge must make no matter whether Section (a)(5), Section (a)(15) or both are at issue, and no matter what language was used in the agreement or divorce decree since 'even an obligation designated as property settlement may be related to support because State courts often will adjust alimony awards depending on the nature and amount of marital assets available for distribution.")

F. Intervention; substitution

FDIC v. Meyer (In re Meyer), 120 F.3d 66 (7th Cir. 1997) (substitution of RTC or FDIC as successor to a failed bank in § 523 litigation is appropriate when nondischargeability complaint was timely filed in the bank’s name, the debtor was on notice and there is no prejudice to the debtor. That the original complaint was filed by a subsidiary to the parent bank that actually held the debt is "of no consequence.")
State Bank of India v. Chalasani (In re Chalasani), 92 F.3d 1300 (2d Cir. 1996) ("substitution" of parties does not avoid 60-day deadline for complaints. Original plaintiff asserted both § 523 and § 727 objections, but obtained default judgment only on § 523 ground. Five months after the default judgment was noticed to the trustee and to creditors, and more than one year after expiration of the original deadline for filing complaints, another creditor sought to be substituted as plaintiff to reopen the proceeding to amend the judgment to deny debtor's discharge under § 727. The attempted substitution was procedurally inappropriate. "[C]ommon sense argues against a discretionary substitution that facilitates an end-run around the 60-day time limit.").

Papadakis v. Zelis (In re Zelis), 66 F.3d 205 (9th Cir. 1995) (where original complaint asserted both §§ 523 and 727, substituted plaintiff permitted to reopen adversary proceeding and obtain default judgment under § 727 despite its failure to intervene when original plaintiff served notice of intention to default on § 523 cause of action).

FDIC v. Meyer (In re Meyer), 197 B.R. 277 (N.D. Ill. 1996) (FDIC, as successor to RTC, was properly substituted as plaintiff for failed bank; extension of time to file complaint granted to bank inures to benefit of successor party. Debtor challenged the timeliness of the FDIC's complaint on the ground that only the bank, not the FDIC or the RTC, obtained extensions of time to file a complaint. Argument, while clever, was rejected. Debtor's argument failed to "demonstrate that Rule 17(a) is intended to distinguish between substitutions that involve an adverse complaint filed without an extension of time under Rule 4007, and substitutions that involve an adverse complaint filed with an extension of time.")

G. Jury trial in discharge and dischargeability proceedings

American Express Travel Related Servs. Co. v. Hashemi (In re Hashemi), 104 F.3d 1122 (9th Cir. 1996) ("Bankruptcy litigants . . . have no Seventh Amendment right to a jury trial in dischargeability proceedings.")

Jaster v. Schmidt (In re Schmidt), 188 B.R. 86 (Bankr. D. Nev. 1995) (debtor is not entitled to jury trial on complaint to revoke discharge. "[F]or the purposes of jury trial analysis, there is no logical distinction which can be made between an action under § 523 and one under § 727. The remedy sought under both [sections] is a declaration that the debt (§ 523) or the debtor (§ 727) is not entitled to the equitable power of the Bankruptcy Code.")

Samson v. Ward (In re Ward), 184 B.R. 253, 256-57 (Bankr. D.S.C. 1995) (where liability and damages were fixed by state court judgment, no right to jury trial in dischargeability action. Alternatively, debtor waived jury trial right by stipulated judgment in state court.)
H. Estoppel and res judicata

1. Res judicata or “claim preclusion” generally not available in discharge and dischargeability proceedings


Swate v. Hartwell (In re Hartwell), 99 F.3d 1282 (5th Cir. 1996) (res judicata bars relitigation of dischargeability of alimony and support in second bankruptcy case. Award of monthly payments to former spouse was determined by bankruptcy court to be nondischargeable in debtor’s 1987 bankruptcy case. In subsequent suit to enforce divorce decree state court found debtor in breach of agreement and jury awarded former spouse lump sum judgment for all past due and future alimony (anticipatory breach of contract), child support and attorneys’ fees. Debtor filed second bankruptcy in 1993 seeking to discharge the lump sum judgment. That the agreement incident to divorce merged into the post divorce final judgment did not change the substance of the liability. Because the liability was determined to be nondischargeable in the first case, second complaint was barred by res judicata.)

Read v. Read (In re Read), 183 B.R. 107, 110-12 (Bankr. E.D. La. 1995) (where debtor failed to raise § 523(a)(5) dischargeability defense, post-bankruptcy state court judgment for alimony arrearage precludes claim that debt was discharged. Brown v. Felsen applies only to pre-petition state court judgments).

2. Collateral estoppel or “issue preclusion” may be available in discharge and dischargeability proceedings

a. In general


(1) First Circuit

Piccicuto v. Dwyer, 39 F.3d 37 (1st Cir. 1994) (jury verdict for intentional interference with an advantageous business relationship coupled with finding that debtors engaged in unfair trade practices under Massachusetts law collaterally estopped debtors from (re)litigating issues of willfulness and maliciousness under § 523(a)(6)).

Century 21 Balfour Real Estate v. Menna (In re Menna), 16 F.3d 7 (1st Cir. 1994) (collateral estoppel may preclude real estate agent from proving reasonable reliance on debtor’s misrepresentations to agent where state court found agent and debtor jointly liable for negligent misrepresentations to buyer and element of state court action was that agent failed to exercise
reasonable care in obtaining or communicating information from the debtor).

**Phalon v. Varrasso (In re Varrasso)**, 194 B.R. 537 (Bankr. D. Mass. 1996) ("Under full faith and credit statute, 28 U.S.C. § 1738, the preclusive effect of a state court judgment in a subsequent nondischargeability proceeding under federal bankruptcy law is governed by the collateral estoppel law of the state from which the judgment is taken.")

**Brzys v. Lubanski (In re Lubanski)**, 186 B.R. 160, 165 (Bankr. D. Mass. 1995) (although state law action for installing eavesdropping device had no "malice" element, there is an "identity of issues" and state court findings satisfied "malice" element of § 523(a)(6). State court found no compensable injury and awarded only statutory liquidated damages, but such damages constitute a "deemed" injury).

(2) **Second Circuit**


**Bender v. Tobman (In re Tobman)**, 107 B.R. 20 (S.D.N.Y. 1989) (jury's finding of fraudulent inducement not sufficient to collaterally estop the debtor from relitigating the issue of fraud where verdict could have been based on some or all of several misrepresentations not all of which would suffice for § 523(a)(2)(A) purposes); **Stone v. Stone (In re Stone)**, 94 B.R. 298 (S.D.N.Y. 1988), aff'd without op., 880 F.2d 1318 (2d Cir. 1989) (collateral estoppel appropriate on issue of embezzlement under § 523(a)(4) where: (1) debtor found by state court to have engaged in the defalcation of partnership assets; (2) finding was necessary to state court ruling; (3) appellant had sufficient incentive to litigate matters at that time; (4) issues raised in bankruptcy and state proceedings essentially the same; (5) state and federal standards for embezzlement were identical).

(3) **Third Circuit**

**Baldino v. Wilson (In re Wilson)**, 116 F.3d 87, 90 (3d Cir. 1997) (bankruptcy court abused its discretion by denying relief from the stay to allow the plaintiff to appeal state trial court's dismissal of the malicious prosecution complaint. If the plaintiff is successful in the state courts, a judgment for malicious prosecution will have preclusive effect in nondischargeability litigation under § 523(a)(6). If the plaintiff is not allowed relief from the stay to appeal the state court judgment, issue preclusion
may prevent the plaintiff from litigating the elements of the malicious prosecution action in the bankruptcy court. Citing the Rooker-Feldman doctrine, the state court plaintiff “cannot relitigate the adverse trial court judgment in bankruptcy court . . . [I]t is necessary to lift the stay to permit prosecution of her appeal to the state appellate courts.”)

In re Conte, 33 F.3d 303 (3d Cir. 1994) (jury verdict in attorney malpractice action not entitled to collateral estoppel effect in § 523(a)(6) action because jury finding of “knowledge” of high probability of harm and “reckless indifference” to the consequences was not a finding of “willful and malicious injury.”)

(4) Fourth Circuit

Pahlavi v. Ansari (In re Ansari), 113 F.3d 17 (4th Cir. 1997) (applying Virginia law, default judgment entered as sanction for discovery tactics by debtor was entitled to collateral estoppel effect in dischargeability litigation.)

Hagen v. McNallen (In re McNallen), 62 F.3d 619 (4th Cir. 1995) (“federal courts must, as a matter of full faith and credit, apply the forum state’s law of collateral estoppel.” Sister sued brother in Texas state court for tortiously removing their mother from a retirement home. Texas jury verdict that debtor acted in an “outrageous” manner—in a manner that a civilized community would find to be atrocious and utterly intolerable—and in wanton disregard for the welfare of his mother, collaterally estopped debtor from contesting malice for purposes of § 523(a)(6).)

Eborn v. Sawyer (In re Sawyer), 192 B.R. 671 (Bankr. E.D.N.C. 1996) (district court finding in admiralty proceeding that debtor refused to pay “maintenance” and “cure” to an injured seaman bars relitigation of willfulness and malice in § 523(a)(6) action. Debtor was sued by seaman in federal district court for injuries suffered on debtor’s shrimping vessel. District court found the vessel was seaworthy and that plaintiff’s injuries were not caused by any unseaworthy condition. However, pursuant to the laws of admiralty, the court ordered debtor to pay “cure,” “maintenance,” and lost wages—the shipowner’s duty of care toward seamen who become injured while in the owner’s service. That debtor did not voluntarily pay and attempted to shield himself of liability, the court found to “constitute willful and arbitrary conduct that justifies the award of both attorney’s fees and punitive damages. . . . Under maritime law, a shipowner’s failure to pay maintenance and cure is an independent tort that renders the shipowner liable for any aggravation of the seaman’s injury.” The district court finding that debtor’s failure to pay was “willful and arbitrary,” estops the debtor from (re)litigating willfulness and maliciousness under § 523(a)(6).)
Catron v. Morrison (In re Catron), 186 B.R. 197, 202 (Bankr. E.D. Va. 1995) (state juvenile court lacked jurisdiction to determine whether hold harmless provision was in the nature of support. Former spouse not collaterally estopped in subsequent dischargeability proceeding.)

Catercorp. Inc. v. Henicheck (In re Henicheck), 186 B.R. 211, 215, 217 (Bankr. E.D. Va. 1995) (complaint, answer, amended counterclaim, jury instructions, and special jury verdict define issues litigated in state court; if sufficiently detailed, court may determine whether issue preclusion applies. Jury finding that debtor made intentional misrepresentations to induce plaintiff to enter into settlement agreement had collateral estoppel effect.)

(5) Fifth Circuit

Schwager v. Fallas (In re Schwager), 121 F.3d 177, 182-4 (5th Cir. 1997) (collateral estoppel does not preclude debtor’s relitigation of § 523(a)(4) elements where state court jury found in the alternative that the debtor had breached a fiduciary duty and breached a partnership agreement. “The bankruptcy court found, and the district court agreed, that collateral estoppel applied, based on the jury’s findings in the 1989 judgment. The jury found several facts that pertain to this case. In response to Question No. 16, the jury found that ‘Schwager breach[ed] his fiduciary duty to [the limited partners] in the performance of his responsibilities, . . . which proximately caused damages [to the limited partners].’ In response to Question No. 17, the jury determined that ‘Schwager materially breach[ed] the limited partnership agreement, . . . proximately causing damages to the [limited partners].’ The jurors were instructed to answer Question No. 18 only if they answered ‘yes’ to either Question No. 16 or Question No. 17. The jury then awarded damages pursuant to Question No. 18, which is as follows: ‘What sum of money . . . would fairly and reasonably compensate [the limited partners] for damages sustained, if any, as a result of breach of fiduciary duty or the material breach of the partnership agreement (which you previously found)?’ . . . The jury also answered ‘yes’ to Question No. 19, which is as follows: Was Bruce Schwager’s breach of fiduciary duty, if any, committed intentionally, maliciously or with heedless and reckless disregard of the rights of any of the limited partners? . . . Texas courts have adopted the Restatement (Second) of Judgments § 27, which is the general rule on issue preclusion. The Texas Supreme Court applied comment i to the Restatement, which states: ‘i. Alternative determinations by court of first instance. If a judgment of a court of first instance is based on determinations of two issues, either of which standing independently would be sufficient to support the result, the judgment is not conclusive with respect to either issue standing alone.’ . . . [T]his case falls directly under the rule of comment i. The limited partners seek
to use one issue in the judgment, the breach of fiduciary duty, standing alone. However, the jury was asked in a single question to award damages for either breach of fiduciary duty or breach of the partnership agreement. Therefore, neither ground was essential to the judgment awarding these damages to the limited partners because the award can be upheld on either basis. . . . We reverse and remand for a redetermination of the dischargeability issues, with specific, independent factual findings.

Fielder v. King (In re King), 103 F.3d 17, 19-20 (5th Cir. 1997) (state court judgment on debtor’s motion for a new trial that eliminated jury finding that debtor had committed fraud does not collaterally estop the state court plaintiff from asserting fraud in subsequent § 523(a)(2)(A) complaint. A Texas state court jury found that the debtor had breached a contract and committed fraud. On the debtor’s motion for a new trial, the trial court substituted a judgment limited to contract damages. “In this circuit, issue preclusion will prevent a bankruptcy court from determining dischargeability issues for itself only if ‘the first court has made specific, subordinate, factual findings on the identical dischargeability issue in question . . . and the facts supporting the court’s findings are discernible from that court’s record.’ . . . The record reflects no ‘specific, subordinate, factual findings’ that King’s debt to the Fielders was not obtained by false pretenses, false representations, or actual fraud . . . King essentially argues that the substituted state court judgment, which awarded contract damages and denied ‘all relief not expressly granted,’ constitutes a specific finding that King did not obtain the debt by false pretenses, false representation, or actual fraud. We disagree. The bare fact that the state court awarded only contract rather than fraud damages does not preclude the bankruptcy court from inquiring into the true nature of that debt. The bankruptcy court is not bound by the ‘breach of contract’ label that the state-court assigned to the judgment awarded to the Fielders . . . Under these circumstances, the state court’s elimination of fraud damages can hardly be construed as a specific factual finding regarding the federal law dischargeability issue.”)

Boyce v. Greenway (In re Greenway), 71 F.3d 1177, 1181 (5th Cir. 1996) (plaintiff is collaterally estopped to prove willful and malicious injury under § 523(a)(6) where state court jury refused to find gross negligence by the debtor in the operation of a motorboat while drinking. “A state court judgment’s preclusive effect on a subsequent federal action is determined by the full faith and credit statute . . . Under this statute, we must look to the rules of preclusion of the state in which the judgment was rendered . . . Because Greenway’s state judgment was entered by a Texas court, we apply Texas preclusion rules . . . In the state court proceeding, gross negligence was defined to the jury as ‘such an entire want of care as to establish that the act or
omission in question was the result of actual conscious indifference to the rights, welfare and safety of the persons affected thereby. 'Conscious indifference is the salient element of gross negligence under Texas law. . . . We have consistently defined 'willful and malicious' under § 523(a)(6) . . . to mean 'intentional' and lacking 'just cause or excuse.' . . . Comparing Texas' standard for gross negligence with the language of § 523(a)(6), we agree with the district court that the jury's refusal to find that Greenway acted with 'actual conscious indifference' necessarily precludes a subsequent finding that Greenway's actions were both 'intentional' and without 'just cause or excuse.' Accordingly, we affirm the district court's holding that the plaintiffs are collaterally estopped from litigating whether Greenway's actions were willful and malicious under § 523(a)(6) of the Bankruptcy Code.

Garner v. Lehrer (In re Gamer), 56 F.3d 677 (5th Cir. 1995) (state court judgment that debtor "acted with spite, ill-will and malice" entered after trial at which debtor did not appear, was a "post-answer 'default' judgment" entitled to collateral estoppel effect in § 523(a)(6) action against debtor. Preclusive effect of a state court judgment is guided by the full faith and credit statute, 28 U.S.C. § 1738. Federal bankruptcy jurisdiction over discharge and dischargeability proceedings does not effect an exemption from the full faith and credit statute.); Pancake v. Reliance Ins. Co. (In re Pancake), 199 B.R. 350 (N.D. Tex. 1996) (Texas default judgment entered after court struck debtor's pleadings as a sanction for failing to comply with discovery did not collaterally estop the debtor from litigating dischargeability under § 523(a)(11). State court did not hear evidence, hold a prove-up hearing or otherwise consider witness testimony), aff'd, 106 F.3d 1242 (5th Cir. 1997).

RecoverEdge L.P. v. Pentecost (In re Carpenter), 44 F.3d 1284, 1289-1294 (5th Cir. 1995) (RTC and its successor in interest are collaterally estopped to assert the debtor's conspiracy to commit fraud where jury returned verdict for debtor in a civil conspiracy trial. Debtor and others were named by the RTC in a civil complaint for conspiracy to defraud a bank by participating in a sham real estate transaction. "The jury ultimately rendered a special verdict finding that all of the . . . defendants except Carpenter had engaged in a conspiracy to defraud the RTC . . . ."

Notwithstanding the jury's verdict, the separate issue of nondischargeability under § 523(a)(2)(A) was submitted to the district court which found the debt nondischargeable reasoning: "The Court must disregard the jury's finding on this point because the evidence establishes and logic dictates that Houston Storage, Inc. [a codefendant] could not be a conspirator except through the conduct of Carpenter . . . . The inquiry is whether Carpenter incurred a debt by false pretenses, representation or fraud. This Court finds that he did and the record is sufficiently
ample on this point.” The Fifth Circuit reversed: “There is no question that the issue of whether Carpenter conspired with others to defraud Universal Savings was actually litigated in the first proceeding and necessary to the court’s final judgment entered on the jury’s verdict. Therefore, the crucial issue in this case is whether the issues are identical. ... Collateral estoppel will apply in a second proceeding that involves separate claims if the claims involve the same issue ... To define the issue that was actually litigated in the first proceeding, we look to the jury’s special verdict ... The verdict form submitted to the jury demonstrates that the issue in the first case was whether Carpenter ‘engaged in a civil conspiracy with [named and unnamed defendants] to defraud [the RTC as receiver for Universal Savings] in connection with [the Houston Storage transaction].’ ... When asked whether it found by a preponderance of the evidence that Carpenter engaged in the conspiracy, the jury answered ‘No.’ The issue in the second proceeding was whether the RTC’s breach of contract judgment was nondischargeable under § 523(a)(2)(A). ... Viewed in the abstract, the elements of nondischargeability under § 523(a)(2)(A) are sufficiently distinct from the elements of civil conspiracy to defraud to suggest that a jury verdict in a conspiracy to defraud case would not ordinarily preclude a determination of nondischargeability under § 523(a)(2)(A). ... However, we do not compare the issues in the abstract, and in this case, the specific nature of the RTC’s nondischargeability claim against Carpenter has made what might otherwise be distinct issues identical. ... In other words, the RTC argued that Carpenter’s debt is nondischargeable under § 523(a)(2)(A) because he participated in a conspiracy to defraud the RTC. That issue, however, is precisely the issue decided by the jury in the RTC’s conspiracy case against Carpenter. ... Because the issues of ultimate fact in the two proceedings are identical, we hold that the RTC was precluded from asserting its ‘participation in a fraudulent scheme’ theory of nondischargeability under § 523(a)(2)(A) and the district court was bound by the jury’s verdict in Carpenter’s favor on the factual issue underlying the RTC’s theory. We do not hold that a finding of nonliability for civil conspiracy to defraud necessarily precludes litigation of nondischargeability under § 523(a)(2)(A). Rather we hold that where, as here, the factual issue that forms the basis for the creditor’s theory of nondischargeability has been actually litigated in a prior proceeding, neither the creditor nor the debtor may relitigate those grounds.”); Geisler v. Pansegrau (In re Pansegrau), 180 B.R. 468, 471 (Bankr. N.D. Tex. 1995).

(6) Sixth Circuit

Rally Hill Prods., Inc. v. Bursack (In re Bursack), 65 F.3d 51 (6th Cir. 1995) (Bankruptcy court’s exclusive jurisdiction over
dischargeability issues does not alter the fundamental principle that “judicial proceedings [of any court of any state] 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.” Jury verdict of fraud entitled to collateral estoppel effect in § 523(a)(2) litigation notwithstanding that debtor did not appear at trial. Because the judgment was not a “true default judgment,” court did not have to address continuing vitality of statement in Spilman v. Harley, 656 F.2d 224 (6th Cir. 1981), “that default judgments can never have preclusive effect in bankruptcy proceedings regardless of their treatment under relevant state law.”; White v. Rogers (In re Rogers), No. 94-5056, 1995 U.S. App. LEXIS 15394 (6th Cir. June 16, 1995) (unpublished) (Quoting Harris v. Byard (In re Byard), 47 B.R. 700, 707 (Bankr. M.D. Tenn. 1985), “There is no compelling statement of federal bankruptcy law which expressly or impliedly excepts to the normal operation of § 1738 where the state court judgment for which issue preclusive effect is sought is a default judgment.” Civil “default” judgment for malicious and intentional shooting was “actually litigated” where victim testified. “Even if the default judgment had been rendered without the hearing of evidence . . . Tennessee law would give it preclusive effect. . . Because a Tennessee court would give preclusive effect to the default judgment in this case, and no federal policy creates an exception to the normal rules of full faith and credit in this case, the bankruptcy court was obligated to give preclusive effect to the default judgment.”)

Wood v. Dealers Financial Servs., Inc., 199 B.R. 25 (E.D. Mich. 1996) (default judgment in Michigan state court action for fraud, conversion, misappropriation and conspiracy did not collaterally estop debtor from litigating dischargeability under § 523(a)(2)(A). Bankruptcy court erred in its reliance on Michigan law to determine the preclusive effect of the default judgment. The Sixth Circuit decision in Spilman “excepted dischargeability determinations from [28 U.S.C.] § 1738.” The sixth Circuit established a federal collateral estoppel standard which requires “that the precise issue in the later proceedings have been raised in the prior proceeding, that the issues were actually litigated, and that the determination was necessary to the outcome.” . . . [T]aken literally, Spilman seemingly precludes satisfaction of the ‘actually litigated’ requirement by any state court default judgment as a matter of law.” Court did not discuss Sixth Circuit’s later decisions in Bursack and Rogers.)

Rowe Oil, Inc. v. McCoy (In re McCoy), 189 B.R. 129 (Bankr. N.D. Ohio 1995) (Ohio state court judgment for misappropriation of trade secrets collaterally estopped debtor from defending nondischargeability action under § 523(a)(4). Finding of malice was prerequisite to award of attorneys’ fees in state court.)
Eighteenth Circuit

Tudor Oaks Ltd. Partnership v. Cochrane (In re Cochrane), 1997 WL 542249 *4 (8th Cir. Sept. 5, 1997) (state court jury verdict that debtor breached fiduciary duty to partnership collaterally estopped debtor in § 523(a)(4) litigation. "[I]ssues concerning Cochrane’s breach of his fiduciary duties were fully, fairly and actually litigated and were essential to the final judgment entered in the underlying state court action. . . . [T]he bankruptcy court did not err in concluding that Cochrane is bound by the jury’s findings.").

Abbott Bank v. Armstrong, 44 F.3d 665, 666-7, n.3 (8th Cir. 1995) (prior judgment denying the debtor’s discharge under § 727(a)(2) collaterally estops debtor’s objection to the same creditor’s claim. Abbott Bank successfully prosecuted the denial of the debtor’s discharge. Later, the debtor objected to the bank’s claim on the grounds that the claim was extinguished because the bank failed to give proper notice of a sale of its collateral and that the claim was barred because the bank had received a preference. Bankruptcy and district courts sustained the debtor’s objection to the bank’s claims. Reversing, the court of appeals explained: “The denial of discharge is predicated on the holding that the Armstrongs defrauded a creditor and that the Bank was that creditor. . . . Holding that the bank was a creditor was necessary to our judgment . . . [t]he issue was inherent in the first litigation, and essential to the valid final judgment that was entered . . . [T]hat the Bank was a creditor was admitted in the Armstrong’s initial pleading.” The court does not explain how the bank’s status as a “creditor” collaterally estops the debtor to litigate the allowance of the bank’s claim. With respect to the preference argument, the court notes in a footnote “The Armstrongs’ argument that the Bank’s claim should be barred on account of preferences is subject to the same collateral estoppel analysis.”)

Ninth Circuit

Cowen v. Kennedy (In re Kennedy), 108 F.3d 1015, 1018 (9th Cir. 1997) (voluntary dismissal before trial of state court lawsuit does not collaterally estop plaintiff from litigating dischargeability. Dismissal was voluntary, without prejudice and left the debtor “as if he were never a party to the suit, with the result that collateral estoppel does not apply”).

Kelly v. Okoye (In re Kelly), 182 B.R. 255 (B.A.P. 9th Cir. 1995), aff’d mem., 100 F.3d 110 (9th Cir. 1996) (legal malpractice judgment finding “gross negligence” does not satisfy nondischargeability standards. State court legal malpractice judgment does not satisfy all requirements for nondischargeability under §§ 523(a)(2), (a)(4), or (a)(6).
Insufficient identity of issues. The state court judgment was based on a finding of “gross negligence as a fiduciary.” Gross negligence is not sufficient to satisfy § 523(a)(6)'s willful and malicious standard because there was no evidence of an intentional deception."

Papadakis v. Zelis (In re Zelis), 66 F.3d 205 (9th Cir. 1995) (debtor is collaterally estopped to contest willfulness and maliciousness where California Court of Appeals sanctioned the debtor for “intentionally and wrongfully” filing frivolous notices of appeal “in bad faith and for abusive litigation tactics.” “In Grogan . . . the Supreme Court recognized that a creditor who successfully obtained a fraud judgment in state court could invoke collateral estoppel in an action under section 523(a). The same reasoning applies to the present case where the requirements for collateral estoppel have been met, i.e., actual litigation of the issue and a determination in a prior action of those elements of the claim that are the same as the elements required for nondischargeability . . . . [F]iling a frivolous appeal necessarily causes harm to the opposing parties by requiring them to incur unnecessary litigation costs and attorneys’ fees, and by delaying final resolution of the dispute. Likewise, a court generally orders sanctions only when the party’s conduct has been particularly abusive and there is no justification or excuse for the behavior.”)

Silva v. Smith’s Pacific Shrimp, Inc. (In re Silva), 190 B.R. 889 (B.A.P. 9th Cir. 1995) (unopposed motion for summary judgment in federal litigation was not actually litigated for purposes of collateral estoppel).

Stokes v. Vierra, 185 B.R. 341, 345 (N.D. Cal. 1995) (question whether fraud was actually litigated as part of default judgment proceeding in state court remanded because transcript not part of record).

(9) Eleventh Circuit

HSSM #7 Limited Partnership v. Bilzerian (In re Bilzerian), 100 F.3d 886 (11th Cir. 1996) (debtor collaterally estopped to relitigate issues of fraud under § 523(a)(2)(A) because district court jury was presented with nearly identical issues. That the jury was instructed that plaintiff’s reliance must be “reasonable” did not preclude collateral estoppel because it was a higher standard than the “justifiable” reliance required under § 523(a)(2)(A).)

Georgia default judgment for fraud collaterally estops debtor in § 523(a)(2) litigation.

*Mills v. Ellerbee (In re Ellerbee)*, 177 B.R. 731, 737 (Bankr. N.D. Ga. 1995), aff’d, No. 1:95-CV-459-JEC (N.D. Ga. May 31, 1995) [unpublished decision], aff’d mem., 78 F.3d 600 (11th Cir.), cert. denied, ___ U.S. ___, 117 S. Ct. 357, 136 L. Ed.2d 249 (1996) (jury finding in state court defamation case that debtor acted with “actual malice” is not preclusive of “willful and malicious” injury for § 523(a)(6) purposes because finding did not rule out possibility that debtor recklessly disregarded the truth—verdict does not establish that debtor intended to injure or knew that injury would necessarily follow from his conduct.)


b. Default judgment

**Pahlavi v. Ansari (In re Ansari)**, 113 F.3d 17 (4th Cir. 1997) (applying Virginia law, default judgment finding defalcation in a fiduciary capacity is entitled to collateral estoppel effect in dischargeability litigation. State court judgment entered as sanction for debtor’s tactics in avoiding discovery was a default judgment but would satisfy the “actual litigation” requirement for collateral estoppel under Virginia law.)

**Gayden v. Nourbakhsh (In re Nourbakhsh)**, 67 F.3d 798 (9th Cir. 1995) (Florida default judgment finding fraud collaterally estops debtor to relitigate fraud in a § 523(a)(2)(A) action because the supreme court of Florida would give collateral estoppel effect to the default judgment. “Nourbakhsh argues that under federal collateral estoppel law, default judgments should not be given preclusive effect because the issues resolved by default were not ‘actually litigated.’ . . . This argument is misguided, however, because Florida collateral estoppel law, not federal
collateral estoppel law, controls. 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 . . . The Supreme Court of Florida . . . held that collateral estoppel . . . bars relitigation of an issue decided by default judgment . . . If collateral estoppel applies under state law, we next determine whether an exception to § 1738 should apply. . . . [Brown v. Felsen, 442 U.S. 127 (1979)] was a res judicata case, and the Court expressly left open the question of whether a bankruptcy court adjudicating as § 17 claim (now a § 523 claim) should give collateral estoppel effect to a prior state court judgment . . . The Court answered that question conclusively in Grogan v. Garner, 498 U.S. 279 [(1991)] . . .: 'We now clarify that collateral estoppel principles do indeed apply in discharge exception proceedings pursuant to § 523(a).''); FDIC v. Daily (In re Daily), 47 F.3d 365, 368-9 (9th Cir. 1995) (per curium) (default judgment entered against debtor in RICO case for failure to comply with discovery requests collaterally estops debtor to contest nondischargeability under § 523(a)(2)(A) & (B). "The judgment entered in the RICO action was not an ordinary default judgment. Daily did not simply decide the burden of litigation outweighed the advantage of opposing the FDIC's claim and fail to appear. He actively participated in the litigation, albeit obstructively, for two years before judgment was entered against him. A party who deliberately precludes resolution of factual issues through normal adjudicative procedures may be bound, in subsequent, related proceedings involving the same parties and issues, by a prior judicial determination reached without completion of the usual process of adjudication. In such a case the 'actual litigation' requirement may be satisfied by substantial participation in an adversary contest in which the party is afforded a reasonable opportunity to defend himself on the merits but chooses not to do so. . . . Due process is not violated by a court's entry of a default judgment or other sanction against a party for refusal to cooperate with discovery. . . . Nor is due process violated if the defendant is later held to the consequences of such a judgment in a bankruptcy discharge proceeding."); Green v. Kennedy (In re Green), 198 B.R. 564 (B.A.P. 9th Cir. 1996) ("The bankruptcy court is required to give the same collateral estoppel effect to a state court judgment as would a court of that state." Under California law default judgment is entitled to collateral estoppel effect. Debtor was estopped from relitigating issue of fraud.); Newsom v. Moore (In re Moore), 186 B.R. 962, 973 (Bankr. N.D. Cal. 1995) (citing In re Bugna, 33 F.3d 1054 (9th Cir. 1994), default judgment has collateral estoppel effect under California law where defendant participated in case and "prove-up" hearing was conducted. Malice in § 523(a)(6) may be inferred from award of punitive damages in default judgment entered after prove-up hearing). Compare Hernandez v. Pizante (In re Pizante), 186 B.R. 484, 489 (Bankr. 9th Cir. 1995) (default judgment for failing to respond to requests for admissions in state court has no collateral estoppel effect); Stokes v. Vierra, 185 B.R. 341, 344 (N.D. Cal. 1995) (under South Carolina law, issue must be "actually litigated," since state court transcript not in record, case remanded for determination whether fraud actually litigated at default hearing).
Bay Area Factors, v. Calvert (In re Calvert), 105 F.3d 315, 321 (6th Cir. 1997) (because California would give collateral estoppel effect to a “pure” default judgment, a California default judgment is entitled to collateral estoppel effect in a dischargeability proceeding under § 523(a). “In the absence of any indication in the Bankruptcy Code or legislative history suggesting that Congress intended an exception to [28 U.S.C.] § 1738 apply to true default judgments and with no principled distinction between cases where a defendant participates in part in defense of the state court suit and cases where the defendant does not respond at all, we conclude that collateral estoppel applies to true default judgments in bankruptcy dischargeability proceedings in those states which would give such judgments that effect.”); Rally Hill Prods., Inc. v. Bursack (In re Bursack), 65 F.3d 51 (6th Cir. 1995) (jury verdict of fraud entered after a trial at which the debtor did not appear was not a “true default judgment” and thus was entitled to collateral estoppel effect in subsequent § 523(a)(2) litigation without offending Spilman v. Harley, 665 F.2d 224 (6th Cir. 1981)); White v. Rogers (In re Rogers), No. 94-5056, 1995 U.S. App. LEXIS 15394 (6th Cir. June 16, 1995) (unpublished) (civil “default” judgment for malicious and intentional shooting was “actually litigated” and thus entitled to collateral estoppel effect where the victim testified, notwithstanding that the debtor did not appear. In dicta, because Tennessee law would give preclusive effect to a default judgment--even one rendered without the hearing of evidence--the civil default judgment was entitled to collateral estoppel effect in the bankruptcy court in dischargeability litigation.); Dean v. Rogers (In re Rogers), 189 B.R. 136 (Bankr. N.D. Ohio 1995) (“The result of the Bursack opinion is that [bankruptcy court] must look to the laws of Ohio regarding application of the doctrine of collateral estoppel. . . . The Ohio courts have not expanded on what constitutes 'actual and direct litigation.' [However, where] there was no evidence that [debtor] participated at any level in the underlying state court action[, the court would not apply collateral estoppel].”)

Pancake v. Reliance Ins. Co. (In re Pancake), 106 F.3d 1242, 1244 (5th Cir. 1997) (Texas “post-answer” default judgment is not entitled to collateral estoppel effect in dischargeability litigation. “We have held under Texas law that where the court enters a default judgment after conducting a hearing or trial at which the plaintiff meets his evidentiary burden, the issues raised therein are considered fully and fairly litigated for collateral estoppel purposes. In the case at bar, however, we agree with the district court that the record before us fails to demonstrate that the state court conducted a hearing in which Reliance met its burden of proving that Pancake defrauded Sunbelt. . . . In the case at bar the court entered judgment after striking Pancake’s answer, thus creating a situation similar to that where no answer is filed, i.e., a no-answer default judgment. In that context, the defendant is deemed to admit the plaintiff’s pleadings and, thus, judgment may be entered based upon those pleadings. For purposes of collateral estoppel, however, the critical inquiry is not directed at the nature of the default judgment but, rather, one must focus on whether an issue was fully and fairly litigated.
Thus, even though Pancake’s answer was struck, if Reliance can produce record evidence demonstrating that the state court conducted a hearing in which Reliance was put to its evidentiary burden, collateral estoppel may be found to be appropriate. All of that remains to be determined and we express no opinion thereon.”; Gober v. Terra + Corp. (In re Gober), 100 F.3d 1195 (5th Cir. 1996) (Texas default judgment for discovery abuse has collateral estoppel effect in dischargeability litigation. Debtor participated in state court action for two years then failed to post security for costs, failed to respond to discovery requests and failed to appear at hearing to resolve discovery issue. Default judgment for actual and punitive damages was entered after the state court heard plaintiff’s evidence. Texas courts recognize different types of default judgments—those entered for failure to answer (“no-answer” default) and those entered after an answer is filed (“post answer”). “A post-answer default ‘constitutes neither an abandonment of the defendant’s answer nor an implied confession of any issues joined by defendant’s answer.’ Because the merits of the plaintiff’s claim remain at issue, judgment cannot be rendered on the pleadings, and the plaintiff must offer sufficient evidence to meet his burden of proof as if at trial. . . . [I]n a no-answer default judgment, the defendant is deemed to have admitted all of the plaintiff’s allegations with respect to liability. . . . [However,] conduct sufficient to warrant punitive damages is not regarded as admitted by default. . . . [T]o support an award of punitive damages [at the time judgment was rendered in this case], the defendant’s act must not only be unlawful, ‘but must partake of a wanton and malicious nature.’ The state court found ‘after hearing the evidence and arguments of counsel,’ that [debtor] acted ‘maliciously and willfully when he converted [$307,284.96], for which exemplary and punitive damages should be awarded.” Collateral estoppel was appropriate. Court cautioned that it did not “purport to establish a per se rule that collateral estoppel precludes relitigation of issues whenever punitive damages are assessed against a defendant after default.”); In re Garner, 56 F.3d 677 (5th Cir. 1995) (“Post-answer ‘default’ judgment”—a judgment entered after the debtor answered a complaint, but the trial occurred without the debtor in attendance—was entitled to collateral estoppel effect under Texas law and thus was entitled to collateral estoppel effect in § 523(a)(6) litigation in the bankruptcy court).

Bush v. Balfour Beatty Bahamas, Limited (In re Bush), 62 F.3d 1319 (11th Cir. 1995) (The general federal rule is that default judgments are not given collateral estoppel effect. However, “[W]here a party has substantially participated in [a federal action] in which he had a full and fair opportunity to defend on the merits, but subsequently chooses not to do so, and even attempts to frustrate the effort to bring the action to judgment, it is not an abuse of discretion for the district court to apply the doctrine of collateral estoppel to prevent further litigation of the issues resolved by the default judgment in the prior action.” Default judgment for fraud given preclusive effect where judgment was entered as a sanction for debtor’s failure to cooperate in discovery.); Wilcox v. Hritz (In re Hritz), 197 B.R. 702 (Bankr. N.D. Ga. 1996) (default
judgment by Georgia state court after debtor's failure to appear at trial did not collateral estop debtor from litigating issues of fraud and willful and malicious injury. Under Georgia law application of collateral estoppel requires that the issues were necessarily litigated and actually decided in the prior proceeding. From the state court judgment it could not be discerned upon what grounds judgment was entered.); League v. Graham (In re Graham), 191 B.R. 489 (Bankr. N.D. Ga. 1996) (Georgia default judgment for fraud collaterally estops debtor in § 523(a)(2) litigation).

Meyer v. Rigdon, 36 F.3d 1375 (7th Cir. 1994) ("The plain language of section 523(a)(11) . . . [preempts] the common law collateral estoppel rules with respect to default judgments, settlement agreements, and certain administrative agency decisions. . . . [A] debt arising from a debtor's breach of fiduciary duty to a financial institution is not dischargeable if that debt is provided in ‘any final judgment, unreviewable order, or consent decree or order’ entered in any federal or state court.")

Ramsey v. Bernstein (In re Bernstein), 197 B.R. 475 (Bankr. D. Md. 1996) (default judgment after debtor answered complaint but failed to appear at trial, and after plaintiff presented its case to the jury, was not a typical default judgment under Raynor, and collaterally estopped debtor from relitigating issues of willfulness and malice. "There should be a difference in effect as to issue preclusion between a default judgment where there is no participation by the party and an uncontested judgment against a party that has appeared but has elected not to defend. If an answer is filed, then the case may be deemed to have been actually litigated. To hold otherwise would allow defendants to play the litigation game, while providing them with a mechanism by which to escape the collateral estoppel effects of an adverse judgment if things start to go badly. . . . A prior judgment satisfies the actually litigated standard, however, only if the party against whom the judgment was entered had proper incentive to litigate the matter in the prior hearing and could reasonably foresee later litigation on the same issue."); Colwell v. Lucas (In re Lucas), 186 B.R. 67 (Bankr. E.D. Va. 1995) (in the Fourth Circuit, M & M Transmissions, Inc. v. Raynor (In re Raynor), 922 F.2d 1146 (4th Cir. 1991), prevents application of collateral estoppel to issues decided by default. Although not discussed in Raynor, this rule applies to damages). Phalon v. Varrasso (In re Varrasso), 194 B.R. 537 (Bankr. D. Mass. 1996) (while the Massachusetts Supreme Judicial Court has not addressed whether default judgment is "actually litigated," Massachusetts' courts would adopt position that default judgments do not satisfy the actually litigated requirement).

FDIC v. Roberti (In re Roberti), 201 B.R. 614 (Bankr. D. Conn. 1996) (under Connecticut law some default judgments will be entitled to collateral estoppel effect. "[T]he appropriate inquiry . . . is whether the party had an adequate opportunity to litigate issues and such issues
were necessary to a default judgment, that judgment should put to rest subsequent litigation of all issues necessary for the rendering of the default judgment."; Federal Trade Comm'n v. Wright (In re Wright), 187 B.R. 826, 834-36 (Bankr. D. Conn. 1995) (default judgment in prior federal court action has no preclusive effect in dischargeability litigation).

c. Arbitration and other “quasi-judicial” proceedings

Corn v. Marks (In re Marks), 192 B.R. 379 (E.D. Pa. 1996) (confirmed arbitration award collaterally estopped debtor from relitigating willfulness and maliciousness. “A court reviewing the confirmation of an arbitration award must ‘apply [the Full Faith and Credit statute, 28 U.S.C. § 1738,] and follow its directive of assessing the preclusive effect the state court’s decision would be given by another court in the state.” The arbitration award was based on a finding that debtor intentionally interfered with plaintiff’s economic opportunities in connection with a shareholders’ agreement. Under Pennsylvania law “the elements of tortious interference with an economic opportunity are: ‘(1) the existence of a contractual relationship; (2) an intent on the part of the defendant to harm the plaintiff by interfering with that contractual relationship; (3) the absence of a privilege or justification for such interference . . . and (4) damages resulting from the defendant’s conduct.’ . . . The tort of intentional interference requires an intent to injure; this makes it a ‘willful and malicious injury.’” That the arbitrator awarded punitive damages supports conclusion that debtor’s conduct was willful and malicious.)

d. Summary judgment

Polechronis v. Cape Cod Needleworks (In re Polechronis), 186 B.R. 1, 4-5 (D. Mass. 1995) (“actually litigated” requirement not necessarily met where state court entered summary judgment against debtor. Bankruptcy court must 1) review state court proceeding to determine whether “actually litigated” and 2) if summary judgment not opposed by debtor, consider whether failure to oppose was consistent with actions of “honest but unfortunate debtor”—did debtor have good faith excuse for not responding and meritorious defense to state court action).

Bell v. Douglass, 184 B.R. 301, 304-06 (N.D. Ill. 1995) (under Iowa law, issues not “actually litigated” where summary judgment entered after debtor’s attorneys withdrew due to nonpayment of fees and debtor did not respond to requests for admissions. Judgment not qualitatively different from default judgment).

Forrester v. Staggs (In re Staggs), 178 B.R. 767, 778 (Bankr. N.D. Ind. 1994), aff’d, 177 B.R. 92, 98 (N.D. Ind. 1995) (uncontested summary judgment satisfies “actually litigated” requirement where debtor appeared in state court, contested an issue, and state court judgment was based on facts or evidence presented to it).
e. Prior judgment pending on appeal


Moore v. Gill (In re Gill), 181 B.R. 666, 672-73 & n. 7 (Bankr. N.D. Ga. 1995) (that prior action is pending on appeal does not prevent collateral estoppel under Georgia law. If state court later reverses, equity would require bankruptcy court to allow debtor to reopen proceeding to determine whether to vacate nondischargeability judgment).

3. Equitable estoppel

Federal Home Loan Mortgage Corp. v. Potter (In re Potter), 185 B.R. 68, 71-72 (Bankr. C.D. Cal. 1995) (equitable estoppel precludes debtor’s “defense” that complaint is untimely. Bankruptcy Rules 4007(c) and 4004(d) are not jurisdictional. Equitable estoppel requires: “(1) a representation or concealment of material facts; (2) made with knowledge, actual or virtual, of the facts; (3) to a party actually ignorant of the truth; (4) with the intention that the latter act upon it; and (5) the party must have been induced to act upon it.” Debtor lied and failed to disclose filing of bankruptcy to attorney for judgment creditor in post-judgment discovery proceedings.)

4. “Quasi-Estoppel” and “Judicial Admissions”


I. Exceptions to dischargeability apply to individual debtors only

New Venture Partnership v. JRB Consolidated, Inc. (In re JRB Consolidated, Inc.), 188 B.R. 373 (Bankr. W. D. Tex. 1995) (creditor can maintain dischargeability action under § 523(a) against a corporate chapter 12 debtor. Unlike chapter 11, “Chapter 12 . . . contains a specific provision in § 1228(a) which says ‘the debtor’ gets a discharge ‘except’ for debts ‘of the kind’ specified in § 523(a). There is no liquidation versus continuing business distinction for corporate or partnership debtors [ in § 1228] and there is no specific separate section referring to individual debtors. The language of § 1228(a) is not inconsistent with § 523(a) as individual debtors are still subject to the § 523(a) exceptions. But, § 1228(a) is broader in that its language is inclusive of all debtors -- individuals, partnerships, and corporations. . . . The meaning of the word debtor in Chapter 12 is not unclear. The wording in § 1228(a)(2) describing ‘debts of the kind’ specified in § 523(a) does not naturally lend itself to also incorporate the meaning ‘for debts of the kind’ referenced in § 523(a) . . . . [T]his court believes that the term ‘of a kind’ does not incorporate the limiting definition found in the introductory paragraph of § 523(a)."

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J. Exceptions to discharge and community property

Kastner v. Brown (In re Kastner), 197 B.R. 620 (Bankr. E.D. La. 1996) (insurance Commissioner sought determination that Commissioner's claim was nondischargeable against any property of the former community of debtor and her non-debtor ex-husband. “[U]nder Section 524(a)(3), the dischargeability of claims against the debtor, . . . , would operate as a discharge against all community property, unless the court makes a determination that the Commissioner's claims are non-dischargeable as to . . . the non-debtor spouse.” Section 524(a) allows the creditor to proceed in a hypothetical case involving the nonfiling spouse. “If the debt is hypothetically nondischargeable as to the nondebtor spouse, then the community does not receive a discharge.” However, the court's judgment does not reach the non-debtor's separate property.)

K. Jurisdiction, concurrent jurisdiction and abstention

Thaggard v. Pate (In re Thaggard), 180 B.R. 659, 662-65 (M.D. Ala. 1995) (even if stay violation occurred, bankruptcy court did not err in abstaining to allow state court to resolve § 523(a)(5) issue; abstention did not violate due process or equal protection).


Brothers v. Tremaine (In re Tremaine), 188 B.R. 380 (Bankr. S.D. Ohio 1995) (abstention appropriate in § 523(a)(5) proceeding where divorce decree was on appeal in state court, debtor had engaged in forum shopping, and proceeding in one court would be more efficient).

Fidelity Nat'l Title Ins. Co. v. Franklin (In re Franklin), 179 B.R. 913 (Bankr. E.D. Cal. 1995) (state courts have concurrent jurisdiction over § 523(a)(3) action notwithstanding underlying claim of fraud under § 523(a)(2) over which bankruptcy court would have had exclusive jurisdiction. Applying twelve factor test, bankruptcy court abstains.)

L. Standing

Lee-Benner v. Gergely (In re Gergely), 110 F.3d 1448, ___ (9th Cir. 1997) (because California law would permit an unborn child to recover for misrepresentations to the mother, child can maintain § 523(a)(2)(A) action against obstetrician for alleged intentional misrepresentations with respect to the need for amnioencentesis and for negligent performance of the procedure that blinded the unborn child. “California courts allow recovery for negligence occurring before a plaintiff’s birth where damage to the unborn child was foreseeable. . . . This reasoning applies at least as well to fraud as to negligence. . . . If [the plaintiff] has standing to bring an otherwise-traditional fraud claim under California law, then that claim would be for fraud within § 523(a)(2)(A).”)

O'Connor, Cavanagh, Anderson, Westover, Killingsworth & Beshears v. Perlin (In re Perlin), 30 F.3d 39 (6th Cir. 1994) (former spouse's attorneys and expert witnesses did not have standing to contest discharge of state court award of fees and expenses in
divorce proceeding. "As a general rule, one party may not assert the rights of another. . . . In certain instances [however,] a plaintiff with a particularly close relationship to a third party may assert the rights of a third party where the plaintiff faces an actual economic harm." Although superficially plaintiffs had an economic stake in the outcome of the litigation, that the state court could have made (but did not) award directly to plaintiffs clouded the issue. Compare Martin v. Morello (In re Morello), 185 B.R. 753, 754-56 (Bankr. E.D. Tenn. 1995) (attorney has standing in 523(a)(5) proceeding where fee, designated as alimony, was awarded directly to attorney by state court).

Compare Young v. Beugen (In re Beugen), 99 B.R. 961 (B.A.P. 9th Cir. 1989), aff'd mem., 930 F.2d 26 (9th Cir. 1991) (creditor that purchased claims against the debtor pre- and postpetition was without standing to object to debtor's discharge where creditor was a "vexatious litigant" who sought to "use the Court as a whipping post to inflict punishment on the [debtor]. . . . The right to object to a debtor's discharge is not a marketable commodity which may be purchased by one party from another in order to inflict further punishment and discomfort upon the debtor."). Compare Ota v. Samsung Elecs. Co., Ltd. (In re Ota), 192 B.R. 545 (B.A.P. 9th Cir. 1996) (prepetition assignee of claims is a creditor with standing to object to discharge under § 727. Distinguishing Beugen, "there are no facts in the record . . . to support even an inference that [creditor] obtained the claims at issue for a purpose other than to satisfy [debts to creditor].")


Ferraro v. Phillips (In re Phillips), 185 B.R. 121, 127-28, 131 (Bankr. E.D.N.Y. 1995) (shareholder of closely held corporation has standing to sue both individually and as a shareholder to determine dischargeability of debtor's personal expenses paid by corporation. Stockholder's derivative suit may be basis for determination of nondischargeability.)

M. Settlement of discharge and dischargeability litigation

AT&T Universal Card Serv. v. Bermingham (In re Bermingham), 201 B.R. 808 (Bankr. W.D. Mo. 1996) (consent judgments in dischargeability litigation may be rendered only after court is satisfied that the debtor's consent is fully informed. The
court's responsibility is heightened where counsel is retained on a flat fee and has no financial incentive to litigate dischargeability complaints.)

In re Vickers, 176 B.R. 287 (Bankr. N.D. Ga. 1994) (denies trustee's motion to approve $24,000 payment by debtor in settlement of an objection to discharge. "Either the discharges ought to be granted or they ought to be denied. Nothing in the Bankruptcy Code authorizes a trustee to seek funds from a debtor or to release a nondebtor entity as a price for giving up on a discharge complaint. Discharges are not property of the estate and are not for sale. It is against public policy to sell discharges.")

N. Effect of Prebankruptcy Settlement or Novation

Key Bar Inv., Inc. v. Fischer (In re Fischer), 116 F.3d 388, 390-1 (9th Cir. 1997) (prebankruptcy "Compromise Agreement and Mutual Release" precluded § 523(a)(2) action based on alleged misrepresentations in sale of a business. "[O]ur decision in Gonder v. Kelley, 372 F.2d 94 (9th Cir. 1967), squarely controls this case. . . . [I]f it is shown that the note, by express agreement, is given and received, as a discharge of the original obligation or tort action, then the execution of the note extinguishes the tort action and it would be error for the court to look behind the note." . . . [T]he Agreement, by its own terms, created a novation, extinguishing all claims arising out of the sale of Precision Tune. . . . Gonder dictates that the claims at issue here do not qualify as 'nondischargeable debt' under 11 U.S.C. § 523(a)(2).")

United States v. Spicer, 57 F.3d 1151 (D.C. Cir. 1995), cert. denied, ____ U.S. ____ 116 S. Ct. 701, 133 L.Ed.2d 658 (1996) (that debtor entered into a settlement agreement prepetition did not affect a “novation” or otherwise preclude summary judgment that debtor’s misrepresentations of borrowers’ financial conditions on HUD loan applications were actionable under § 523(a)(2)(A). Declining to follow In re West, 22 F.3d 775 (7th Cir. 1995), the court must “inquire into the factual circumstances behind the settlement agreement to ascertain whether . . . the debt . . . was derived from the alleged fraudulent conduct. . . .” Failure to look behind the settlement agreement would elevate form over substance, allowing a fraudulent debtor “through the alchemy of a settlement agreement” to transform into a nonfraudulent one.)

In re West, 22 F.3d 775 (7th Cir. 1994) (note for $75,000 to former employer in return for general release and covenant not to sue on any obligation other than the note, was dischargeable notwithstanding that note was given because of debtor’s embezzlement of $100,000 from employer. Relying on Maryland Casualty Co. v. Cushing, 171 F.2d 257 (7th Cir. 1948), while the obligation arising from debtor’s “embezzlement would have been nondischargeable due to its fraudulent nature, no allegations of fraud surround the note, and the note substituted a contractual obligation for a tortious one.”)

Greenberg v. Schools, 711 F.2d 152 (11th Cir. 1983) (underlying debt was result of debtor’s fraud or defalcation; settlement agreement does not defeat § 523(a)(4) action); Haynes v. Bobofchak (In re Bobofchak), 101 B.R. 465 (Bankr. E.D. Va. 1989).
O. Enhanced damages and costs

1. Punitive damages are nondischargeable

_Hagen v. McNallen (In re McNallen), 62 F.3d 619 (4th Cir. 1995)_ (punitive damages of $100,000 that "sprang from the same conduct" that gave rise to nondischargeable compensatory damages are nondischargeable under § 523(a)(6)).

_Bugna v. McArthur (In re Bugna), 33 F.3d 1054 (9th Cir. 1994)_ (§ 523(a) excepts enumerated "debts" from discharge. Traditional punitive damages imposed by state court for fraud and breach of fiduciary duty constitute a nondischargeable debt under § 523(a)(4). However, had the punitive damages not been predicated on the debtor's culpability or had the jury been given "unlimited discretion to impose punitive damages," their dischargeability would have to be re-evaluated.)

_FDIC v. Roberti (In re Roberti), 201 B.R. 614 (Bankr. D. Conn. 1996)_ (punitive damages are nondischargeable under § 523(a)(2)(A). "Debt" is coextensive with "claim," which is defined as a "‘right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, ...’", which is sufficiently broad to include punitive damages.)

2. Treble damages

_De La Cruz v. Cohen (In re Cohen), 185 B.R. 180 (Bankr. D.N.J. 1995), aff’d, 191 B.R. 599 (D.N.J. 1996)_ (New Jersey Consumer Fraud Act’s treble damages provision applies in § 523(a)(2)(A) rent overcharge case where debtor/landlord recklessly disregarded the truth regarding rent control ordinance), aff’d, 106 F.3d 52, 56 (3d Cir. 1997) ("We conclude that the language ‘to the extent obtained by’ was not intended by Congress to limit the amount of debt considered nondischargeable under § 523(a)(2)(A)."), cert. denied, 65 USLW 3826 (U.S. Sept. 29, 1997).

_FDIC v. Roberti (In re Roberti), 201 B.R. 614 (Bankr. D. Conn. 1996)_ (treble damages are nondischargeable under § 523(a)(4). "‘Whether for compensatory or punitive damages, a state court judgment is a ‘right to payment,’ and thus a ‘debt’ within the meaning of section 523(a)(4).’"

_Masters v. Hamama (In re Hamama), 182 B.R. 757, 758-59 (Bankr. E.D. Mich. 1995)_ (double damages on unpaid wages and treble damages on converted funds allowable under state law are nondischargeable under § 523(a)(6)).

3. Attorneys fees, interest, other damages and costs

See also attorney fees in § 523(a)(5) litigation supra.

_Mayer v. Spanel Int’l Ltd. (In re Mayer), 51 F.3d 670, 677 (7th Cir. 1995), cert. denied, ___ U.S. ___, 116 S. Ct. 563, 133 L.Ed.2d 488 (1995)_ ("Attorneys' fees provided by contract are part of the debt, and if the principal and (pre-bankruptcy) interest on the debt are non-dischargeable, so are the
other elements of the debt. Attorneys' fees, no less than the principal and interest, are the result of the fraud, and the perpetrator cannot escape the consequences. . . . Under the American Rule, attorneys' fees would not be added to a debt as of course. . . . But if a debtor agrees by contract to pay legal expenses, this is no different in principle from agreeing to a higher rate of interest, or a balloon payment, or any other contractual element of compensation to the lender."; Roberts v. Glenn Roberts & Wip, Inc., 199 B.R. 393 (S.D. Ind. 1996) (attorneys' fees and collection costs awarded by state court are part of nondischargeable debt under § 523(a)(2)(B)).


Martin v. Morello (In re Morello), 185 B.R. 753, 758 (Bankr. E.D. Tenn. 1995) (bankruptcy court not authorized to award attorney fees incurred in successful § 523(a)(5) action despite state statute permitting fee awards for enforcing any decree for alimony); Colbert v. Colbert (In re Colbert), 185 B.R. 247 (Bankr. M.D. Tenn. 1995) (bankruptcy court has no authority to award attorney fees incurred in dischargeability litigation under §§ 523(a)(5) and (a)(15) where plaintiff had no contractual right to fees. Under Tennessee law, plaintiff may seek modification of divorce decree in state court if she needs additional support due to cost of dischargeability action).

Silverstein v. Glazer (In re Silverstein), 186 B.R. 85, 87 (Bankr. W.D. Tenn. 1995) (interest on judgment for child support arrearage pursuant to general state statute for interest on all judgments is dischargeable under § 523(a)(5) because not actually in the nature of support).


American Title Ins. v. Marderosian (In re Marderosian), 186 B.R. 341, 344-45 (Bankr. D.R.I. 1995) (rejecting cases that limit nondischargeable attorney fees to state court judgments based on contractual or statutory provisions, awards attorney fees for equitable indemnity in § 523(a)(4) action).

P. Motions to alter or amend and motions for relief from judgment

Ellis v. Ellis (In re Ellis), 72 F.3d 628 (8th Cir. 1995) (February 24th “Motion for Leave to Alter or Amend” bankruptcy court judgment entered on January 28 was untimely under Rule 59 and the bankruptcy court was without jurisdiction to enlarge the 10 days allowed for such a motion. The bankruptcy court’s use of Rule 60 to “overcome the untimeliness” of the Rule 59 motion is improper. Under Bankruptcy Rule 9006(b)(2), the bankruptcy court cannot enlarge the 10 days within which to file a Rule 59 motion. That the bankruptcy court entered an amended judgment which was then timely appealed cures the problem.)

Q. Default judgments

Weingarten v. Campagna (In re Weingarten), 178 B.R. 283 (M.D. Fla. 1995), aff’d without op., 86 F.3d 1169 (11th Cir. 1996) (default against debtor in § 727 action not an abuse of discretion. Eleventh Circuit does not require culpable or willful misconduct by defendant to justify denying motion to set aside default.)

Wells Fargo Bank v. Beltran (In re Beltran), 182 B.R. 820 (B.A.P. 9th Cir. 1995) (after default against defendants and at conclusion of default “prove up” hearing at which the debtor testified, trial court may enter judgment against plaintiff where the proof shows that default judgment is not appropriate and plaintiff did not request additional time to conduct discovery or amend complaint, and did not request a trial on the merits); Kubick v. FDIC (In re Kubick), 171 B.R. 658 (B.A.P. 9th Cir. 1994) (default judgment barring discharge set aside on appeal because FDIC’s § 727 complaint parroting the statute would have been dismissed had the debtor moved to dismiss instead of failing to answer. Before entering a default, bankruptcy court has “independent duty” to determine sufficiency of § 727 complaint. On remand, bankruptcy court is not compelled under Rule 7055 to set aside default but court “must exercise its informed discretion.”); In re Villegas, 132 B.R. 742 (B.A.P. 9th Cir. 1991) (pro se debtors’ failure to respond to § 727 complaint does not necessarily entitle creditor to a default judgment. Bankruptcy court appropriately denied creditor’s motion for judgment on the pleadings because pleadings were not closed for purposes of Rule 12(c) where no answer had been filed by debtors. Creditor’s Rule 12 motion for judgment on the pleadings was more properly treated as a motion for default under Rule 55. At first hearing, court “entered default” against the debtors and set a continued evidentiary hearing on the “entry of a default judgment.” At continued hearing, creditor failed to present any evidence on mistaken assumption that debtor’s failure to answer entitled creditor to automatic entry of default judgment. Bankruptcy court apparently examined debtors at second hearing on its own and concluded to enter judgment in favor of debtors. Appellate panel reversed, holding that failure of creditor to present evidence at default judgment hearing did not authorize trial court to enter judgment in favor of the defaulting debtor. Trial court cannot enter judgment in favor of defaulting debtor until creditor has opportunity for trial on the merits.); General Elec. Capital Corp. v. Bui (In re Bui), 188 B.R. 274 (Bankr. N.D. Cal. 1995) (GECC loses default judgment hearing under Rule 7055 because it failed to prove prima facie § 523(a)(2)(B) case. “A plaintiff must demonstrate a prima facie case by competent evidence in order to obtain a Default Judgment.” Each element of the plaintiff’s § 523(a)(2)(B) case must be demonstrated by a preponderance of the evidence. Declarations filed by GECC failed to prove that debtor’s charge application was false—$3,500 monthly income on application was “not necessarily” inconsistent
with $23,000 annual income in bankruptcy schedules. Court apparently disbelieves GECC’s declaration that it relied on the charge application when it bought the debtor’s accounts from retail merchants.)

Avco Financial Servs. of S. Cal., Inc. v. Cruz (In re Cruz), 198 B.R. 330 (Bankr. S.D. Cal. 1996) (default judgment in favor of creditor will not be entered absent proof of entitlement to judgment on the merits. Allegation that debtor has failed to return merchandise to creditor will not establish conversion for purposes of § 523(a)(6).)

Meganck v. Couts (In re Couts), 188 B.R. 949 (Bankr. E.D. Mich. 1995) (declines to set aside default judgment in § 523(a)(2)(A) fraud action notwithstanding that debtor was not personally served and summons is now more than 120 days old. In exercising discretion whether to set aside default judgment, court should consider the prejudice, if any, to the plaintiff, whether the defendant has a meritorious defense, and whether culpable conduct of the defendant led to the default. Where debtor did not present meritorious defense, judgment would not be set aside. That debtor was not properly served with complaint was not determinative because debtor had actual knowledge of complaint and allowed judgment to be entered. Debtor gambled on a technical reading of the rules.)

Tullock v. Hardy (In re Hardy), 187 B.R. 604 (Bankr. E.D. Tenn. 1995) (considerations under Rule 7055 will be applied more liberally when reviewing entry of default as opposed to default judgment. Because default judgment had been entered, under stricter standard, defendant failed to show excusable neglect to set aside default judgment).

R. Entry of final judgment

Cowen v. Kennedy (In re Kennedy), 108 F.3d 1015 (9th Cir. 1997) (citing In re McLaren, 990 F.2d 850 (6th Cir. 1993), bankruptcy court has jurisdiction in the context of a § 523(a)(2)(A) complaint to enter a final judgment determining the amount of the debt that is nondischargeable).


II. LITIGATION OF DISCHARGEABILITY COMPLAINTS: 11 U.S.C. § 523


“for a tax or a customs duty . . . .”

1. Counting and tolling of time periods

Waugh v. Internal Revenue Serv. (In re Waugh), 109 F.3d 489, 493 (8th Cir. 1997) (three-year priority period in § 507(a)(8)(A)(i) is suspended or tolled during debtor’s prior bankruptcy case. “Although the plain language of section 108(c) states that it tolls priority periods only in nonbankruptcy cases, we
conclude that Congress intended 11 U.S.C. § 108(c) and 26 U.S.C. § 6503(b) and (h) to toll the three-year priority period of 11 U.S.C. § 507(a)(8)(A)(i)."

Smith v. United States (In re Smith), 96 F.3d 800 (6th Cir. 1996) (Rule 9006 is not applied to count the two year element of a nondischargeable tax claim under § 523(a)(1)(B)(ii). Debtor hired a courier service on Friday, November 22, 1991, to deliver his return to the IRS. The service delivered debtor's return on Monday, November 25, 1991. Debtor filed his Chapter 7 petition on November 23, 1993, and argued that his tax indebtedness was discharged under § 523(a)(1)(B). The debtor's first argument that his return was 'filed' when delivered to the courier service was rejected. "Generally, a tax return is 'filed' on the date that it is received by the United States. . . . A familiar exception to that rule applies to tax returns mailed with the United States Postal Service, which are considered 'received' by the United States (and therefore 'filed') on the date of the postmark. . . . However, the 'mailbox rule' does not apply to [the debtor's] returns because he sent them by private courier service." Alternatively, the debtor argued that under FED R. BANKR. P. 9006, "counting backwards from the filing date, the 'last' day is a Saturday, and that the two year period should not begin until the following Monday, November 25." The Sixth Circuit rejected this use of Rule 9006. "The Rule contemplates a deadline given to a party to take some action. The period 'runs' forward from the occurrence of some event until the expiration of the time limit, or the next business day thereafter. The reason for the rule is to encourage courts to read the Code's sometimes draconian catalogue of time limits in a manner that is fair to the party against whom the time limit is running, i.e., to guarantee that no party is shortchanged by an unfortunately - positioned weekend or holiday." Here, the choice of filing date was completely within the debtor's control, and debtor "cannot make a claim that a literal calculation of dates would unfairly cut short the time he had to take action. . . . [Moreover,] as a general matter, we believe that Rule 9006 should apply only to periods calculated by counting forward from the occurrence of some event. . . . The Rule speaks of 'running,' and time does not run backwards. . . . Time periods contemplated by Rule 9006 are times within which a party or court should do something. In this case, the two-year period is a time within which the potential bankrupt must not do something, i.e., not file for bankruptcy lest certain of his debts be non-dischargeable. . . . One must not forget that Rule 9006 is intended to benefit the party against whom a period is running." Debtor's taxes would have been dischargeable if petition had been filed two days later.)

Aberl v. United States (In re Aberl), 159 B.R. 792 (Bankr. N.D. Ohio 1993), aff'd, 175 B.R. 915 (N.D. Ohio 1994), aff'd, 78 F.3d 241 (6th Cir. 1996) (offer of compromise by taxpayer prior to assessment of taxes does not toll the 240-day rule under § 507(a)(7)(A)(ii). Taxes assessed more than 240 days prior to filing are not entitled to priority and are not excepted from discharge under § 523(a)(1)(A) notwithstanding that IRS considered and rejected debtor's offer of compromise during the 240 day period.)

Shedd v. United States (In re Shedd), 190 B.R. 693 (Bankr. M.D. Fla. 1996) ("the priority period for taxes under § 507 of the Bankruptcy Code is tolled during the pendency of a Bankruptcy case, thereby preventing uncollected taxes from becoming stale and dischargeable merely because the Government
is prevented from collecting such taxes by operation of the automatic stay. Further, courts have consistently held that the additional six months afforded the Internal Revenue Service to resume collection activities after the conclusion of a Bankruptcy Case also served to toll the running of the priority period, thereby preserving the nondischargeability of the taxes for the full term provided in the Code.”


Turner v. United States (In re Turner), 182 B.R. 317 (Bankr. N.D. Ala. 1995), adhered to on reconsideration, 195 B.R. 476 (Bankr. N.D. Ala. 1996) (§ 108(c) and IRC § 6503(h) do not suspend three year priority period of § 507(a)(7)(A)(i), the 240 day priority period of § 507(a)(7)(A)(ii), or the three year dischargeability period of § 523(a)(7)(B); however, equitable tolling might apply to non-penalty portion of tax if debtor engaged in dilatory or bad faith conduct in prior bankruptcy cases resulting in injustice to IRS).

Campbell v. United States (In re Campbell), 186 B.R. 731 (Bankr. N.D. Fla. 1995) (despite evidence that debtor’s attorney mailed return and IRS record of “[r]eturn filed and tax assessed,” debtor has not met burden of proving late return was “filed”); Conner v. IRS (In re Conner), 187 B.R. 217, 219-20 (Bankr. E.D. Tenn. 1995) (where IRS failed to prove it made diligent search and did not receive debtor’s return, court may consider extrinsic evidence other than certified or registered mail receipt from debtor, distinguishing Surowka v. United States, 909 F.2d 148 (6th Cir. 1990)).

2. Trust fund, excise or gross receipts tax

Industrial Comm’n of Arizona v. Camilli (In re Camilli), 94 F.3d 1330 (9th Cir. 1996) (statutory obligation for workers’ compensation benefits paid by state commission because debtor failed to obtain insurance was an “excise tax” for purposes of § 523(a)(1). To qualify as a tax, “a debt must be (1) an involuntary pecuniary burden; (2) imposed by the state legislature; (3) for a public purpose; (4) under the police or taxing power.”) Accord Waldo v. Dep’t of Labor & Industry Uninsured Employers Fund (In re Waldo), 186 B.R. 118 (Bankr. D. Mont. 1995) (uninsured employer’s obligation to pay Montana Uninsured Employer’s Fund after injured employee makes claim against fund is “excise tax,” not insurance premium substitute or penalty for failure to pay premiums).

Pert v. United States (In re Pert), 201 B.R. 316 (Bankr. M.D. Fla. 1996) ("transferee liability"—liability assessed pursuant to 26 U.S.C. § 6901 against transferee of assets when transferor is rendered insolvent or unable to pay his taxes as a result of the transfer—is a debt, not a tax within scope of § 523(a)(1). At best, the government has an unsecured claim if it has filed a timely proof of claim.)
3. Fraudulent return or willful attempt to evade tax


*United States v. Fegeley (In re Fegeley)*, 118 F.3d 979, 983-4 (3d Cir. 1997) (citing *Toti*, “[T]he majority of courts have found that affirmative conduct by a debtor designed to evade or defeat a tax is not required. Rather, § 523(a)(1)(C) encompasses acts of culpable omission as well as acts of commission. . . . The majority of courts . . . have adopted the test for ‘civil willfulness’ . . . for purposes of § 523(a)(1)(C), to require that the debtor’s attempts to avoid his tax liability were ‘voluntary, conscious, and intentional.’”).

*In re Birkenstock*, 87 F.3d 947 (7th Cir. 1996) (adopting Sixth Circuit’s interpretation of § 523(a)(1)(C) in *Toti*, “willfulness requirement prevents the application of the exception to debtors who make inadvertent mistakes, reserving nondischargeability for those whose efforts to evade tax liability are knowing and deliberate.” History of efforts by husband to avoid federal income taxes including a trust fund into which all of the debtors’ property and income was transferred for no consideration, and the failure to file tax returns, constituted a willful attempt to evade tax liability. Wife’s state of mind could not be determined on the sole basis that she signed the couple’s joint returns. “[H]er only conduct directed toward evading or defeating tax liability was the filing of returns assigning personal income to family trust. The government needed to put forth evidence that this evasion was *willful*, and it did not.”); *In re Zuhone*, 88 F.3d 469 (7th Cir. 1996) (failure of IRS to call a single witness to refute debtors’ testimony as to intent did not preclude bankruptcy court’s conclusion that tax liability was nondischargeable where bankruptcy court found debtors’ testimony incredible. “Actions speak louder than words.” Debtors engaged in a series of transfers to their children and other questionable transactions over a number of years.)

*Dalton v. IRS*, 77 F.3d 1297, 1300-01 (10th Cir. 1996) (citing *Toti* with approval, “willful attempt . . . to evade or defeat” in § 523(a)(1)(C) requires something more than just failure to pay taxes, but can be proven by conduct less than the willfulness necessary to convict for felony tax evasion. “Congress did not define or limit the methods by which a willful attempt to defeat and evade might be accomplished . . . By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one’s affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal.”
Bankruptcy court did not error in finding that debtor willfully concealed his ownership interest in two assets.

Haas v. IRS (In re Haas), 48 F.3d 1153 (11th Cir. 1995) (debtor who regularly and accurately filed tax returns for 1977 through 1985 did not willfully attempt to evade or defeat his tax liability merely because he did not remit payment with those returns. That debtor chose to prefer other creditors over the IRS did not make a "dishonest debtor." While debtor may have defeated payment of taxes, that is not the conduct Congress sought to punish in § 523(a)(1)(C). Congress is capable of distinguishing evasion of a tax from evasion of payment of a tax. Any other interpretation would "render the general rule of dischargeability of tax liability an empty letter and defeat the central purpose of the Bankruptcy Code.")

Compare United States v. Cox, 189 B.R. 214 (M.D. Fla. 1995) (agrees with Toti, civil tax fraud standard applies under § 523(a)(1)); Binkley v. United States (In re Binkley), 176 B.R. 260 (Bankr. M.D. Fla. 1994) (failure to file returns until summoned to IRS office is sufficient to establish willful attempt to evade or defeat tax liability), with Miller v. United States (In re Miller), 176 B.R. 266 (Bankr. M.D. Fla. 1994) (failure to file tax returns for six years not necessarily a willful attempt to evade or defeat tax liability. Debtor established good faith with $28,000 prepetition payment to IRS.)

Bruner v. United States (In re Bruner), 55 F.3d 195 (5th Cir. 1995) (adopts Sixth Circuit's interpretation of § 523(a)(1)(C) in Toti. Debtors who failed to file tax returns or to pay taxes for eight years willfully attempted to evade or defeat tax liabilities within the meaning of § 523(a)(1)(C)).

United States v. Sumpter (In re Sumpter), 170 B.R. 908 (E.D. Mich. 1994), aff'd, 64 F.3d 663 (6th Cir. 1995) (unpublished), cert. denied, ___ U.S. ___, 116 S. Ct. 1673, 134 L.Ed.2d 777 (1996) (§ 523(a)(1)(C) requires only that the debtor "willfully attempted in any manner to evade or defeat" a tax, not that the debtor be successful. Lack of equity in fraudulently transferred property does not mitigate intent to evade or defeat tax liability. "Mr. Sumpter took the affirmative step of transferring property to avoid its attachment as a tax lien, an act to which he admits. By taking this affirmative step, Mr. Sumpter attempted to 'willfully evade or defeat' payment of his tax debt and he is excepted from discharge of that debt under Section 523(a)(1)(C). . . . Mrs. Sumpter was raised in Italy and has only a high school education. The Bankruptcy Court found that she defers to her husband on most issues and has very little, if anything, to do with his business. . . . There is no evidence that she had any real control over the Trust assets when she signed the document to receive the loan from the Trust or that she understood that transfer to be any different from the earlier transfers. Mrs. Sumpter simply signed the document at the direction of her husband. . . . The transfer was, in effect, another business transaction by Mr. Sumpter of which Mrs. Sumpter had little knowledge or control. . . . Neither we nor the IRS want to encourage a spouse to turn a 'blind eye' to the couple's tax situation and even minimal involvement in the family's financial affairs can be sufficient in some circumstances. In this case, however, where the conduct primarily concerned Mr. Sumpter's business affairs, which
were fairly complex, Mrs. Sumpter's actions cannot be said to be 'willful' under Section 523(a)(1)(C).

Semo v. United States (In re Semo), 188 B.R. 359 (Bankr. W.D. Pa. 1995) (under either the Toti, 24 F.3d 806 (6th Cir. 1994) approach—no affirmative act of evasion required—or the Haas, 48 F.3d 1153 (11th Cir. 1995), approach—mere act of omission not sufficient—this debtor willfully attempted to evade or defeat taxes. Debtor failed to file returns for six years and submitted form W-4's to his employer in which he advanced from claiming one exemption to claiming twelve, fourth-five, fifty and eventually asserting that he was exempt from payroll taxes); Fuller v. United States (In re Fuller), 189 B.R. 352 (Bankr. W.D. Pa. 1995) (the appropriate standard for willfulness under § 523(a)(1)(C) is "whether the debtor-taxpayer voluntarily, consciously, or intentionally attempted to evade taxes . . . . [Under this standard, debtor's mere] failure to pay his taxes, alone, does not fall within the scope of Section 523(a)(1)(C)'s exception to discharge . . . ." Where debtor honestly believed he had no tax liability over amount he had withheld from disability and IRA withdrawal, did not falsify records, made no misstatements as to income and filed accurate, if not overstated, returns when finally filed, tax liability is dischargeable.)


"for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained, by -- (A) false pretenses, a false representation, or actual fraud, . . . (B) use of a statement in writing -- (i) that is materially false; (ii) respecting the debtor's or an insider's financial condition; (iii) on which the creditor . . . reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive."

1. Elements of proof under § 523(a)(2)(A)

a. To the extent obtained by fraud

Lee-Benner v. Gergely (In re Gergely), 110 F.3d 1448, ___ (9th Cir. 1997) (claim that a physician intentionally misrepresented the need for amniocentesis and then negligently performed the procedure states a cause of action for fraud under § 523(a)(2)(A). Obstetrician performed amniocentesis on plaintiff's mother. Plaintiff was born blinded in one eye. Child obtained $780,282 judgment for damages. Three years later, obstetrician filed Chapter 7. The child "alleged damage from negligent performance of a procedure undergone because of intentional misrepresentation. That was sufficient. His [§ 523(a)(2)(A)] claim should not have been dismissed. Gergely's alternative argument that any alleged misrepresentation was made only to, and relied on only by, Lee-Benner's [the plaintiff's] mother is advanced because Lee-Benner, not his mother, is the creditor contesting dischargeability . . . . We have stated that § 523(a)(2)(A) requires misrepresentations made "with the intention and purpose of deceiving the creditor," on which 'the creditor relied.' . . . We are satisfied that under state law Lee-Benner could have stated such a fraud claim. California courts allow recovery for
negligence occurring before a plaintiff’s birth where damage to the unborn child was foreseeable. . . . This reasoning applies at least as well to fraud as to negligence. . . . If Lee-Benner has standing to bring an otherwise-traditional fraud claim under California law, then that claim would be for fraud within § 523(a)(2)(A).”

Anastas v. American Savs. Bank (In re Anastas), 94 F.3d 1280 (9th Cir. 1996) (“[There are] two separate points in the relationship between the credit card issuer and the card holder. First, there is the point at which the credit card is issued. . . . [At this point] there is a representation by the card holder, in accepting the credit card, that he has the intention of paying for the charges incurred. Second, . . . there is the point at which the card holder forms an intent not to repay the debt which he is incurring . . . . [At that point] the card holder has a duty to disclose his new state of mind if he no longer has the intent to repay the credit card debt which he is incurring. . . . In many credit card cases the inquiry is not whether the card holder lacked an intent to repay all of the charges made on the card because of a fraudulent financial scheme, but rather whether the card holder lacked an intent to repay when making certain individual charges because he planned to shortly discharge them in bankruptcy. This behavior is commonly referred to as ‘loading up’. In cases where the question is simply whether a card holder defrauds a card issuer by making charges when he plans to discharge them in bankruptcy, we should look to whether the individual charges were made with a fraudulent intent. This inquiry is easily applied if we view each individual credit card transaction as the formation of a unilateral contract between the card holder and card issuer.”)

Cho Hung Bank v. Kim (In re Kim), 163 B.R. 157 (B.A.P. 9th Cir. 1994), aff’d, 62 F.3d 1511 (9th Cir. 1995) (an extension, renewal or refinancing obtained in a manner proscribed by § 523(a)(2) need not be joined with new value or additional funds for the original indebtedness to be declared nondischargeable. The creditor must demonstrate, however, that it had valuable collection remedies at the time of the extension, renewal or refinancing, that in reliance on debtor’s misrepresentation it did not exercise those remedies, and that the remedies lost value after extension, renewal or refinancing.)

HSSM #7 Limited Partnership v. Bilzerian (In re Bilzerian, 100 F.3d 886 (11th Cir. 1990) (adopts “receipt of benefits” theory to define “obtain” in § 523(a)(2)(A). Debtor may not have directly obtained money invested in limited partnership based on his misrepresentations, but he had connections with companies that “placed him in a position to benefit from any infusion of capital to that enterprise.” To limit § 523(a)(2)(A) to direct benefits “would provide a dangerous incentive for the sophisticated debtor, who could circumvent the provision by creating a shell corporation to receive the fruits of his or her fraud.”)

United States v. Spicer, 57 F.3d 1152 (D.C. Cir. 1995), cert. denied, _ U.S. _, 116 S. Ct. 701, 133 L.Ed.2d 658 (1996) (“only that portion of a debt attributable to the debtor’s fraud is nondischargeable.”)
All of the $339,000 settlement by the debtor of false claims actions by HUD was attributable to fraudulent misstatements by the debtor in mortgage loan applications. That debtor plead guilty to only 1 of 80 transactions and denied liability for fraud in settlement of civil action did not preclude finding that underlying misconduct extended to all transactions and all injury suffered by HUD.

Medley v. Owen (In re Owen), 181 B.R. 288 (Bankr. W.D. Va. 1995) ("to the extent obtained by" limits nondischargable debt to amount obtained by actual fraud and does not include pre-judgment interest, attorneys' fees or other charges).

Vaughn v. Aboukhater (In re Aboukhater), 165 B.R. 904 (B.A.P. 9th Cir. 1994) (fraudulent acts must be part of transaction through which money or property was obtained. Debtor’s allegedly wrongful conduct after the fact is of no consequence under § 523(a)(2).)

b. Actual fraud, not constructive or statutory fraud

Anastas v. American Savs. Bank (In re Anastas), 94 F.3d 1280 (9th Cir. 1996) (bankruptcy court mistakenly overemphasized inferences from debtor’s hopeless financial condition in finding fraud. “A finding that a debt is non-dischargeable under 523(a)(2)(A) requires a showing of actual or positive fraud, not merely fraud implied by law. . . . Actual fraud ‘is the type involving moral turpitude, or intentional wrong, and thus there can be no mere imputation of bad faith.’” Although overall financial condition may be relevant to establish an inference that the debtor incurred the debt “maliciously and in bad faith, . . . the hopeless state of a debtor’s financial condition should never become a substitute for an actual finding of bad faith.”)

Bombardier Capital, Inc. v. Baietti (In re Baietti), 189 B.R. 549 (Bankr. D. Me. 1995) (debtor’s silence that boats at dealership were sold, not available for sale, was fraud because debtor knew that creditor’s “walk through” of dealership was intended to confirm available inventory. Section 523(a)(2)(A) requires plaintiff to prove that “debtor engaged in conduct that is truly blameworthy in an everyday sense, as well as in a technical legal sense.” “False pretense” encompasses “implied representations, or conduct intended to create or foster a false impression.”)

De La Cruz v. Cohen (In re Cohen), 185 B.R. 171, 177-79 (Bankr. D.N.J. 1994) (“actual fraud requires knowledge of the falsity and an intent to deceive” but reckless indifference will suffice to show both knowledge and intent elements. Pattern of rent overcharges by debtor/landlord who should have been aware of rent control ordinance are nondischargable).
c. Fraud must be pleaded with particularity

_Fuller v. Johannessen (In re Johannessen)_ 76 F.3d 347 (11th Cir. 1996) (bankruptcy and district courts imposed too high a burden on the creditor to plead facts in support of fraud in response to debtor's motion to dismiss under Fed. R. Civ. P. 12(b)(6). It is sufficient that the plaintiff alleged that the defendant/debtor misrepresented how he would use money he received from the plaintiff, that the plaintiff relied on the misrepresentations and was justified in doing so.).

d. Express, affirmative misrepresentations of existing facts

_Citibank (South Dakota), N.A. v. Eashai (In re Eashai)_ 87 F.3d 1082 (9th Cir. 1996) ("In the case of credit card kiting, the debtor makes a false representation: (1) by creating the facade that all of his accounts are in good standing; and (2) by failing to disclose to the creditor his intent not to pay his credit card debt. . . . [A] credit card kiter has a duty to disclose his intention not to pay because he previously represented to the card issuer his intention to pay for charges incurred on the credit card. . . . When a debtor, with intent to defraud the creditor, makes minimum payments with cash advances from other credit cards, the debtor has a duty to disclose to the creditor that he no longer intends to pay his credit card debt. If the debtor fails to make this disclosure, then he commits actual fraud."

Yet, the making of a minimum payment on one credit card with a cash advance from another is not alone grounds for nondischargeability. Courts should recognize the "fragility of human nature,"—"[h]uman experience tells us debtors can be unreasonably optimistic despite their financial circumstances."; _American Express Travel Related Servs. Co. v. Hashemi (In re Hashemi)_ 104 F.3d 1122 (9th Cir. 1996) (each time debtor used American Express card, he made a fraudulent representation because he did not actually intend to repay the debt).

_Anastas v. American Savs. Bank (In re Anastas)_ 94 F.3d 1280 (9th Cir. 1996) ("When the card holder uses his credit card, he makes a representation that he intends to repay the debt. The intention to perform an agreement may be expressed but it is normally merely to be implied from the making of the agreement. . . . When the card holders uses the card without an intent to repay, he has made a fraudulent representation to the card issuer. . . . Thus, the central inquiry in determining whether there was a fraudulent representation is whether the card holder lacked an intent to repay at the time he made the charge. . . . [T]he representation made by the card holder in a credit card transaction is not that he has an ability to repay the debt; it is that he has an intention to repay. . . . [R]eckless disregard for the truth of a representation satisfies the element that the debtor has made an intentionally false representation in obtaining credit.")

_Apte v. Japra (In re Apte)_ 96 F.3d 1319 (9th Cir. 1996) (debtor as sublessor incurred nondischargeable obligation by failing to tell sublessee that landlord would not approve terms required by sublessee.
"[T]he nondisclosure of a material fact in the face of a duty to disclose has been held to establish the requisite reliance and causation for actual fraud under the Bankruptcy Code. . . . In determining the duty to disclose in the context of fraud under 11 U.S.C. § 523(a)(2)(A), we look to the common law concept of fraud at the time such language was added to the statute. . . . [The Restatement (Second) Torts (1976), provides:] (1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question. (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, * * * (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts." Here, debtor had a duty to disclose to the sublessee that the landlord would never agree to certain of the provisions of the sublease on which the sublessee was insistent. "[A] party to a business transaction has a duty to disclose when the other party is ignorant of material facts which he does not have an opportunity to discover." Accord Drake Capital Secs., Inc. v. Larkin (In re Larkin), 189 B.R. 234 (Bankr. D. Mass. 1995) (debtor's failure to reveal an injunction that prohibited the transfer of stock supports § 523(a)(2)(A) action. "A debtor's silence and failure to disclose a material fact constitute a misrepresentation actionable under Section 523(a)(2)(A)." This is consistent with the common law tort of deceit.)

Brothers v. Young (In re Young), 91 F.3d 1367 (10th Cir. 1996) (attorney/debtor's failure to disclose in writing the terms of a business relationship with a client, pursuant to the New Mexico Rules of Professional Conduct, together with his failure to disclose potential conflicts of interest relating to an exchange of service agreement, constituted misrepresentations for purposes of § 523(a)(2)(A)).

Caccamo v. Pouliot (In re Pouliot), 196 B.R. 641 (Bankr. S.D. Fla. 1996) (debtor-obstetrician's transfer of his assets to a revocable trust and election not to carry medical malpractice insurance under Fla. Stat. § 458.320(5)(g)(4), did not give rise to a nondischargeable malpractice judgment when debtor was not financially responsible for $10 million judgment. Sign required under Florida law to be posted in patient area was not a materially false statement as "[t]he statutory language set forth in the Sign is limited in that a noninsured physician must simply, in lieu of carrying medical malpractice insurance, 'demonstrate financial responsibility.' The Sign does not state that [debtor] will satisfy all adverse judgments. The Sign only provides that [debtor] will either satisfy an adverse judgment against him or be subject to penalties pursuant to Florida law.")
Chase Manhattan Bank v. Murphy (In re Murphy), 190 B.R. 327 (Bankr. N.D. Ill. 1995) (cash advances for gambling and options trading were dischargeable because debtor intended to repay at time of advances and had some history of doing so. Mindful of the Supreme Court’s admonition in Field v. Mans, ___ U.S. ___, 116 S. Ct. 437, 133 L. Ed.2d 351 (1995), that “[w]here Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms,” the court looked to common law fraud to determine whether credit card advances taken by a gambler were dischargeable under § 523(a)(2)(A). “Under the common law a promise to perform a statement of future intention is actionable as fraud only if, at the time the statement was made, the debtor never intended to honor his statement.” Further, the “out-come determinative question,” whether the court should apply a subjective test or an objective, reasonable person test is also answered by reference to Field “which requires us to answer that question in accordance with the common law of fraud. The Restatement (Second) of Torts § 526 suggests that it is inappropriate to apply a ‘reasonable person’ test to determine fraudulent intent. . . . Finding whether the Debtor had that intent requires a consideration of all the circumstances. . . . [A] factor-counting exercise turns the job of fact finding on its head. . . . What the courts need to do is determine whether all the evidence leads to the conclusion that it is more probable than not that the debtor had the requisite fraudulent intent. This determination will require a review of the circumstances of the case at hand, but not a comparison with circumstances (a/k/a ‘factors’) of other cases. . . . [T]he fact-finding process is only clouded by copying a list of factors from other cases and weighing evidence according to how well it matches that list.” Debtor that incurred substantial debt gambling and options trading intended at the time he took the cash advances to repay those debts and “believed (however unreasonably) that he would have the means to do so from his gambling and investments. The Debtor had for years successfully relied on such ‘income’ to pay off his credit card debt.” There had been no significant increase in spending before he filed and no evidence that he considered bankruptcy at the time of the advances.)

Chevy Chase Bank, FSB v. Briese (In re Briese), 196 B.R. 440 (Bankr. W.D. Wis. 1996) (“Field . . . neatly solves the struggle over conceptualizing credit card fraud. At common law, a promise of future performance or intention is actionable as fraud if at the time the statement was made, the debtor never actually intended to honor the statement.” That there is no face to face contact between the debtor and the credit card issuer should not present a conceptual problem because the scope of “representation” is broad enough to encompass acts or conduct which transmit a promise. “There is no longer a need to craft ‘legal fictions’ under which the debtor purportedly makes various representations regarding ability or intent to pay. . . . This approach to fraudulent representations can be examined by reference to Popeye’s good friend Wimpy, who always promised, ‘I’ll gladly pay you Tuesday’ for a hamburger today. Wimpy is not guilty of fraud just
because on Tuesday he doesn’t have the money, or even if he was hopelessly insolvent when he made the promise. The common law notion of actual fraud requires that he have acted with an intent to deceive when he made the promise to pay. . . . The situation is the same even if Popeye gives Wimpy a credit card to use in making the purchase. The act of using the card constitutes a ‘representation’ or promise regarding Wimpy’s future performance.” Because it is difficult if not impossible for a plaintiff to prove debtor’s intent to deceive, “courts may legitimately utilize circumstantial evidence to ascertain the debtor’s intent.” The issue then becomes whether the court should judge the debtor’s intent on objective or subjective grounds. Common law principles direct the court to a subjective standard -- whether the person making the statement was aware of its falsity. Applying this standard to credit card debts from gambling addiction, court concluded that debtor had “an honest, if questionable and undoubtedly foolish, belief that she could win enough to pay her debts. She paid her debts and maintained her minimum payments [on approximately $30,000 in credit card debt] until the day she filed bankruptcy.”

_Bank One Columbus, N.A. v. McDaniel (In re McDaniel), 202 B.R. 74_ (Bankr. N.D. Tex. 1996) (the use of a credit card carries with it no representation, express or implied).

_Hecht’s v. Valdes (In re Valdes), 188 B.R. 533_ (Bankr. D. Md. 1995) ($732.16 in unpaid department store credit card purchases are dischargeable. Rejects theories of implied representation and assumption of risk in credit card cases; adopts totality of circumstances theory. Court employs twelve factor test: the length of time between the charges made and the filing of the bankruptcy; whether an attorney had been consulted concerning the filing of the bankruptcy before the charges were made; the number of charges made; the amount of the charges; the financial condition of the debtor at the time the charges were made; whether the charges were above the credit limit of the account; whether the debtor made multiple charges on the same day; whether debtor was employed and debtor’s prospects for employment; the financial sophistication of the debtor; whether there was a sudden change in the debtor’s buying habits; and whether the purchases were made for luxuries or necessities. List is neither exhaustive nor determinative. Creditor need not establish all twelve factors to prevail. Debtor’s insolvency is just one additional element that may be considered.)

_AT & T Universal Card Servs. v. Samani (In re Samani), 192 B.R. 877_ (Bankr. S.D. Tex. 1996) (“Creditors cannot establish fraud [for purposes of § 523(a)(2)(A)] based on the implied representation of an intent to repay and ability to pay based on the mere use by the debtor of a credit card.” Rather, the court must apply an objective totality of circumstances test.)
Barnett Bank of Pinellas County v. Tinney (In re Tinney), 188 B.R. 1015 (Bankr. M.D. Fla. 1995) (after consulting an attorney and deciding not to file bankruptcy, debtor drew nearly $12,000 in cash advances on two credit cards and a line of credit to pay the IRS to release levy against his medical practice. The cash advances were dischargeable under § 523(a)(2)(A). "The availability of credit for difficult financial times is one very good reason to establish credit. The test for nondischargeability is not whether the credit is used in difficult times; the test . . . is whether credit was used with the intent not to repay." Debtor reasonably believed at the time of the advances that his medical practice would turn around and show a profit, and the funds were drawn for the purpose of continuing the practice. Unforeseen and unforeseeable circumstances caused debtor ultimately to reconsider his decision not to file bankruptcy.); American Express Travel Related Servs. Co., Inc. v. Diaz (In re Diaz), 185 B.R. 867, 869-70 (Bankr. M.D. Fla. 1994) (credit card charges incurred after debtors conferred about bankruptcy with friend are nondischargeable, including charges made before card revocation).

Union Nat’l Bank & Trust Co. of Souderton v. Guest (In re Guest), 193 B.R. 745 (Bankr. E.D. Pa. 1996) (utterance of NSF check “is not, standing alone, a fraudulent misrepresentation sufficient to sustain a nondischargeable claim under § 523(a)(2)(A)”); Tusco Grocers, Inc. v. Coatney (In re Coatney), 185 B.R. 546 (Bankr. N.D. Ohio 1995) (check is not a representation whether it will be honored. No fraud exists without some positive statement regarding sufficiency of bank balance at the time check is offered.)

e. Agency, master-servant, corporate officers, spouses, and partners

Insurance Co. of N. Am. v. Cohn (In re Cohn), 54 F.3d 1108 (3d Cir. 1995) ("[C]ommon law principles of agency law would probably dictate the imputation of an agent’s fraud to a principal under § 523(a)(2)(B)(iv) analysis. If principles of imputability applied, [the debtor] could be held responsible for Scutto’s statements and intent to deceive. However under the facts of this case, agency law is not directly applicable. . . . The third party—INA—never relied upon anything [the debtor’s] agent said on behalf of [the debtor]. Because INA relied only upon the principal’s representations, agency law is irrelevant to this case.")

RecoverEdge L.P. v. Pentecost (In re Carpenter), 44 F.3d 1284, 1296-7 (5th Cir. 1995) (distinguishing Luce, fraud of other individuals who acted through a corporation in which the debtor was president, a director and a shareholder is not properly imputed to the debtor for § 523(a)(2)(A) purposes where there has been no finding or allegation that the debtor was the alter ego of the corporation. RTC sued the debtor and several other individuals claiming they conspired through a corporation to defraud a bank by sham loan transactions. A jury found all of the other defendants guilty of civil conspiracy to defraud but found for the debtor on the conspiracy claim. "In [Luce] we held that
a partner's fraud could be imputed to an innocent partner to make the innocent partner's debt nondischargeable under § 523(a)(2)(A). . . . Luce is consistent with the general rule that '[a] debtor who has made no false representation may, nevertheless, be bound by the fraud of an agent acting within the scope of the debtor's authority.' . . . That rule, like our decision in Luce, has no bearing on this case because RecoverEdge does not contend that Pentecost and Westmoreland acted as Carpenter's agents. RecoverEdge's imputation argument is supported neither by the cases it cites nor by existing case law on nondischargeability. It is also inconsistent with the general principle that § 523(a)(2)(A) 'contemplates frauds involving "moral turpitude or intentional wrong; fraud implied in law which may exist without imputation of bad faith or immorality, is insufficient."' [citing Allison].")

Luce v. First Equip. Leasing Corp. (In re Luce), 960 F.2d 1277 (5th Cir. 1992) (fraud of one partner is properly imputed to another partner where the partner proclaiming innocence benefitted in some manner from the fraud of the other partner).

Allison v. Roberts (In re Allison), 960 F.2d 481 (5th Cir. 1992) (fraud of one spouse not imputed to other spouse where there was no evidence linking the "innocent" spouse to the fraudulent conduct); O'Connell v. Floyd (In re Floyd), 177 B.R. 985, 988 (Bankr. M.D. Fla. 1995).


Walker v. Citizens State Bank (In re Walker), 726 F.2d 452 (8th Cir. 1984) (fraud of agent will not be imputed to debtor absent showing debtor knew or should have known of agent's fraudulent actions).

In re Fravel, 143 B.R. 1001 (Bankr. E.D. Va. 1992) (state's claims against debtors, and their closely held corporation, for violations of Virginia Prizes and Gifts Act and Virginia Consumer Protection Act in connection with debtors' tele-marketing scheme were nondischargeable under § 523(a)(2)(A). Corporation's sales representatives were acting as agents for debtors; therefore, representations by sales representatives were attributable to debtors as if they had made the representations themselves. Representations regarding cleaning products sold by corporation and promotional promises of free durable goods were actionable in fraud where the parties were on unequal terms, representations were made by persons holding themselves out as knowledgeable in the field, and promises of free gifts were made with no intention of giving such gifts.)

In re Sostarich, 73 B.R. 731 (W.D. Ky. 1987) (actual fraud must be the debtor's, not imputed to debtor through contractual relationship with agent who commits actual fraud. Collateral estoppel effect not given to prior state court judgment finding debtor liable for the imputed fraud of its agent.)


f. Intent to deceive

Palmacci v. Umpierrez (In re Umpierrez), 121 F.3d 781 (1st Cir. 1997) (debtor lacked intent to deceive when represented that he and his brother would invest $75,000 "of their own money" in a project but instead encumbered the project. Citing Anastas, 94 F.3d 1280 (9th Cir. 1996), "The factual question to be determined by the trier of fact is not whether Umpierrez knew or should have known that he did not have the money available to invest, but whether in good faith he intended to keep his promise. This is because '[a] finding that a debt is non-dischargeable under 523(a)(2)(A) requires a showing of actual or positive fraud, not merely fraud implied by law.'... This is not a negligence case where the standard is whether a reasonable person would have acted as Umpierrez did. ... Fraudulent intent requires an actual intent to mislead, which is more than mere negligence. ... A 'dumb but honest' defendant does not satisfy the test of scienter. ... There must ... be an actual finding of intent to deceive: mere inability to pay does not constitute such a finding. ... Umpierrez testified that he thought he would be able to come up with his $75,000 investment from his personal funds, and the judge believed him, apparently taking into account all circumstances including the weight of the alleged unreliability of his belief. ... We cannot say the trial court clearly erred in its choice of which inferences to draw from the evidence.
presented to it.” Bankruptcy court did not err in refusing evidence about the debtor’s actions after the alleged misrepresentations. Although “subsequent conduct may be relevant to an earlier state of mind,” the offered testimony “related to events almost two years after [the plaintiff’s] investment was induced . . . [and] would not have been directly prohibitive of Umpierrez’s intent to deceive.”

Anastas v. American Savs. Bank (In re Anastas), 94 F.3d 1280 (9th Cir. 1996) (bankruptcy court mistakenly focused on debtor’s financial condition which revealed no realistic hope of repaying gambling debts on credit card. “However, apart from the fact of his financial condition, the record contains no other persuasive evidence of an intent to defraud.” Debts were incurred over six month period during which debtor made monthly payments. Debtor contacted bank in attempt to work out repayment. Debtor testified he “always” intended to repay. Finding of intent to defraud was clearly erroneous.)

National Union Fire Ins. Co. of Pittsburgh, PA. v. Bonnanzio (In re Bonnanzio), 91 F.3d 296 (2d Cir. 1996) (unsophisticated debtor who signed blank financial statement for investment in tax shelter had no actual intent to defraud where financial advisor actually filled out the credit application using false information that vastly exaggerated the debtor’s income and assets, unbeknownst to the debtor. Debtor did not have “constructive intent” based on reckless disregard for consequences because the debtor was unsophisticated and the bankruptcy court’s finding of lack of recklessness was not clearly erroneous. However, fraudulent intent might be “imputed” to the debtor “under general principles of agency.” “[T]here is conflicting authority regarding whether, under § 523(a)(2)(B), the fraudulent intent of a debtor’s agent may be imputed to the debtor without a further finding that the debtor knew or should have known of the fraud. No court of appeals has directly ruled on this issue, but the Third Circuit has observed in dicta ‘common law principles of agency law would probably dictate the imputation of an agent’s fraud to a principal under § 523(a)(2)(B)(iv) analysis’. . . . The Eighth Circuit, construing a closely related provision of the Bankruptcy Code, has held that ‘more than the mere existence of an agent-principal relationship is required to charge the agent’s fraud to the principal. . . . If the principal either knew or should have known of the agent’s fraud, the agent’s fraud will be imputed to the debtor-principal.’ . . . We need not decide this issue . . . . The bankruptcy court made no factual findings as to whether Bonnanzio knew or should have known of Berlin’s fraud. If we hold that such a showing is necessary to demonstrate an intent to deceive under § 523(a)(2)(B), we would still have to remand so that the bankruptcy court could make that factual determination in the first instance. On the other hand, if we hold that no such showing is necessary, Bonnanzio may still prevail, on the theory that a principal is not charged with an agent’s misdeeds if the agent acts in a manner completely adverse to the principal’s interest. . . . The district court emphasized that Bonnanzio cannot rely on the adverse interest exception, because she retained a benefit as a consequence of the fraud. . . . Whether Bonnanzio received a benefit from Berlin’s
fraud is unclear on this record . . . . We further observe that, even if a principal receives a benefit from an agent's fraudulent actions, under agency principles that benefit is only significant if the principal knowingly retains it before a change of position. . . . We are unaware of any case that has addressed this particular issue of agency law in the bankruptcy context. Generally, a change in position is a change in the principal's circumstances induced by the receipt of the benefit. . . . [W]e remand for decisions on the following: (1) whether under 11 U.S.C. § 523(a)(2)(B), the fraudulent intent of a debtor's agent may be imputed to the debtor without a further finding that the debtor knew or should have known of the fraud; (2) if so, whether Bonnanzio knew or should have known of Berlin's fraudulent actions; (3) in any event, whether Berlin acted in a manner that was completely adverse to Bonnanzio's interest; (4) if so, whether a debtor who knowingly retains the benefit of an agent's fraud before a change in position has the requisite intent to deceive under § 523(a)(2)(B); and (5) if so, whether Bonnanzio did knowingly retain such a benefit and therefore had the requisite intent to deceive.

Citibank (South Dakota), N.A. v. Eashai (In re Eashai), 87 F.3d 1082 (9th Cir. 1996) (adopts Dougherty's twelve factors. "A creditor in a credit card kiting case must also prove the other elements of common law fraud, including a false representation, justifiable reliance, and damages."); In re Dougherty, 84 B.R. 653 (B.A.P. 9th Cir. 1988) (in credit card case, factors to be considered bearing on intent are: (1) length of time between charges made and filing of bankruptcy; (2) whether attorney has been consulted concerning the filing of bankruptcy before charge is made; (3) number of charges; (4) amount of charges; (5) financial condition of debtor at time charge is made; (6) whether charges were above credit limit of account; (7) whether debtor made multiple charges on same day; (8) whether debtor employed; (9) debtor's prospects for employment; (10) financial sophistication of debtor; (11) whether there was sudden change in debtor's buying habits; and (12) whether purchases were made for luxuries or necessities). See also American Express Travel Related Servs. Co. v. Hashemi (In re Hashemi), 104 F.3d 1122 (9th Cir. 1996).

Williamson v. Busconi, 87 F.3d 602 (1st Cir. 1996) ("[S]ubsequent conduct may reflect back to the promisor's state of mind and thus may be considered in ascertaining whether there was fraudulent intent' at the time the promise was made, proper application of the 'totality' test in the instant context often warrants consideration of post-transaction conduct and consequences, as well as pre-transaction conduct and contemporaneous event. . . . [T]he bankruptcy court ruling excluding [debtor's] relevant post-closing conduct constituted an abuse of discretion.")

New Jersey Lawyers' Fund for Client Protection v. Trombadore (In re Trombadore), 201 B.R. 710 (D.N.J. 1996) ("mere insolvency is insufficient to establish fraud. . . . Although incurring debt while insolvent may be indicative of an intent not to repay, this Court adopts
the Ninth Circuit’s holding that “the hopeless state of a debtor’s financial condition should never become a substitute for an actual finding of bad faith.”

Chase Manhattan Bank v. Sparks (In re Sparks), 154 B.R. 766 (N.D. Ala. 1993) (use of credit card with knowledge that debtor will be unable to repay is actual fraud for purpose of § 523(a)(2)(A). Debtor drew on line of credit after creditor took substantial judgment. Debtor knew or should have known that he would be unable to repay debts.). Compare Chase Manhattan Bank v. Ford (In re Ford), 186 B.R. 312 (Bankr. N.D. Ga. 1995) (criticizing “actual fraud” definition in Chase Manhattan v. Sparks, inability to pay credit card does not automatically make debt nondischargeable).

Carroll & Sain v. Vernon (In re Vernon), 192 B.R. 165 (Bankr. N.D. Ill. 1996) (plaintiff failed to prove intent not to pay attorneys fees to divorce counsel notwithstanding evidence that debtor asked divorce counsel about bankruptcy on several occasions during the divorce. “Where there is room for an inference of honest intent, the question of fraudulent intent must be resolved in favor of the debtor.”

AT&T Universal Card Servs. Corp. v. Totina (In re Totina), 198 B.R. 673 (Bankr. E.D. La. 1996) (applying subjective test, debtor’s testimony that he believed he could repay advances taken to supply his gambling problem was credible. Debtor had an annual income of $42,000 and did not take advances after he consulted bankruptcy attorney.)

National Bank of Commerce v. Lazar (In re Lazar), 192 B.R. 161 (W.D. Tenn. 1995) (intent not to pay credit cards was formed when debtor’s attorney wrote issuer a prebankruptcy letter threatening bankruptcy and offering workout. Intent not to repay debt must be present at the time the charge is made or the advance taken. While the debtor may not have the ability to repay the debt when it is incurred, if the debtor had an intent to repay coupled with a legitimate expectation that he would eventually be able to do so, then the obligation is discharged.)

g. Reliance

Field v. Mans, ___ U.S. ___, 116 S. Ct. 437, 133 L.Ed.2d 351 (1995) (standard for reliance in § 523(a)(2)(A) litigation is “justifiable” reliance. Citing the Restatement (Second) of Torts and Prosser, “The Restatement expounds upon justifiable reliance by explaining that a person is justified in relying on a representation of fact ‘although he might have ascertained the falsity of the representation had he made an investigation.’ . . . ’Although the plaintiff’s reliance on the misrepresentation must be justifiable . . . this does not mean that his conduct must conform to the standard of the reasonable man. Justification is a matter of the qualities and characteristics of the particular plaintiff, and the circumstances of the particular case, rather than of the application of a community standard of conduct to all cases.’ . . . a person is ‘required to use his senses, and cannot recover if
he blindly relies upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation. . . . [T]he rule stated in this Section applies only when the recipient of the misrepresentation is capable of appreciating its falsity at the time by the use of his senses.' . . . 'It is only where, under the circumstances, the facts should be apparent to one of his knowledge and intelligence from a cursory glance, or he has discovered something which should serve as a warning that he is being deceived, that he is required to make an investigation of his own.'), on remand, 200 B.R. 293 (Bankr. D.N.H. 1996) (debtor's representations that he wanted to avoid due on sale clause, “coupled with the fact that payments under the note were kept current for three years after the [unauthorized] transfer,” support conclusion that plaintiffs justifiably relied on debtor’s representations. Plaintiffs not required to make no independent inquiry into ownership of property notwithstanding suggestions of a transfer of the property without consent.)

Anastas v. American Savs. Bank (In re Anastas), 94 F.3d 1280 (9th Cir. 1996) (a “credit card issuer justifiably relies on a representation of intent to repay as long as the account is not in default and any initial investigations into a credit report do not raise red flags that would make reliance unjustified.”)

Citibank (South Dakota). N.A. v. Eashai (In re Eashai), 87 F.3d 1082 (9th Cir. 1996) (“The issue in this case is how a creditor establishes justifiable reliance when the debtor employs a kiting scheme. In a kiting case, the creditor continues to extend credit to the debtor in reliance on the fact that the debtor’s credit card account is not in default. In some instances, the creditor may initially rely on the debtor’s credit report (before issuing the credit card) which shows that the debtor has a history of servicing his credit card debt in a timely manner. The debtor, who is kiting his credit cards, creates the illusion that he intends to pay his credit card debts and honor his credit agreements. Presumably, if the creditor knew the true state of the debtor’s financial affairs and intentions, the creditor would revoke the debtor’s credit card or deny the debtor’s request for a credit card. Thus, by kiting, the debtor induces the creditor to refrain from action in reliance on the appearance of the debtor’s intent to repay. If the creditor has warning that the debtor’s account was in danger of default, the creditor will not be able to establish justifiable reliance. We will not allow a creditor who has been put on notice of the debtor’s intent not to repay, to extend credit and then later claim nondischargeability on the basis of fraud. Unfortunately, the true deceit of kiting is that by making minimum payments the debtor almost guarantees that his account will never raise a red flag.”)

Apte v. Japra (In re Apte), 96 F.3d 1319 (9th Cir. 1996) (sublessee's reliance on representations and repeated assurances of debtor/sublessor that the landlord approved the sublease and construction was justified. “[Sublessee] was highly educated in medicine, but he was not highly experienced in real estate. He had never negotiated a sublease and did
not have legal counsel. . . . [Sublessee's] only source of information was [debtor, as landlord would not communicate with sublessee directly]. [Debtor] not only encouraged [sublessee] to continue construction, he assured him his plans had been approved and gave plausible explanations why [landlord's] written consent had been delayed. Unaware of [debtor's] dire financial condition, [sublessee] has no reason to believe [debtor] would lie. [Sublessee] may have been negligent in continuing construction without [the landlord's] written approval, but negligence in failing to discover a misrepresentation is not a defense to fraud." "[T]he nondisclosure of a material fact in the face of a duty to disclose has been held to establish the requisite reliance and causation for actual fraud under the Bankruptcy Code. . . . [A] party to a business transaction has a duty to disclose when the other party is ignorant of material facts which he does not have an opportunity to discover.")

City Bank & Trust Co. v. Vann (In re Vann), 67 F.3d 277, 283 (11th Cir. 1995) (decided before Field, "justifiable" is the reliance standard in § 523(a)(2)(A) litigation. "To constitute justifiable reliance, 'if the plaintiff's conduct must not be so utterly unreasonable, in the light of the information apparent to him, that the law may properly say that his loss is his own responsibility.' . . . This conclusion, however, does not mean that the reliance must be objectively reasonable. "Although the plaintiff's reliance on the misrepresentation must be justifiable, . . . this does not mean that his conduct must conform to the standard of the reasonable man.' . . . Justifiable reliance is gauged by "an individual standard of the plaintiff's own capacity and the knowledge which he has, or which may fairly be charged against him from the facts within his observation in the light of his individual case.' . . . It is only where, under the circumstances, the facts should be apparent to one of [plaintiff's] knowledge and intelligence from a cursory glance, or he has discovered something which should serve as a warning that he is being deceived, that he is required to make an investigation of his own.""

Arndt v. Hanna (In re Hanna), 197 B.R. 413 (Bankr. E.D.N.Y. 1996) (reliance on representation that stockbroker would not execute trades without authorization was neither justified nor reasonable. Over a seven month period debtor executed unauthorized trades. Plaintiff received monthly statements and confirmations after every trade. Plaintiff admitted that she was aware of debtor's activity almost immediately. Plaintiff may have telephoned debtor's firm to complain, she never made a written complaint and did not transfer or close her account.)

Bank One Columbus, N.A. v. McDaniel (In re McDaniel), 202 B.R. 74 (Bankr. N.D. Tex. 1996) (credit card issuer did not justifiably rely on any representation by the debtor when it unilaterally raised credit limit and enticed debtor to increase use of card. "Passively extending credit hardly constitutes reliance on individual instances of card usage, nor can this Court conceive why such reliance, if it did exist, should always be justifiable. A creditor cannot sit back and do nothing and still meet the standard for actual and justifiable reliance when it had a opportunity to make adequate examination or investigation."
h. Proximate cause

United States v. Spicer, 57 F.3d 1152, 1159, 1160 (D.C. Cir. 1995), cert. denied, ___ U.S. ___, 116 S. Ct. 701, 133 L.Ed.2d 658 (1996) (courts below appropriately inferred that debtor’s misrepresentations of financial qualifications of home buyers on HUD mortgage applications proximately caused HUD’s losses when some of those buyers defaulted on their mortgages. This inference was appropriate on summary judgment notwithstanding that the debtor’s guilty plea to one count of fraud in a separate criminal action was insufficient to establish the fraudulent nature of 80 other transactions in which the debtor participated. Debtor’s settlement of civil False Claims actions by the government contained a denial of liability clause: “Here, Spicer adduced no evidence supporting an inference contrary to that reached by the court below. Instead he argues only that as a matter of law his misrepresentations could not have been the proximate cause of HUD’s losses. . . . However, Spicer’s legal argument is without merit. . . . It follows ineluctably that Spicer’s misrepresentations must have been the proximate cause of HUD’s losses. It is undisputed that Spicer intentionally misrepresented buyers’ downpayments in order to induce HUD to approve FHA-insured mortgages for parties who otherwise would not qualify; without evidence of adequate downpayments, HUD would have rejected the applications, calculating the risk of default too high. HUD went for Spicer’s bait, and suffered massive losses when those buyers subsequently defaulted. Viewing all the evidence in the light most favorable to Spicer, we think a rational factfinder could only conclude from the undisputed facts that Spicer’s misrepresentations did indeed proximately cause HUD’s losses. . . . We agree with Spicer that proof that his misrepresentation proximately caused harm to the government is required in order to establish the fraudulent nature of his debt for purposes of § 523(a)(2)(A). . . . Spicer’s misrepresentations were material to HUD’s determination that the mortgage applicants met the financial requirements to qualify for FHA-insured mortgages . . . The misrepresentations were thus more than a ‘but-for’ cause; they proximately caused HUD’s losses when the buyers to whom HUD improvidently granted FHA-insured mortgages on the basis of Spicer’s misrepresentations of their financial qualifications defaulted. The defaults were thus a foreseeable consequence of Spicer’s conduct. It is undoubtedly true that in each case other factors also ‘caused’ the buyer’s default, but that is of no moment, for as long as Spicer’s misrepresentations were a material and proximate cause, they need not have been the sole factor causing HUD’s losses.”)

2. Elements of proof under § 523(a)(2)(B)

a. Materially false

Candland v. Insurance Co. of N. Am. (In re Candland), 90 F.3d 1466 (9th Cir. 1996) (material misrepresentations for purposes of § 523(a)(2)(B) are “substantial inaccuracies of the type which would generally affect a lender’s or guarantor’s decision.” Sophisticated
debtor's failure to discount to present value annuities and pensions listed on financial statement constituted material misrepresentations.)

Bethpage Fed. Credit Union v. Furio (In re Furio), 77 F.3d 622 (2d Cir. 1996) (omission of guarantee of a promissory note with a potential monthly payment of $240 and failure to disclose a $140 per month child support payment were not material for § 523(a)(2)(B)(i) purposes because credit union incorrectly calculated whether the debtor was eligible for the loan and would have made the loan even if the debtor had properly accounted for his debts).

Norris v. First Nat'l Bank (In re Norris), 70 F.3d 27 (5th Cir. 1995) (statement at renewal that debtors "enjoyed a cash flow surplus of over $45,000" is material--exaggerated the actual financial situation by approximately $37,000. This amount "would be a material discrepancy in everybody's book.")

Insurance Co. of N. Am. v. Cohn (In re Cohn), 54 F.3d 1108, 1114-5 (3d Cir. 1995) ("The materiality prong of the 'material falsehood' test includes a certain reliance component. Under a materiality analysis, we refer to a creditor's reliance upon a false statement in the sense that a untruth can be considered important (or 'material') if it influences a creditor's decision to extend credit. However, a statement can still be material if it is so substantial that a reasonable person would have relief upon it, even if the creditor did not in fact rely upon it at hand. . . . We note that there is also a reliance component in the 'reasonable reliance' requirement of § 523(a)(2)(B)(iii). . . . These are certainly overlapping concepts. Section 523(a)(2)(B)(iii), however, requires that the creditor actually rely on the debtor's statement. Accordingly, if it were reasonable to rely on a debtor's statement, but the creditor did not in fact rely upon the false statement, (B)(iii) would not be satisfied. We recognize that the distinction between the two reliance concepts is somewhat subtle, and to a degree, the reliance concept in (B)(i) is subsumed within (B)(iii). However, it is important to keep the distinction intact . . . . The element of materiality under § 523(a)(2)(B)(i) is a question of law." A debtor's false statement on a bond application that he owned $110,000 in real estate was "material" where the application indicated a total net worth of $259,000, the false asset constituted a substantial proportion of the debtor's net worth and the bonding company offered the testimony of an employee that the bond would not have been issued if the application had been accurate with respect to the nonexistent $110,000 of real estate.)

Mazeika v. Townsley (In re Townsley), 195 B.R. 54 (Bankr. E.D. Tex. 1996) (that future sales were overestimated in pro forma provided to creditor would not alone support nondischargeability under § 523(a)(2)(B)).
b. Intent to deceive

Anastas v. American Svs. Bank (In re Anastas), 94 F.3d 1280 (9th Cir. 1996) (conclusion that debtor made credit card charges without an intent to repay was clearly erroneous where the bankruptcy court relied almost exclusively on evidence of hopeless financial condition. Gambling addiction caused debtor to overload credit card during a six-month period. Debtor attempted to workout a payment schedule with the card’s issuer. Although it was unlikely that debtor would win back the money to pay back cash advances, “the record fully support[ed] [debtor’s] good faith intention to do so.”)

National Union Fire Ins. Co. of Pittsburgh, PA. v. Bonnanzio (In re Bonnanzio), 91 F.3d 296 (2d Cir. 1996) (unsophisticated debtor who signed blank financial statement for investment in tax shelter had no actual intent to defraud where financial advisor filled out the credit application using false information that vastly exaggerated the debtor’s income and assets, unbeknownst to the debtor. Debtor did not have “constructive intent” based on reckless disregard for consequences because the debtor was unsophisticated. However, fraudulent intent might be “imputed” to the debtor “under general principles of agency.” “[T]here is conflicting authority regarding whether, under § 523(a)(2)(B), the fraudulent intent of a debtor’s agent may be imputed to the debtor without a further finding that the debtor knew or should have known of the fraud. No court of appeals has directly ruled on this issue, but the Third Circuit has observed in dicta ‘common law principles of agency law would probably dictate the imputation of an agent’s fraud to a principal under § 523(a)(2)(B)(iv) analysis’ . . . . The Eighth Circuit, construing a closely related provision of the Bankruptcy Code, has held that ‘more than the mere existence of an agent-principal relationship is required to charge the agent’s fraud to the principal. . . . If the principal either knew or should have known of the agent’s fraud, the agent’s fraud will be imputed to the debtor-principal.’ . . . We need not decide this issue . . . . The bankruptcy court made no factual findings as to whether Bonnanzio knew or should have known of Berlin’s fraud. If we hold that such a showing is necessary to demonstrate an intent to deceive under § 523(a)(2)(B), we would still have to remand so that the bankruptcy court could make that factual determination in the first instance. On the other hand, if we hold that no such showing is necessary, Bonnanzio may still prevail, on the theory that a principal is not charged with an agent’s misdeeds if the agent acts in a manner completely adverse to the principal’s interest . . . . The district court emphasized that Bonnanzio cannot rely on the adverse interest exception, because she retained a benefit as a consequence of the fraud . . . . Whether Bonnanzio received a benefit from Berlin’s fraud is unclear on this record . . . . We further observe that, even if a principal receives a benefit from an agent’s fraudulent actions, under agency principles that benefit is only significant if the principal knowingly retains it before a change of position. . . . We are unaware of any case that has addressed this particular issue of agency law in the bankruptcy context. Generally, a change in position is a change in the
principal's circumstances induced by the receipt of the benefit.

We remand for decisions on the following: (1) whether under 11 U.S.C. § 523(a)(2)(B), the fraudulent intent of a debtor's agent may be imputed to the debtor without a further finding that the debtor knew or should have known of the fraud; (2) if so, whether Bonnanzio knew or should have known of Berlin's fraudulent actions; (3) in any event, whether Berlin acted in a manner that was completely adverse to Bonnanzio's interest; (4) if so, whether a debtor who knowingly retains the benefit of an agent's fraud before a change in position has the requisite intent to deceive under § 523(a)(2)(B); and (5) if so, whether Bonnanzio did knowingly retain such a benefit and therefore had the requisite intent to deceive."

In re Sheridan, 57 F.3d 627 (7th Cir. 1995) (that debtor used an overly aggressive valuation process to arrive at financial statement values was not enough to find reckless or wrongful intent for purposes of § 523(a)(2)(B). Intent to defraud can be inferred from circumstantial evidence but bankruptcy court's refusal to so infer is not reversible as a matter of law in the absence of clear error in its fact finding.)

Insurance Co. of N. Am. v. Cohn (In re Cohn), 54 F.3d 1108, 1119-20 (3d Cir. 1995) (intent to deceive can be derived from the totality of the circumstances. "[A] creditor can establish intent to deceive by proving reckless indifference to, reckless disregard of, the accuracy of the information in the financial statement of the debtor when the totality of the circumstances supports such an inference. . . . We find of interest discussion in certain bankruptcy courts within this circuit regarding a rebuttable presumption of intent to deceive that arises upon the making of a false financial statement. . . . and a shifting burden of production of evidence upon a creditor's establishing a prima facie case . . . . We conclude that it is not necessary to utilize a presumption of intent or a shifting burden of production in processing objections to the discharge of a debt. . . . It is sufficient that fraud must be pled and proven with particularity. . . . Thus, the creditor at all times retains both the burden of proof and the burden of production regarding all four elements of § 523(a)(2)(B). We believe that the standards adopted today (i.e., that 'intent to deceive' includes both recklessness and subjective intent and that it is not appropriate to use a shifting burdens analysis) achieve the preferable balance between a creditor's difficult burden of proof and the underlying purpose of bankruptcy law to provide the debtor with a 'fresh start.'"

Equitable Bank v. Miller (In re Miller), 39 F.3d 301 (11th Cir. 1994) (district court erred in reversing bankruptcy court's factual determination that debtors lacked intent to deceive under § 523(a)(2)(B). "It is plausible that the [debtors'] financial estimates, though perhaps careless or presumptuous were made without dishonest intent." That the debtors "netted" notes against the value of assets rather than listing notes, and used exempt assets to try and prop up failing businesses was accepted by bankruptcy court to negate inference of bad intent. District court should not have substituted its judgment.)
c. Reasonable reliance

First Nat'l Bank v. Pontow, 111 F.3d 604 (8th Cir. 1997) ("borrowing base certificates" that overstated the eligible accounts receivable may have been false statements respecting the debtor's business, but the bank failed to prove that it relied on the certificates by advancing funds in excess of its line of credit agreement with the debtor. "The Bank made A/R loans despite [the debtor's] failure to supply all the financial information called for in the certificates. On four occasions, the Bank made loans even though the resulting indebtedness exceeded eighty percent of the accounts receivable. The Bank's discarding of the certificates shortly after they were submitted, instead of retaining them . . . strongly suggests that the Bank did not rely upon those documents in making the loans. . . . 'the borrowing base certificates were merely a means to request funds be advanced under a line of credit.' . . . Indeed, it appears that the Bank made the additional $200,000 loan not because of reliance upon . . . reported accounts receivable, but because the Bank realized that without that loan the debtor would fail and jeopardize whatever chance the Bank had of recovering its loans.")

National Union Fire Ins. Co. of Pittsburgh, PA. v. Bonnanzio (In re Bonnanzio), 91 F.3d 296 (2d Cir. 1996) (once a creditor has proven that the debtor furnished a materially false financial statement, "the reasonableness requirement of § 523(a)(2)(B) 'cannot be said to be a rigorous requirement, but rather is directed at creditors acting in bad faith' . . . Reasonableness is therefore 'a low hurdle for the creditor to meet, and is intended as an obstacle only for creditors acting in bad faith.' . . . The reasonableness of reliance requires the fact finder to consider the 'totality of the circumstances' . . . the bankruptcy court is 'most familiar' with this factual setting" and thus must have the opportunity to determine the reasonableness of reliance as a matter of fact in the first instance.)

Norris v. First Nat'l Bank (In re Norris), 70 F.3d 27 (5th Cir. 1995) (bank demonstrated reasonable reliance on debtors' overstatement of income in financial statement at renewal of loan notwithstanding practice of "automatically" renewing the note. Bank officers testified that there had been a substantial decline in the value of collateral securing the loan at the last renewal and thus they relied "to a greater extent than they previously had upon the [debtors'] financial statement.")

In re McFarland, 84 F.3d 943 (7th Cir. 1996) (credit union proved reliance on a false financial statement by testimony from collection administrator that 45% debt to income ratio would have been violated had the debtor told the truth about the liabilities on the financial statement).

McQuaid v. First Interstate Bank (In re McQuaid), 65 F.3d 175 (9th Cir. 1995) (unpublished) (reliance on debtor's misrepresentation of the
ownership of a farm was “reasonable and justifiable” where bank used “the industry standard and practice in the rural farming community” which “did not include title searches into farms.”

Citizens Bank v. Broyles (In re Broyles), 55 F.3d 980 (4th Cir. 1995) (bankruptcy court’s determination that bank did not rely on misrepresentations made by debtor/guarantors in financial statements submitted to the bank was not clearly erroneous. There was no evidence that either the original loan or the extension made a year later had been conditioned on the personal financial statements of the debtors. Rather, the bank relied on the parties’ long term financial relationship and the corporation’s assets.); Riggs Nat’l Bank of Washington, D.C. v. Ross (In re Ross), 180 B.R. 121, 128 (Bankr. E.D. Va. 1994), aff’d, 199 B.R. 576 (E.D. Va. 1995) (reliance satisfied where financial statement was requested and furnished and was substantial consideration or contributory cause for transaction).

Insurance Co. of N. Am. v. Cohn (In re Cohn), 54 F.3d 1108 (3d Cir. 1995) (reasonable reliance is a question of fact “insulated by the clearly erroneous standard of review.” Considered must be: “(1) the creditor’s standard practices in evaluating credit-worthiness . . . ; (2) the standards or customs of the creditor’s industry in evaluating credit-worthiness . . . ; and (3) the surrounding circumstances existing at the time of the debtor’s application for credit.” District court correctly used a different legal standard for evaluating the reasonableness of reliance than did the bankruptcy court. However, the district court erred by engaging in its own fact finding with respect to the reasonableness of reliance. Where the record from the bankruptcy court is susceptible of more than one reading, “factual findings are only properly made by the bankruptcy court after a hearing where both parties have an opportunity to offer such evidence as they deem appropriate.” Case is properly remanded to the bankruptcy court to make the determination in the first instance of the reasonableness of a creditor’s reliance.)

General Elec. Capital Corp. v. Bui (In re Bui), 188 B.R. 274 (Bankr. N.D. Cal. 1995) (on motion for default judgment, creditor failed to prove that it relied, actually or justifiably, on false statements of the debtor. Plaintiff purchased debtor’s account from store which had sold debtor furniture. In its declarations in support of a default judgment under Rule 7055, plaintiff offered no evidence that debtor made any statement concerning debtor’s financial condition, or anything else, to plaintiff. Plaintiff did not represent that when it agreed to purchase the debtor’s account from the store, it reviewed debtor’s application. That statement of income by debtor in application to store was inconsistent with statement of income in bankruptcy schedules did not show that GECC relied on application. “In a situation such as this, involving a ‘middleman’, reliance should be shown by each link in the chain of parties involved.”)
e. Causation

In re McFarland, 84 F.3d 943 (7th Cir. 1996) ("Read as a contextual whole and as applicable to the facts of this case, § 523(a)(2)(B) provides that dischargeability is not available for . . . an extension, renewal, or refinancing of credit, to the extent obtained by . . . use of a written statement . . . that is materially false.' The May 1993 note was, in part, a refinancing of the May 1991 note: the proceeds of the McFarland's May 1993 note were used to pay off her existing debt on the May 1991 note. . . . The ordinary and common meaning of 'refinance' in the context of § 523(a)(2)(B) requires that the portion of the May 1993 note constituting the balance previously due on the May 1991 note be nondischargeable. . . . The language of the district court's order suggests that its analysis was premised upon a conclusion that the Credit Union was no worse off than it would have been had it not refinanced McFarland's debt on the May 1991 note prior to her filing under Chapter 7. This implies the existence of a detriment requirement in the statute, but the text of § 523(a)(2)(B) contains no damage or detriment requirement, and the courts are not empowered to add one.").

Norris v. First Nat'l Bank (In re Norris), 70 F.3d 27 (5th Cir. 1995) (the "renewal . . . of credit" provision of § 523(a)(2) covers renewal loan where no new funds were disbursed. It is not necessary that the bank show an advance of new funds proximately caused by the misleading financial statement at renewal; it is sufficient that there was a "renewal of credit.")


Carroll & Sain v. Vernon (In re Vernon), 192 B.R. 165 (Bankr. N.D. Ill. 1996) ("legal fees and expenses incurred during divorce proceedings do not qualify as 'luxury goods or services' within the meaning of § 523(a)(2)(O)."")

4. 11 U.S.C. § 523(d): Fees and costs

In re Sheridan, 105 F.3d 1164, 1166 (7th Cir. 1997) (an admittedly commercial debt cannot be the basis for an award of attorneys fees to a successful debtor under § 523(d). Florida state law that imposes reciprocity with respect to contract provisions for recovery of attorneys fees cannot be basis for debtor to recover fees because § 523(a)(2) "does not qualify as [an action] 'with respect to the contract'” for purposes of the Florida fee shifting statute.)

Mercantile Bank v. Williamson (In re Williamson), 181 B.R. 403 (Bankr. W.D. Mo. 1995) (under § 523(d) pro se debtor entitled to costs including value of time spent preparing for trial).


"neither listed nor scheduled under section 521(1) . . . unless such creditor had notice or actual knowledge of the case in time . . . ."
Judd v. Wolfe (In re Judd), 78 F.3d 110, 114-16 (3d Cir. 1996) (in a no asset, no bar date Chapter 7 case, debtor’s failure to list a claim does not affect discharge; if the claim does not fall within the fraud exceptions in §§ 523(a)(2), (4) or (6) as described in § 523(a)(3) the debt is discharged without scheduling and there is no purpose served to reopen the bankruptcy case under § 350 to add the omitted creditor. “Because section 727(b), on its face, does not create an exception for unlisted or unscheduled debts, every prepetition debt is discharged under section 727(b) subject to the provisions of section 523(a)(3). . . . Because this is a ‘no-asset’ Chapter 7 case, the time for filing a claim has not, and never will, expire unless some [non-]exempt assets are discovered; thus, section 523(a)(3)(A) cannot be applied in Judd’s circumstances. . . . Thus, in a no-asset Chapter 7 case where no bar date has been set, we conclude that there would be no purpose served by reopening a case to add an omitted creditor to the bankrupt’s schedules. If the debt at issue is not a debt described under section 523(a)(2), (4) or (6), the debt has been discharged by virtue of section 727(b), whether or not it was listed. If, however, the debt is a debt that falls under sections 523(a)(2), (4) or (6), the debt is not discharged by virtue of section 523(a)(3)(B). . . . Our interpretation of section 727(b) and 523(a)(3) is consistent with that of the Court of Appeals for the Ninth Circuit. . . . In re Beezley, 994 F.2d 1433 (9th Cir. 1993) . . . . We decline to hold that the issue here, whether Judd’s debt to Wolfe is discharged pursuant to section 523(a)(3)(A) and 727(b), turns on whether the omission of Wolfe from Judd’s schedules was made in good faith, for the Bankruptcy Code does not impose a requirement of good faith for the discharge of an omitted debt in a no asset, no bar date case. ‘No where in section 523(a)(3) is the reason why a debt was omitted from the bankruptcy schedules made relevant to the discharge of that debt.’ In re Beezley, 994 F.2d at 1439. As the Court of Appeals for the Ninth Circuit observed there, such a holding would interpose ‘an equitable barrier between the debtor and his discharge that Congress simply did not enact in the Bankruptcy Code.’ Id. The plain language of section 523(a)(3), represents a congressional policy choice. Clearly, Congress could have exempted from the debtor’s discharge, pursuant to section 727(b) and 523, debts that were omitted intentionally, rather than merely inadvertently, from the debtor’s schedules. Congress chose not to do so. Unless Wolfe can show that his claim falls under the statutory exceptions of section 523(a)(2), (4) or (6), his debt has been discharged by operation of law.”; In re Anderson, 196 B.R. 839 (Bankr. W.D. Mo. 1996) (“the Bankruptcy Code does not impose a requirement of good faith for the discharge of an omitted debt.” That debtor intentionally omitted creditor from schedules is irrelevant to dischargeability of the unscheduled debt.)

Gagan v. American Cablevision, Inc., 77 F.3d 951, 968 (7th Cir. 1996) (pro se defendant in RICO trial in U.S. district court was appropriately refused permission to amend his answer in July of 1994 to allege discharge in bankruptcy in April 1992 where plaintiff in RICO case was not listed in defendant’s bankruptcy case. Discharge in bankruptcy is an affirmative defense that must be pleaded under Fed. R. Civ. P. 8(c). Pro se defendant’s failure to raise the defense of bankruptcy during two years of preparation for RICO trial justifies denial of leave to amend. Furthermore, defense of discharge in bankruptcy was “insufficient as a matter of law” because defendant failed to give notice to plaintiff of the bankruptcy case and “since [the plaintiff] had no notice of [the debtor/defendant’s] bankruptcy until after the April 13, 1992, discharge order, that order did not discharge [the debtor/defendant’s] debt in this case. 11 U.S.C. § 523(a)(3)(B).”
GAC Enters. v. Medaglia (In re Medaglia), 52 F.3d 451 (2d Cir. 1995) (the § 523(a)(3)(B) “notice or actual knowledge of the case” proviso does not offend due process by requiring persons with actual, timely knowledge of a case to take necessary steps to preserve their rights. Creditor’s counsel was aware of bankruptcy 57 days before bar date and wrote debtor’s counsel warning that his clients’ debts would not be discharged if they were not scheduled by the debtor.)

Faden v. Insurance Co. of N. Am. (In re Faden), 96 F.3d 792 (5th Cir. 1996) (In no asset, no bar date Chapter 7 case, debtors’ failure to provide counsel accurate address for creditor barred dischargeability of claim under § 523(a)(3) notwithstanding absence of prejudice to creditor because debtor “intentionally or recklessly avoided supplying . . . proper address.” Debtors failed to provide their counsel the correct address for plaintiff. Counsel used an address from phone book but transcribed it incorrectly. The bankruptcy court found the debtor’s testimony to be vague and not credible. Fifth Circuit noted that the debtor had reliable information in his original investment documents with the creditor, in documents relating to a state court action filed by creditor upon debtor’s default on a bond, and in correspondence from the creditor. “Despite this reliable information, the [debtors] made no attempt to provide any address to their counsel.” Debtors “did not reasonably calculate their notice under the circumstances.” Because debtors were “more than negligent” in their failure to list the creditor, the bankruptcy court properly denied their request to add a creditor. “Even absent prejudice, equitable action should not be taken in cases where the debtor’s failure to properly schedule a creditor is a result of more than ‘mere negligence or inadvertence.’” While Ms. Faden was not a signatory on the creditor’s investment documents and was not named in the creditor’s suit against Mr. Faden, “[b]y filing for protection under the Code as a joint debtor, she assumed the obligation to comply with the Code requirements for 11 U.S.C. § 523.”) (Carpet Servs., Inc. v. Hutchinson (In re Hutchinson), 187 B.R. 533 (Bankr. S.D. Tex. 1995) (“the proper scheduling of a creditor requires listing the creditor at its own address or at least that of an agent designated for service of process . . . [T]he initial scheduling which occurs before a creditor or its attorney has made an appearance in the case should be the creditor’s own address if it has one.” While actual timely notice to a creditor’s attorney might meet due process requirements, “imputed notice to a creditor’s attorney does not.” Creditor improperly scheduled by its name in care of attorney in state court litigation was entitled to proceed with a complaint under § 523(a)(3)(B).)

Stone v. Caplan (In re Stone), 10 F.3d 285 (5th Cir. 1994) (§ 523(a)(3) is anything but clear and unambiguous. Legislative history of the Bankruptcy Reform Act of 1978 makes clear that Congress sought to validate liberal interpretations of § 523(a)(3)’s predecessor, § 17(3) of the Bankruptcy Act and to overrule the Supreme Court’s strict interpretation of the former statute in Birkett v. Columbia Bank, 195 U.S. 345 (1904). In the words of Congress, a “debt is excepted from discharge if it was not scheduled in time to permit timely action by the creditor to protect his rights. . . .” In Robinson v. Mann, 339 F.2d 547 (5th Cir. 1964), the Fifth Circuit (ignored Birkett?) adopted a liberal construction of § 17(a)(3) of the Bankruptcy Act. That construction is appropriate for § 523(a)(3). Under Robinson the court must consider three factors: “1) the reasons the debtor failed to list the creditor; 2) the amount of disruption [to the court] which would likely occur; and 3) any prejudice suffered by the listed creditors and the unlisted creditor in question.” Under the first prong, “a court should not discharge a debt under section 523(a)(3) if the debtor’s failure to schedule that debt was due to intentional design, fraud or improper motive.” Negligence or inadvertence

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will excuse the failure to schedule. Only undue disruption to courts’ dockets is addressed by second factor. Under the third prong, “[c]reditors are prejudice only if their rights to receive their share of dividends and obtain dischargeability determinations are compromised.” In a no asset case, because no creditor will receive a dividend, there is no prejudice unless a creditor has a ground to argue nondischargeability under a section other than § 523(a)(3). Inadvertent omission coupled with absence of any other ground for challenging dischargeability preclude § 523(a)(3) action in no asset case.)

Omni Mfg. Inc. v. Smith (In re Smith), 21 F.3d 660 (5th Cir. 1994) (bankruptcy court erred in extending time for omitted creditor to file a proof of claim in Chapter 11 case and extending time for creditor to make objection to discharge or dischargeability. Under § 523(a)(3) and Stone v. Caplan (In re Stone), 10 F.3d 285 (5th Cir. 1994), whether the claim of a creditor without notice or actual knowledge of a bankruptcy filing is discharged is determined by examination of “the reason debtor failed to list the creditor, the amount of disruption which would likely occur by an untimely listing of the claim, and any prejudice suffered by the listed creditors and the unlisted creditor in question.” Lower courts’ result did not conform to this methodology. First, the “facts . . . reek of [debtor’s] irresponsibility, if not worse . . . .” Although bankruptcy court’s resolution minimized disruption associated with late claim, the court misconstrued the prejudice to the unlisted creditor because it “overlooked . . . a critical difference between liquidation and reorganization cases. Dramatic consequences integral to . . . Chapter 11 [accompany debtors’ obligation to schedule creditors.] . . . Chapter 11 is a participatory endeavor in which . . . creditors negotiate with the debtor a plan of reorganization. . . . If a creditor is not scheduled or notified of the bankruptcy, it loses its opportunity to participate and influence the negotiating process. . . . It may also lose the opportunity to try to call a halt to a Chapter 11 case that is hopelessly mismanaged or over-extended. . . . [it] loses the rights to object to its initial claim-classification, to vote on the plan, and if necessary, to object to confirmation.” Remanded with instructions to declare creditor’s debt nondischargeable.)

Beezley v. California Land Title Co. (In re Beezley), 994 F.2d 1433 (9th Cir. 1993) (bankruptcy court’s denial of debtor’s motion to reopen Chapter 7 case to schedule omitted creditor was not an abuse of discretion. In a no asset, no bar date Chapter 7 case, dischargeability is unaffected by whether a claim is scheduled; amendment of debtor’s schedules was a pointless act. The unscheduled debt was either discharged under § 523(a)(3)(A), or not under § 523(a)(3)(B), pursuant to § 727; In re Hicks, 184 B.R. 954, 959 (Bankr. C.D. Cal. 1995) (Beezley is “misguided in its dictum about the pointlessness of reopening and amending the schedules.” Appropriate to reopen to permit debtor to seek injunction against post discharge collection action.)


“for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.”
1. Fraud or defalcation

Schwager v. Fallas (In re Schwager), 121 F.3d 177, 185 (5th Cir. 1997) ("While defalcation may not require actual intent, it does require some level of mental culpability. It is clear in the Fifth Circuit that a 'willful neglect' of fiduciary duty constitutes a defalcation—essentially a recklessness standard.")

R.E. America, Inc. v. Garver (In re Garver), 116 F.3d 176, 179-80 (6th Cir. 1997) (because attorney-client relationship is not an express or technical trust, debtor/attorney could not have committed a "misappropriation or failure to properly account for" trust funds, thus the debtor did not commit a defalcation. "We find that the bankruptcy court erred in relying upon this dictionary definition of defalcation because the dictionary definition improperly expands upon our previous definition of the term. ... Interstate Agency, [760 F.2d 121 (6th Cir. 1995)] defined defalcation as the embezzlement, misappropriation of trust funds held in a fiduciary capacity, and failure to properly account for trust funds. ... This definition did not include the broader language of 'failure to meet an obligation' while acting in a fiduciary capacity. The mere failure to meet an obligation while acting in a fiduciary capacity simply does not rise to the level of defalcation; an express or technical trust must also be present." In a note, "an attorney's breach of fiduciary duty, without more, does not constitute defalcation. Absent an express or technical trust, an attorney's legal malpractice, like all other types of professional malpractice, remains dischargeable under the Code. ... [Section] 523(a)(4) is limited to only those situations involving an express or technical trust relationship arising from placement of a specific res in the hands of the debtor. ... Defalcation then occurs though the misappropriation or failure to properly account for those trust funds. ... Although Garver stipulated to the existence of a fiduciary relationship sufficient to satisfy the fiduciary relationship aspect of the defalcation provision of § 523(a)(4), we hold under the facts of this case that Garver did not commit defalcation. REA does not contend that Garver misappropriated or improperly accounted for its $600,000. To the contrary, the funds were merely lost because the venture turned out to be a poor investment. Because all funds in this case were properly accounted for, no defalcation occurred, and the debt is dischargeable.").

Otto v. Niles (In re Niles), 106 F.3d 1456, 1461-62 (9th Cir. 1997) (burden of proof with respect to defalcation is on the debtor once the creditor proves that funds were entrusted to a fiduciary and not properly accounted for. "In the absence of evidence that ... Congress intended to impose sub silentio a particular burden of proof on a creditor asserting the § 523(a)(4) exception ... we conclude that the appropriate point of reference is the burden imposed by the common law. ... [C]ommon law generally ... places the burden on one acting as a fiduciary to explain all transactions taken on the principal's behalf. ... Basic principles of the law of fiduciaries therefore place the burden to render an accounting on the fiduciary once the principal has shown that funds have been entrusted to the fiduciary and not paid over or otherwise accounted for." "The burden that the common law places on the fiduciary to account is more than a shifting of the burden of coming forward with evidence." Debtor/real estate broker was a fiduciary under California law.
and thus the burden of proof shifted to the debtor to account for rents and other monies.)

Lewis v. Scott (In re Lewis), 97 F.3d 1182 (9th Cir. 1996) ("Defalcation is defined as the 'misappropriation of trust funds or money held in any fiduciary capacity; [the] failure to properly account for such fund'. . . . Under section 523(a)(4), defalcation 'includes the innocent default of a fiduciary who fails to account fully for money received.' Rejects Martin, 161 B.R. 672 (B.A.P. 9th Cir. 1993). Debtors commingled plaintiff's investment with other monies and were unable to account for monies invested by plaintiff in a partnership.); Johns v. Johns (In re Johns), 181 B.R. 965, 974 (Bankr. D. Ariz. 1995) (Martin adopted new, more stringent test for determining defalcation; dissent in Martin more persuasive—mere inadvertence or negligence can constitute defalcation).

Schaffer v. Dempster (In re Dempster), 182 B.R. 790, 801 (Bankr. N.D. Ill. 1995) (close friend and co-habitant who handled plaintiff's finances was not a fiduciary. In re Marchhiando, 13 F.3d 1111, 1116 (7th Cir. 1994), cert. denied sub nom., Illinois Dept. of Lottery v. Marchhiando. ___ U.S. ___, 114 S.Ct. 2675, 129 L. Ed.2d 810 (1994) requires an express trust or fiduciary relations of "inequality that justify the imposition on the fiduciary of a special duty. . . .").

2. Fiduciary capacity

a. In general

Newsom v. Moore (In re Moore), 186 B.R. 962, 974-75 (Bankr. N.D. Cal. 1995) ("fiduciary capacity" is question of federal law which defines term narrowly. State law is consulted to determine when a trust exists. Constructive, resulting and implied trusts not sufficient. Employer/employee relationship insufficient.)

Houston v. Capps (In re Capps), 193 B.R. 955 (Bankr. N.D. Ala. 1996) (divorce decree that granted debtor sole possession of marital home until the children graduated high school at which time the debtor would sell the house and remit to plaintiff $5,000, created express trust for purposes of § 523(a)(4). Decree had all characteristics of an express trust under Alabama law: "(1) it is a relationship; (2) it is a relationship of a fiduciary character; (3) it is a relationship with respect to property; (4) it involves the existence of equitable duties imposed upon the holder of the title to the property to deal with it for the benefit of another; and (5) it arises as a result of a manifestation of an intent to create the relationship." Encumbrance by debtor which caused the property to yield an insufficient amount for plaintiff upon sale was a defalcation in a fiduciary capacity by the debtor.)

Rowe Oil, Inc. v. McCoy (In re McCoy), 189 B.R. 129 (Bankr. N.D. Ohio 1995) (the words "while acting in a fiduciary capacity' do not qualify the words 'embezzlement' or 'larceny,' . . . [L]arceny can be defined as the actual or constructive taking away of property of another without the consent and against the will of the owner or possessor with

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the intent to convert to [sic] the use of the property to the use of someone other than the owner.

b. Partners and joint venturers

Schwager v. Fallas (In re Schwager), 121 F.3d 177 (5th Cir. 1997) (applying Texas law, general partners duties to limited partners “fall squarely” within the definition of a fiduciary relationship for § 523(a)(4) purposes).

Johnson v. Woldman, 158 B.R. 992 (N.D. Ill. 1993), aff’d, 92 F.3d 546 (7th Cir. 1996) (under Illinois law the relationship of joint venturers is governed by the same principles applicable to partners. Duty of “utmost good faith and honesty” is general statement of “fiduciary” and is not sufficient for § 523(a)(4) purposes. Illinois partnership law creates only a trust maleficio--a trust when there is wrongdoing--insufficient under § 523(a)(4).)

Lewis v. Scott (In re Lewis), 97 F.3d 1182 (9th Cir. 1996) (in Arizona, as in California, see Ragsdale, 780 F.2d 794 (9th Cir. 1986), partners are fiduciaries within the meaning of § 523(a)(4)).


c. Officers, directors and shareholders

Umholtz v. Brady, 169 B.R. 569 (E.D.N.C. 1993), aff’d mem., 27 F.3d 564 (4th Cir. 1994) (under North Carolina law, dominant shareholder who is also an officer and director, is a fiduciary of other corporate shareholders. That dominant shareholder did not disclose his inability to make cash contributions when soliciting contributions from other shareholders did not breach a duty. That the dominant shareholder was making large withdrawals (loans) did not breach duty because all withdrawals were internally disclosed on the books, and readily available to anyone who cared to inspect them.)

Energy Prods. Eng’g. Inc. v. Reuscher (In re Reuscher), 169 B.R. 398 (S.D. Ill. 1994) (under Illinois law “[t]he moment a corporation becomes insolvent its directors occupy a different relation. The assets . . . must then be regarded as a trust fund for payment of all its creditors, and the directors occupy a position of trustees. . . .” This relationship falls within § 523(a)(4). The duty arises upon insolvency, alone, absent any bad acts. Subsequent breach of that duty is a nondischargeable liability.)

Mozeika v. Townsley (In re Townsley), 195 B.R. 54 (Bankr. E.D. Tex. 1996) (“a corporate officer’s breach of fiduciary duty by diverting a corporate opportunity for his personal benefit falls well within the meaning of the term ‘defalcation’ under § 523(a)(4).“)

d. Attorneys

Tudor Oaks Ltd. Partnership v. Cochrane (In re Cochrane), 1997 WL 542249 *5 (8th Cir. Sept. 5, 1997) ("In general, an attorney-client relationship is the type of relationship for which the attorney's breach of fiduciary duties to the client may give rise to a finding of a 'defalcation' within the meaning of § 523(a)(4). ... Cochrane had been engaged by Tudor ... to represent them in the bank foreclosure on Tudor Oak's failing multimillion dollar condominium project. His clients understood that he would assemble a group of investors (i.e. KSCS) to buy out the project while allowing Tudor Oaks to retain a 20% interest. Cochrane instead kept the 20% interest for himself as a 'fee' and also failed to disclose to his clients that he was a 25% shareholder in KSCS. ... [T]he bankruptcy court did not err in finding, for purposes of applying § 523(a)(4), that he had committed an act by defalcation while acting in a fiduciary capacity.").

R.E. America, Inc. v. Garver (In re Garver), 116 F.3d 176, 179 (6th Cir. 1997) (adopting "narrow interpretation" of fiduciary relationship for § 523(a)(4) purposes, "The attorney-client relationship, without more, is insufficient to establish the necessary fiduciary relationship for defalcation under § 523(a)(4). Instead, the debtor must hold funds in trust for a third party to satisfy the fiduciary relationship element of the defalcation provision of § 523(a)(4)."") Although the parties stipulated a fiduciary relationship for § 523(a)(4) purposes, the debtor/attorney could not have committed a "defalcation" because there was no express or technical trust and the debtor did not misappropriate or improperly account for money invested by client in a joint venture with the debtor.

Brothers v. Young (In re Young), 91 F.3d 1367 (10th Cir. 1996) (business relationship between attorney and client is not alone sufficient to establish fiduciary relationship required in § 523(a)(4)).

e. Debtors and debtors-in-possession

Bombardier Capital, Inc. v. Black (In re Black), 179 B.R. 509 (Bankr. E.D. Tex. 1995) (must have evidence of alter ego or veil piercing theories to prove nondischargeability against officer of corporate Chapter 11 debtor notwithstanding that DIP violated fiduciary duties by converting proceeds and failing to account for property).
f. Miscellaneous

Lee-Benner v. Gergely (In re Gergely), 110 F.3d 1448 (9th Cir. 1997) (doctor/patient relationship is not an express trust for purposes of § 523(a)(4)).

Otto v. Niles (In re Niles), 106 F.3d 1456 (9th Cir. 1997) (real estate broker/manager is a fiduciary subject to an expressed trust under California law and for purposes of § 523(a)(4); once plaintiff proved that rents came into the debtor’s trust account, burden of proof rested on the debtor to account and to prove that no defalcation occurred).

Tritter v. Corry (In re Tritter), 69 F.3d 531 (1st Cir. 1995) (unpublished) (custodian of an account pursuant to the Uniform Gifts to Minors Act is a fiduciary within the meaning of § 523(a)(4). Custodian’s failure to properly account for funds in his daughter’s account and use of monies for his own legal fees constitute defalcation.)

Martin v. Fidelity & Deposit Co. (In re Martin), 161 B.R. 672 (B.A.P. 9th Cir. 1993), overruled on other grounds, Lewis v. Scott (In re Lewis), 97 F.3d 1182 (9th Cir. 1996) (California conservator relationship creates an express trust for purposes of § 523(a)(4)).

Harsch v. Eisenberg (In re Eisenberg), 189 B.R. 725 (Bankr. E.D. Wis. 1995) (district court award of attorneys’ fees and statutory penalties for violation of ERISA supports summary judgment on nondischargeability complaint for defalcation in a fiduciary capacity under § 523(a)(4). Fees and penalties “arose out of and were ancillary” to the principal debt owed to the plaintiffs, and accordingly were nondischargeable.);


Texas Lottery Commission v. Tran (In re Tran), 190 B.R. 85 (Bankr. S.D. Tex. 1995) (following Marchiando,___ U.S. ___, 114 S. Ct. 2675, 129 L. Ed.2d 810 (1994), “a lottery ticket agent is not in a sufficient position of control vis a vis the state or the trust res to impose the ‘high level of responsibility’ required in a fiduciary relationship [under § 523(a)(4)]”).


3. Embezzlement or larceny

Brady v. McAllister (In re Brady), 101 F.3d 1165 (6th Cir. 1996) (debtor embezzled money transferred from joint account with creditor to account of a corporation controlled by debtor. "A creditor proves embezzlement by showing that he entrusted his property to the debtor, the debtor appropriated the property for a use other than that for which it was entrusted, and the circumstances indicate fraud." The "appropriation requirement" for embezzlement under § 523(a)(4) does not demand "a showing that the debtor individually profited in an amount equal to that lost by the creditor.")

Lin v. Ehrle (In re Ehrle), 189 B.R. 771 (B.A.P. 9th Cir. 1995) (lender with unrecorded second deed of trust has no basis for nondischargeability under § 523(a)(4)'s embezzlement prong as creditor had no recognized interest in the property).

Chrysler First Commercial Corp. v. Nobel (In re Nobel), 179 B.R. 313, 315 (Bankr. M.D. Fla. 1995) (no embezzlement under § 523(a)(4) where inventory subject to floor plan was sold out of trust but agreement did not require segregation of funds. Facts may establish § 523(a)(6) cause of action if debtor had requisite intent).


"to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support . . . 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, . . . ."

1. To spouse, former spouse or child

See "Attorneys' fees" infra; "Standing" supra.

Hudson v. Raggio & Raggio, Inc. (In re Hudson), 107 F.3d 355, 357 (5th Cir. 1997) (attorneys fees awarded directly to law firm for representation of the debtor's child's mother in state court paternity proceeding are excepted from discharge under § 523(a)(5). "A court ordered obligation to pay attorney fees charged by an attorney that represents a child's parent in child support litigation against the debtor is non-dischargeable. . . . Because the ultimate purpose of such a proceeding is to provide support for the child, the attorney fees incurred inure to her benefit and support, and therefore fall under the exception to dischargeability set out in § 523(a)(5).")

Miller v. Gentry (In re Miller), 55 F.3d 1487 (10th Cir. 1995), cert. denied, ___ U.S. ___, 116 S. Ct. 305, 133 L. Ed.2d 210 (1995) (the emphasis of § 523(a)(5) is on the nature of support, rather than on the identity of the payee. "[D]ebts to a guardian ad litem, who is specifically charged with representing the child's
best interests, and, a psychologist hired to evaluate the family in child custody proceedings, can be said to relate just as directly to the support of the child as attorney's fees incurred by the parents in a custody proceeding.

O'Connor, Cavanagh, Anderson, Westover, Killingsworth & Beshears v. Perlin (In re Perlin), 30 F.3d 39 (6th Cir. 1994) (former spouse's attorneys and expert witnesses did not have standing to contest discharge of state court award of fees and expenses in divorce proceeding. "As a general rule, one party may not assert the rights of another. . . . In certain instances [however,] a plaintiff with a particularly close relationship to a third party may assert the rights of a third party where the plaintiff faces an actual economic harm." Although plaintiffs had an economic stake in the outcome of the litigation, that the state court could have made (but did not) award directly to plaintiffs clouded the issue.

Compare Martin v. Morello (In re Morello), 185 B.R. 753, 754-56 (Bankr. E.D. Tenn. 1995) (attorney has standing under § 523(a)(5) where fee, designated as alimony, awarded directly to attorney by state court); Hubbard v. Woodall (In re Woodall), 185 B.R. 743, 744 (Bankr. E.D. Ky. 1995) (medical bills are in the nature of child support and nondischargeable although originally payable to third-party providers).

County v. Crouch (In re Crouch), 199 B.R. 690 (B.A.P. 9th Cir. 1996) (costs incurred by county when debtor's child was housed by county were dischargeable because debt was neither owed to a child of the debtor nor would become a liability of a child of the debtor in the event debtor did not pay.)

Saafir v. Kansas Dep't of Social Servs. (In re Saafir), 192 B.R. 964 (Bankr. D. Neb. 1996) (department of social services judgment for support of debtor's child while the child was a ward of the state is dischargeable because it was not a debt to a child or to a former spouse. Debt arose from the debtor's statutory obligation to reimburse the state for expenditures incurred on behalf of a child. State's rights were not derivative of child's right of support under Kansas law.)

2. Alimony, maintenance or support

a. In general

Friedkin v. Sternberg (In re Sternberg), 85 F.3d 1400 (9th Cir. 1996) ("A trial court should consider several factors in determining how the parties intended to characterize the obligation. . . . Foremost, the trial court should consider whether the recipient spouse actually needed spousal support at the time of the divorce. . . . The trial court should examine if there was an 'imbalance in the relative income of the parties' at the time of the divorce decree. . . . The trial court should also consider whether the obligation terminates upon the death or remarriage of the recipient spouse and whether the payments are 'made directly to the recipient spouse and are paid in installments over a substantial period of time.' . . . Finally, the labels given to the payments by the parties may be looked at as evidence of the parties' intent." That the debtor's payments were taxable to the ex-spouse and were to survive the ex-spouse's remarriage was not controlling. The courts have "'rarely found the tax treatment of a debt dispositive on dischargeability.'" The parties'
election to extend support payment beyond remarriage was “not in conflict with an intent to provide spousal support under California law.... Whether the monthly payments are modifiable under state law is not a dispositive factor in determining whether the parties intended to create a spousal support obligation for purposes of 11 U.S.C. § 523(a)(5).”.

Fraser v. Fraser, 196 B.R. 371 (E.D. Tex. 1996) (determination whether obligation is in the nature of alimony, maintenance or support under § 523(a)(5) is a factual finding reviewed under the clearly erroneous standard. Rejects “actual effect test” of Calhoun, 715 F.2d 1103 (6th Cir. 1983), in favor of “functional analysis” of Gianakas, 917 F.2d 759 (3d Cir. 1990). “Reasonableness” inquiry is best left to the state divorce court.)

Fitzgerald v. Fitzgerald (In re Fitzgerald), 9 F.3d 517 (6th Cir. 1993) (Calhoun has been applied more broadly than was intended. “When [this court] stated in Calhoun that [a] loan assumption should be treated, to the extent possible, the same as ordinary direct child support or alimony payments, we were not suggesting that alimony or support payments be reduced to necessary support. Rather, we were applying to loan assumptions a minimum standard ordinarily applied by state courts, holding that, to the extent loan assumptions exceed what a court would have awarded for alimony, maintenance or support, they are dischargeable.”); Long v. Calhoun (In re Calhoun), 715 F.2d 1103 (6th Cir. 1983) (four-step test for determining whether state court award is nondischargeable: (1) Did state court or parties intend to create a support obligation; (2) Does state court order have the actual effect of providing support necessary to ensure the daily needs of the former spouse or children; (3) Is obligation manifestly unreasonable under traditional concepts of support; and, (4) if the original obligation was excessive, then what is now a reasonable limit on the portion of the obligation which is nondischargeable); Silverstein v. Glazer (In re Silverstein), 186 B.R. 85, 87 (Bankr. W.D. Tenn. 1995) (judgment for child support arrearage nondischargeable; no need to apply Calhoun four step analysis because obligation designated by parties as child support).

Ehlers v. Howell (In re Ehlers), 189 B.R. 835 (Bankr. N.D. Ala. 1995) (support for child who reached majority prior to bankruptcy filing retains its character as child support and is nondischargeable under § 523(a)(5)).

Nix v. Nix (In re Nix), 185 B.R. 929 (Bankr. N.D. Ga. 1994) ($500,000 lump sum “alimony” to homemaker wife of orthodontist payable in five yearly installments is nondischargeable where amount served as only viable means for former wife to meet living expenses. That award did not cease upon death or remarriage not a reliable method for deciding award’s purpose).
b. State court labels

_Dennis v. Dennis (In re Dennis),_ 25 F.3d 274 (5th Cir. 1994), _cert. denied, ___ U.S. ___, 115 S. Ct. 732, 130 L. Ed.2d 636 (1995) (that Texas state court found debtor’s agreement to pay taxes on his former spouse’s half of debtor’s military pension “part of the division of community property between the parties and did not constitute nor should it be interpreted to be any form of spousal support, alimony or child support” did not collaterally estop the bankruptcy court from finding the obligation was nondischargeable support, alimony or maintenance under § 523(a)(5). Texas court could label the obligation in no other manner because Texas has “no such animal as alimony.” Federal bankruptcy law, not Texas law, governs dischargeability issues.)

_Gionis v. Wayne (In re Gionis),_ 170 B.R. 675 (B.A.P. 9th Cir. 1994), _aff’d mem.,_ 92 F.3d 1192 (9th Cir. 1996) (state court denial of spousal support based on short length of marriage and other factors does not preclude bankruptcy court from finding that award of $185,000 to ex-spouse’s attorneys for fees and expenses in custody battle were nondischargeable support under § 523(a)(5). State court label is merely some evidence.)

_Tevella v. Edwards (In re Edwards),_ 162 B.R. 83 (D. Conn. 1993) (state court’s description of award in divorce proceeding as “in the nature of alimony and support” is not determinative of § 523(a)(5) issue. Standard applied under state law considered factors not relevant to discharge, such as cause of divorce.). _Compare Carter v. Carter (In re Carter),_ 138 B.R. 356 (Bankr. D. Conn. 1992) (that divorce decree states that the obligation “shall be nondischargeable in bankruptcy” established that parties intended to foreclose issue in any future bankruptcy).

_Light v. Adkins (In re Adkins),_ 151 B.R. 458 (Bankr. M.D. Tenn. 1992) (clause in marital dissolution agreement that declares obligations nondischargeable in the event of bankruptcy has no effect in § 523(a)(5) litigation.)

_Freeman v. Freeman (In re Freeman),_ 165 B.R. 307 (Bankr. S.D. Fla. 1994) (Schmetтерer, J., by designation) (provision in property settlement agreement that its obligations are nondischargeable is neither specifically enforceable nor binding. “[A]greement to waive the benefit of a discharge . . . is void. . . .” The agreement, however, can assist the inquiry into the parties’ intent.)

_Catron v. Morrison (In re Catron),_ 186 B.R. 197 (Bankr. E.D. Va. 1995) (hold harmless agreement nondischargeable that included: “The parties mutually . . . agree that it is their mutual intent and bargain, which goes to the very essence of this entire agreement, that the monetary . . . liabilities assumed . . . including spousal support, . . . shall be considered, for the purposes of federal bankruptcy law, exempt from discharge and non-dischargeable in bankruptcy as debts to a spouse or
former spouse of the obligor, for alimony to, maintenance for, or support of a spouse or former spouse as being in the nature of alimony, maintenance or support as the debts, liabilities and obligations created by this agreement are intended for economic security, after considering many facts, circumstances, and factors,

Ianke v. Ianke (In re Ianke), 185 B.R. 297, 298-300 (Bankr. E.D. Mo. 1995) (although separation agreement provided that attorney fees and joint credit card accounts were not dischargeable in bankruptcy and former spouse testified that she accepted smaller monthly maintenance in reliance on debtor’s agreement to pay those bills, nondischargeability agreement not binding on bankruptcy court).

c. Attorneys’ fees

Macy v. Macy (In re Macy), 114 F.3d 1, 3 (1st Cir. 1997) (enactment of § 523(a)(15) in 1994 did not upset nondischargeability of attorneys’ fees awarded in connection with divorce or separation under § 523(a)(5). “[A]ttorneys’ fees continue to be governed by section 523(a)(5). There is a strong policy interest in protecting ex-spouses and children from the loss of alimony, support and maintenance owed by a debtor who has filed bankruptcy. . . . Congress sought to apply section 523(a)(15) to debts that had previously been construed as property obligations. . . . There is no indication that Congress intended to affect the liberal interpretation of section 523(a)(5). It follows, then, that Congress did not intend to apply section 523(a)(15) to debts that were, prior to the Bankruptcy Reform Act, considered to be nondischargeable under section 523(a)(5).” The plaintiff’s action under §§ 523(a)(5) and 523(a)(15) was filed beyond the 60-day period for complaints under § 523(a)(15). Debt was nondischargeable under § 523(a)(5), thus untimeliness of (a)(15) action was not fatal.)

Hudson v. Raggio & Raggio, Inc. (In re Hudson), 107 F.3d 355, 357 (5th Cir. 1997) (attorneys fees awarded directly to a law firm for representation of the debtor’s child’s mother in a state court paternity proceeding are in the nature of support for the child and are excepted from discharge under § 523(a)(5)).

Strickland v. Shannon (In re Strickland), 90 F.3d 444 (11th Cir. 1996) (award of attorneys’ fees for post dissolution custody dispute constitutes support under § 523(a)(5). Under Florida law, former spouse may be entitled to attorneys’ fees in a modification action depending on need and ability to pay. State court necessarily determined that former spouse had a greater need than debtor.); Lanting v. Lanting (In re Lanting), 198 B.R. 817 (Bankr. N.D. Ala. 1996) (“an award of attorneys’ fees is nondischargeable as alimony, maintenance, or support under 11 U.S.C. § 523(a)(5) where the decree contains an award of child support, alimony, or a combination thereof”); Robinson v. Robinson (In re Robinson), 193 B.R. 367, 373 (Bankr. N.D. Ga. 1996) (attorneys’ fees awarded by state divorce court may be nondischargeable support under § 523(a)(5). “[I]t appears to make no
difference that the divorce court may have ordered payment directly to the attorney . . . provided that it truly came "in the nature of alimony, support or maintenance." To determine whether award is nondischargeable, court will "employ a mixed approach, balancing both the apparent function of the award and the nature of the litigation in an attempt to discover the intent behind the award of fees." That the state court denied alimony to the plaintiff is not alone determinative of whether an award of attorneys' fees is in the nature of support. "Independent of any need for general maintenance payments, the fee award frequently bases itself on the recognition that support 'may be essential to a spouse's ability to defend a matrimonial action and thus necessary under the law.'"

Holliday v. Kline (In re Kline), 65 F.3d 749 (8th Cir. 1995) (attorneys' fees awarded in divorce proceeding are not dischargeable, though payable to the former spouse's attorney, if the award is in the nature of maintenance or support to the former spouse or a child of the debtor. "[E]xceptions from discharge for spousal and child support deserve a more liberal construction.""

Gionis v. Wayne (In re Gionis), 170 B.R. 675 (B.A.P. 9th Cir. 1994), aff'd mem., 92 F.2d 1192 (9th Cir. 1996) (state court order awarding $185,000 in fees directly to attorneys for former spouse is nondischargeable because of unbalanced financial resources, notwithstanding that state court refused to award "spousal support" to former spouse); In re Slater, 188 B.R. 852 (Bankr. E.D. Wash. 1995) ("the payment of the fees to a third party is not in and of itself sufficient to exclude the payment from the § 523(a)(5) exception to dischargeability." Intent of the parties, substance of the obligation and relative financial positions of the parties are considered.)

Miller v. Gentry (In re Miller), 55 F.3d 1487 (10th Cir.), cert. denied, _U.S._, 116 S. Ct. 305, 133 L. Ed.2d 210 (1995) (the emphasis of § 523(a)(5) is on the nature of support, rather than on the identity of the payee. “[D]ebts to a guardian ad litem, who is specifically charged with representing the child’s best interests, and, a psychologist hired to evaluate the family in child custody proceedings, can be said to relate just as directly to the support of the child as attorney’s fees incurred by the parents in a custody proceeding.”); Champion v. Champion (In re Champion), 189 B.R. 516 (Bankr. D.N.M. 1995) (attorneys' fees to ex-spouse were nondischargeable because intent of award was to provide support to children and ex-spouse. Debtor shot ex-spouse disabling her to work. That debtor was destitute without any likelihood of significant income while incarcerated was his own doing. Substantial portion of attorneys’ fees were direct result of debtor’s unreasonable conduct concerning child custody.)

Colbert v. Colbert (In re Colbert), 185 B.R. 247 (Bankr. M.D. Tenn. 1995) (bankruptcy court has no authority to award attorney fees in dischargeability litigation under §§ 523(a)(5) and (a)(15) absent contractual right to fees. Under Tennessee law, plaintiff may seek modification of divorce decree in state court if she needs additional support due to cost of dischargeability litigation; state court has concurrent jurisdiction to determine dischargeability of any such fees awarded.)

d. Rights in future pension benefits

Gendreau v. Gendreau (In re Gendreau), 1997 WL 464710 *2 (9th Cir. Aug. 15, 1997) (decree that awarded ex-spouse a 50% interest in ERISA qualified pension plan was not dischargeable under § 523(a)(5) notwithstanding that state court order was not a Qualified Domestic Relations Order. The ex-spouse's claim "is against the United Pilot's pension plans and not against [the debtor]. . . . Therefore, the claim is not a personal liability of [the debtor] that could be discharged by his bankruptcy.")

McCafferty v. McCafferty (In re McCafferty), 96 F.3d 192 (6th Cir. 1996) (prepetition state court award of one-half interest in pension was a constructive trust that never came into bankruptcy estate. Seven months prior to chapter 7 filing, state court awarded ex-spouse one-half of debtor's pension. State court referred to this as "a distribution of [debtor's] retirement plan" and called the award a "property distribution." Sixth Circuit accepted former spouse's argument that "her share of the pension benefits was her sole and separate property held in constructive trust by her former husband and could not be considered property of [debtor's] estate." Unlike In re Omegas Group, Inc., 16 F.3d 1443 (6th Cir. 1994), imposition of a constructive trust would not offend the bankruptcy policy of equitable distribution because debtor's pension benefits "would not have been subject to the reach of creditors, even after he filed bankruptcy." "The [state] court having entered judgment for the stated amount as 'a distribution of her interest' in the retirement plan, we believe [debtor] retained only a bare legal title in the designated portion of the plan's benefit and that [the non-debtor] became the equitable owner of the retirement plan to that extent. Thus, this property interest never became part of the property of the bankruptcy estate. . . . Since it would result in an unjust enrichment for [debtor] to receive the entire value of the retirement benefits, a constructive trusts arose to the extent of the interest awarded to [the non-debtor]. . . . It makes not difference that the payments to Ms. McCafferty do not begin until 1998 or that [debtor's] interest in the benefits may or may not have matured at that time (depending on when he takes retirement). The Ohio court enjoyed complete discretion in determining how best to divide the retirement benefits. . . . The court's decree irrevocably established Ms. McCafferty's separate interest in her husband's pension benefits. . . . How the pension distribution was to be effected does not change the fact that Ms. McCafferty was the
equitable owner of $100,250.21 of the pension benefits when [debtor] began the bankruptcy proceeding.

Ellis v. Ellis (In re Ellis), 72 F.3d 628 (8th Cir. 1995) (decree that awarded former spouse $300,000 interest in debtor’s pension and profit sharing plan, to be paid in $50,000 installments, was a prepetition division of marital property, not an award of maintenance or support and thus was dischargeable); Walston v. Walston, 190 B.R. 66 (E.D.N.C. 1995) (“marital property interests in a debtor’s military pension are not dischargeable in bankruptcy.” Under North Carolina law military pensions are marital property. Distinguishes Perlow v. Perlow, 128 B.R. 412 (E.D.N.C. 1991), which held that wife’s equitable distribution action was discharged in bankruptcy because at filing she had no specific interest in marital property, only an unsecured claim.)

Albert v. Albert (In re Albert), 187 B.R. 697, 701-03 (Bankr. D. Kan. 1995), aff’d, 194 B.R. 907 (D. Kan. 1996) (former spouse’s entitlement to percentage of future retirement pay not property of bankruptcy estate and not a pre-petition debt subject to discharge. However, pre-bankruptcy arrearage is dischargeable since not § 523(a)(5) support, not § 523(a)(6) “malicious” injury, and constructive trust remedy not available where no evidence of fraud or unconscionable conduct).

g. Miscellaneous

Silverstein v. Glazer (In re Silverstein), 186 B.R. 85, 87 (Bankr. W.D. Tenn. 1995) (interest on state court judgment for child support arrearage pursuant to general state statute for interest on all judgements is not actually in the nature of support and therefore dischargeable in § 523(a)(5) proceeding).

3. Changed circumstances

Swate v. Hartwell (In re Hartwell), 99 F.3d 1282 (5th Cir. 1996) (not appropriate for bankruptcy court to review the reasonableness of state court lump sum alimony award. Even where review by the state court is no longer available, federal court should not interfere with state policy decisions in the area of domestic relations.)

Friedkin v. Sternberg (In re Sternberg), 85 F.3d 1400 (9th Cir. 1996) (relevant inquiry “is the intent of the parties at the time the divorce decree or settlement agreement was executed.” Bankruptcy court did not abuse its discretion in refusing debtor’s offer of evidence with respect to financial circumstances at time of dischargeability trial.)

Fitzgerald v. Fitzgerald (In re Fitzgerald), 9 F.3d 517 (6th Cir. 1993) (Calhoun has been applied more broadly than was intended. “When [this court] stated in Calhoun that [a] loan assumption should be treated, to the extent possible, the same as ordinary direct child support or alimony payments, we were not suggesting that alimony or support payments be reduced to necessary support. Rather, we were applying to loan assumptions a minimum standard ordinarily
applied by state courts, holding that, to the extent loan assumptions exceed what a court would have awarded for alimony, maintenance or support, they are dischargeable.

Long v. Calhoun (In re Calhoun), 715 F.2d 1103 (6th Cir. 1983) (four-step analysis for determining whether a state court divorce or separation judgment constitutes alimony, maintenance or support. The fourth step requires consideration of changed and/or current circumstances of the debtor and the debtor’s former spouse.);

4. Assignment of support rights

See “§ 523(a)(18)” infra.

Visness v. Contra Costa County (In re Visness), 57 F.3d 775 (9th Cir. 1995), cert. denied, ___ U.S. ___, 116 S. Ct. 828, 133 L. Ed.2d 770 (1996) (reaffirming Ramirez, 795 F.2d 1494 (9th Cir. 1986), cert. denied, 481 U.S. 1003, 107 S. Ct. 1624, 95 L. Ed.2d 198 (1987), county’s claim for assigned support rights is dischargeable in bankruptcy because under California law neither the custodial parent nor a minor child has a right to support payments absent a court decree or agreement and at the time of assignment to the county, neither the debtor’s spouse nor the debtor’s child had established a right to support from the debtor. Neither the 1984 or 1986 amendments to § 523(a)(5) changed this outcome.)


5. Postpetition and postdischarge alimony or support modification

Siragusa v. Siragusa (In re Siragusa), 27 F.3d 406 (9th Cir. 1994) (state domestic relations court can increase debtor’s alimony obligation after discharge based on changed circumstances including the discharge of property settlement portion of state court decree. Debtor owed former spouse alimony arrears and $1.2 million property settlement. After bankruptcy court ordered payment of alimony portion and discharged property settlement portion, former spouse petitioned domestic relations court for alimony modification due to change circumstances--discharge in bankruptcy of $1.2 million property settlement. State court granted modification by more than doubling debtor’s monthly alimony to $7,500 per month. That decision was appealed to state supreme court. Debtor sought relief from bankruptcy court on ground that alimony modification accomplished indirectly what could not be accomplished directly--collection of a discharged property settlement. Bankruptcy court abstained. Ninth Circuit affirmed: “In deciding whether to modify the alimony, the divorce court properly considered [debtor’s] discharge in bankruptcy of the property settlement debt as ‘changed circumstance.’” Abstention appropriate because state court could address all of debtor’s claims and complaint in bankruptcy court was “an end run over the state court jurisdiction.”); Siragusa v. Siragusa, 843 P.2d 807 (Nev. 1992) (“discharge of a property settlement obligation in bankruptcy may be taken into account in determining whether the
parties' circumstances have changed sufficiently to justify a modification of alimony.

Richardson v. Richardson, 868 P.2d 259 (Wyo. 1994) ("[T]here is a significant body of authority which consistently supports the district court’s decision to treat the results of the bankruptcy proceeding as a change of circumstances justifying modification of original decree . . . .")

Carter v. Carter, 447 S.E.2d 522 (Va. 1994) (obligation to former wife was a dischargeable property settlement. However, discharge in bankruptcy of property settlement agreement breached the debtor’s obligations under the settlement agreement. In effect, debtor repudiated the agreement, which gave his former wife the right to rescind. Upon rescission, marital home was ordered sold with a division of funds between the parties. Debtor also required to pay attorneys’ fees of $500.)

Dickson v. Dickson, 474 S.E.2d 165 (Va. App. 1996) (discharge in bankruptcy is a change in circumstances justifying modification of spousal support award. Former spouse petitioned state court for increase in spousal support on ground that bankruptcy discharge of husband’s equitable distribution obligations constituted a material change in circumstances. Court found that bankruptcy discharge of over $620,000 in debt that greatly reduced the debtor’s monthly expenditures and improved his financial condition was a material change in circumstances.)

Eckert v. Eckert, 424 N.W.2d 759 (Ct. App. Wis.), review denied, 430 N.W.2d 351 (Wis. 1988) (rejected debtor’s argument that maintenance modification order “re-created” discharged debt, frustrating fresh start objective of Bankruptcy Code).

Brabham v. Brabham (In re Brabham), 184 B.R. 476 (Bankr. D.S.C. 1995) (hold harmless and other provisions of divorce decree were property settlement and were discharged in wife’s Chapter 7. Husband’s reopening of state divorce proceeding seeking new division of property based on changed circumstance of wife’s discharge violated discharge injunction in § 524).


“for willful and malicious injury by the debtor . . . .”

1. In general

Boyce v. Greenway (In re Greenway), 71 F.3d 1177, 1181 (5th Cir.), cert. denied, ___ U.S. ___, 116 S. Ct. 2499, 135 L. Ed.2d 191 (1996) (state court jury’s refusal to find “gross negligence” collaterally estops plaintiff from proving willful and malicious injury under § 523(a)(6). Debtor had a motorboat accident while drinking. Jury in state court trial rejected liability for “gross negligence,” but found the debtor 60% responsible for the accident and awarded damages. Gross negligence was defined by Texas law as “such an entire want of care as to establish that the act or omission in question was the result of actual conscious indifference to the rights, welfare and safety of the persons affected thereby.” Willful and malicious for purposes of § 523(a)(6)
means “intentional” and lacking “just cause or excuse.” “[T]he jury’s refusal to find that Greenway acted with ‘actual conscious indifference’ necessarily precludes a subsequent finding that Greenway’s actions were both ‘intentional’ and without ‘just cause or excuse.’”

Corley v. Delaney, 97 F.3d 800 (5th Cir. 1996) (per curiam) (tapping barrel of loaded sawed-off shotgun on window of car to get driver’s attention was not willful and malicious injury when gun went off. “For willfulness and malice to prevent a discharge under § 523(a)(6), the debtor must have intended the actual injury that resulted. . . . [I]ntent to injure may be established by a showing that the debtor intentionally took action that necessarily caused, or was substantially certain to cause, the injury. ‘[T]he plain language of Section 523(a)(6) excepts from discharge debts arising from ‘willful and malicious injury’ rather than willful and malicious acts which cause an injury.’” To the extent that Seven Elves has been construed to support a looser standard, it can no longer be so construed. Debtor intentionally loaded shotgun, carried it to where plaintiff was, aimed it at plaintiff and twice tapped it against the windshield of the car in which plaintiff sat. The firing of the gun was neither intentional nor deliberate within the meaning of § 523(a)(6); “on the contrary, it was wholly unintentional, even though possibly not wholly unforeseeable. It follows that under our . . . reading of § 523(a)(6), [debtor] did not intend [plaintiff’s] injury -- or any injury for that matter. . . . [Debtor] neither intended the injury nor intentionally took action that was ‘substantially certain’ to cause the injuries that [plaintiff] suffered.”

Conte v. Gautman (In re Conte), 33 F.3d 303 (3d Cir. 1994) (“An injury is willful and malicious under the Code only if the actor purposefully inflicted the injury or acted with substantial certainty that injury would result.” Under that standard, the court vacated a judgment holding a malpractice verdict preclusive on the issue whether debtor’s actions were willful and malicious. The jury had merely found that debtor acted with knowledge of a high probability of harm and with reckless indifference to consequences, neither of which equate with willful and malicious.)

Romesh Japra, M.D., F.A.C.C., Inc. v. Apte (In re Apte), 180 B.R. 223, 231-32 (B.A.P. 9th Cir. 1995), aff’d on other grounds, 96 F.3d 1319 (9th Cir. 1996) (§ 523(a)(2)(A) and (a)(6) are not mutually exclusive but have different elements: (a)(2)(A) requires showing of specific intent to deceive plaintiff while (a)(6) does not require specific intent to deceive or specific intent to harm plaintiff; (a)(2)(A) actual fraud requires only losses proximately caused by misrepresentation while (a)(6) malice element requires stronger showing that act necessarily produced the harm); McCravy v. Barrack (In re Barrack), 201 B.R. 985 (Bankr. S.D. Cal. 1996) (creditor cannot escape the writing requirement of § 523(a)(2)(B) by asserting an action under § 523(a)(6). “[A] claim for financial loss which fails under Section 523(a)(2) for lack of a writing may [not] be brought [without more] under Section 523(a)(6).”

2. Libel and slander


3. Drunk driving

*Boyce v. Greenway (In re Greenway)*, 71 F.3d 1177 (5th Cir.), *cert. denied, ___ U.S. __*, 116 S. Ct. 2499, 135 L. Ed.2d 191 (1996) (motorboat accident that occurred while the debtor was drinking was not “willful and malicious injury” for purposes of § 523(a)(6) because jury refusal to find “gross negligence” collaterally estops the plaintiff to prove willful and malicious misconduct. Motorboat is not a “motor vehicle” for purposes of § 523(a)(9)); *Schachter v. Fall (In re Fall)*, 192 B.R. 16 (Bankr. D.N.H. 1995) (drunken driving of a motor boat did not prove that drunkenness was the cause of the accident or that debtor’s conduct was willful and malicious under § 523(a)(6). Drunkenness was not certain or even substantially certain to result in injury to the plaintiff. Debtor’s actions after the accident were reprehensible—he left the scene and lied to the marine patrol—but they were not relevant to the court’s inquiry.)

*Taneff v. Hoehn (In re Taneff)*, 190 B.R. 501 (W.D.N.Y. 1996) (bankruptcy court improperly denied debtor summary judgment in § 523(a)(6) action against tavern owner for drunk driving by patron. Willfulness “requires not only intentional conduct on the part of the debtor, but also intentional or deliberate injury.” A “should have known” standard “misstates the standard for a willful injury. ... [N]egligence, or even recklessness for that matter, does not establish a willful injury for nondischargeability under § 523(a)(6). ... No matter how hard the tragic and devastating injury that underlies this proceeding tugs at the heartstrings, there must be some modicum of evidence that [debtor] intended the injury for § 523(a)(6) to except the debt from discharge.” Not only was there no evidence that the debtor sold alcohol to someone who he “knew or even suspected was intoxicated ... even if he did, § 523(a)(6) requires at least a deliberate action substantially certain to produce harm.”)

*Choi v. Brown (In re Brown)*, 201 B.R. 411 (Bankr. W.D. Pa. 1996) (owner of car (wife) not responsible under § 523(a)(6) for injury caused by husband who was driving while intoxicated, without a license, and without insurance. Creditor failed to establish that wife gave husband permission or otherwise allowed husband to drive the car, thus wife’s conduct could not be said to have been willful under § 523(a)(6). Plaintiff’s injury was not substantially certain to result from wife’s failure to insure the car.)
4. Conversion

Printy v. Dean Witter Reynolds, Inc., 110 F.3d 853 (1st Cir. 1997) (debtor willfully and maliciously injured brokerage firm by knowingly taking advantage of brokerage firm’s mistake in crediting stock to a trust account controlled by the debtor. After reviewing the conflicting definitions of “willful and malicious” from other circuits, First Circuit adopts “[t]he majority rule followed by the bankruptcy courts for the District of Massachusetts . . . ‘malicious’ means an act done in conscious disregard of one’s duties. No special malice toward the creditor need be shown. . . . [T]he term ‘willful and malicious’ in § 523(a)(6) means an act intentionally committed, without just cause or excuse, in conscious disregard of one’s duty and that necessarily produces an injury. . . . While something more than a mere voluntary act is necessary to satisfy the scienter requirement . . . specific intent to injure is not necessary. . . . An injury inflicted willfully and with malice . . . is one inflicted intentionally and deliberately, and either with the intent to cause the harm complained of, or in circumstances in which the harm was certain or almost certain to result from the debtor’s act.” The debtor “willfully and maliciously injured Dean Witter by not informing it that a mistake had been made by crediting to the Trust account the . . . stock that [the debtor] knew he did not own. [The debtor] took advantage of Dean Witter’s computer error by borrowing against and withdrawing funds from the false margin account that derived its value from shares of stock that [the debtor] knew he did not own. Such conduct by [the debtor] translates easily into an intent to willfully and maliciously cause harm.”)

Navistar Fin. Corp. v. Stelluti (In re Stelluti), 94 F.3d 84 (2d Cir. 1996) (transfer of funds, in which floor plan financier had an interest, from operating account of dealership to new accounts in dealership and personal names at banks in neighboring state was willful and malicious under § 523(a)(6). Willful means “deliberate or intentional.” Debtor/wife’s actions were deliberate as she personally made a withdrawal from dealership account and opened new bank accounts. “[M]alicious’ means wrongful and without just cause or excuse, even in the absence of personal hatred, spite, or ill-will. . . . Malice may be constructive or implied. . . . Implied malice may be demonstrated ‘by the acts and conduct of the debtor in the context of [the] surrounding circumstances.’” Debtor/wife performed bookkeeping and clerical work for dealership. Funds were transferred to out-of-state banks during an ongoing dispute with the floor plan financier amid rumors that the financier was about to pull-the-plug on the dealership. Wife’s participation was malicious although she may not have understood exactly why she was moving money and opening new accounts. Debtors “[did] not indicate that there were any legitimate personal or business justifications for their actions.”)

First Nat’l Bank v. Stanley (In re Stanley), 66 F.3d 664 (4th Cir. 1995) (willful and malicious conversion when an $8,000 line of credit was mistakenly listed as $80,000 on bank statement and debtor drew down the $72,000 difference for an investment in speculative real estate. Debtor applied for a $10,000 line of credit. Application was approved but for only $8,000. Three months later, statement from bank indicated “without explanation” that credit line increased from $8,000 to $80,000. Debtor called branch manager and inquired “whether
the statement was accurate." Branch manager checked computer and "verified" that the limit was $80,000. Debtor then bought several acres of unimproved property which he held for 13 months and eventually sold at a substantial loss. "The act or conduct at issue here . . . is a conversion—an unauthorized exercise of dominion or control over property belonging to another that seriously interferes within the owner's rights. . . . The conversion was wrongful. . . . Stanley knew that something was amiss when his credit limit was suddenly increased by a factor of ten. Stanley’s explanation that the thought that the bank had granted him a $72,000 'unsecured' line of credit is wholly irreconcilable with his knowledge that, just three months earlier, he had been approved for $2,000 less than the relatively modest secured line that he had requested. . . . [The debtor] is an accountant with one year of graduate school education; he is by no means unsophisticated. In finding that he lacked the requisite malice to be denied discharge, the bankruptcy court concentrated on Stanley's intent to repay FNB out of the 'profits' from the sale of the Howard County property. The bankruptcy court's finding that Stanley acted with hopeful intentions is probably correct; indeed, Stanley remained current on his FNB payments for over a year. However, that Stanley did not intend for FNB to ultimately suffer a loss is legally irrelevant. For conversion to occur, it is not necessary that the property be damaged, but merely that the owner suffer a serious deprivation of the incidents of ownership. Consequently, the proper focus in this case is not on Stanley’s ‘good intentions,’ but simply on his exercise of dominion and control over funds that he knew belonged to another. Stanley's deliberate conversion of the funds is the intentional, wrongful act that prevents the discharge of his debt to FNB.

Wolfson v. Equine Capital Corp. (In re Wolfson), 56 F.3d 52 (11th Cir. 1995) (citing Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934), not every conversion results in willful and malicious injury for purposes of § 523(a)(6). Debtor’s use of income from sale of lender's collateral deposited to general business account did not constitute willful and malicious conversion of lender’s proceeds. As stated by the Supreme Court in Davis "'[t]here may be an honest, but mistaken belief, engendered by a course of dealing, that powers have been enlarged or incapacities removed. In these and like cases, what is done is a tort, but not a wilful and malicious one.’ . . . Here, the course of dealing clearly indicates that Wolfson had a reasonable belief that his business practices were known to his secured creditor. More importantly, it indicates that the secured creditor knowingly acquiesced in Wolfson’s business practices, and took no steps to protect its collateral. . . . [The lender] knew that the Farm placed its proceeds into a general account out of which it paid ordinary business expenses, and knew also which of the loan collateral the Farm had sold during the month. Wolfson’s belief, engendered by a course of dealing, was thus reasonable, and under Davis could support the conclusion that if Wolfson committed the tort of conversion, it was not a willful or malicious one. However, it is not necessary to reach the question of whether Wolfson’s actions were willful and malicious, nor the question of whether Wolfson’s sale of collateral and failure to remit the proceeds amounted to conversion. As the bankruptcy court recognized, [the lender] not only knew of and failed to object to the Farm’s sales of collateral and its business practice of depositing all proceeds into a general business account, but [the lender] also continued to renew and extend additional credit to the Farm. . . . [S]ince [the lender] failed
to enforce whatever rights it may have had regarding the disposition of its collateral, it waived its right to assert under 11 U.S.C. § 523(a)(6) that its claim is non-dischargeable and that it suffered ‘willful and malicious’ injury by Wolfson. . . . [The lender’s] ‘failure to take reasonable steps to protect its collateral . . . prevented application of the exception.’”); American Gen. Fin. v. Taylor (In re Taylor), 187 B.R. 736, 739-40 (Bankr. N.D. Ala. 1995) (creditor fails willfulness standard where several items of personal property were taken by ex-wife without debtor’s permission and debtor sold dinette chairs to pay rent nine months before bankruptcy, intending at time to continue paying for dinette set).

Straub v. Straub (In re Straub), 192 B.R. 522 (Bankr. D.N.D. 1996) (transfer of property subject to a judicial lien was nondischargeable because debtor knew that transfer would foil plaintiff’s efforts to collect judgment); United States v. Vandrovec (In re Vandrovec), 61 B.R. 191 (Bankr. D.N.D. 1986) (guilty plea to conversion of grain does not collaterally estop debtor to contest nondischargeability under § 523(a)(6). The conversion to which the debtor pled guilty included the element of willfulness but had no prerequisite of maliciousness.)

5. Professional “negligence”

Lee-Benner v. Gergely (In re Gergely), 110 F.3d 1448, ___ (9th Cir. 1997) (botched amniocentesis that blinded child was not a willful and malicious injury because harm was not certain or almost certain to result from the physicians malpractice. Misrepresentation of need for procedure was actionable under § 523(a)(2)(A). “Lee-Benner [the child] did not allege that Gergely [the debtor] acted maliciously. We recognize that malice can be proved without showing an intent to injure. . . . However, without such an intent it is ‘necessary to show that [Gergely] committed a wrongful act which necessarily produced harm.’ . . . This standard requires that the act be ‘certain or almost certain to cause’ the harm. . . . Nothing in In re Britton, 950 F.2d 602 (9th Cir. 1991), changed this standard. . . . Our conclusion in Britton that the debtor acted maliciously was derived from the particular facts of that case, including that the debtor had intentionally misrepresented himself to be a doctor. . . . Malpractice was not certain or almost certain to occur. Lee-Benner therefore failed to allege that Gergely acted maliciously.”)

Geiger v. Kawaaahau (In re Geiger), 93 F.3d 443 (8th Cir. 1996) (medical malpractice is not willful and malicious injury for purpose of § 523(a)(6). “Conduct that is merely reckless is not malicious within the meaning of the statute. . . . Congress intended ‘to allow discharge of liability for injuries unless the debtor intentionally inflicted an injury.’” Where debtor/doctor’s treatment of plaintiff was “at very least negligent, the bankruptcy court erred when it concluded that his conduct was willful and malicious. . . . [T]he worst thing that can be said about [debtor] is that he acted recklessly in treating [plaintiff] . . . . The evidence showed only that [debtor] failed to save [plaintiff’s] leg from the ravages of infection, not that he intended to harm her. In other words, his efforts . . . were not calculated to result in the loss of [plaintiff’s] leg, and were therefore not malicious.”), on reh’g en banc, 113 F.3d 848, 853-4 (8th Cir. 1997) (rejecting Perkins, 817 F.2d 292 (6th Cir.
1987), cert. denied, 484 U.S. 853 (1987), “we hold only that for a judgment debt to be nondischargeable under § 523(a)(6) it is necessary that it be based on the commission of an intentional tort. . . . [S]ince it is not even alleged that Dr. Geiger intended to inflict an injury on his patient, and it cannot be said that he believed that an injury was substantially certain to result, the judgment underlying this case could not have given rise to a ‘debt . . . for willful and malicious injury by the debtor.’”), cert. granted, 66 USLW 3108 (U.S. Sept. 29, 1997).

Conte v. Gautam (In re Conte), 33 F.3d 303 (3d Cir. 1994) (debtor, a lawyer, failed to answer discovery requests resulting in dismissal of medical malpractice action. Debtor did not tell clients in time to reinstate case. Jury awarded $520,000 compensatory and $1 million punitive damages based on findings that debtor knew of dismissal, deliberately did not inform his clients and had reckless indifference to the high degree of probability of harm to his clients. Jury verdict not preclusive of § 523(a)(6) action because “willful and malicious” requires a finding that debtor acted with a purpose of producing injury or deliberately and with the knowledge that there was a “substantial certainty” of producing injury. Substantial certainty is something more than a “high probability.” That the debtor “deliberately committed a wrongful act with a high probability of producing injury” is not enough because such a test would capture all merely reckless acts.)

Caccamo v. Pouliot (In re Pouliot), 196 B.R. 641 (Bankr. S.D. Fla. 1996) (debtor-obstetrician’s transfer of substantially all of his assets to a revocable trust and election not to carry medical malpractice insurance under Fla. Stat. § 458.320(5)(g)(4), did not constitute willful and malicious injury to woman or child whose skull was crushed due to alleged improper use of forceps during delivery. However, whether debtor acted willfully and maliciously during woman’s pregnancy and delivery was not beyond § 523(a)(6). Issues of fact remained “whether debtor’s alleged malpractice constituted a ‘wilful’ injury to [the child] when he committed certain intentional acts the purpose of which may have been substantially certain to cause [child’s] injuries.”)

Smith v. Assevero (In re Assevero), 185 B.R. 951, 955-56 (Bankr. N.D. Ga. 1995) (negligence or recklessness not sufficient to make medical malpractice nondischargeable. No willfulness unless debtor intended to cause injury or knew that injury was substantially certain.)

Fernandez v. McMahon (In re McMahon), 183 B.R. 948, 950, 952 (Bankr. M.D. Fla. 1995) (plaintiff showed more than negligence or gross negligence by oral surgeon where during 9 hour inappropriate surgery resulting in migration of dental implants into sinus cavity, surgeon rebuffed debtor’s cries for relief from pain by telling her he “would cut her tongue off if she did not keep quiet”).

6. Breach of contract

Catercorp. Inc. v. Henichek (In re Henichek), 186 B.R. 211, 215, 217 (Bankr. E.D. Va. 1995) (breach of covenant not to compete is not per se violation of
§ 523(a)(6). Plaintiff collaterally estopped because state court jury found defendant did not act with malice.

7. Other wrongful acts

Baldino v. Wilson (In re Wilson), 116 F.3d 87 (3d Cir. 1997) (success in a state court malicious prosecution action would be preclusive in nondischargeability litigation under § 523(a)(6). Bankruptcy court abused its discretion in not granting relief from the stay to permit the plaintiff to appeal the state trial court’s dismissal of the complaint. Unless reversed on appeal, the state trial court’s dismissal of the malicious prosecution complaint would preclude malicious prosecution as the basis for a § 523(a)(6) complaint in the bankruptcy court. Citing the Rooker-Feldman doctrine, because bankruptcy court could not review the trial court judgment, it was necessary to lift the stay to permit the state court plaintiff to appeal.)

Murray v. Bammer (In re Bammer), 112 F.3d 1355 (9th Cir. 1997) (debtor did not willfully and maliciously injure judgment creditor by accepting fraudulent conveyance from his mother before creditor could record judgment nor by encumbering the property and giving the loan proceeds to his mother just before reconveying the property to his mother because son subjectively had compassion for his mother and the loan proceeds helped the mother not the son. “We have considered both objective facts and subjectively held beliefs of the debtor in determining whether an individual’s conduct was malicious. . . . A debtor is not free to injure others maliciously, however, and escape liability for his actions by pleading that he subjectively held a belief that his actions would lead to good. Instead, the debtor’s subjectively held beliefs are examined for their objective reasonableness. . . . The court found Bammer credible when he testified that he did not obtain the loan as a way of unjustly enriching himself at the expense of creditors, but rather, as a way to help his mother with expenses he viewed as critical. . . . Bammer acted out of compassion for his mother . . . . Bammer’s motives and the lack of personal benefit he derived from obtaining the loan are compelling reasons favoring discharge.” The debtor’s mother embezzled money in fictitious real estate transactions. By agreement she conveyed her residence to her son without consideration. The son then obtained a loan using the property as collateral and gave the proceeds to his mother. Before creditors could record judgments, the son reconveyed the property to his mother. Dissenting judge failed to find “just cause or excuse” in the son’s participation in the fraudulent conveyances and the son’s surrender of the proceeds to his mother.), petition for reh’g en banc granted, 121 F.3d 531 (9th Cir. 1997).

Corley v. Delaney (In re Delaney), 97 F.3d 800 (5th Cir. 1996) (debtor intentionally loaded a shotgun, carried it to where plaintiff was, aimed it at plaintiff and twice tapped it against the windshield of the car in which plaintiff sat. The gun discharged. The firing of the gun was neither intentional nor deliberate within the meaning of § 523(a)(6); “on the contrary, it was wholly unintentional, even though possibly not wholly unforeseeable. It follows that under our . . . reading of § 523(a)(6), [debtor] did not intend [plaintiff’s] injury -- or any injury for that matter. . . . [Debtor] neither intended the injury nor intentionally took action that was ‘substantially certain’ to cause the injuries
that plaintiff suffered.” “The plain language of Section 523(a)(6) excepts from discharge debts arising from ‘willful and malicious injury’ rather than willful and malicious acts which cause an injury.”

Waugh v. Eldridge (In re Waugh), 95 F.3d 706 (8th Cir. 1996) (50% shareholder’s participation in transactions that stripped assets from corporation after accident involving corporation’s truck was willful and malicious injury to victims of accident. Debtor “repeatedly engaged in transactions to the benefit of himself and the other shareholders and to the detriment of [the corporation’s] creditors.”)

Papadakis v. Zelis (In re Zelis), 66 F.3d 205 (9th Cir. 1995) (sanctions imposed by state court for frivolous appeal of a consent judgment are nondischargeable under § 523(a)(6). Debtor is collaterally estopped to contest willfulness and maliciousness because California Court of Appeals found that the debtor “intentionally and wrongfully filed two frivolous notices of appeal in bad faith and for abusive litigation tactics.” “[F]iling a frivolous appeal necessarily causes harm to the opposing parties by requiring them to incur unnecessary litigation costs and attorneys’ fees, and by delaying final resolution of the dispute. Likewise, a court generally orders sanctions only when the party’s conduct has been particularly abusive and there is no justification or excuse for the behavior.” Plaintiff’s settlement of sanctions award with co-defendant precludes recovery of part of the sanctions from the debtor.)

Hope v. Walker (In re Walker), 48 F.3d 1161 (11th Cir. 1995) (failure of employer to obtain workers’ compensation insurance does not result in willful and malicious injury under § 523(a)(6). The statute excepts from discharge debts arising from willful and malicious injury, not willful and malicious acts which cause an injury. Debtors are responsible for willful injury when they commit an intentional act the purpose of which is to cause injury or which is substantially certain to cause injury. The plaintiff’s work injury was not “substantially certain” to result from the debtor’s failure to have insurance. The debtor did not intend his employee to suffer a fall.)

Barnett Bank v. Ussery (In re Ussery), 179 B.R. 737 (Bankr. S.D. Ga. 1995) (damage to car caused by tree falling during violent storm is nondischargeable where contract required insurance, debtor cancelled insurance because he could no longer afford it, debtor intended to sell car, and did not drive car after cancellation. Rejects “majority view” that lack of insurance was not cause of injury.)

Kaufman v. Vamvakaris (In re Vamvakaris), 197 B.R. 228 (Bankr. E.D. Va. 1996) (bailee’s failure to maintain loss insurance on bailed goods that were stolen, and misrepresentations to plaintiff that he did carry such insurance, did not constitute willful and malicious injury under § 523(a)(6). “The debtor did not intend to cause injury. And even though debtor’s misrepresentation may be considered a deliberate and intentional act, it did not directly or necessarily lead to the loss of plaintiff’s jewelry.”)

Princess House, Inc. v. Kraft (In re Kraft), 192 B.R. 735 (Bankr. W.D. Mo. 1996) (jury verdict that debtor interfered with contractual relationship and
misappropriated trade secrets not sufficient to preclude trial of § 523(a)(6)
complaint. Collateral estoppel was not applicable because "... for conduct to be
malicious . . . [it] must not only be 'certain or almost certain to cause . . .
harm,' it must also be targeted at the creditor." ... In other words, the jury must
have found that debtor's conduct was motivated by an 'intent to cause injury'
to plaintiff, 'rather than [being] merely an 'intentional act which causes injury.'
Here, the fact that the jury found that debtor, acting in her own self-interest,
took steps which resulted in harm to plaintiff, does not necessarily mean that
the jury also found that she acted with malice towards the plaintiff.

Compare Rowe Oil, Inc. v. McCoy (In re McCoy), 189 B.R. 129 (Bankr. N.D.
Ohio 1995) (misappropriation of trade secrets constitutes willful and malicious injury
within § 523(a)(6)).

(shipowner's failure to pay "maintenance" and "cure" to injured seaman was
willful and malicious injury. Debtor was sued by seaman for injuries suffered
on debtor's shrimping vessel. District court found that plaintiff's injuries were
not caused by any unseaworthy condition on board the ship, but ordered debtor
to pay "cure," "maintenance," and lost wages—the shipowner's duty of care
toward seamen injured while in the owner's service. That debtor did not
voluntarily pay and attempted to shield himself of liability "constitute
willful and arbitrary conduct that justifies the award of both attorney's fees and
 punitive damages. . . . Under maritime law, a shipowner's failure to pay
maintenance and cure is an independent tort that renders the shipowner liable
for any aggravation of the seaman's injury." District court finding that failure
to pay was "willful and arbitrary," estopped the debtor from (re)litigating
willfulness and maliciousness under § 523(a)(6).)

(violation of statute prohibiting electronic eavesdropping will support
§ 523(a)(6) action. Injury under § 523(a)(6) not limited to bodily injury or
physical abuse).

(attorneys' fees awarded to defendant as sanctions for an unfounded lawsuit are
nondischargeable under § 523(a)(6)).

1995) (award of attorney's fees in connection with divorce decree enforcement
is nondischargeable under § 523(a)(6) because debtor intentionally failed to
pay child support and financial injury was certain to occur).

(debtor's use of errant insurance benefit check to pay nonmedical debts, despite
assignment of benefits to health care provider, was willful but not malicious
under § 523(a)(6). Debtor was not experienced in such matters, he made no
attempt to conceal receipt of the benefit check, he was expecting
reimbursement for personal medical expenses and the explanation of benefits
did not make clear whose claims the benefit check was to cover.)
(debtor’s use of joint credit cards in violation of separation agreement does not fit § 523(a)(6) because extension of credit and credit rating are not “property”).

(state court judgment against employer for sexual harassment of employee is a nondischargeable claim for willful and malicious injury under § 523(a)(6)); Avery v. Sotelo (In re Sotelo), 179 B.R. 214 (Bankr. S.D. Cal. 1995); Hainline v. Neal (In re Neal), 179 B.R. 234, 238-39 (Bankr. D. Idaho 1995) (cause of action in Idaho for sexual battery does not require acts that “necessarily caused injury” and therefore will not automatically result in nondischargeable debt under § 523(a)(6)).

Moore v. C.F. (In re Moore), 165 B.R. 495 (M.D. Ala. 1994) (state court default judgment for sexual abuse of a minor precluded debtor from relitigating willfulness and maliciousness under § 523(a)(6)).

Wells v. Jennings (In re Jennings), 188 B.R. 110 (Bankr. E.D.N.Y. 1995) (failure to maintain property did not constitute willful and malicious injury when adjoining building was damaged by a fire that originated in debtor’s building. “Mere negligence, even if gross or reckless, will not support an exception under 11 U.S.C. § 523(a)(6).”)

Agency, master-servant and imputed liability

Ascher v. Yarom (In re Yarom), 86 F.3d 1165 (9th Cir. 1996) (table decision; text at 1996 WL 285713) (state court award of punitive damages “necessarily” means state court found that the debtor had “ratified” the fraudulent acts of his agents. “Yarom’s ratification of the fraud, therefore, was willful and malicious because he had the requisite intent to commit the acts that caused harm to [the plaintiff].”)

Tanef v. Hohn (In re Tanef), 190 B.R. 501 (W.D.N.Y. 1996) (owner of tavern not liable under § 523(a)(6) for injuries caused by patron. Willfulness “requires not only intentional conduct on the part of the debtor, but also intentional or deliberate injury.” A “should have known” standard “misstates the standard for a willful injury. . . . [N]egligence, or even recklessness for that matter, does not establish a willful injury for nondischargeability under § 523(a)(6). . . . No matter how hard the tragic and devastating injury that underlies this proceeding tugs at the heartstrings, there must be some modem of evidence that [debtor] intended the injury for § 523(a)(6) to except the debt from discharge.” Not only was there no evidence that the debtor sold alcohol to someone who he “knew or even suspected was intoxicated . . . even if he did, § 523(a)(6) requires at least a deliberate action substantially certain to produce harm.”)

Choi v. Brown (In re Brown), 201 B.R. 411 (Bankr. W.D. Pa. 1996) (owner of car (wife) not responsible under § 523(a)(6) for injuries caused by husband who was driving while intoxicated, without a license, and without insurance. Creditor failed to establish that wife had given husband permission or
otherwise allowed husband to drive the car, thus wife's conduct could not be said to have been willful under § 523(a)(6). Plaintiff's injury was not substantially certain to result from wife's failure to insure the car.)

_Deroche v. Miller (In re Miller), 196 B.R. 334 (Bankr. E.D. La. 1996)_ (state court judgment against debtor for intentional, wanton, willful and malicious shooting by debtor's son is dischargeable under § 523(a)(6). "[T]he phrase 'by the debtor' follows the phrase 'for willful and malicious injury' [in § 523(a)(6)]. Thus, the plain meaning test requires that the debtor must have been the one who caused the willful and malicious injury. Imputed liability is insufficient.")

_Bairstow v. Sullivan (In re Sullivan), 198 B.R. 417 (Bankr. D. Mass. 1996)_ (damages for trespass and timber cutting by agents and employees of debtor is nondischargeable under § 523(a)(6) because debtor knew what was happening but deliberately did nothing to stop it. Debts based on vicarious liability are ordinarily dischargeable because they are not based on the deliberate or intentional conduct of the debtor. Where debtor knew or should have known of misconduct of agents and did nothing to stop it, the debt will be nondischargeable if it otherwise satisfies § 523(a)(6)).


"... for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, ... not compensation for actual pecuniary loss, other than tax penalty ...."


_United States Dep't of Housing & Urban Dev. v. Cost Control Mktg. & Sales Management of Va., Inc., 64 F.3d 920, 927-8 (4th Cir. 1995), cert. denied, ___ U.S. ___, 116 S. Ct. 1673, 134 L. Ed.2d 777 (1996)_ (order requiring the officers of a corporate real estate marketing firm to disgorge $8.65 million in profits pursuant to anti-fraud provisions of Interstate Land Sales Full Disclosure Act is nondischargeable under § 523(a)(7). The Supreme Court has given § 523(a)(7) a broad reading, and has held that it applies to all criminal and civil penalties, even those designed to provide restitution to injured private citizens. [Kelly v. Robinson, 479 U.S. 36 (1986)] ... We interpret these cases to say that so long as the government's interest in enforcing a debt is penal, it makes no difference that injured persons may thereby receive compensation for pecuniary loss. In other words, the 'not compensation for actual pecuniary loss' phrase in § 523(a)(7) refers to the government's pecuniary loss.")

_Betts v. Attorney Registration & Disciplinaty Comm'n, 165 B.R. 870 (N.D. Ill. 1994), aff'd mem., 51 F.3d 275 (7th Cir.), cert. denied, ___ U.S. ___, 116 S. Ct. 571, 133 L. Ed.2d 495 (1995)_ (Illinois Supreme Court rule that any attorney subject to discipline must reimburse the disciplinary commission for costs incurred imposes a nondischargeable liability under § 523(a)(7). The disciplinary commission is a "governmental unit." Inherent authority to regulate attorney admissions lies with the Illinois Supreme Court, and the commission "acts as an agent in administering its disciplinary function." Costs imposed by the commission acting in that capacity are
penal in nature because they are triggered by misconduct like the criminal fines in *Hollis* and *Zarzenski*. "Costs" imposed under the Supreme Court rule are a component of the discipline, and nondischargeable.

**County v. Damore (In re Damore),** 195 B.R. 40 (Bankr. E.D. Pa. 1996) (suretyship agreement that related to a forfeited bail bond was dischargeable where the debtor was not the defendant who failed to appear. Surety's obligation is contractual, not penal, and thus dischargeable under § 523(a)(7).)

**Compare** *Ricketson v. Florida Dep't of Environmental Protection (In re Ricketson),* 190 B.R. 684 (Bankr. M.D. Fla. 1995) (civil penalty awarded state department of environmental protection was not within the scope of § 523(a)(7)(B)). Section 523(a)(7)(B) applies only to "tax fines, forfeitures, and penalties." *with* *In re Corbly,* 149 B.R. 1367 (Bankr. D.S.D. 1992) (Section 523(a)(7)(B) is not limited to tax related penalties, fines or forfeitures.)

**Clayton v. Tennessee Dep't of Safety (In re Clayton),** 199 B.R. 29 (Bankr. W.D. Tenn. 1996) (statutory fees under state financial responsibility statute, which must be paid to regain driving privileges, constitute a "penalty" under § 523(a)(7). "First, the underlying offenses lend great weight to the determination that such statutory fees are penal sanctions for wrongdoing. The statutory fees are imposed upon a conviction for offenses ranging from driving without a license to vehicular homicide. Second, there is not a single reinstatement fee, but rather each offense carries a separate and distinct $65.00 fee... This cumulative characteristic of the reinstatement fees supports the proposition that the fees indeed are in the nature of 'penalties' as contemplated under 11 U.S.C. §523(a)(7).")

**H. 11 U.S.C. § 523(a)(8):**

"... for an educational benefit ...

1. Cosigners, guarantors and non-students

   **Keilig v. Massachusetts Higher Educ. Assistance Corp. (In re LaFlamme),** 188 B.R. 867 (Bankr. D.N.H. 1995) (that loan proceeds were used by debtor's child not by debtor, does not change calculus under § 523(a)(8). Nature of the loan, not identity of the borrower controls.); **Uterhark v. Great Lakes Higher Educ. Corp. (In re Uterhark),** 185 B.R. 39, 40-42 (Bankr. N.D. Ohio 1995) (debt nondischargeable where only the non-student parent is liable; Congress was concerned with solvency of educational loan programs as well as prevention of student fraud).

2. Government made, government guaranteed or funded by non-profit institution

   **T I Fed. Credit Union v. DelBonis,** 72 F.3d 921, 932-38 (1st Cir. 1995) (federal credit union is a "governmental unit" for purposes of § 523(a)(8); erroneous stipulation that credit union was "not a governmental unit" does not preclude appellate court from holding otherwise. "[H]istory demonstrates that federal credit unions were intended to perform a variety of governmental functions... to issue loans and dividends to their members... to invest their funds in obligations of the United States... [to] serve as fiscal agents of the
United States and depositories of public monies. . . In United States v. Michigan, 851 F.2d 803 (6th Cir. 1988), the Sixth Circuit found that federal credit unions are government instrumentalities precisely because they perform such functions. . . . [The] performance of governmental functions, exemption from federal tax, and extensive government regulation are compelling indicia of federal instrumentality status. . . . [T]reating federal credit unions as ‘government instrumentalities’ and, thus, ‘government units,’ is consistent with Section 523(a)(8)’s discharge-limiting purpose. . . . [N]arrowly construing the term ‘government unit’ to exclude federal credit unions would create a perverse incentive for educational debtors. . . . Allowing educational loans issued by federal credit unions to be freely discharged in bankruptcy could devastate many federal credit unions.”

Keilig v. Massachusetts Higher Educ. Assistance Corp. (In re LaFramme), 188 B.R. 867 (Bankr. D.N.H. 1995) (“Parent Plus Loans” originated with private bank are funded under the Higher Education Act of 1965 and are thus “made, insured or guaranteed by a governmental unit” within the scope of § 523(a)(8). That loan originated with private bank is not relevant.)

3. Scholarship v. loan; educational benefit overpayment

Santa Fe Medical Servs., Inc. v. Segal (In re Segal), 57 F.3d 342 (3d Cir. 1995) (loan made pursuant to an employment contract, although used to repay educational debt is not within the scope of § 523(a)(8). The loan did not facilitate the debtor’s education, rather it was an inducement to accept employment. Discharge of the obligation to the employer/refinancer did not frustrate the purposes of § 523(a)(8). The nonprofit institution, federal treasury or service obligation would not be affected; they were fully satisfied.); A.L. Lee Memorial Hospital v. McFayden (In re McFayden), 192 B.R. 329 (Bankr. N.D.N.Y. 1995) (hospital’s buyout of debtor’s tuition costs for completing nursing school in exchange for a three year commitment to hospital is beyond § 523(a)(8). While the hospital was a nonprofit institution, and the loan was made as part of a program, the loan did not constitute an educational loan. “Educational loans” are “made without business considerations.” The loan at issue was “inextricably tied to the Debtor’s employment with the Plaintiff as a registered nurse for a period of three years. It was an ‘all or none’ proposition. . . . [T]he Plaintiff’s program was intended not as an educational benefit to the Debtor, but rather it was intended to benefit the Plaintiff by assuring that it had a qualified nursing staff on a relatively long-term basis.”)

Dakota Wesleyan Univ. v. Nelson (In re Nelson), 188 B.R. 32 (D.S.D. 1995) (rejecting Najafi v. Cabrini College (In re Najafi), 154 B.R. 185 (Bankr. E.D. Pa. 1993), and Stone, 180 B.R. 499 (Bankr. M.D. Tenn. 1995), as flawed and unsupportable, debts incurred on open account with university for tuition, room and board, course fees, books and supplies are not loaned funds and were not advanced as an educational benefit by an institution that qualifies under § 523(a)(8)).
4. Measurement of seven-year period

Gibson v. Virginia, State Educ. Assistance Authority (In re Gibson), 86 F.3d 1150 (4th Cir. 1996) (table decision; text at 1996 WL 267322) (105 days during which the debtor's Chapter 7 case was pending is an "applicable suspension" excluded from the 7-year counting period in § 523(a)(8)); Williams v. United States Dept' of Educ. (In re Williams), 195 B.R. 644 (Bankr. N.D. Tex. 1996) (automatic stay of prior bankruptcy filing tolled running of seven year period under § 523(a)(8)(A)).

Nunn v. Washington (In re Nunn), 788 F.2d 617 (9th Cir. 1986) (all of a student loan is dischargeable under § 523(a)(8) if the first repayment installment became due more than five years prior to petition. Subsequent installments becoming due within the five-year period and partial payments by debtor within five years of petition do not render any portion of the student loan nondischargeable. Congressional intent behind five-year provision was to prohibit recipients from completing studies and precipitously filing bankruptcy.)

Feuer v. Pennsylvania College of Podiatric Medicine (In re Feuer), 195 B.R. 866 (Bankr. E.D. Pa. 1996) (change from five to seven years applied to debtor whose loan was initiated when five year rule was in effect. Application of the longer period did not threaten any protected property interest.)

5. Undue hardship

Cuenca v. Dep't of Educ., 64 F.3d 669 (10th Cir. 1995) (Table decision; text at 1995 WL 49511), cert. denied, ___ U.S. ___, 116 S. Ct. 1044, 134 L. Ed.2d 191 (1996) (not undue hardship for debtor with income of $36,000 to repay student loan of $37,724.02. "'Undue hardship' means something more than an inconvenience or doing without what most would regard as luxuries. Student loans are different from most loans. They are made without the usual protections given to a lender.... Consequently, the discharge of a student loan should be based upon an inability to earn and not simply a reduced standard of living.")

Pennsylvania Higher Educ. Assistance Agency v. Faish (In re Faish), 72 F.3d 298 (3d Cir. 1995) (adopts undue hardship standard in Brunner, 831 F.2d 395 (2d Cir. 1987). "The Brunner standard meets the practical needs of the debtor by not requiring that he or she live in abject poverty for up to seven years before a student loan may be discharged. [Yet, the] Brunner standard safeguards the financial integrity of the student loan program by not permitting debtors who have obtained the substantial benefits of an education funded by taxpayer dollars to dismiss their obligation merely because repayment... would require some major personal and financial sacrifices. ... Equitable concerns or other extraneous factors not contemplated by the Brunner framework may not be imported into the court's analysis to support a finding of dischargeability."); Mayer v. Pennsylvania Higher Educ. Assistance Agency (In re Mayer), 198 B.R. 116 (Bankr. E.D. Pa. 1996) (under Faish the court need not consider the debtor's motivation for filing bankruptcy. Faish did not retain the requirement that debtor maintain only a minimal standard of living.)
"Faish... appears to direct that a bankruptcy court take a broader view of the debtor's financial circumstances. ... [T]he Faish court makes no mention of the fact that the Faish debtor's income [was] over twice that of the applicable poverty guidelines." That debtor maintained a standard of living above the poverty level was not determinative.)

Rice v. United States (In re Rice), 78 F.3d 1144, 1149-50 (6th Cir. 1996) (more stringent "unconscionable" standard in 42 U.S.C. § 292f(g) is applied to determine the dischargeability of HEAL loan; citing Brunner, bankruptcy courts should examine totality of the circumstances to determine unconscionability of HEAL loans. "[I]n employing the term 'unconscionable,' Congress intended to adopt the ordinary usage of the term as 'excessive, exorbitant,' 'lying outside the limits of what is reasonable or acceptable,' 'shockingly unfair, harsh, or unjust,' or 'outrageous.' ... We find the standard imposed by this definition of 'unconscionability' to be significantly more stringent than the 'undue hardship' standard established for the discharge of educational loans under 11 U.S.C. § 523(a)(8)(B). ... [W]e believe that bankruptcy courts should examine the totality of the facts and circumstances surrounding the debtor and the obligation to determine whether nondischarge of the obligation would be unconscionable. ... [T]he bankruptcy court should be guided principally by such objective factors as the debtor's income, earning ability, health, educational background, dependents, age, accumulated wealth, and professional degree. ... [T]he court should consider the amount of the debt... the rate at which interest is accruing... [T]he court should examine the debtor's claimed expenses and current standard of living... ascertaining whether the debtor has attempted to minimize the expenses of himself and his dependents. ... [T]he court should examine whether, and to what extent, the debtor's current situation is likely to continue or improve... whether the debtor has attempted to maximize his income... whether the debtor is capable of supplementing his income... whether [dependents] are, or could be, contributing financially to their own support... the debtor's previous efforts to repay the HEAL obligation... the debtor's financial situation over the course of time when payments were due;... the debtor's voluntary undertaking of additional financial burdens despite his knowledge of his outstanding HEAL debt;... the percentage of the debtor's total indebtedness represented by student loans. ... We believe the debtor's good faith to be an appropriate and necessary consideration."); Hornsby v. Tennessee Student Assistance Corp. (In re Hornsby), 201 B.R. 195 (Bankr. W.D. Tenn. 1996) (Cheesman set forth three factors to guide inquiry into undue hardship: "(1) whether the debtor is capable of paying the loan while maintaining a minimal standard of living; (2) whether the debtor's financial situation will improve in the foreseeable future; and (3) whether the debtor is acting in good faith or is attempting to abuse the student loan system by having a loan forgiven before embarking upon a lucrative career in the private sector." Debtors earn a combined monthly net income of $2,556.66, which results in "surplus" income of between $191 and $280 depending on overtime. Notwithstanding income that is far above the national poverty level of $17,710 for a family of five, debtors fell behind on their obligations several times during the year while maintaining a modest lifestyle. To require debtors to repay student loan would "cause the Debtors to default on several of their existing obligations." "[T]his Court is of the opinion that Debtors should not be forced to live at or near the
poverty level in order to prove an undue hardship exception to the nondischargeability of student loans.” Further, because there was little likelihood that debtors’ financial (mis)fortunes would change in the foreseeable future and there was no evidence of bad faith, loans were dischargeable.; Fox v. Student Loan Mkgt. Ass’n (In re Fox), 189 B.R. 115 (Bankr. N.D. Ohio 1995) (three-pronged test of undue hardship from Johnson, 5 Bankr. Ct. Dec. 532 (Bankr. E.D. Pa. 1979) will be met only “under circumstances of extraordinary hardship, rather than mere hardship, financial adversity, or present inability to pay . . . . However, sometimes where undue hardship is not found it may be equitable to reduce the nondischargeable portion of the obligation.” Debtor’s “failure to maximize income from her [soon-to-be ex-husband’s] untapped earning potential or child care services” resulted in only a portion of debtor’s student loan being discharged.; Elebrashy v. Student Loan Corp. (In re Elebrashy), 189 B.R. 922 (Bankr. N.D. Ohio 1995) (court adopts “slightly modified version of the Johnson test . . . . in Brunner [831 F.2d 395 (2d Cir. 1987)].” Monthly net income of $1,213 with modest expenses totaling $1,325 demonstrated a minimal standard of living. Nothing budgeted for entertainment, newspapers or education other than $35 per month for cable television. No reserve for unforeseen expenditures. Debtor had no expectation for advancement in the foreseeable future. That debtor’s wife did not contribute to family income did not change the calculus—her English was poor and employment in the future was speculative. Debtor acted in good faith. Although no payments were made on the $42,000 of student loans prior to filing, debtor made payments toward the debt for three years under a chapter 13 plan.)

Keilig v. Massachusetts Higher Educ. Assistance Corp. (In re LaFlamme), 188 B.R. 867 (Bankr. D.N.H. 1995) (to quality for an undue hardship discharge debtor’s condition must be “something extraordinary and exceptional and generally indicate a hopelessness for the indefinite future as to any possibility of repayment.”)


Commonwealth v. Dillon, 189 B.R. 382 (W.D. Va. 1995) (no undue hardship under three part test of Brunner where debtor testified that she and her husband
could pay $50 to $75 a month to retire the student loan and payments would not cause their standard of living to fall below that minimally necessary.)

O'Donnell v. New Hampshire Higher Educ. Assistance Foundation (In re O'Donnell), 198 B.R. 1 (Bankr. D.N.H. 1996) (student loan could not be discharged because debtor able to increase her income in the future. However, repayment deferred for six months to allow debtor to become settled in new job or to obtain more stable employment); Dennehy v. Sallie Mae (In re Dennehy), 201 B.R. 1008 (Bankr. N.D. Fla. 1996) (student loan is nondischargeable but repayment and accrual of interest “deferred” for two years).

Walcott v. USA Funds, Inc. (In re Walcott), 185 B.R. 721, 725 (Bankr. E.D.N.C. 1995) (despite substantial, unsuccessful effort to find employment, debt nondischargeable where debtor is “very articulate, has no disabilities or dependents, has family support, has an education, has some experience teaching literacy, and has the prospect of advancing in that field . . . [and] does not suffer from any extraordinary circumstances.” Chapter 7 filed shortly after debtor ran out of loan deferments).


“... for death or personal injury caused by the debtor’s operation of motor vehicle if such operation was unlawful because the debtor was intoxicated . . . .”

In re Reese, 91 F.3d 37 (7th Cir. 1996) (§ 523(a)(9) does not violate the uniformity clause notwithstanding that states may affect the scope of the discharge under § 523(a)(9) through varying definitions of unlawful driving under the influence).

Hoehn v. Taneff (In re Taneff), 172 B.R. 744 (Bankr. W.D.N.Y. 1994), rev’d on other grounds, 190 B.R. 501 (W.D.N.Y. 1996) (§ 523(a)(9) applies only to driver-debtors. It is not sufficiently broad to cover obligations imposed on nondriver debtors by state dram shop statutes. Dischargeability of a debt arising under dram shop statute may be challenged, if at all, under § 523(a)(6).)

Willison v. Race, 192 B.R. 949 (W.D. Mo. 1995) (the phrase “motor vehicle” in § 523(a)(9) is not limited to its common understanding. While neither the Code nor the legislative history are particularly useful in defining the phrase, “[c]learly, the provision was enacted to protect the victims of irresponsible persons who get drunk and injure others. Congress could not have intended for the drunk boater’s victim to suffer while the drunk boater floats away with a ‘fresh start.’”), on remand, 198 B.R. 740 (Bankr. W.D. Mo. 1996) (plaintiff failed to establish that debtor was intoxicated at the time the collision occurred); Radivoj v. Williams (In re Williams), 101 B.R. 356 (Bankr. S.D. Fla.), aff’d, 111 B.R. 361 (S.D. Fla. 1989) (motorboat is a motor vehicle for purposes of § 523(a)(9)). Contra Boyce v. Greenway (In re Greenway), 71 F.3d 1177, 1179-80 (5th Cir.), cert. denied, ___ U.S. ___, 116 S. Ct. 2499, 135 L. Ed.2d 191 (1996) (motorboat is not a “motor vehicle” for purposes of § 523(a)(9). “The terms ‘motorboat’ or ‘water craft’ do not appear in § 523(a)(9) of the Bankruptcy Code. . . . Congress has used ‘motor vehicle’ to refer exclusively to automobiles in other statutes. . . . The above definitions comport with our understanding that the plain and common meaning of the term ‘motor vehicle’ does not include motorboats. Had
Congress intended to include motorboats within § 523(a)(9) they would have either defined the term 'motor vehicle' to include motorboats or added motorboats to the exception."; Schachter v. Fall (In re Fall), 192 B.R. 16 (Bankr. D.N.H. 1995) (motor boat is not motor vehicle within § 523(a)(9)).


for any payment of restitution under title 18, United States Code.


incurred to pay a tax to the United States that would be nondischargeable pursuant to paragraph (1).

MBNA America v. Chrusz (In re Chrusz), 196 B.R. 221 (Bankr. D.N.H. 1996) ($16,000 credit card access check deposited two days before debtor issued a check to the IRS for $28,007.04 is nondischargeable to the extent of $13,641.60. Notation on check read “Bus/IRS/Taxes,” which rebutted debtor’s testimony that the advance was not taken to pay taxes. Amount declared nondischargeable represented the ratio between the payment to IRS and the total balance in commingled account at the time the check was deposited, or 85.26 percent.)


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;
1. Timing of decision

Christison v. Christison (In re Christison), 201 B.R. 298 (Bankr. M.D. Fla. 1996) ("The relevant date for Section 523(a)(15) analyses is at or about the time of trial. . . . It obviously is impossible . . . for the court to anticipate future events. To the extent that support obligations are subject to changing circumstances, those future events are left to disposition by the divorce court."); Willey v. Willey (In re Willey), 198 B.R. 1007 (Bankr. S.D. Fla. 1996) (applies time of trial standard but notes that a different standard may apply in another case).

Greenwalt v. Greenwalt (In re Greenwalt), 200 B.R. 909 (Bankr. W.D. Wash. 1996) (ability to pay is measured from the trial date).

Henderson v. Henderson (In re Henderson), 200 B.R. 322 (Bankr. N.D. Ohio 1996) (debtor’s financial condition at time of trial should be considered for purposes of § 523(a)(15)).


Becker v. Becker (In re Becker), 185 B.R. 567 (Bankr. W.D. Mo. 1995) (§ 523[(a)](15) is "concerned with the relative positions of the parties at the time of the bankruptcy, not at the time of the divorce").

Samayoa v. Jodoin (In re Jodoin), 196 B.R. 845 (Bankr. E.D. Cal. 1996) (date for assessing debtor’s ability to pay and for balancing the benefit and the burden of discharge is the trial date); Bodily v. Morris (In re Morris), 193 B.R. 949 (Bankr. S.D. Cal. 1996) (measure the debtor’s ability to pay and the relative harm to the parties at the time of trial).

Sterna v. Paneras (In re Paneras), 195 B.R. 395 (Bankr. N.D. Ill. 1996) (court will consider relative financial positions at the time of trial; evidence of future prospects is relevant); Gantz v. Gantz (In re Gantz), 192 B.R. 932 (Bankr. N.D. Ill. 1996) ("Facts and circumstances existing at the time of trial provide the most pragmatic measuring stick to assess whether the Debtor has the ability to pay the debt or whether the benefit of a discharge outweighs the detrimental consequences to the non-debtor spouse."); Hill v. Hill (In re Hill), 184 B.R. 750
In re Smith, 194 B.R. 102 (Bankr. W.D. Ky. 1996) (the date of trial is the appropriate starting point for making determinations under § 523(a)(15). However, the court’s “inquiry in this matter is not controlled by mere 'snapshot' of the debtor's financial strength as of a single moment in time. Rather, this inquiry must allow a court to consider the debtor's prospective earning ability. Unlike Chapter 13 cases where, if a debtor's finances improve or deteriorate, plan payments can be adjusted over the term of the plan, the court has no ability to revisit a debtor's financial circumstances after the conclusion of the trial on the 11 U.S.C. § 523(a)(15) issues.”); Belcher v. Owens (In re Owens), 191 B.R. 669 (Bankr. E.D. Ky. 1996) (measure ability to pay at the time of trial).

Schmitt v. Eubanks (In re Eubanks), 197 B.R. 312 (Bankr. W.D. Ark. 1996) (relevant point of inquiry is the time of trial; however, appropriate analysis under § 523(a)(15) “includes a view of the debtor's future financial situation, including an ability to make minimal monthly payments on the debt, rather than a static view of the debtor's current ability to pay the debt.”). Accord Johnston v. Henson (In re Henson), 197 B.R. 299 (Bankr. E.D. Ark. 1996).

Humiston v. Huddelston (In re Huddelston), 194 B.R. 681 (Bankr. N.D. Ga. 1996) (“the point of inquiry mandated by section 523(a)(15) appears nebulous at best. . . . Whether measured at the petition date or at the time of trial, the adopted ‘snap shot’ version of the disposable income test fails to take into account the nature of the analysis at hand -- the debtor's 'ability to pay' a debt, if that debt is declared nondischargeable. Unlike any analysis under section 1325(b)(2), which actually turns on the ability to make payments in the bankruptcy, section 523(a)(15) looks beyond to the debtor's ability to pay after the bankruptcy event. . . . Indeed, any standard which focuses on the debtor's current financial burden without taking into account the effect of his impending discharge may not be said to properly measure the debtor's ability to pay a divorce-related debt upon its relegation to nondischargeability. . . . Perhaps more importantly, a single-factorized 'snap shot' approach that looks only to existing disposable income will do nothing to account for debtors, . . ., who for whatever reason have underemployed themselves in the near term. . . . [A] 'snap shot' standard would lead to the incongruous result of a discharge being granted despite the debtor's actual 'ability' to pay the debt in question.”)

Craig v. Craig (In re Craig), 196 B.R. 305 (Bankr. E.D. Va. 1996) (the court should examine whether the debtor has the ability to pay the debt over time, rather than at any particular point in time).

2. Burden of proof.

Cleveland v. Cleveland (In re Cleveland), 198 B.R. 394 (Bankr. N.D. Ga. 1996) (creditor bears initial burden of establishing that the debt owed arose from out of a divorce or separation agreement and that it is not a debt for alimony, maintenance or support under § 523(a)(5). Thereafter the debtor has the burden of proving ability to pay and that the relative benefits of discharge
favor the debtor.); Humiston v. Huddelston (In re Huddelston), 194 B.R. 681 (Bankr. N.D. Ga. 1996) (creditor bears initial burden of establishing that debt falls within § 523(a)(15), thereafter burden shifts to debtor to demonstrate either that he lacks the ability to pay, or that discharge of the debt would produce a benefit to the debtor that far exceeds any detriment to the former spouse.)

Morris v. Morris (In re Morris), 197 B.R. 236 (Bankr. N.D. W. Va. 1996) (The burden of going forward and the burden of proof are bifurcated on the issues of ability to pay and relative harm. The debtor has the burden on the issue of ability to pay, as the creditor has no motivation to meet that burden—if the debtor has no ability to pay the inquiry stops. If the debtor has the ability to pay, then the creditor has the burden to prove that the detrimental consequences to the creditor outweigh those to the debtor.)

Samayoa v. Jodoin (In re Jodoin), 196 B.R. 845 (Bankr. E.D. Cal. 1996) (both § 523(a)(15)(A) and (B) “are drafted in terms of defenses rather than as substantive elements of nondischargeability.” Thus, debtor has the burden of proof on both issues.); Bodily v. Morris (In re Morris), 193 B.R. 949 (Bankr. S.D. Cal. 1996) (under § 523(a)(15) burden is shifted to the debtor to establish inability to pay and that the balance of equities is in debtor’s favor. The burden shift “amplifies the policy that even though the debtor is entitled to a fresh start, the debtor sometimes must show he or she deserves a fresh start with respect to a particular debt.”)

Gamble v. Gamble (In re Gamble), 196 B.R. 54 (Bankr. N.D. Tex. 1996) (the burden of proof is on the debtor under § 523(a)(15). Section 523(a)(15) “sets up a rebuttable presumption that any property settlement obligation arising from a divorce is nondischargeable unless the debtor can prove that one of the two exceptions in subdivisions (A) or (B) apply.”)

Taylor v. Taylor (In re Taylor), 199 B.R. 37 (N.D. Ill. 1996) (plaintiff has burden of proof as to both ability to pay and relative detriments under § 523(a)(15)); Sterna v. Paneras (In re Paneras), 195 B.R. 395 (Bankr. N.D. Ill. 1996) (once plaintiff establishes the existence of a debt within the scope of § 523(a)(15), burden of going forward shifts to the debtor to show either that debtor does not have the ability to pay or that the discharge would be more beneficial to debtor than detrimental to the former spouse); Collins v. Florez (In re Florez), 191 B.R. 112 (Bankr. N.D. Ill. 1995) (burden shifts to debtor to prove either inability to pay or that the benefit of discharge outweighs the detriment to the creditor as a result of the discharge); Hill v. Hill (In re Hill), 184 B.R. 750 (Bankr. N.D. Ill. 1993) (debtor has burden of proof under § 523((a)(15)(A) & (B). Subsections (A) and (B) are in the nature of affirmative defenses which debtor must plead and prove.)

King v. Speaks (In re Speaks), 193 B.R. 436 (Bankr. E.D. Va. 1996) (inability to pay and balance of harm are affirmative defenses to be raised and proved by the debtor. That the plaintiff did not allege these issues in her complaint was not fatal.); Craig v. Craig (In re Craig), 196 B.R. 305 (Bankr. E.D. Va. 1996) (burden is on debtor to prove inability to pay and to demonstrate that the
benefit of a discharge of this debt outweighs the detriment of discharge to the
former spouse).

1996) (debtor bears burden of proving either inability to pay or that benefit of
discharge outweighs detriment of discharge to creditor); Willey v. Willey (In
re Willey), 198 B.R. 1007 (Bankr. S.D. Fla. 1996) (burden on objecting
creditor); Phillips v. Phillips (In re Phillips), 187 B.R. 363, 368 (Bankr. M.D.
Fla. 1995) (debtor has burden of proof).

(burden shifts to debtor).

(debtor has burden of proof); Woodworth v. Woodworth (In re Woodworth),

523(a)(15) creates a rebuttable presumption of nondischargeability. Nondebtor
must prove only a claim arising out of a divorce which is not covered by
§ 523(a)(5). To overcome presumption, debtor must establish either an
inability to pay or that the benefit to the debtor from discharge of the debt
outweighs the benefit to the nondebtor in having the debt declared
nondischargeable. Ability to pay looks beyond the debtor's current financial
resources, much like the inquiry under § 523(a)(8).)

(§ 523(a)(15) sets up rebuttable presumption that any property settlement
obligation is nondischargeable unless debtor can prove either inability to pay
debt from income or property while supporting herself and dependents or
continuing, preserving, or operating a business, or on balance the debt should
be discharged because benefit to debtor outweighs detriment to former
1995) (after creditor/former spouse proves a claim for property settlement,
burden of going forward, but not burden of proof, shifts to debtor).

In re Stone, 199 B.R. 753 (Bankr. N.D. Ala. 1996) (exhaustively collecting and
analyzing § 523(a)(15) cases discussing burden of proof, debtor has burden to
prove exceptions within the exception, citing Hill v. Smith, 260 U.S. 592
(1923)); McGinnis v. McGinnis (In re McGinnis), 194 B.R. 917 (Bankr. N.D.
Ala. 1996) (section 523(a)(15) "sets up rebuttable presumption of
nondischargeability upon the filing of an adversary proceeding. . . . [T]he non-
debtor spouse bears the initial burden of establishing that the debt arose in the
course of a separation agreement. . . . Thereafter, the burden of coming forth
shifts to the debtor to demonstrate that the debtor lacks the ability to pay the
obligation or that the benefit of the discharge would outweigh the detrimental
consequences to the non-debtor spouse.); Anthony v. Anthony (In re
Anthony), 190 B.R. 433 (Bankr. N.D. Ala. 1995) (debtor has burden of proof
under § 523(a)(15)(A) & (B)).
In re Smither, 194 B.R. 102 (Bankr. W.D. Ky. 1996) (creditor must demonstrate that the debt is of a kind dealt with under § 523(a)(15), then the burden shifts to the debtor who “must either prove an inability to pay the debt under § 523(a)(15)(A) or that a discharge of the debt would result in a benefit to the debtor that outweighs the detrimental consequences of a discharge to the spouse, former spouse or children of the debtor under § 523(a)(15)(B). . . . [B]oth the debtor and creditor will [however] have to present evidence under Section 523(a)(15)(B) concerning the consequences of the discharge on the respective parties.”

Greenwalt v. Greenwalt (In re Greenwalt), 200 B.R. 909 (Bankr. W.D. Wash. 1996) (inasmuch as the statute and rules do not allocate the burden of proof under § 523(a)(15), the court follows Grogan and holds that a plaintiff in an action under § 523(a) bears the burden on all issues).

Dressler v. Dressler (In re Dressler), 194 B.R. 290 (Bankr. D.R.I. 1996) (“Congressional silence should not be read to overturn long-standing burden of proof rules. . . . Although § 523(a)(15)’s structure bears resemblance to that of § 523(a)(8) . . . , that resemblance is insufficient to demand burden shifting under § 523(a)(15) because the context and requirements of the section differ in telling ways. . . . The statute and the rules do not require[] procedural gymnastics. . . . Congress did not intend the section to be a complex provision. . . . A § 523(a)(15) plaintiff has every motivation (and ability) to demonstrate that the debtor has the ability to pay the obligation in question. And the plaintiff has the motivation (and ability) to prove that the detrimental consequences of discharge outweigh the benefits that the debtor would otherwise gain. . . . [T]he § 523(a)(15) plaintiff [therefore] bears the burden of production and proof on all elements of dischargeability.”)

Adie v. Adie (In re Adie), 197 B.R. 8, n.1 (Bankr. D.N.H. 1996) (“the proper interpretation is that the burden of proof in the sense of burden of persuasion is on the creditor seeking a nondischargeability determination under § 523(a)(15) of what would otherwise be a dischargeable debt.”)


3. Tests and standards

Beasley v. Adams (In re Adams), 200 B.R. 630 (N.D. Ill. 1996) (bankruptcy court may properly consider anticipated changes in the financial situations of the parties “because, in applying balancing tests of the type required by Section 523(a)(15)(B), bankruptcy judges must consider the ‘totality of the circumstances.’’’); Taylor v. Taylor (In re Taylor), 199 B.R. 37 (N.D. Ill. 1996) (that debtor has ability to pay is not dispositive or even suggestive of the balancing of relative detriment. Plaintiff must prove by a preponderance of the evidence that the detriment suffered by plaintiff would substantially outweigh the benefit to debtor of the fresh start. In weighing the relative benefits the court should consider “a variety of factors, including the amount and nature of the debt sought to be discharge, the conduct of the parties, and the income and expenses of the parties.”’’); Jenkins v. Jenkins (In re Jenkins),
202 B.R. 102 (Bankr. C.D. Ill. 1996) ("[A] judgment against Debtor . . . would not improve [ex-spouse's] monthly financial deficit -- its effect would be a virtual wash. Even if Plaintiff were awarded all she asks for . . . [her] budget indicates that she would continue to fall [behind each month]. This is one of the all-too-common instances in which '[a] discharge of debts by both parties strikes the Court as the most sensible solution . . . .’"); Sterma v. Paneras (In re Paneras), 195 B.R. 395 (Bankr. N.D. Ill. 1996) (disposable income standard is proper test of debtor’s ability to pay under § 523(a)(15)(A)); Collins v. Florez (In re Florez), 191 B.R. 112 (Bankr. N.D. Ill. 1995) ("subsections (A) and (B) of Section 523(a)(15) are disjunctive, [therefore] no equitable factors figure into the Debtor’s ability to pay under Section 523(a)(15)(A). The irony is that the Plaintiff could be a millionaire, but that is irrelevant to the analysis under Section 523(a)(15)(A). A debtor may be forced to struggle to pay off an obligation from a paltry salary while the ex-spouse maintains a more advantageous financial position. The concept of a fresh start is amply challenged by application of Section 523(a)(15)(A). [In many cases,] the Court is forced to apply Section 523(a)(15)(A) in a way which nickels and dimes the Debtor.”); Hill v. Hill (In re Hill), 184 B.R. 750 (Bankr. N.D. Ill. 1995) (Section 523(a)(15)(A)’s “ability to pay” test is similar to § 1325(b)(2)’s “disposable income” test. Factors relevant to § 523(a)(15)(B) include: “the income and expenses of both parties; whether the nondebtor spouse is jointly liable on the debts; the number of dependents; the nature of the debts; the reaffirmation of any debts; and the nondebtor spouse’s ability to pay.” Where discharge will cause both parties significant detriment, the debtor must prevail. Where the debtor’s fresh start is weighed against the possibility that the nondebtor may be forced to file bankruptcy, the debtor’s fresh start should prevail. “A discharge of debts by both parties strikes the courts as the most sensible solution to the combined problems of the Plaintiff and the Debtor.” Court rejects “undue hardship” comparison.)

Christison v. Christison (In re Christison), 201 B.R. 298 (Bankr. M.D. Fla. 1996) (disposable income test is appropriate under § 523(a)(15)(A). Congress did not intend “to force debtors with obligations under domestic property settlements into a poverty state but instead intended to require these debtors to pay obligations to former spouses under property settlement agreements if they could also pay the normal and reasonable everyday living expenses for themselves and their new families.”); Willey v. Willey (In re Willey), 198 B.R. 1007 (Bankr. S.D. Fla. 1996) (“If debtor prevails under § 523(a)(15)(A), where the debtor has no ability to pay the debt, the inquiry must end and the debt must be discharged.” Disposable income analysis of § 1325(b) appropriate for purposes of calculating debtor’s ability to pay under § 523(a)(15)(A). Under § 523(a)(15)(B) court should look at the totality of the circumstances).

Humiston v. Huddelston (In re Huddelston), 194 B.R. 681 (Bankr. N.D. Ga. 1996) (disposable income test of § 1325(b)(2) is the appropriate standard by which to evaluate ability to pay, provided that a broader net is cast to properly view ability in light of all relevant circumstances. “Whether measured at the petition date or at the time of trial, the adopted ‘snap shot’ version of the disposable income test fails to take into account the nature of the analysis at hand -- the debtor’s ‘ability to pay’ a debt, if that debt is declared nondischargeable. Unlike any analysis under section 1325(b)(2), which
actually turns on the ability to make payments in the bankruptcy, section 523(a)(15) looks beyond to the debtor's ability to pay after the bankruptcy event. . . Indeed, any standard which focuses on the debtor's current financial burden without taking into account the effect of his impending discharge may not be said to properly measure the debtor’s ability to pay a divorce-related debt upon its relegation to nondischargeability. . . Perhaps more importantly, a single-factor ‘snap shot’ approach that looks only to existing disposable income will do nothing to account for debtors, . . . who for whatever reason have underemployed themselves in the near term. . . [A] ‘snap shot’ standard would lead to the incongruous result of a discharge being granted despite the debtor’s actual ‘ability’ to pay the debt in question.” Within this scope the court must consider the totality of circumstances, which has proven the most accurate gauge to make similar findings of ability to pay under § 523(a)(8). Factors such as income and expenses of each party, a former spouse’s ability to pay the debt, and the nature of the debt “present a starting point of inquiry [under § 523(a)(15)(B)], . . . courts also must give weight to the intangible effect that [their] findings[s] have will upon each party involved.”); Cleveland v. Cleveland (In re Cleveland), 198 B.R. 394 (Bankr. N.D. Ga. 1996) (debtor “may not rely upon a ‘snapshot’ of his financial abilities at the time of filing. . . Rather, [debtor]s must prove entitlement to discharge by reference to the totality of their financial circumstances. . . . Notwithstanding the results of any closely tailored financial snapshot, if surveying these broader considerations reveals an actual ability to perform, the debtor cannot avail himself of section 523(a)(15)’s safe harbor.”)

Greenwalt v. Greenwalt (In re Greenwalt), 200 B.R. 909 (Bankr. W.D. Wash. 1996) (ability to pay standard is more akin to the disposable income test of § 1325(b)(2) “given the use of the phrase ‘reasonably necessary’ in both sections of the Code, and further given the fact that § 523(a)(15) debts are dischargeable in Chapter 13. Under this standard, the court must critically assess the debtor’s budgeted expenses to determine the minimum the debtor could afford to pay over a three year period. . . . The court need not accept debtor’s assessment of what expenses are ‘reasonably necessary.’ . . . The debtor should not be permitted to direct the outcome of this proceeding by voluntary manipulations of either his income or his expenditures.” “[S]imply providing the debtor with additional disposable income is not the kind of benefit Sec. 523(a)(15)(B) ought to protect.” The court must assess the totality of circumstances of both parties including the effect of the bankruptcy discharge on the debtor and the assets of the former spouse, for while the nondebtor may not be able to pay the debt at issue she may not be judgment proof.)

In re Smither, 194 B.R. 102 (Bankr. W.D. Ky. 1996) (ability to pay requires a four step analysis: “First, the Court will have to determine the amount of the debts which a creditor is seeking to have held nondischargeable and the repayment terms and conditions of those debts. Second, the Court will have to calculate the Debtor’s current income and the value and nature of any property which the Debtor retained after his bankruptcy. Third, the Court will have to ascertain the amount of reasonable and necessary expenses which the debtor must incur for the support of the Debtor, the Debtor’s dependants and the continuation, preservation and operation of the Debtor’s business, if any.
Finally, the Court must compare the Debtor’s property and current income with his reasonable and necessary expenses to see whether Debtor has the ability to pay these obligations.” Analysis of debtor’s income must be viewed under the rubric of chapter 13’s disposable income test of § 1325(b)(2). Excess income is not determinative of the court’s consideration under § 523(a)(15)(B). Focus on excess income “ignores the value of the Debtor’s discharge and simply blends 11 U.S.C. § 523(a)(15)(B) into an inseparable mass with 11 U.S.C. § 523(a)(15)(A) . . . . [T]he best way to apply 11 U.S.C. § 523(a)(15)(B) balancing test is to review the financial status of the debtor and the creditor and compare their relative standards of living to determine the true benefit of the debtor’s possible discharge against any hardship the spouse, former spouse and/or children would suffer as a result of the debtor’s discharge. If, after making this analysis, the debtor’s standard of living will be greater than or approximately equal to the creditor’s if the debt is not discharged, then the debt should be nondischargeable under the [§] 523(a)(15)(B) test . . . . [W]here either a Debtor or Creditor has voluntarily reduced their income, that voluntarily [sic] reduction should still be considered by the Court in making the [§] 523(a)(15)(B) balancing test.”; Patterson v. Patterson (In re Patterson), 199 B.R. 21 (Bankr. W.D. Ky. 1996) (a typical trial under § 523(a)(15) will proceed as follows: 1) decree will be used a starting point to determine if indebtedness falls within this section; 2) then debtor will be required to demonstrate inability to pay; 3) then, if debtor fails, plaintiff will be required to demonstrate the detrimental consequences of the discharge; and finally, 4) debtor may present rebuttable proof with respect to detriment to the debtor); Belcher v. Owens (In re Owens), 191 B.R. 669 (Bankr. E.D. Ky. 1996) (disposable income analysis of § 1325(b) appropriate for purposes of calculating debtor’s ability to pay under § 523(a)(15)(A)).

Campbell v. Campbell (In re Campbell), 198 B.R. 467 (Bankr. D.S.C. 1996) (proper test to determine ability to pay is the disposable income test of § 1325(b)); Scott v. Scott (In re Scott), 194 B.R. 375 (Bankr. D.S.C. 1995) (analysis under § 523(a)(15), like § 523(a)(8), requires consideration of future income prospects. Where debtor physician had realistic prospect to increase income from $60,000 to $140,000 and where most of debtor’s $168,000 in prepetition debts would be discharged, debtor had the ability to pay $35,000 in marital debts under property settlement agreement.)

Florio v. Florio (In re Florio), 187 B.R. 654, 657 (Bankr. W.D. Mo. 1995) (determine ability to pay on case by case basis; § 523(a)(8) analysis is helpful).

Woodworth v. Woodworth (In re Woodworth), 187 B.R. 174, 177 (Bankr. N.D. Ohio 1995) (“income or property of the debtor” in § 523(a)(15)(A) means debtor’s exempt property and postpetition income; “reasonably necessary for . . . maintenance and support” permits consideration of assistance or property from friends or relatives. Statute does not permit consideration of fact that discharging debts will result in non-debtor spouse having to pay debts from funds reasonably necessary for her support. As stated in legislative history, one factor favoring debtor is that spouse probably judgment-proof); Carroll v. Carroll (In re Carroll), 187 B.R. 197, 201 (Bankr. S.D. Ohio 1995) (under relative benefit and detriment test, examine totality of circumstances including
income and expenses of both parties, nature of debts, and non-debtor’s ability to pay debts).

**Schmitt v. Eubanks (In re Eubanks),** 197 B.R. 312 (Bankr. W.D. Ark. 1996) (section 523(a)(15)(B) requires court to “weigh the benefit against the detriment -- an odd balancing and an impossibly amorphous standard. Despite this odd language, the courts appear to engage in a balancing of numerous factors regarding the finances, needs, and general merits of each party’s position, trying to determine who will suffer more, . . ., an issue Congress foolishly placed exclusively before the federal courts rather than state domestic and family courts which are clearly the courts with the expertise to assess need of the former spouses and their families.”)

**Morris v. Morris (In re Morris),** 197 B.R. 236 (Bankr. N.D. W. Va. 1996) (ability to pay test mirrors the disposable income test of § 1325(b)(2). The court will consider combined annual income of the debtor and the debtor’s current spouse, and examine the debtor’s expenses to determine if they are reasonably necessary. Court will consider pension or retirement funds from which the debtor is currently receiving monthly distributions. No equitable factors figure into the court’s § 523(a)(15)(A) analysis. Balancing of equities under § 523(a)(15)(B) requires the court to “conduct a comparison of the relative financial conditions of the parties, while also keeping in mind the totality of each party’s circumstances.” Plaintiff with $500 surplus each month is in much better position to repay $6,800 indebtedness.)

**Adie v. Adie (In re Adie),** 197 B.R. 8 (Bankr. D.N.H. 1996) (“court cannot determine finally the ability to pay and/or ultimate detriment and benefit without knowing what the state court will do in [] scheduled hearings to consider adjusting the marital obligations of these parties[,]” due to the changed circumstances of bankruptcy.)

**Bodily v. Morris (In re Morris),** 193 B.R. 949 (Bankr. S.D. Cal. 1996) (standard for determining debtor’s ability to pay is § 1325(b)(2) not § 523(a)(8), as the former standard “permits the Court to consider reasonably projectable future events known at the time of trial. Under this standard, the court must also evaluate whether the debtor’s expenses are reasonably necessary for support.” A finding that debtor has the ability to pay, however, is not determinative of the balance of harms. “[F]orcing the Debtor to pay the equalizing debt [may] nickel[] and dime[]{] the Debtor and jeopardize[ ] [debtor’s] relationship with his children. While preservation of the Debtor’s relationship with his children may not be considered under §§ 523(a)(15)(A), the Court gives significant weight to this factor under § 523(a)(15)(B). This factor tips the scale in favor of discharging the debt where the Court also finds the Plaintiff is hopelessly in debt.”); Samayoa v. Jodoin (In re Jodoin), 196 B.R. 845 (Bankr. E.D. Cal. 1996) (a modified version of the disposable income test is the appropriate standard to evaluate ability to pay. The test must be modified “so that ‘disposable income’ may be considered with an indefinite horizon in mind, instead of the three years that apply in chapter 13.” Further, the ability to pay standard should not be limited to financial factors; the courts should be afforded wide latitude to consider subjective and nonfinancial factors. This latitude is required to allow the court to respond, when necessary,
where a spouse refuses to work or intentionally impairs his or her ability to earn an income. In this regard, the standard resembles the test applied in undue hardship cases under § 523(a)(8). “[D]ebtor’s ability to pay is no more than one factor to consider in what amounts to a ‘totality of circumstances’ standard for the balancing under § 523(a)(15)(B)”).


*Anthony v. Anthony (In re Anthony)*, 190 B.R. 433 (Bankr. N.D. Ala. 1995) (“Ability to pay,” under subsection (A), may be assessed by reference to § 1325(b)(2) (disposable income), § 707(b) (substantial abuse of bankruptcy process), and § 523(a)(8) (undue hardship discharge of a student loan). Section 523(a)(15)(B) requires debtor to establish that the hardship to the debtor from a finding of nondischargeability would exceed the hardship on the nondebtor if the debt were discharged. Debtor had ability to pay the hold harmless debt on the former couple’s modular home. A modest inheritance received by the nondebtor after debtor’s discharge did not shift the balance of harm in debtor’s favor. To find that the nondebtor would be harmed less by a determination of nondischargeability because she could use her inheritance to pay the indebtedness, might be legally correct but not equitably correct -- “an ironic circumstance for a court of equity.”); 190 B.R. 429 (on debtor’s motion to alter or amend, it was not the nondebtor’s burden to prove that the “Debtor should pay the debt.” “Absent a clear and unambiguous mandate from Congress, the Court is unwilling to interpret Section 523(a)(15)(B) in a manner that would diminish [nondebtor’s] nest egg, afforded to her through the foresight of her grandmother. Such an interpretation would cause her detrimental consequences that would outweigh the benefit to [debtor] if he is allowed to discharge the debt.”); *McGinnis v. McGinnis (In re McGinnis)*, 194 B.R. 917 (Bankr. N.D. Ala. 1996) (“the Court’s ‘inquiry in this matter is not controlled by [a] mere ‘snapshot’ of the debtor’s financial strength as of a single moment in time.’ . . . [The] Court will not restrict its review of the Debtor’s financial condition as of some historical point in time, but instead will examine the Debtor’s current and future circumstances.”)

*Dressler v. Dressler (In re Dressler)*, 194 B.R. 290 (Bankr. D.R.I. 1996) (section 1325(b)(2)’s disposable income standard is the appropriate test to determine ability to pay under § 523(a)(15)).

*Slover v. Slover (In re Slover)*, 191 B.R. 886 (Bankr. E.D. Okla. 1996) (court may consider income the debtor is capable of earning under § 523(a)(15)(A)).

4. Income or property of debtor

*Christison v. Christison (In re Christison)*, 201 B.R. 298 (Bankr. M.D. Fla. 1996) (“Under Section 523(a)(15)(A), income of the debtor’s current spouse is irrelevant to debtor’s ability to pay. . . . However, the current spouse’s income may be considered in relation to any reasonably necessary expenses incurred for debtor’s own support -- particularly those incurred jointly or since the date of the marriage.”); *Carter v. Carter (In re Carter)*, 189 B.R. 521 (Bankr. M.D. Fla. 1995) (section 523(a)(15) restricts ability to pay inquiry to the

Beasley v. Adams (In re Adams), 200 B.R. 630 (N.D. Ill. 1996) (court may consider new spouse's income under § 523(a)(15)(A) because "courts cannot determine how much of a debtor's own income is truly 'necessary' for his and his dependant's support without inquiring into whether or not, and how much, his new spouse is contributing to the family's maintenance." Language of § 523(a)(15) in nearly identical to § 1325(b)(2), and debtor’s spouse’s income is taken into account to determine "disposable income."; Gantz v. Gantz (In re Gantz), 192 B.R. 937 (Bankr. C.D. Ill. 1996) (section 523(a)(15)(A) "restricts the determination of the ability to pay solely to the income of the debtor." . . . Section 523(a)(15)(B), however, requires the Court to measure and weigh a 'benefit' to one party, as opposed to the 'detrimental consequences' to the other party . . . Thus, the extent to which a spouse’s contributions or expenses impact on the debtor should be relevant in balancing the equities.")

Cleveland v. Cleveland (In re Cleveland), 198 B.R. 394 (Bankr. N.D. Ga. 1996) ("when supplemental income from a new spouse or live-in companion serves to alter the debtor’s financial prospects, the Court must factor that consideration into its evaluation of his ‘ability to pay.’")

Samayoa v. Jodoin (In re Jodoin), 196 B.R. 845 (Bankr. E.D. Cal. 1996) ("the total income and assets of the plaintiff and her new spouse are relevant, as are the total income and assets of the debtor and his new spouse").

Celani v. Celani (In re Celani), 194 B.R. 719 (Bankr. D. Conn. 1996) ("Where the debtor and/or the debtor’s former spouse have remarried, the financial circumstances of the new spouses logically and sensibly should be included in the balancing test set forth in § 523(a)(15)(B).")

In re Smither, 194 B.R. 102 (Bankr. W.D. Ky. 1996) (where the debtor has remarried prior to trial, the income of the new spouse should be included in any calculation of the debtor’s disposable income).

Woodworth v. Woodworth (In re Woodworth), 187 B.R. 174, 177 (Bankr. N.D. Ohio 1995) ("income or property of the debtor" in § 523(a)(15)(A) means debtor's exempt property and postpetition income; "reasonably necessary for . . . maintenance and support" permits consideration of assistance or property from friends or relatives. Statute does not permit consideration of fact that discharging debts will result in non-debtor spouse having to pay debts from funds reasonably necessary for her support. As stated in legislative history, one factor favoring debtor is that spouse probably judgment-proof.) But see Craig v. Craig (In re Craig), 196 B.R. 305 (Bankr. E.D. Va. 1996) (detriment to former spouse off set by her own chapter 7 filing).

Slover v. Slover (In re Slover), 191 B.R. 886 (Bankr. E.D. Okla. 1996) (court may consider income the debtor is capable of earning under § 523(a)(15)(A)).
5. Partial discharge?

**Greenwalt v. Greenwalt (In re Greenwalt)**, 200 B.R. 909 (Bankr. W.D. Wash. 1996) (“[A] partial discharge is justified by § 523(a)(15), but not by analogy to § 523(a)(8). Section 523(a)(15) itself speaks to the dischargeability of ‘such debt,’ suggesting that the court may review each liability separately. . . . [T]he liability to the former spouse is comprised of the various underlying obligations, and there is nothing to prevent the court from analyzing them separately.”)

**McGinnis v. McGinnis (In re McGinnis)**, 194 B.R. 917 (Bankr. N.D. Ala. 1996) (“all or nothing” approach is not mandated by the language of § 523(a)(15)).

**In re Smither**, 194 B.R. 102 (Bankr. W.D. Ky. 1996) (“courts may grant partial discharges.” Debtor has ability to pay if he can pay “all or a material part . . . within a reasonable amount of time.”)

**Comisky v. Comisky (In re Comisky)**, 183 B.R. 883 (Bankr. N.D. Cal. 1995) (§ 523(a)(15)(A) permits court to fashion equitable relief when to hold entire debt either dischargeable or nondischargeable would be inequitably harsh on one party. Court found support for this approach in § 523(a)(8) cases where courts have excepted from discharge a portion of a debtor’s student loans on grounds of undue hardship. Here, debtor owed former spouse $25,000 on property settlement. Court discharged $15,000 and ordered debtor to pay $200 per month toward balance.)


6. In general

**Macy v. Macy (In re Macy)**, 114 F.3d 1, 3 (1st Cir. 1997) (enactment of § 523(a)(15) in 1994 did not affect nondischargeability of attorneys’ fees under § 523(a)(5). “[A]ttorneys’ fees continue to be governed by section 523(a)(5). There is a strong policy interest in protecting ex-spouses and children from the loss of alimony, support and maintenance owed by a debtor who has filed bankruptcy. . . . Congress sought to apply section 523(a)(15) to debts that had previously been construed as property obligations. . . . There is no indication that Congress intended to affect the liberal interpretation of section 523(a)(5). It follows, then, that Congress did not intend to apply section 523(a)(15) to debts that were, prior to the Bankruptcy Reform Act, considered to be nondischargeable under section 523(a)(5).” The plaintiff’s action under §§ 523(a)(5) and 523(a)(15) was filed beyond the 60-day period for complaints under § 523(a)(15). Debt was nondischargeable under § 523(a)(5), thus untimeliness of (a)(15) cause of action was not fatal.)

Dressler v. Dressler (In re Dressler), 194 B.R. 290 (Bankr. D.R.I. 1996) (“If a debtor has agreed to assume a credit card obligation and hold his or her ex-spouse harmless, it is only the hold harmless obligation that may escape discharge. The debtor’s obligation to the credit card company . . . will be wiped out.”)

Christison v. Christison (In re Christison), 201 B.R. 298 (Bankr. M.D. Fla. 1996) (debtor’s argument under § 523(a)(15)(B) that former spouse could avoid consequences of a discharge of debts assigned to debtor under property settlement agreement by merely filing bankruptcy herself “cavalierly ignores questions of whether the creditor spouse is eligible to file a bankruptcy case or is entitled to receive a discharge under Section 727 or discharge debts under Section 523 . . . . In addition, many individuals today continue to consider bankruptcy as antithetical solution to oppressive debt, and courts should not be in the business of forcing innocent parties into bankruptcy because they regard that as the lesser evil under Section 523(a)(15). Neither should one spouse be able to force a non-filing creditor spouse into bankruptcy by using the exception contained in Section 523(a)(15) . . . . Rather, the balancing test set forth in Section 523(a)(15)(B) requires a court to examine the harm and benefits caused to the parties in their existing situations.” A potential bankruptcy filing by the non-debtor is not relevant.); Schmitt v. Eubanks (In re Eubanks), 197 B.R. 312 (Bankr. W.D. Ark. 1996) (under the balancing prong of § 523(a)(15) court “rejects any notion that the non-debtor should resolve his situation by filing bankruptcy himself . . . . Rather, the implication that a non-debtor would need to file bankruptcy because of another debt militates in his favor because it is a detriment to his financial status and credit rating.”); Craig v. Craig (In re Craig), 196 B.R. 305 (Bankr. E.D. Va. 1996) (detriment to former spouse off set by her own chapter 7 filing).

Beasley v. Adams (In re Adams), 200 B.R. 630 (N.D. Ill. 1996) (amendment allowed to add § 523(a)(15) cause of action to complaint asserting only § 523(a)(5) because both actions arise out of the same transaction, i.e., the settlement agreement or the divorce decree. “Sections 523(a)(5) and (a)(15) are, . . . , ‘merely alternate theories for an objecting ex-spouse to establish a debt as nondischargeable.’ . . . Which of these alternate theories applies depends upon whether the debt is in the nature of alimony, maintenance or support; or in the nature of a property settlement. This is a factual determination that the bankruptcy judge must make no matter whether Section (a)(5), Section (a)(15) or both are at issue, and no matter what language was used in the agreement or divorce decree since ‘even an obligation designated as property settlement may be related to support because State courts often will adjust alimony awards depending on the nature and amount of marital assets available for distribution.’”); Samayoa v. Jodoin (In re Jodoin), 196 B.R. 845 (Bankr. E.D. Cal. 1996) (that complaint raised only § 523(a)(15) did not
preclude the court from reaching a determination of nondischargeability under § 523(a)(5). Section 523(a)(5) is at issue in every § 523(a)(15) case. Further, Fed. R. Civ. P. 15(b) allows for the amendment of the pleadings to conform to the evidence -- the § 523(a)(5) issue was tried by implied consent of the parties. Finally, Fed. R. Civ. P. 54(c) obliged the court to award plaintiff the relief to which she was entitled under the evidence adduced at trial provided the relief is within the court's jurisdiction and authority.)

Macy v. Macy (In re Macy), 200 B.R. 467 (Bankr. D. Mass. 1996) (§ 523(a)(15) is not necessarily the appropriate section under which to consider awards of attorneys' fees. Section 523(a)(15) did not supplant traditional analysis under § 523(a)(5). "[A]ttorneys' fees 'should follow the classification of the primary obligation'.")

Compare Schmitt v. Eubanks (In re Eubanks), 197 B.R. 312 (Bankr. W.D. Ark. 1996) (absence of hold harmless provision in divorce decree or settlement agreement is not fatal to action under § 523(a)(15). The "ordered" language in the decree created an obligation to comply with the decree, sufficient to bring debts within dischargeability provision. Further, at the time the decree was entered, the debtor was obligated to indemnify her former husband.); Johnston v. Henson (In re Henson), 197 B.R. 299 (Bankr. E.D. Ark. 1996) (accord); with, Stegall v. Stegall (In re Stegall), 188 B.R. 597 (Bankr. W.D. Mo. 1995) (property settlement agreement providing that debtor would pay a liability that the former couple was jointly liable for did not bring the debt within § 523(a)(15). There was no debt "incurred" under the property settlement agreement—the property settlement agreement did not create a debt that otherwise did not exist.)


for a fee or assessment that becomes due and payable after the order for relief to a membership association with respect to the debtor's interest in a dwelling unit that has condominium ownership or in a share of cooperative housing corporation, but only if such fee or assessment is payable for a period during which—

(A) the debtor physically occupied a dwelling unit in the condominium or cooperative project; or

(B) the debtor rented the dwelling unit to a tenant and received payments from the tenant for such period, but nothing in this paragraph shall except from discharge the debt of a debtor for a membership association fee or assessment for a period arising before entry of the order for relief in a pending or subsequent bankruptcy case.
Affeldt v. Westbrooke Condominium Ass’n (In re Affeldt), 60 F.3d 1292 (8th Cir. 1995) (under pre-1994 law, condominium association failed to prove whether assessments were pre- or postpetition claims. If condominium assessments accrued prepetition, they were discharged; if they accrued postpetition, they were not discharged. This question turned on whether the assessments contained in the Condominium Declaration were “more akin to a contract or to a covenant running with the land.” Court of appeals could not make this determination because condominium association failed to introduce into evidence the Condominium Declaration or any other condominium agreement. Debtor won on burden of proof.)

In re Whitten, 192 B.R. 10 (Bankr. D. Mass. 1996) (post discharge condominium fees not discharged. Debtor’s obligation to pay fees is a covenant that runs with the land and is not dischargeable.)


for a fee imposed by a court for the filing of a case, motion, complaint, or appeal, or for other costs and expenses assessed with respect to such filing, regardless of an assertion of poverty by the debtor under section 1915(b) or (f) of title 28, or the debtor’s status as a prisoner, as defined in section 1915(h) of title 28.


(18) owed under State law to a State or municipality that is—

(A) in the nature of support, and
(B) enforceable under part D of title IV of the Social Security Act (42 U.S.C. 601 et seq.).

A companion amendment changed 42 U.S.C. § 656(b) to read:

NONDISCHARGEABILITY.—A debt (as defined in section 101 of title 11 of the United States Code) owed under State law to a State (as defined in such section) or municipality (as defined in such section) that is in the nature of support and that is enforceable under this part is not released by a DISCHARGE in BANKRUPTCY under title 11 of the United States Code.

P. 18 U.S.C. § 3613(e) and (f) (as amended by the Antiterrorism and Effective Death Penalty Act of 1996, Pub. L. No. 104-132, § 207(c), 110 Stat. 1214, 1238 (1996)).

DISCHARGE OF DEBT INAPPLICABLE.—No discharge of debts in a proceeding pursuant to any chapter of title 11, United States Code, shall discharge liability to pay a fine pursuant to this section, and a lien filed as prescribed by this section shall not be voided in a bankruptcy proceeding.
APPLICABILITY TO ORDER OF RESTITUTION.—In accordance with section 3664(m)(1)(A) of this title, all provisions of this section are available to the United States for the enforcement of an order of restitution.

III. LITIGATION OF COMPLAINTS TO BAR DISCHARGE: 11 U.S.C. § 727

A. In general

United States v. Cluck, 87 F.3d 138 (5th Cir. 1996) (per curiam) (successful action to revoke discharge for fraud did not preclude bankruptcy fraud prosecution under 18 U.S.C. § 152. Later action did not violate Double Jeopardy Clause because debtor was not entitled to discharge and revocation of discharge did not constitute punishment.)


“... with intent to hinder, delay, or defraud ... has transferred, removed, destroyed, mutilated, or concealed ... (A) property of the debtor, ... (B) property of the estate, ...”

Hughes v. Lawson (In re Lawson), 1997 WL 469694 (9th Cir. Aug. 19, 1997) (adopting the doctrine of “continuing concealment,” recording $350,000 deed of trust on debtor’s residence in favor of debtor’s mother on the same day state court jury awarded $750,000 malpractice judgment against the debtor, though more than a year before the Chapter 7 petition, satisfies § 727(a)(2) because the bankruptcy court could permissibly infer that the debtor “retained a secret property interest.” Proof of this “secret benefit” was found in the debtor’s continued use of the residence and that the mother’s deed of trust was later subordinated to a $175,000 loan to the debtor.)

Gullickson v. Brown (In re Brown), 108 F.3d 1290, 1293-94 (10th Cir. 1997) (debtor’s transfer of security interest in antique car collection four days prior to bankruptcy did not violate § 727(a)(2)(A) because money received was used as capital for his business and was not “squandered.” “In this case, the corporations of which Brown was a fifty percent owner required a cash infusion to pay attorneys and suppliers. The granting of a security interest in his only unencumbered asset in order to obtain much needed capital for his businesses, which were his sole source of income, does not evince fraud. ... There was no evidence that the money was not reasonably used or that it was squandered. Indicia of fraud are totally lacking. ... Brown’s mere possession of the vehicles does not constitute evidence of fraudulent intent. Although some inference of fraudulent intent might be drawn from the fact that Brown’s car collection became exempt due to this transaction, such an inference is de minimis at best.” Differences in the value of assets by the debtor on financial statements prior to bankruptcy was explained as “puffery.” “Though we do no condone such behavior, it does explain the disparity and no creditor is now claiming harm from this behavior. ... [T]he inference of fraud does not flow from the facial discrepancy in the financial statement and bankruptcy schedule values absent other evidence. ... As to the failure to list the automobile on the bankruptcy schedules, it is undisputed that the debtor raised the omission of the automobile at the § 341 creditors’ meeting. Although Brown should have amended his bankruptcy schedules to correct the error, we believe as a matter of law that no inference of
fraudulent intent can be drawn from an omission when the debtor promptly brings it to the court’s or trustee’s attention absent other evidence of fraud.

**Martin v. Bajgar (In re Bajgar),** 104 F.3d 495, 497-501 (1st Cir. 1997) (reconveyance of property from wife to debtor four months after voluntary petition does not cure an admittedly fraudulent prepetition conveyance for purposes of § 727(a)(2)(A). Distinguishing *Adeeb,* 787 F.2d 1339 (9th Cir. 1986), “Limiting the definition of ‘transferred’ to ‘transferred and remained transferred,’ in fact, would contradict the drafters’ intent. . . . In this case, . . . Bajgar did not reveal his initial fraudulent transfer until he filed his bankruptcy petition. In addition, Bajgar consulted with an experienced bankruptcy attorney at the time he executed the initial fraudulent transfer. It was not until he faced the prospect of being denied discharge pursuant to Section 727(a)(2)(A) that Bajgar actually reconveyed the property.”

**Kestell v. Kestell (In re Kestell),** 99 F.3d 146 (4th Cir. 1996) (affirms bankruptcy court’s denial of discharge under § 727(a)(2)(B) then dismisses bankruptcy case altogether. Bankruptcy court denied debtor’s discharge for fraudulent concealment under § 727(a)(2)(B). Debtor concealed over $33,000 in accrued sick leave paid postpetition, and an income tax reimbursement of $13,000. The Fourth Circuit “affirmed” but then seems to confuse the concepts of discharge and dismissal, concluding that “[a]lthough the bankruptcy court addressed this case under the fraudulent concealment of section 727(a)(2), we think this petition is more appropriately dismissed under sections 707(b) and 105(a).” Debtor testified at his meeting of creditors that he intended to reaffirm all debts except the debt to his former spouse.)

**Equitable Bank v. Miller (In re Miller),** 39 F.3d 301 (11th Cir. 1994) (that the “totality of the circumstances” surrounding a transfer were “highly suspect” did not justify district court’s reversal of bankruptcy court’s factual determination that debtors lacked requisite intent to hinder, delay or defraud under § 727(a)(2). Debtors’ explanation of discrepancies in valuation of transferred assets was “plausible.” That debtors’ “estimated values [were] at odds with other viable estimates . . . is not dispositive evidence that [debtors] acted with fraudulent intent.”)

**Barclays/American Business Credit, Inc. v. Adams (In re Adams),** 31 F.3d 389 (6th Cir. 1994), *cert. denied,* ___ U.S. ___, 115 S. Ct. 903, 130 L. Ed.2d 786 (1995) (property of the debtor for purposes of § 727(a)(2)(A) includes accounts receivable of corporation wholly-owned by individual debtor. Cites § 727(a)(7) in support of this proposition, because corporation was debtor in separate case.)

**Perdue v. Cantrell (In re Cantrell),** 88 F.3d 344 (5th Cir. 1996) (bankruptcy court properly dismissed complaint under §§ 523(a)(2) and 727(a)(2)(A) because statute of limitations had run prior to state court complaint, thus plaintiff had no prosecutable claim in the bankruptcy case).

**Bernard v. Sheaffer (In re Bernard),** 96 F.3d 1279 (9th Cir. 1996) (discharge properly denied based on “transfer” of money from debtor’s bank account to personal safe. Within three weeks of service of a request for a protective order in state court litigation, debtors withdrew approximately $64,000 from money market and demand accounts. Debtor testified that “he had cashed out his [money market] account because an attorney had advised him to do so to evade attachment.” He stacked the
cash in a safe in his home and later used it for a vacation during which he incurred substantial gambling losses. The Ninth Circuit held that debtors had transferred property with intent to hinder, delay or defraud creditors. The debtors argued that the withdrawals were not “transfers” within the scope of § 727(a)(2). Rather, “they claim[ed] they merely moved their assets from one of their own pockets to another -- they had not ‘transferred’ anything to anyone.” The court rejected this argument under two theories. First, “lack of injury to creditors is irrelevant for purposes of denying a discharge in bankruptcy.” Second, “transfer” is defined broadly under the Code. “If . . . depositing money into a bank account is a transfer, then later withdrawing money from that account should be a transfer, too -- it ought to be a two-way street. . . . [Moreover, the debtors] did not own money gathering dust in their bank accounts. ‘As between the bank and the depositor such money becomes the property of the bank and the bank becomes the debtor of the depositor for the amount deposited.’ . . . Instead of owning money sitting in their accounts, [debtors] owned claims against their bank. When they withdrew from their accounts, they exchanged debt for money. . . . When [debtors] made their withdrawals they parted with property, satisfying the Code’s definition of transfer.”); Finalco. Inc. v. Roosevelt (In re Roosevelt), 87 F.3d 311 (9th Cir. 1996) (the question of when a transfer is “made” for § 727(a)(2) purposes is one of federal law. As between the “BFP rule,” under which a transfer is not “made” for § 727(a)(2) purpose until the instrument of transfer is recorded, and the “party rule,” under which a transfer is “made” for § 727(a)(2) purposes on the date the agreement between the parties is executed, the “party rule,” is “more consistent with the purposes animating § 727(a)(2) [which focuses on the debtor’s wrongdoing].”); Lawson v. Hughes (In re Lawson), 193 B.R. 520 (B.A.P. 9th Cir. 1996) (for purposes of § 727(a)(2), the “question of continuing concealment, . . . , is based not on timing, but on the reality of the transfer between the parties. . . . [T]he debtor can conceal assets by transferring them to a cooperative creditor so long as the transfer allows the debtor to retain a secret benefit.”)

Marine Midland Bank v. Portnoy (In re Portnoy), 201 B.R. 685 (Bankr. S.D.N.Y. 1996) (“Mere failure to volunteer information to a creditor is insufficient, . . . , to constitute concealment.” While debtor may have no duty to speak, “once [debtor] opened his mouth to set forth the facts, he thereby gave life to a duty to tell the truth.” Misrepresentations in the course of settlement discussions with a creditor that assets had been used for cancer treatments when assets had really been transferred to offshore trust are actionable.)


“ . . . has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, . . . unless . . . justified under all of the circumstances of the case.”

Gullickson v. Brown (In re Brown), 108 F.3d 1290, 1295 (10th Cir. 1997) (failure to keep records with respect to car collection was not a bar to discharge under § 727(a)(3) because “the car collection was a hobby, not a business entered into for profit, and cash sales in this hobby were commonplace. Thus, the district court found that any failure to keep records was justified on the facts of the case. We agree.”)

In re Juzwiak, 89 F.3d 424 (7th Cir. 1996) (“Section 727(a)(3) requires as a precondition to discharge that debtors produce records which provide creditors with
enough information to ascertain the debtor’s financial condition and track his financial dealings with substantial completeness and accuracy for a reasonable period past to present. . . The provision ensures that trustees and creditors will receive sufficient information to enable them to trace the debtor’s financial history; to ascertain the debtor’s financial condition; and to reconstruct the debtor’s financial transactions. . . Records need not be kept in any special manner, nor is there any rigid standard of perfection in record-keeping mandated by § 727(a)(3). . . On the other hand, courts and creditors should not be required to speculate as to the financial history or condition of the debtor, nor should they be compelled to reconstruct the debtor’s affairs.” While the ultimate goal of § 727(a)(3) is to distinguish the honest from the dishonest debtor, “creditors need not prove that the debtor intended to defraud them in order to demonstrate a § 727(a)(3) violation.” “The records furnished by [debtor] --checking account ledgers, canceled checks, bank statements, and a 1993 income tax return--do not enable [the creditor] to reconstruct [debtor’s] grain sale transactions or to track his financial dealings for any period of time with any degree of completeness or accuracy.” Where debtor “engaged in a steady stream of large scale transactions involving substantial sums of money,” small scale bookkeeping was unacceptable. Debtor’s method of bookkeeping placed the burden on the creditor to organize and reconstruct the debtor’s business affairs. Section 727(a)(3), however, makes it the debtor’s responsibility to “maintain and retain comprehensible records.” Creditors are entitled to written documentation with regard to important business information—a debtor’s testimony is not sufficient.)

Cox v. Lansdowne (In re Cox), 904 F.2d 1399 (9th Cir. 1990) (court should consider whether one spouse’s reliance on the other justifies a failure to keep records when a married couple shares the duty to maintain records.); Lansdowne v. Cox (In re Cox), 41 F.3d 1294 (9th Cir. 1994) (on remand, bankruptcy court found debtor’s reliance on her husband unreasonable and denied her discharge under § 727(a)(3). Ninth Circuit reversed (again). Conduct the bankruptcy court viewed as a “self-imposed curtain of ignorance,” the Circuit found “entirely consistent with ‘[debtor’s] general reliance on [her spouse] to handle all business matters.’” Where there are no warning signals that recordkeeper is delinquent, the court must measure whether the reliance is objectively reasonable under the totality of circumstances.).


“. . . knowingly and fraudulently, in or in connection with the case -- (A) made a false oath or account, . . .”

Gullickson v. Brown (In re Brown), 108 F.3d 1290, 1294 (10th Cir. 1997) (that the debtor came forward with evidence of an omitted car at the meeting of creditors is “strong evidence that there was no fraudulent intent in the omission.” Although the debtor did not amend his schedules to reflect the omitted vehicle, “he did rectify the omission very early in the process and of his own accord.”)

Desmond v. Varrasso (In re Varrasso), 37 F.3d 760 (1st Cir. 1994) (admitted omission from schedules of two assets of relatively small value was not sufficient grounds to grant summary judgment to trustee on discharge complaint. Debtors rectified omissions at § 341 meeting when questions refreshed debtors’ recollection. The facts were consistent with either an inference of deliberateness or an inference of carelessness. “[T]he undisputed facts require a choice between competing inferences,
and since both inferences are plausible, the choice cannot be made under the banner of summary judgment.”

Garcia v. Coombs (In re Coombs), 193 B.R. 557 (Bankr. S.D. Cal. 1996) (“an essential element under § 727(a)(4)(A) is that debtor acted with an actual intent to defraud. . . . [T]here must be specific facts or circumstances which point toward fraud. . . . Neither sloppiness nor an absence of effort by the debtor supports, by itself, an inference of fraud. Courts which hold otherwise are simply devising a court-made prophylactic rule that the debtor must make substantial effort to provide accurate and complete schedules. . . . The essential point is that there must be something about adduced facts and circumstances which suggest that the debtor intended to defraud creditors or the estate. For instance, multiple omissions of material assets or information may well support an inference of fraud if the nature of the assets or transactions suggest that the debtor was aware of them at the time of preparing the schedules and that there was something about the assets or transactions which, because of their size or nature, a debtor might want to conceal.” Omissions of money, accounts, pension and security deposit either were immaterial, weren’t property of estate or simply didn’t indicate intent to hurt anyone.)

Garcia v. Garcia (In re Garcia), 168 B.R. 403 (D. Ariz. 1994) (creditor can challenge homestead exemption under § 727(a)(4)(A) as a false oath or account, notwithstanding failure to timely object to exemptions under Fed. R. Bankr. P. 4003(b)).

Behrman Chiropractic Clinics Inc. v. Johnson (In re Johnson), 189 B.R. 985 (Bankr. N.D. Ala. 1995) (debtor’s failure to account for medical equipment and transfer of x-ray machine warrant denial of discharge. “The purpose of the false oath exception is not to punish debtors for mere inadvertence, but, rather to insure that adequate information is available to the trustee and all interested parties.” What is adequate is not for the debtor to decide, rather, all property related to the debtor’s business transactions and estate and all information concerning the discovery of assets, disposal of assets and business dealings must be disclosed without regard to the potential monetary benefit to the estate such property or information might yield.); Wade v. Wade (In re Wade), 189 B.R. 522 (Bankr. M.D. Fla. 1995) (value of omitted assets may be considered to ascertain whether debtor defendant had intent or motivation to deceive and to assess materiality of omissions).


“ . . . failed to explain satisfactorily, any loss of assets or deficiency of assets . . . .”

In re D’Agnese, 86 F.3d 732 (7th Cir. 1996) (Section 727(a)(5) “requires a satisfactory explanation for the whereabouts of a debtor’s assets. . . . [A] satisfactory explanation ‘must consist of more than . . . vague, indefinite and uncorroborated’ assertions by the debtor.” Bankruptcy court did not error in concluding that debtor failed to “specifically provide an explanation from which the court could determine how she disposed of the assets.”)
Hawley v. Cement Indus. (In re Hawley), 51 F.3d 246 (11th Cir. 1995) (Section 727(a)(5) does not require a creditor to "call upon a debtor to explain a loss of assets prior to filing an adversary proceeding. A denial of discharge under § 727(a)(5) requires only that the debtor fail to explain a loss of assets 'before determination of denial of discharge under this paragraph.' . . . 'To be satisfactory, an explanation [of lost or diminished assets] must convince the judge.'" Debtor's signed financial statement dated June 15, 1989 listed assets of $13,822,477. The Chapter 7 schedules filed in September, 1990 showed less than $20,000 in assets. The debtor, a "sophisticated and experienced businessman" said he sold most of his assets "for cash" and did not keep records of the sales.)

Mozeika v. Townsley (In re Townsley), 195 B.R. 54 (Bankr. E.D. Tex. 1996) (the initial burden of identifying (lost) assets rests with the plaintiff. "The simple showing of some amount of gross receipts by one who operated a business at a point ranging from a year to several months prior to his bankruptcy does not discharge the original burden of establishing the existence of assets.")

Straub v. Straub (In re Straub), 192 B.R. 522 (Bankr. D.N.D. 1996) ("A cause of action advanced under § 727(a)(5) is not a substitute for one based upon alleged pre­petition fraud, conversion or other malfeasance. Rather, its purpose is to deny a discharge to a debtor who refuses to cooperate with the trustee or creditors in their effort to trace property that should have been part of the estate." Plaintiff could not use § 727(a)(5) as grounds to deny debtor's discharge for alleged fraudulent conveyances ten, eight and six years before petition.)


". . . the debtor has committed any act specified in [§§ 727(a)(2), (3), (4), (5) or (6)] . . . within one year . . . concerning an insider . . ."

In re Krehl, 86 F.3d 737 (7th Cir. 1996) (the definition of "insider" in § 101(31) is illustrative only. "[T]he term also encompasses anyone with 'a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor.'" Debtor's insider status was not defeated by his resignation as an officer and director of a corporate entity in which he was the sole shareholder. "If insider status could automatically be shed through the largely ministerial act of resignation [section 727(a)(7) would become toothless]." "Access to inside information can be sufficient to confer insider status even where there is no legal right or ability to exercise control over a corporate entity.")

IV. REVOCATION OF DISCHARGE: 11 U.S.C. § 727(d), (e)

Barr v. Barr (In re Barr), 188 B.R. 565 (Bankr. N.D. Ill. 1995) (complaint to revoke discharge sufficient to escape a motion to dismiss where plaintiffs offered the court's prior opinion in a dischargeability action that found debtors to have engaged in misconduct actionable under Fed. R. Civ. P. 60(b)(3). Plaintiff need only plead the identity of the person who made the alleged misrepresentation, the time, the place, the content of the misrepresentation, and the method by which the representation was communicated to plaintiff.)
Roost v. Reynolds (In re Reynolds), 189 B.R. 199 (Bankr. D. Or. 1995) ("The very wording of § 727 prevents application of the doctrine of equitable tolling. Note that an interested party may bring an action to revoke discharge only if '... the requesting party did not know of such fraud until after the granting of such discharge;'... Yet, § 727(e)(1) requires that revocation of discharge be requested '... within one year after such discharge is granted;' if the doctrine of equitable tolling were to be applied, the one year period prescribed in § 727(e)(1) would not begin until the fraud were discovered by the requesting party. Yet the statute clearly indicates that the one year period of time begins to run upon entry of the discharge at a time, when, by its terms, the requesting party is ignorant of the fraud. ... [T]he doctrine of equitable tolling is fundamentally inconsistent with the provisions of § 727(d)(1) and § 727(e)(1)."); Davis v. Johnson (In re Johnson), 187 B.R. 984 (Bankr. S.D. Cal. 1995) (equitable tolling does not extend statute of limitation in § 727(e). Where case had been closed after entry of discharge and reopened within one year of closing, one year limitation is counted from closing and is satisfied).
DOMESTIC RELATIONS
AND
BANKRUPTCY

Hon. Ray Reynolds Graves
United States Bankruptcy Judge
Eastern District of Michigan

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INTRODUCTION

It is imperative for the practitioner to contemplate and understand the effect of bankruptcy in a potential divorce action. The failure to consider the impact of bankruptcy and divorce approaches malpractice. A determination of the rights and liabilities of the respective parties in a divorce proceeding may contain significant challenges. The diversity of the intent of the respective laws can certainly result in unanticipated outcomes, as the legal philosophy guiding each proceeding are quite diverse in nature.

State court's governing divorce actions are consumed with the notion of balancing the assets, and liabilities of the parties and their children, while the bankruptcy court is concerned with providing the debtor a "fresh start." The dissolution of a marriage is greatly affected by bankruptcy. The intended rights of the parties by interactions of community property, tenancy by the entirety, often result in a devastatingly different result from those rights contemplated under the code. The practitioner in both community property states, and separate property states, must carefully consider the impact of the division of property, alimony, maintenance and the assets involved in the event that one of the parties files bankruptcy.

The filing of any chapter proceeding triggers the automatic stay.

I. THE AUTOMATIC STAY

A. Stay Defined

1. A temporary injunction prohibiting all creditors and other entities from attempting to collect a debt or obligation owed by the debtor, generally before the petition is filed.

2. 11 U.S.C. §362 commands that all collection efforts should cease upon the filing of a voluntary or involuntary petition.

B. Purpose

1. To give the debtor a breathing spell from creditors and stop foreclosure action, collection efforts, creditor harassment, litigation including divorce proceedings. In re University Medical Center, 973 F.2d 1065, 1074 (3rd Cir. 1992).

2. To prevent chaos upon the initiation of a case.

C. Scope

1. The stay becomes effective as soon as the petition is filed.
2. The stay protects against the pursuit of actions by any party, including:
   a. judicial, administrative or other proceedings against the debtor;
   b. enforcement of judgments;
   c. attempts to gain possession of or to exercise control over the estate;
   d. attempts to create, perfect or enforce liens against property of the estate;
   e. attempts to recover a claim against the debtor that arose prepetition;
   f. set offs; and
   g. the commencement or continuation of tax court proceedings.

3. However, there are exceptions to these general rules. The stay does not operate against:
   a. the commencement or continuation of a criminal action or proceeding against the debtor;
   b. attempts to perfect, maintain or continue the perfection of an interest in property subject to the trustee’s rights and powers and subject to the time provision of §547(e)(2)(A);
   c. an action or judgment obtained by the government in enforcing its policy or regulatory power;

4. Duration
   a. 11 U.S.C. §362(c)(1) states that the stay of an act against property continues until such property is no longer property of the estate.
b. 11 U.S.C. §362(c)(2) states that the stay of any other act continues until the earliest of:

(1) the time the case is closed;
(2) the time the case is dismissed; or
(3) the time a discharge is granted or denied.

D. Effect of the Automatic Stay in Divorce Proceedings

1. The commencement of a bankruptcy case creates an automatic stay which prohibits the commencement or continuation of judicial proceedings that were commenced, or could have been commenced prior to the bankruptcy.

2. As a result, divorce proceedings against the debtor are automatically stayed by the filing of the bankruptcy case.

3. Since the automatic stay is generally not applicable to actions taken by the debtor, a divorce proceeding filed by the debtor is normally not stayed under Section 362 of the Bankruptcy Code.

4. The specific statutory exception provided by Section 362(b)(2) of the Bankruptcy Code exempts from application of the automatic stay a proceeding for the collection of alimony, maintenance or support from property that is not property of the bankruptcy estate.

5. Technically, even custody, adoption and visitation and domestic violence proceedings could be viewed as stayed but bankruptcy courts rarely interfere with such matters pending or filed in state courts.

6. On the other hand, attempts by state courts to interfere with property rights of the bankruptcy estate will constitute a violation of the automatic stay.

7. Relief from the automatic stay is routinely granted in the case of

a. custody,

b. domestic violence, or

c. other matters in the state family court proceeding which are unrelated or remotely related to the bankruptcy case.
d. Relief is also usually granted to pursue current support payments.

E. Exception to Stay after 1994

1. 11 U.S.C. §362(b)(2) as amended, expands the exception and provides that the filing of a bankruptcy petition will not operate as a stay of:

   a. the commencement or continuation of an action or proceeding for
      (1) the establishment of paternity, or
      (2) the establishment or modification of an order for alimony, maintenance or support, or
      (3) of the collection of alimony, maintenance or support from property that is not property of the estate

F. Divorce Proceedings

1. Conducted during the pendency of one of the parties' bankruptcy case will sometimes be bifurcated.

   a. Generally, the pendency of a bankruptcy case should not prevent dissolution of a marriage or the granting of child custody and support.

2. The automatic stay may be modified thus allowing

   a. the grant of divorce
   
   b. a determination of child custody; while
   

G. Stay Violation

1. Modification of child support has been held to violate the stay.

   a. See, In re Stringer, 847 F.2d 549, 550 (9th Cir. 1988).

2. Post-petition child support arrearage collection.

a. District attorney violated automatic stay by continuing wage assignment for the collection of child support arrearages after notice of filing of chapter 13 case, in which confirmed plan called for 100% payment of child support arrearages.

b. Although §1327(b) vests property of the estate in the debtor upon plan confirmation, unless the confirmation order or plan provides otherwise, the creditor in this case collected from the debtor's wages prior to plan confirmation.

c. Since §362(b)(2) exception only allows for collection from non-estate property, the creditor could not claim this exception from the stay for wages garnished prior to plan confirmation.

d. The creditor is also barred from using §1327(b) to claim the §362(b)(2) exception for payments accepted subsequent to plan confirmation.

e. The Trustee's order confirming debtor's plan specifically states that

(1) "the property of the estate does not vest in the debtor upon confirmation of the plan."... In the face of such language, it would appear that the property remains property of the estate until the case is closed, dismissed, or a discharge is granted or denied. ... Creditor has willfully violated the automatic stay by accepting payments from its wage assignment order after receiving notice of debtors' bankruptcy." Id.

f. Because the district attorney did not file a proof of claim, sovereign immunity precluded monetary damages; however, declaratory and injunctive relief were allowed including an order that the district attorney cease accepting payments pursuant to its prepetition wage assignment.

g. The court further determined that permitting the district attorney to retain the funds already collected from the wage assignment was not prejudicial to the debtor or the bankruptcy estate because the plan called for payment in full of the prepetition child support arrearages
and the claim was non-dischargeable and continuing to accrue interest.

   
a. The trustee of an ERISA qualified pension plan did not violate the automatic stay by paying the debtor's ex-spouse benefits awarded in a prepetition divorce decree.

b. However, pension trustee did violate the automatic stay by making payments of continuing support from the portion of the pension plan that remained property of the debtor and became property of the Chapter 13 estate.

c. The pension trustee committed a willful violation, because it was notified of the bankruptcy case, but continued to make support payments from the debtor's portion of the pension fund.

d. "Nonetheless, we will not award punitive damages on this occasion. ...

..."

e. Despite the technical violation of the stay, we find no evidence on this record of injury or actual damage to Debtor inasmuch as the support obligation is nondischargeable and debtor is in no position different from that he would have been in absent bankruptcy." *Id.*

4. *In re Mark Nelson, 994 F. 2d 42 (1st Cir. 1993)*
   
a. The debtor brought an adversary proceeding against former wife and wife's attorney for their alleged willful violation of the automatic stay.

b. Upon appeal, the circuit court held that the debtor's former spouse did not willfully violate stay, and was not liable for sanctions, for seeking to enforce rights granted by the judgment of divorce against property, that the debtor had transferred to his father, prior to filing for bankruptcy, where the debtor failed to list sub-transfer on his bankruptcy schedules.

H. Relief from Stay

1. *Carver v. Carver, 954 F.2d 1573 (11th Cir. 1992)*
a. A chapter 13 debtor sought to have former wife and her counsel held in contempt for violation of the automatic stay. The bankruptcy court imposed sanctions against the debtor's former wife and counsel. On appeal, the district court affirmed the holding of the bankruptcy court.

b. The Court of Appeals for the 11th Circuit reversed and held that the bankruptcy court should have abstained from hearing chapter 13 debtor's claim for violation of the automatic stay, where alleged violation involved enforcement of debtor's divorce decree obligation.

c. In this case, where the spouse sought to enforce the divorce decree obligation to pay the mortgage on former marital residence, the court determined that such action violated the automatic stay, only to the extent that the former wife sought collection of arrearage from debtor's wages, which were part of his chapter 13 estate.

d. The court further held that the bankruptcy court should liberally grant relief from the automatic stay in situations involving collection of alimony, maintenance or support in order to avoid entangling federal court in family law matters left to state court.

e. The alleged violation involved enforcement of debtor's divorce decree obligation.

f. The purpose underlying the automatic stay provision would not have been served.

g. The court concludes that it was clear that the bankruptcy court was being used as a weapon in an ongoing dispute, between the debtor and his former spouse.


a. A chapter 7 debtor's former spouse filed a complaint to force the trustee to abandon estate's alleged one-half interest in golf course, on the theory that an equitable distribution order entered by state's divorce court had deprived the debtor of any interest in the golf course.

b. The U.S. Bankruptcy Court for the District of Colorado entered an order dismissing the complaint, and the former wife appealed.
c. The District Court reversed and remanded.

d. On remand, the Bankruptcy Court held that the bankruptcy court's prior order modifying the stay satisfied the equitable distribution order previously entered by the state divorce court, which awarded the golf course to the debtor's former spouse.

e. Upon appeal, the District Court held that:

(1) former wife's untimely motion to amend the bankruptcy court's order was properly treated as a motion to lift stay; and

(2) the decision to grant requested relief from automatic stay was not an abuse of discretion.

f. Upon appeal to the Court of Appeals for the 10th Circuit, the Court held, in an unpublished decision, that:

(1) the District Court's affirmance of the relief granted to the former wife was reversed.

(2) the case was remanded with instruction to the District Court and/or Bankruptcy Court to either conduct a hearing on the merits to fix the respective marital property interests in the golf course and driving range, or to defer the matter to state court for adjudication.

3. In re Robbins, 964 F.2d 342 (4th Cir. 1992)

a. The chapter 11 debtor's wife moved for lift of stay in order to allow the state court divorce action to continue.

b. The U.S. District Court affirmed the bankruptcy court's order lifting stay.

c. An appeal was taken and the court of appeals held that lifting of stay for cause, so that the state court could enter equitable distribution judgment was not an abuse of discretion.

a. Former chapter 7 debtor moved to reopen her bankruptcy case in order to commence adversary proceeding against her former husband, for husband's alleged violation of discharge injunction in seeking to modify divorce court's equitable distribution award based on the debtor's discharge in bankruptcy.

b. The bankruptcy court held that the husband violated discharge injunction when, following entry of wife's bankruptcy discharge, the husband sought to modify property settlement provisions of divorce decree.

5. Exceptions to the automatic stay

a. 11 U.S.C. §362(b)(2) exempts the following from the automatic stay

   (1) collection of alimony, maintenance or support from non estate property.

II. PROPERTY OF THE ESTATE

A. The bankruptcy court may take an active role in determining the status and ownership of the property of parties to a marriage.

1. The property of a marriage formerly under the jurisdiction of the divorce court, becomes property of the estate under the exclusive jurisdiction of the bankruptcy court.

2. This includes all community property and all of the filing spouses share of jointly owned property in a non-community property state.

3. 11 U.S.C. §541 provides that property of the estate includes all interests of the debtor and the debtor' spouse in community property as of the commencement of the case.

4. An estate is created with the filing of a petition.

B. Property of the estate includes:

1. Real and personal property.

2. Property in the debtor's possession.
3. Property of the debtor that is in another person's possession.

4. Awards from lawsuits.

5. Any interest in property that the debtor acquires or becomes entitled to acquire within 180 days post-petition:
   a. By bequest, device, or inheritance.
   b. As a result of a property settlement agreement with debtor's spouse or per final divorce decree.
   c. As a beneficiary of a life insurance policy or a death benefit plan.

C. Exemptions

1. The debtor is entitled to certain exemptions. Exempted property cannot be reached by the trustee or creditors, with the exception of creditors holding liens against the property.

2. There are state exemptions and federal exemptions available. The debtor must choose one of the two. Common exemptions include:
   a. Homestead exemption.
   b. Household goods.
   c. Motor vehicles.
   d. Tools of the trade.

D. Applicable Case Law

1. Debtor's pension is not considered property of the debtor's estate, as divorce decree creates constructive trust in favor of former wife.

2. Entry of divorce decree post-petition, creates new property interest that becomes estate property and renders debtor's claimed exemption for marital exemption inapplicable.
a. Virginia law terminates co-ownership upon divorce.

(1) See In re Cordova, 73 F.3d 38 (4th Cir. 1996).

b. 11 U.S.C. §541 includes in the bankruptcy estate a debtor's interest in entirety property.


Once a tenancy by the entirety terminates, the debtor and the bankruptcy estate are released "from all conditions of the tenancy conditions to preserve the unity of entirety property." Id. at 371-72.

III. LIENS

A. Liens and security obligations are not discharged in bankruptcy.

1. When possible, property settlement obligations should be secured with property retained by the debtor's spouse.

2. Agreements for one spouse to pay the obligations of the marriage are usually dischargeable as being in the nature of a property settlement.

a. Although some courts in considering the financial ability of the non-filing spouse, have held that a duty to pay third party claims, to be in the nature of support rather than property settlement.

B. Protection of the non-filing spouse

1. The non-filing spouse should be protected from collection enforcement by creditors by securing a lien in the property retained by the debtor.

2. Often, the family home is awarded to one spouse with an equalizing claim given to the other,

3. A judicial lien is placed on the one-half interest owned by the spouse granted full ownership for the loss of ownership interest to the other spouse.

a. However, 11 U.S.C. §522(f) of the bankruptcy code permits the debtor to avoid a judicial lien which impairs a homestead.
b. The Supreme Court in *Farrey v. Sanderfoot*, 500 U.S. 291 (1991) held that 11 U.S.C. §522(f) of the bankruptcy code could not be used to void the divorce lien on the creditor spouse's former ownership interest in the family home.

4. To the extent that the decree also creates a lien on the one-half interest owned by the spouse granted full ownership in the decree, section 522(f) may still be effective.


C. The liens securing an obligation are not discharged in bankruptcy.

1. Wherever possible, property settlement obligations should be secured with property retained by the debtor's spouse.

2. Agreements for one spouse to pay the obligations of the marriage are usually dischargeable as being in the nature of a property settlement although some bankruptcy courts, in consideration of the financial ability of the non-filing spouse, have held that a duty to pay third-party claims to be in the nature of support rather than a property settlement.

3. It is the better practice to protect the non-filing spouse from collection enforcement of creditors by securing a lien in the property retained by the debtor.

4. Frequently, the family home is awarded to one spouse with an equalizing claim given to the other to compensate for the loss of his or her ownership interest.

5. A dangerous practice prevalent in dissolution cases is the reliance on the decree itself as a judgment lien to secure that obligation.

6. Section 522(f) of the Bankruptcy Code permits the debtor to avoid a judicial lien which impairs a homestead.

a. The United States Supreme Court in the case of *Farrey v. Sanderfoot*, 500 U.S. 291 (1991) ruled that Section 522(f) of the Bankruptcy Code could not be used to void the divorce lien on the creditor spouse's former ownership interest in the family homestead.
b. To the extent that the decree also creates a lien on the one-half interest owned by the spouse granted full ownership in the decree, Section 522(f) may still be effective. See Owen, supra.

7. The state court may proceed in further protecting its decree by conditioning the award of the home to one party, and the recipient spouse executing a mortgage or deed of trust to the other spouse to secure the amount of equalizing debt.

8. In re Parrish, 7 F.3d. 76 (5th Cir. 1993)

a. The Fifth Circuit Court of Appeals held that under Texas law, property inherited by husband during marriage and prior to divorce was his separate property, and thus the attaching to the property pursuant to state court divorce decree was avoidable under bankruptcy code provision, and

b. thus allowed debtor to avoid the fixing of judicial lien on property made exempt as homestead.

c. See also Mead v. Mead (In re Mead), 974 F.2d 990 (8th Cir. 1992)

(1) A chapter 13 debtor sought to avoid a lien on her homestead granted in favor of former husband in a divorce decree and reinstated by judgment in a fraud suit.

(2) The bankruptcy court denied the debtor's motion and the district court affirmed.

(3) The debtor appealed and the court of appeals affirming in part, held that reinstatement on grounds of fraud of lien which chapter 13 debtor's former husband had been granted in a divorce decree and which had been released by a quit claim deed, resulted in lien securing the same debt as the lien imposed in the divorce decree.

(4) Therefore the debtor could not avoid reinstated lien on her homestead;

(a) but a portion of the lien securing the prejudgment interest was a new judicial lien, and could be avoided.
IV. TENANTS BY THE ENTIRETY

A. Certain states have given statutory recognition to the concept of tenancy by the entireties.

1. The existence of this property distinction means the existence of the indestructible right to survivorship derived from the former concept of husband and wife as a single legal entity.

2. Neither husband or wife can individually sell his or her interest in the couple’s real estate or any future interest.

3. The property is immune from the reach of creditors to satisfy the individual debt of either spouse.

4. Although the entirety estate may be reached by joint creditors, the estate may not be levied upon execution of a judgment against either spouse individually.

5. In tenants by the entirety states, the debtor spouse has no power to transfer or alienate his interest in real property held by the entirety.

B. The trustee may not alienate entireties property as the debtor’s spouses’ interest in the property is not vested in the bankruptcy estate.

V. DOMESTIC RELATIONS OBLIGATIONS & THE CHAPTER 13 PLAN

A. Confirmation may be denied on feasibility grounds pursuant to Section 1325(a)(6) when the debtor’s plan does not provide for alimony or support obligations

B. Some courts have allowed plans paying less than 100% of pre-petition arrearage, and the remainder being non-discharged at the end of the case.

C. Most courts have concluded that a chapter 13 plan must make reasonable provisions for paying pre-petition arrearages on alimony, maintenance and support; and property settlement claims.

D. Applicable case law

1. Alimony, maintenance and support after October 22, 1994


c. This court must therefore determine whether the provisions of the divorce decree fall within the aegis of being actually in the nature of alimony, maintenance or support. ...

d. According to general rules of statutory construction, identical words used in different parts of the same act are intended to have the same meaning. ...

e. The language of §523(a)(5)(B), the provision governing which specific debtors' exemptions from discharge is identical [sic] to that of amended §507(a)(7)(B)...

f. "The plethora of case law discussing whether debts are `actually in the nature of alimony, maintenance or support under §523(a)(5) is applicable and useful precedent in determining whether such debts should receive priority treatment."

g. Payment of support need not be paid directly to the spouse or ex-spouse to be considered a non-dischargeable debt. ...

h. "We must look to the intent of the trier [of] fact with respect to those obligations. ..."

i. "The fees incurred in the litigation would be actually in the nature of support or maintenance."

j. "The intent of the Circuit Court of the City of Portsmouth was that the debtor pay the fees and costs enumerated after due consideration of the parties' respective assets and financial ability to pay the costs of divorce."

k. Therefore, this court finds that the debts for attorney's fees and costs are actually in the nature of maintenance or support under the
statutory language of both 11 U.S.C. §523(a)(5) and §507(a)(7)(B), and are therefore priority claims."


a. Non-dischargeable judgment for prepetition child support arrearages accumulates post petition and post confirmation interest at the Kentucky statutory rate of 12%;

b. plan payment of arrearages without interest does not defeat the former spouse's right to postpetition and post-confirmation interest.

c. Citing *Bruning*, and analogizing to student loans, child support arrearages are non-dischargeable, accrue post-petition and post-confirmation interest and the accumulating interest is non-dischargeable upon completion of payments.

d. However, during the chapter 13 case, the arrearage claim holder cannot have an allowable claim for the post-petition (unmatured) interest.

VI. DISCHARGEABILITY

A. Under the Bankruptcy Code, there are various limitations regarding dischargeability of debt.

1. Chapters 7, 11, 12 and 13 each contain restrictions on obtaining a general discharge.¹

2. In addition, exceptions to the dischargeability of specific debts are covered by 11 U.S.C. §523(a), which is applicable to individuals under Chapters 7, 11 and 12, and,

3. to some extent, under chapter 13.

B. In some instances debts that are not specifically excepted by bankruptcy law from discharge, are discharged in bankruptcy.

1. *See, In re Johnson, 323 F.2d 574 (3rd Cir. N.J. 1963).*

¹See 11 U.S.C. §727, and §1141(b), §1228 and §1328.
2. Debts to a spouse, former spouse or child of the debtor, for alimony, maintenance, or support, are non-dischargeable.

3. Palimony obligations are not dischargeable.
   a. See, e.g., In re Doyle, 70 B.R. 106 (9th Cir. BAP 1986).

C. The 1985 code clarified marital obligations and determined that property settlement obligations may no longer be dischargeable.

1. See In re White, 84 B.R. 818, 821 (Bankr. N.D. Fla. 1988); In re Swiczkowski, 84 B.R. 487, 489 (N.D. Ohio 1988)


D. There are three categories of financial obligations emanating from divorce. These include:

1. Alimony or spousal support

2. Child support; and/or

3. Property settlement obligations
   a. The first two categories are prospective at the time of the divorce in that they access any obligation to provide temporary, and future support to a party's former spouse or children, based upon future need.

2. Thus, contrary to the prospective aspect of alimony and support, property settlement issues involve retrospective consideration relating to dividing assets and liabilities accumulated during marriage.

3. Property settlement obligations entail debts payable by former spouses to each other, or to third parties, where the obligated spouse has received marital assets in exchange for the responsibility to make certain payments, or where the division of marital liabilities requires that third party payments be made.

E. 11 U.S.C. §523(a)(5) does not make a distinction between spousal and child support, alimony, maintenance or support.

1. They are all given equal status.
2. Historically, the code provided for nondischargeability of support only when granted in a separation agreement, divorce decree or property settlement.


3. However, under the bankruptcy amendments of 1984 support became nondischargeable if provided for in any order of a court of record.


4. Thus, in determining dischargeability, the bankruptcy court needs to make an independent determination as to the true nature of the financial obligation in question.

5. Dischargeability is no longer controlled solely by the language of the divorce decree.

   a. See, e.g., Sampson v. Sampson (In re Sampson) 997 F.2d 717 (10th Cir. 1993), and


F. Various forms of what amounts to maintenance or support can be identified by many labels including alimony, property settlement, support, property settlement in lieu of alimony or any other related terms which are not dispositive for bankruptcy purposes.

1. Traditional characteristics of true alimony include periodicity of payments, termination of the obligation upon death or remarriage of the obligee, spouse, and modifiability.

2. Are support or maintenance payments modifiable?

   a. See Matter of Albin, 591 F.2d 94 (9th Cir. 1979);


3. The court in In re Midnet, 84 B.R. 776, 779 (Bankr. M.D. Fla. 1988) identifies several factors to be considered in determining whether an obligation is in the nature of alimony, support or maintenance and states as follows:
a. A determination of what constitutes support or alimony should include whether the obligation is subject to contingency such as remarriage, or death,

b. whether payment appears to balance disparate incomes,

c. whether the obligation is payable in installments or in a lump sum,

d. whether there are minor children, where there was in fact a need for support at the time it was awarded,

e. the structure in terms of the final decree,

f. whether the award is modifiable,

g. the manner of enforcement of the award and debts.


4. The Sixth Circuit has held that Congress has apparently charged the bankruptcy court with a duty to form a federal bankruptcy common-law of domestic relations in order to determine what constitutes support or maintenance.


b. It has been held that application of a federal law standard is appropriate since a federal law doctrine that of "the fresh start" is at issue. See In re Warner, 5 B.R. 434 (Bankr. D. Utah, 1980).

G. A determination of whether support payments are intended as support and maintenance becomes a necessary issue in determining dischargeability of debt.

1. Not all debts are discharged by filing bankruptcy.

2. Payments in the nature of property settlements are discharged, however Section 523(a)(5) exempts from discharge a debt to a spouse, former spouse, or child of the debtor for alimony, to maintenance for, or support of both such spouse or child.

3. In addition, a property settlement agreement which is in the nature of alimony, maintenance or support is also nondischargeable.
4. The bankruptcy court will not be bound by the labels given to the debts in a decree or settlement. Although the bankruptcy court is not bound by principles of state law regarding this matter, the bankruptcy court will give attention to the intent of the parties as expressed by the totality of the agreement for the divorce judgment.

5. Although the bankruptcy court will look to the development of federal law, it may also look to state law for "guidance" in making its decision.

6. Disputes over child support are infrequent as the obligation is not typically subject to confusion with property settlement payments.

H. The fact that state law or an agreement characterizes payment as support or property settlement, or even the fact that state law does not recognize alimony or a duty of support, is not dispositive.

1. Most courts have held that a debt for the divorce attorney's fees is owed to the former spouse as a third-party beneficiary as well as to the attorney, and therefore may be nondischargeable, if it is in the nature of support.

I. Bankruptcy Court decisions that analyze the characteristics of spousal support and of property settlement set forth a series of criteria to aid in determining the issue including the following:²

1. Do the payments terminate after the remarriage of the other spouse?

2. Are the payments made directly to the other spouse?

3. What were the relative earnings of the parties?

4. What was the extent and nature of the property of the marriage to be divided?

5. Was there a business of professional practice involved?

6. Do the payments appear to have a relationship to the property awarded to the spouse making the payments?

7. Is the payment obligation enforceable by contempt?

²See, generally Section VIII infra.
8. Is the payment obligation subject to modification due to a change in economic circumstances of either spouse?
9. What are the living expenses of the receiving spouse?
10. What inferences can be drawn from the settlement documents, findings, or decree regarding the nature of the obligation?
11. Whether payments are for a sum certain payable over a short period of time?
12. What is the tax treatment of the obligation?
13. The issue of whether a debt is in the nature of alimony or child support does not have to be determined by the Bankruptcy Courts.
   a. Both Bankruptcy Courts and State courts share concurrent jurisdiction over issues of alimony, support and maintenance.

VII. ALIMONY AND CHILD SUPPORT PAYMENTS PURSUANT TO 11 U.S.C. §523(a)(5) ARE NON DISCHARGEABLE

A. Generally a determination of whether marital debts are dischargeable is a matter of federal law.

B. Bankruptcy Courts may look beyond the language of a divorce judgment and determine if alimony payments are actually intended as maintenance or support payments.

1. In In re Calhoun, 715 F.2d 1103 (6th Cir. 1983)
   a. The Court held that the Bankruptcy Court should not merely rely on language in separation agreement to determine whether assumption of joint debts constituted non dischargeable support.
   b. The Court should examine party’s intent and look at whether assumption has effect of providing necessary support.
   c. But see Forsdick v. Turgeon, 812 F.2d 801 (2nd Cir. 1987).³

³See also In re Fitzgerald, 9 F.3d 517 (6th Cir. 1993) where Judge Kennedy sought to clarify In re Calhoun means test.
2. See also Boyle v. Donovan, 724 F.2d 681 (8th Cir. 1984)
   a. The court held that the debtor's promise to pay for son's graduate education as part of a divorce settlement was intended as support and is non-dischargeable.

3. In re Harrell, 754 F.2d 902 (11th Cir. 1985)
   a. The court held that the debtor's obligation to pay accrued alimony arrearages and postmaturity child support and education expenses are non-dischargeable,
   b. Notwithstanding the ex-wife's lack of need or state law which does not require debtor to support debtor's child after age of majority.

4. In re Singer, 787 F.2d 1033 (6th Cir. 1986)
   a. The court held that separation agreement indicates that periodic cash payments, which were not to exclude future maintenance or support,
   b. represents non-dischargeable debt in connection with alimony, maintenance or support.

5. In re Goin, 808 F.2d 1391 (10th Cir. 1987)
   a. The court held that four factors are necessary in determining whether a debt is support: (1) if the agreement fails to provide explicitly for spousal support, the court may presume that the property settlement is intended for support; (2) if there are minor children; (3) direct payments to the recipient; (4) an obligation that terminates upon re-marriage.
   b. See also Shaver v. Shaver, 736 F.2d 1314 (9th Cir. 1984);
   c. Matter of Benich, 811 F.2d 943 (5th Cir. 1987).

6. In re Gianakas, 917 F.2d 759 (3rd Cir. 1990)
   a. The court held that the intent of parties at the time of agreement, determines whether property settlement agreement is in the nature of alimony, maintenance, or support.
7. *In re Dvorak*, 986 F.2d 940 (5th Cir. 1993)

   a. The court held that court ordered obligation to pay attorneys' fees and guardian ad litem fees, incurred in connection with the post-divorce child custody proceeding, was non-dischargeable support.

C. Attorney fees may be non-dischargeable

   1. In *In re Spong*, 661 F.2d 6, 8 (2nd Cir. 1981), the court held that attorney fees of wife which debtor agreed to pay pursuant to stipulation incorporated into divorce decree are properly characterized as alimony and support.

   2. In *In re Silansky*, 897 F.2d 743 (4th Cir. 1990), the court held that obligation to pay ex-spouse's attorneys fees incurred in divorce proceeding held non-dischargeable.

   3. In *In re Rios*, 901 F.2d 71 (7th Cir. 1990), the court held that §523(a)(5) should not be read literally, and debtor's attorneys fees from child support proceedings were held dischargeable.

D. Pension Benefits

   1. In *Bush v. Taylor*, 893 F.2d 962 (8th Cir. 1990), the court held that former spouse's one-half share in debtor's pension benefits held by debtor is non-dischargeable constructive trust for former spouse.

E. Hold harmless agreements

   1. *In re Robinson*, 921 F.2d 252 (10th Cir. 1990)

      a. The court held that when divorce decree requires debtor to hold spouse harmless on debt, refinancing of debt by spouse has no affect on debtor's duty.

F. *United States v. Sutton*, 786 F.2d 1305 (5th Cir. 1986)

   a. The court held that: unmatured support claims are not allowable against assets of debtor's estate and may be only collected against debtor personally, either from exempt or post-petition assets.


   A. Expansion of non-dischargeable debt
1. The 1994 Amendments added 11 U.S.C. §523(a)(15) to establish a new category of non-dischargeable marital related debts, thus expanding the support exceptions pursuant to §523(a)(5).

2. 11 U.S.C. §523(a)(15) establishes two new opportunities for recovery on behalf of a non-debtor spouse left with an unfulfilled property settlement debt, which are incurred as part of a divorce or separation agreement or those that do not qualify under 11 U.S.C. §523(a)(5) as alimony, maintenance or support are dischargeable if

   a. the debtor has the ability to pay them; or

   b. if discharge would create a benefit which outweigh the detriment imposed upon the claimant.

B. Bankruptcy Courts have disagreed as to burden of proof issues under 11 U.S.C. §523(a)(15)

1. All agree that general black letter law is that an objecting creditor must establish non-dischargeability by a preponderance of the evidence.


C. Some bankruptcy courts have held that the objecting creditor has the burden of persuasion of all material issues under 11 U.S.C. §523(a)(15).


   a. In this case the court stated that practically speaking 11 U.S.C. §523(a)(15) calls for a creditor showing that the debtor can pay for his or her obligations despite the bankruptcy petitioner's plan.

   b. Some bankruptcy courts have determined that under 11 U.S.C. §523(a)(15) as with the dischargeability of student loans under §523(a)(8) that the debtor has the burden of persuasion on certain material issues.

   c. First the creditor must show that he or she holds a claim incurred by the debtor in the course of a divorce or separation in connection with the separation agreement, divorce decree or other order of a court of record.
2. Upon such a showing the burden of proof will shift to the debtor who must prove either an inability to pay the debt under 11 U.S.C. §523(a)(15) or that the discharge would result in a benefit to the debtor that outweighs the detrimental consequences to the debtor's spouse or children under 11 U.S.C. §523(a)(15)(b).

3. The court in In re Carroll stated that by its language 11 U.S.C. §523(a)(15) sets up a rebuttable presumption that any property settlement obligation arising from a divorce is non-dischargeable, unless the debtor can prove one of the above stated elements.

a. Thus, once a former spouse brings a timely dischargeability action under 11 U.S.C. §523(a)(15) the burden of proof shifts from the debtor.


D. Some court have held that the exceptions to non-dischargeability under 11 U.S.C. §523(a)(15) should be pled as affirmative defenses. See, Hill v. Hill (In re Hill), 184 B.R. 750 (Bankr. N.D. Ill. 1995).

1. Alternatively, it has been held that at least the burden of going forward shifts to the debtor if not the burden of proof.


2. There are essentially two defenses that the debtor may assert:

a. the debtor may argue a reasonable inability to pay the obligation while supporting himself or herself, or

b. the debtor may show that discharging the debt would result in a benefit to the debtor that outweighs the detrimental consequences to the complaining spouse, former spouse or child of the debtor. See 11 U.S.C. §523(a)(15)(B).

E. Debtor's ability to pay
1. A non-support divorce judgment obligation is dischargeable if paying the debt reduces the debtor's current income below that necessary for the support of a debtor and the debtor's dependents.

   a. *In re Carroll, supra*

2. In the same vein, a debtor engaged in the business is not required to expend funds necessary for the continuation, preservation or operation of the business.


3. Thus the court must engage in a careful evaluation and analysis of the debtor's expenses, potential to earn income, both current and future.

F. Hardship

1. Even if a debtor is able to pay the obligation in question, the debt is dischargeable if discharge is more beneficial to the debtor and detrimental to the complaining party.


2. The House Committee's Judicial Report relative to 11 U.S.C. §523(a)(15) states that the debt will also be discharged if the benefit to the debtor of discharging the debt outweighs the harm to the obligee.

   a. For example, if a non-debtor spouse who suffers little detriment from the debtor's non-payment of an obligation required to be paid under a hold harmless agreement (perhaps because it could not be collected from the non-debtor's spouse, or because the non-debtor spouse could easily pay it) the obligation would be discharged. The benefits of the debtor's discharge should be sacrificed only if there would be substantial detriment to the non-debtor's spouse that outweighs the debtor's need for a fresh start. *H.R. Rep. No. 103-835, 103rd Cong. 2d Sess. 54,* reprinted in 1994 U.S. Code. Cong. and Admin. News 3363; *Woodworth v. Woodworth (In re Woodworth)* 187 B.R. 174 Bankr. N.D. Ohio 1995); *Hill v. Hill (In re Hill)*, 184 B.R. 750 (Bankr. N.D. Ill. 1995).
6. The court in Phillips v. Phillips (In re Phillips), 187 B.R. 363 (Bankr. M.D. Fla. 1995) said that 11 U.S.C. §523(a)(15)(B) requires this court to exercise its pure equitable powers. To apply this section Congress intended, this court must in essence evaluate the lifestyles of the parties that measure the benefit of former husbands discharged against the degree of harm suffered by former wives. The legislative history essentially requires the court to make a value judgment in determining which party suffers the most.

7. Is A Partial Discharge Possible?

a. It is unclear whether or not Congress intended an all or nothing clause.

b. Some scholars have argued that the phrase to the extent that precludes the court from issuing or limiting a discharge and that the court is mandate to issue an all or nothing result.

c. See, e.g., In re Florio, supra.

d. But see, Comisky v. Comisky (In re Comisky) 183 B.R. 883 (Bankr. N.D. Cal. 1995) where a California Bankruptcy Court recently discharged part of the divorce decree obligation on grounds that the debtor did not have the ability to pay it all but accepted part on the basis that, over a reasonable period of time, the debtor could afford to pay part of the debt.

(1) In addition the court allowed the debtor to pay in installments.

IX. MISCELLANEOUS CASE LAW

A. Bad Faith

1. In re Huckfeldt, 39 F.3d 829 (8th Cir. 1994)

a. A motion was filed to dismiss debtor's chapter 7 case as bad faith filing.

2. The bankruptcy court dismissed the case and the debtor appealed the Court of Appeals held that cause existed for dismissal of chapter 7 case which was filed for the purpose of frustrating the state court divorce decree.
B. Transfers

1. Prepaid Support Obligations Recoverable by the Bankruptcy Estate

   a. In re Futoran, 76 F.3d 265 (9th Cir. 1996).

      (1) A chapter 7 debtor made a lump sum, prepetition payment to his former wife in exchange for the cancellation of the marital termination agreement, which obligated the debtor to make monthly support payments to his wife for up to five years.

      (2) The Ninth Circuit ruled that such debtors may not decrease the amount of their non-exempt assets by pre-paying support obligations that come due postpetition, reasoning that such obligations constitute antecedent debt, not new value, and are therefore preferential transfers recoverable by the trustee under Code §547.

      (3) The court also stated that equitable considerations do not preclude recovery by the trustee because that would frustrate the Code's goal of providing a "proportionate distribution of the debtor's assets among it creditors."
ISSUES AND PROBLEMS
IN
CHAPTER 11 CASES

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Atlanta, Georgia
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SOME NUMBERS

$1,494,900 - budget for Bankruptcy Review Commission

{not counting preface, page 918a, and "Individual Commissioners' Views"}

0 - people willing to take responsibility for choice of yellow cover of Bankruptcy Review Commission Report


100 - years since the publication of Dracula

1,316,999 - cases filed in the 12 month period ending 6/30/97

26.4% - increase in filings over the same period in 1996

12,859 to 11,159 - decrease in Chapter 11 filings for this period

36 - Joe Lee's years of service on the bankruptcy bench
SOME WORDS OF INSIGHT AND INSPIRATION

After Marjorie fell asleep, he reached over to his nightstand and grabbed his Bankruptcy Code. Whenever he had a big case coming up, a confirmation hearing, a hearing on a lift-stay motion, or any other dispositive proceeding, instead of girding his loins and painting his face, he prepared himself, late at night, by studying the Code. After the clamor and smoke of the daily battles had cleared, after everyone else had gone to bed, after his opponents had gone home to weaken themselves with alcohol or distract themselves with women or children, after it was absolutely quiet, Randall sat up absorbed in the Code, the source of all his power.

In any bankruptcy proceeding, no matter how big or how much money was involved, the parties usually ended up arguing over the meaning of a mere six or seven sections of the Code that were crucial to the disposition of assets in that particular case. Randall already knew most of those sections by heart, but early in his career he discovered that if, on the eve of battle, he read those crucial provisions, over and over, ten or twenty times, late into the night, and on into the morning, he often discovered some new relationship between them, some new bit of legislative history, or an obscure but creative judicial gloss on one of the clauses, which in turn affected the provision and its relationship to the other provisions in that section, and ultimately the relationship of the section to the other sections and to the Code itself, which in turn led to another theory of the case, and before he knew it -- almost as if by magic -- he discovered an entirely new method for destroying his client's adversaries and recapturing the assets that had wrongfully been taken on a fraudulent promise to repay.

Randall was Magister Ludi, the Code was his glass-bead game. Everyone knew the sections and the provisions in the sections, but it was the relationships between them that only the masters understood.

I. VALUATION AFTER RASH

In June, the United States Supreme Court's decision in Associates Commercial Corporation v. Rash, 117 S. Ct. 1879 (1997), brought to an end a five-year battle over $9,125. In an 8-1 opinion, the Supreme Court held that when a debtor under Chapter 13 of the United States Bankruptcy Code (the "Code") proposes to cram down a plan of reorganization over the objection of a secured creditor, the creditor's collateral must be valued at its replacement cost.

Section 506(a) of the Code is the provision that deals with valuing secured claims. This section states:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

In an en banc decision, the Fifth Circuit in In re Rash, 90 F.3d 1036 (5th Cir. 1996) had held that the first sentence of Section 506(a) instructed courts to focus upon valuation from the creditor's perspective, using as a starting point the amount the creditor would receive if it exercised its state law remedies by repossessing and selling the collateral.

The Supreme Court reversed. In an opinion by Justice Ginsberg, the court rejected the Fifth Circuit's approach to section 506 and stated that "[t]he full first sentence of § 506(a), in short, tells a court what it must evaluate, but it does not say more; it is not enlightening on how to value collateral." 117 S. Ct. at 1885 (1997). The Court then looked to the second sentence of Section 506(a) for enlightenment on how value should be determined. Because value should be determined "in light of the purpose of the valuation and of the proposed disposition or use of such property," a bankruptcy court must look to the proposed disposition or use of the property when considering the appropriate value for a particular piece of collateral. The Court concluded its opinion by stating:

In sum, under § 506(a), the value of property retained because the debtor has exercised the § 1325(a)(5)(B) "cram down" option is the cost the debtor would incur to obtain a like asset for the same "proposed . . . use." Id. at 1886.

But the Court attached a footnote to this last sentence of the opinion which emphasized that determining replacement value will be a fact intensive inquiry.

Because this concluding footnote in the Rash decision is likely to be the focus of significant future litigation, it is set forth below in its entirety.
Our recognition that the replacement-value standard, not the foreclosure-value standard, governs in cram down cases leaves to 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. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is its retail value, an adjustment to that value may be necessary: A creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties, inventory storage, and reconditioning. Cf. 90 F.3d at 1051-52. Nor should the creditor gain from modifications to the property--e.g., the addition of accessories to a vehicle--to which a creditor's lien would not extend under state law.

Future litigation is likely to focus on the sentence that is underscored. More specifically, future litigation is likely to focus on the words in that sentence in bold print: "inventory storage." Cf. In re Mulvania, 1997 WL 619201 (BAP) 9th Cir. 1997) ("this language [fn. 6] does not require a court to deduct costs of sale when determining the replacement value of a secured claim.")

II. AUTOMATIC STAY

"The dead shade tree gives no shelter." T.S. Eliot, The Waste Land (1922). Like a shade tree, the automatic stay which attends the initiation of bankruptcy proceedings must be nurtured if it is to retain its vitality.

In re Soares, 107 F.3d 969, 971 (1st Cir. 1997).

A. Overview of Stay Questions

#1. When does stay become effective?
#2. What is affected by the stay?
#3. When does the stay become ineffective?
#4. How can a creditor effect relief from the stay?
#5. What are the effects of violating the stay?
B. Some Current Stay Problem Areas

1. Does a creditor violate the automatic stay by dismissing an employee who has filed for bankruptcy relief?


2. Is continued possession by a secured party who repossessed prepetition a violation of the automatic stay?


3. Does the automatic stay end when property is abandoned?


4. What is the effect of a provision in a prebankruptcy workout agreement that waives the automatic stay in the event of a subsequent bankruptcy?


5. What is the applicability of Rash to stay litigation?

6. When will the court "annul" the stay?

See section 362(d); In re Soares, 107 F.3d 969 (1st Cir. 1997) ("Because the stay is a fundamental protection for all parties affected by the filing of a petition in bankruptcy, it should not be dismantled without good reason . . . Thus, if congressional intent is to be honored and the integrity of the automatic stay preserved, retroactive relief should be the long-odds exception, not the general rule."); In re Stork, 212 B.R. 970 (Bankr. N.D. Cal. 1997) (prepetition purchaser who records postpetition is entitled to annulment of stay if it qualifies for protection under 549(c)). For a more complete consideration of the relationship between sections 362(d) and 549(c), see In re Carpio, 1997 WL 610632 (Bankr. W.D. Mo. 1997).
III. LEASES AND OTHER EXECUTORY CONTRACTS

A. Gap Period Payment Obligations

365(d)(3)

The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period. This subsection shall not be deemed to affect the trustee's obligations under the provisions of subsection (b) or (f) of this section. Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

1. Is the debtor under a nonresidential real property lease required to pay rent in accordance with the terms of the lease until the lease is assumed or rejected?

As a result of the reference in section 365(d)(3) to "notwithstanding section 503(b)(1)," most courts have required gap period payments at the contract rate, regardless of the benefit to the estate. E.g., Norritech v. Geonex Corp., 204 B.R. 684 (Md. 1997); In re Twigland Fashions, Inc., 198 B.R. 199 (W.D. Texas 1996); Kirk Kennedy, The Case for Extending Super Administrative Expense Priority to Claims for Unpaid Rent Under Section 365(d)(3), Norton Bankruptcy Law Adviser (February 1996); contra In re Mr. Gatti's, Inc., 164 B.R. 929 (Bankr. W.D. Texas 1994) (Kelly).

2. Is the debtor required to pay prepetition taxes that become due under the lease postpetition?

National Terminals Corp. v. Handy Andy Home Improvement Centers, Inc., 1997 WL 619824 (U.S.D.C. N.D. Ill. 1997) held that the debtor was not obligated to make section 365(d) payment on the taxes that accrued prepetition but became due under the lease postpetition. The court based this holding on the language of the lease and the language of the majority of the

3. Is the debtor required to make section 365(d)(3) payments in cases where administrative solvency is questionable?

In answering this question, courts have looked to the phrase "timely perform" in section 365(d)(3), have looked to the priority over administrative expenses expressly provided for in section 364, (but not section 365(d)(3)) and have looked to section 726(b). Compare, In re Tel-Central Communications, Inc., 212 B.R. 342, 347 (Bankr. W.D. Mo. 1997) (after Chapter 7 administrative expenses), with In re New Almacs, Inc., 196 B.R. 244 (N.D.N.Y. 1996), (the court concluded that section 365(d)(3) gives the court discretion as to the timing but not the priority of lease payments: "In the event that it is necessary to delay said payments, the Court wishes to make it clear that any such payments are to be made in full and are not dependent on the extent to which other administrative claims ... are paid.") See generally In re Rich's Department Stores, Inc., 209 B.R. 810, 816 (Bankr. Mass 1997).

B. Assumption

In In re Klein Sleep Products, Inc., 78 F.3d 18 (2d Cir. 1996), the court reversed lower court rulings that rents due after surrender by the trustee would be treated as an unsecured claim and subject to the cap on rejection damages. The Second Circuit held that the rejection of an assumed lease gives rise to an administrative priority claim that is not subject to the limits of section 502(b)(6). See generally John Rapisardi, Landlords Take Delight: "Klein Sleep" Has Been Reversed, 4/19/96 NYLJ 1. Because of the consequences of an early assumption, In re Gateway Apparel, Inc., 210 B.R. 567 (Bankr. E.D. Mo. 1997) sustained a committee objection to the debtor's motion early in the case to assume leases.

C. Nonmonetary Defaults

Section 365(b)(2)(D) is set out below:

(2) Paragraph (1) of this subsection [requiring cure of defaults] does not apply to a default that is a breach of a provision relating to

(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.
Prior to its Chapter 11 filing, debtor had defaulted on its GM dealer agreement by its failure to operate for more than 7 days. The debtor asserted that under section 365(b)(2)(D) it was not required to cure the default in order to assume and assign. GM contended that section 365(b)(2)(D) only excused the payment of penalties arising from nonmonetary defaults. In In re Claremont Acquisition Corp., 186 B.R. 977 (C.D. Calif. 1995) reversed 113 F.3d 1029 (9th Cir 1997), the district court concluded that a debtor does not have to cure preassumption nonmonetary defaults but does have to provide adequate assurance that it can perform these nonmonetary obligations in the future. In overruling the district court, the Ninth Circuit looked to (1) grammatical construction, (2) the structure of Section 365, and (3) legislative history. 113 F.3d at 1034. See also Steven M. Goldman & Patricia Redmond, Does Reform Act Eliminate the Requirement that a Debtor Cure Nonmonetary Defaults When Assuming Executory Contracts? BCD Weekly News & Comment, October 24, 1995, at A3.

IV. SETOFF

553

A. Prepetition Setoff

A prepetition setoff can not be invalidated under section 547; section 553 controls. See, In re Wild Bills, Inc., 206 B.R. 8 (Bankr Conn. 1997) (Shiff); In re Murphy, 203 B.R. 972 (Bankr. C.D. Ill. 1997) (Lessen).

B. Government Agencies

In re HAL, Inc., 122 F.3d 851 (9th Cir. 1997) held that the government can setoff a debtor airline's overpayment to the IRS of excise taxes against the claims of other federal agencies against the debtor: "the United States is a unitary creditor for purposes of bankruptcy [both sections 553 and 106.]" This is consistent with the Ninth Circuit's decision in In re Doe, 58 F.3d 494 (9th Cir. 1995). It is inconsistent with the 1995 decision of the Tenth Circuit in In re Turner, 59 F.3d 1041 (10th Cir. 1995), however, in 1996, the Tenth Circuit, siting en banc, overruled its 1995 decision, In re Turner, 84 F.3d 1294 (10th Cir. 1996). See also In re Pyramid Industries, 210 B.R. 445 (U.S.D.C. N.D. Ill. 1997). Even after "Turner 2", In re Lopes, 197 B.R. 15 (Bankr. RI. 1996) (Votolato) held that the IRS and HUD lack section 553 "mutuality" -- that two different federal agencies can not be treated as a single unit for purposes of section 553. See also the concluding footnote in In re Guterl Special Steel Corp., 198 B.R. 128 (Bankr. W.D. Pa. 1996), a case in which the federal Economic Development Administration (EDA) held a lien on contaminated land and an issue before the court was whether the EDA or the EPA would bear the cleanup costs:

The discerning reader might think it odd to conclude that EDA, an agency of the federal government, would enjoy an
unfair windfall unless EDA reimburses EPA, another agency of the federal government, for the costs and expenses EPA incurs in cleaning up the site subject to EDA's security interest. We would not disagree with their assessment. However, we are constrained to employ such tortured, convoluted reasoning because, until very recently, different federal agencies refused to speak with a single voice and instead have elected to further their own parochial agendas.

See generally Wilbur Foster, Federal Agencies as a "Unitary Creditor" for Setoffs in Bankruptcy Cases, 114 Banking L.J. 142 (Feb. 1997); Barry Zaretsky, The Federal Government As a Creditor, 9/21/95 NYLJ 3 (col.1).

C. Discretion

In re Pyramid, 210 B.R. 445 (U.S.D.C. N.D. Ill. 1997), the district court affirmed the bankruptcy court's discretionary disallowance of setoff, stating:

As noted, section 553 does not require the bankruptcy court to allow or disallow a setoff. In fact, the bankruptcy court must exercise its equitable discretion in deciding to allow or disallow a setoff under section 553. ... The Hal court held that Congress allows discretionary use of setoff under section 553 of the Bankruptcy Code. Bankruptcy courts must take into account special considerations bearing on setoff as it arises in the bankruptcy context. They also must take into account the effects setoff may have on innocent third parties. Setoff should only be allowed where appropriate. Because allowing setoff is equitable and discretionary in nature, the bankruptcy court should disallow setoff if the rights of those other than the debtor and creditor are affected by the act: ... Here, the rights of those other than the SBA, Navy, and the contractor would be affected if the bankruptcy court allowed setoff. Allowing setoff would affect Subcontractors' right to payment for work that they completed on the Prime Contract. The bankruptcy court considered equitable principles, such as the equal treatment of creditors in similar positions, when it decided not to allow the Navy to offset its debt with the SBA. Allowing setoff would affect a percentage of Subcontractors' right to the Proceeds merely because of the "fortuitous" circumstances rendered especially probable where the competing creditor is an agency of the federal government. This problem is augmented in situations involving the federal government, as here, "given the pervasive nature of the government involvement in business (as debtor and creditor)." Consequently, the government's ubiquitous presence in the market
may inflict a unique level of violence to the principles of equity, at least where other creditors' interests are also at risk. In light of these considerations, the court finds that the bankruptcy court did not abuse its discretion in disallowing setoff in the given circumstances.

D. Setoff/Recoupment

The two major recoupment questions are (i) how is recoupment different from setoff and (ii) when is recoupment available.

In re Newbery Corp., 95 F.3d 1392 (9th Cir. 1996) contains a (i) comprehensive comparison of setoff/recoupment, (ii) a discussion of various debtor defenses to recoupment, (iii) the Ninth Circuit's "same transaction" test and (iv) resolution of a priority contest between a recouping creditor and a secured party. C issued payment and performance bonds for D's construction projects and D entered into a general indemnity agreement for losses from any default by D on the construction projects. After D's default on the projects, C and D entered into a second agreement under which C would complete the projects. This second agreement allowed C to use D's equipment and required C to pay rent for the use of the equipment to Citibank who held a security interest in D's assets. The Ninth Circuit emphasized that this second agreement specifically incorporated by reference the first agreement.

Newbery also dealt with and rejected the argument that recoupment impairs the rights of secured party Citibank, stating:

the purpose of the recoupment doctrine is merely to arrive at a just determination of the proper amount of a plaintiff's claim. Accordingly, when a third party has a security interest in that very claim, application of the recoupment doctrine does not impair the security interest, but merely serves to determine the value of the claim in which the third party holds its interest. In this case, Citibank's security interest in the Pooled Assets is in reality merely a right to a portion of the unspecified proceeds of Newbery's claim against Fireman's Fund. Because recoupment is designed merely to arrive at a proper calculation of the value of that claim, Citibank has little grounds to object to the application of the recoupment doctrine, even if application of that doctrine ultimately results in a determination that the property in which Citibank has a security interest is worthless. Accordingly, we reject Citibank's argument that application of recoupment here would impermissibly impair its security interest in the Pooled Assets.

In United States v. Consumer Health Services of America, Inc., 108 F3d 390 (D.C. Cir. 1997), the D.C. Circuit dealt with the issue of adjustment of postpetition Medicare reimbursements by prepetition Medicare overpayments. The court looked to the Medicare statute:
In determining whether the pre-petition and post-petition services should be thought of as one transaction, the key to us is the Medicare statute. Since it requires the Secretary to take into account pre-petition overpayments in order to calculate a post-petition claim -- as we have described above -- Congress rather clearly indicated that it wanted a provider's stream of services to be considered one transaction for purposes of any claim the government would have against the provider.

Contra University Medical Center v. Sullivan, 973 F.2d 1055 (3d Cir. 1992).

Recently, the Second Circuit held that a utility's postpetition application of a prepetition deposit to the debtor's prepetition utility bill was a valid recoupment ["within a single contract or transaction of a single set of transactions"] and so not subject to the automatic stay. In re McMahon, 1997 WL 691072 (2d. Cir. 1997).

V. CLASSIFICATION, 1122

The Code is silent as to whether all legally similar claims, i.e., nonpriority unsecured claims, must be in the same class. The courts are not silent but speak in several voices (if not in tongues). There is language in reported cases suggesting that section 1122 permits separate classification of similar claims, absent gerrymandering; there is also language suggesting that section 1122 prohibits separate classification of similar claims. Most courts have probably taken a middle ground permitting separate classification of similar claims if there is a business justification. See generally Scott Nordberg, Classification of Claims Under Chapter 11 of the Bankruptcy Code.: The Fallacy of Interest Based Classification, 63 Am.Bankr.L.J. 119 (1995); Bruce Markell, Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Classification, 11 Bankr.Dev.J. 1 (1994-95).

A. Secured Creditor's Deficiency Claim

B. Valid Business Reason

In cases involving classification of a secured creditor's deficiency claim, gerrymandering is generally the concern. What are the concerns if voting is not an issue -- i.e., there is a impaired assenting class?

LTV plan placed workers compensation claims in a separate class and provided for full payment of that class while other creditors would receive common stock that would yield between 37 cents and 44 cents on the dollar. In re Chateaugay Corp., 89 F.3d 942 (2d Cir. 1996) approved the classification because of the valid business reason for it.

In In re Graphic Communications, Inc., 200 B.R. 143 (Bankr. E.D. Mich. 1996) (Rhodes), the debtor's plan placed Midwest in a different class from other unsecured claims and proposed to pay 10% to Midwest on its unsecured loan and 100% to unsecured trade creditors. The court first found that there was a "rational business reason for the separate classification of Midwest's claim. Unlike the Class III trade creditors, Midwest is a competitor of the debtor and is not currently doing business with the debtor." The court then found that the debtor failed to demonstrate that the discriminatory treatment of Midwest - 10% v. 100% - was reasonable.

C. Relevance of 13 Case Law

The Chapter 13 debtors in In re Davis, 209 B.R. 893 (Bankr. N.D. Ill. 1997) (Schmetterer) filed a Chapter 13 plan that classified a landlord's back rent claim in a separate class to be paid 100% and all other unsecured claims in a class receiving 10%. In confirming the plan, the court stated:

If any plan discriminated unfairly simply because one unsecured creditor was paid more than another, the "discriminates unfairly" language of section 1322(b)(1) would be meaningless. A certain amount of disparity of treatment among unsecured creditors in a Chapter 13 plan is permitted. Debtors here have demonstrated their urgent necessity for full payment of the rental arrearage in order to save their home and have some cash flow to pay even the 10% to general unsecured creditors. While this treatment is certainly discriminatory, Debtors have shown that the discrimination is fair, even from the creditor's point of view. If the Amended Plan fails, those creditors will likely receive nothing, as all of Debtors' available income will go to pay higher rent. They will not get the 45% dividend that Harrison projects. In this case, the 10% dividend offered is worth more to creditors than a speculative 45% dividend.
VI. CRAM DOWN INTEREST RATES

A. Statutory Provisions

1129(b)(2)

For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides:

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

1225(a)(5)(B) and (C) and 1325(a)(5)(B) and (C)

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under the plan on account of such claim is not less than the allowed amount of such claim; or
B. 1997 Case Law From Circuits


While the reported decisions from the bankruptcy courts reflect diverse views, the Circuit Court opinions are essentially uniform. Eight of the circuits - Third, Fourth, Sixth, Seventh, Eighth, Ninth, Tenth and Eleventh - have issued opinions approving a comparable loan or "coerced loan" approach to "present value", *i.e.*, measuring cram down interest rate by what the secured creditor could have obtained had it foreclosed and reinvested the proceeds in loans of equivalent duration and risk. Two circuits, Eighth and Ninth, have recognized measuring cram down interest rate by a riskless base rate plus risk factors, as a possible alternative to the comparable loan approach. Only the Second Circuit has rejected the comparable loan approach.

1. Second Circuit

In *In re Valenti*, 105 F.3d 55 (2d Cir. 1997), a Chapter 13 car case, I presented the appellant's oral argument in Valenti; the appellant lost. Valenti is the only Circuit court decision on this question that I have argued. Valenti is the only appellate decision on this question that directly and expressly rejects comparable loans ("forced loans") as a possible measure of present value:

> We believe that courts adopting the "forced loan" approach misapprehend the "present value" function of the interest rate. The objective of section 1325(a)(5)(B)(ii) is to put the creditor in the same economic position that it would have been in had it received the value of its allowed claim immediately. The purpose is not to put the creditor in the same position that it would have been in had it arranged a "new" loan.

Are the second and third sentences of the above quotation consistent? What if the creditor would have arranged a new loan if it had received the value of its allowed claim immediately?
In the Second Circuit's view, the "forced loan" approach necessarily and improperly includes a profit for the lender. Valenti instead "hold(s) that the market rate of interest under section 1325(a)(5)(B)(ii) should be fixed at the rate on a United States Treasury instrument with a maturity equivalent to the repayment schedule under the debtor's reorganization plan "with a risk adjustment -- "a range of one to three per cent is reasonable in this Circuit."

2. Fifth Circuit

In Matter of Smithwick, 121 F.3d 211 (5th Cir. 1997), Chapter 13 debtors filed a plan that provided for a cram down interest rate of 11%, based on a local rule which required a formula approach to Chapter 13 cram down interest -- 2% plus The Wall Street Journal prime rate. The bankruptcy court confirmed and the district court affirmed. In reversing, the Fifth Circuit adopted the coerced loan approach, with the rebuttable presumption that the contract rate is the rate for a new loan. In dictum, Judge Jones noted that Smithwick is "consistent with the approach we have taken in Chapter 11 cases." But cf. Financial Security Assurance Inc. v. T-H New Orleans Limited Partnership, 116 F3d 790, 799 (5th Cir. 1997).

VII. STATE IMMUNITY

A. Possible Bankruptcy Proceedings Against State Government

- 362 stay violations
- 363 sale of property of the estate free and clear of liens held by State
- 505 determination of state tax liability
- 510 subordination of State's claims
- 522(f) avoidance of State lien on exempt property
- 523 dischargeability of State claim
- 544 to 548 avoidance of prepetition payment or other transfer to State
- 549 avoidance of postpetition payment or other transfer to State
- 28 U.S.C. 1452 removal of state court action by State agency against debtor

B. Sovereign Immunity

Sovereign immunity is a judicially created doctrine, derived from the common law premise that the king can do no wrong. There is no constitutional guarantee of sovereign immunity; there are not constitutional limitations on Congressional waiver of sovereign immunity.
C. Abrogation of Sovereign Immunity

Because sovereign immunity is not constitutionally guaranteed, Congress can by statute eliminate or abrogate sovereign immunity. Section 106 abrogates sovereign immunity.

United States v. Nordic Village, 503 U.S. 30 (1992) addressed the effectiveness of an earlier version of section 106 and found that ineffective because the abrogation of sovereign immunity was not "unequivocally expressed." 503 U.S. at 354. The present, amended version of section 106 seems to be the kind of unequivocal expression required by the Court.

D. Eleventh Amendment Immunity

The Eleventh Amendment is not sovereign immunity. It is not based on the common law premise that the king can do no wrong and does not immunize the State from suit. Rather, it was adopted to protect the States from the interference of the federal judiciary and deprives the federal courts of jurisdiction over suits brought against unconsenting states.

E. Abrogation of Eleventh Amendment Immunity

Congress can abrogate Eleventh Amendment "immunity" when it is legislating pursuant to the Fourteenth Amendment which was aimed at the States, came after the Eleventh Amendment and limited Eleventh Amendment immunity. After the Supreme Court's 1996 decision in Seminole Tribe of Florida v. Florida, 116 S.Ct. 416 (1996), a case involving the Indian Gaming Regulatory Act promulgated pursuant to the Indian Commerce Clause of Article I of the Constitution, "Article I cannot be used to circumvent the constitutional limitations placed upon federal jurisdiction." 116 S.Ct. at 1128.

F. Questions

1. Does the Seminole decision impact bankruptcy?

The Seminole decision has implications far beyond the regulation of Indians operating gambling venues in Florida. The majority's language and reasoning encompass all federal legislation enacted pursuant to Article I that attempts to abrogate the States' Eleventh Amendment immunity. (The bankruptcy clause is in Article I of the Constitution).

Footnote 16 in the majority opinion and footnote 12 in the dissent suggest that Seminole impacts bankruptcy. In Light v. State Bar of California, 87 F.3d 1320 (9th Cir. 1996), states that Seminole "forecloses any argument that section 106 of the Bankruptcy Code abrogates the States' sovereign (11th Amendment?) immunity."
There is some case authority that section 106 is a valid enactment pursuant to the privileges and immunities clause of the Fourteenth Amendment. See In re Straight, 209 B.R. 540 (U.S.D.C. Wy. 1997); In re Headrick, 200 B.R. 963 (Bankr. S.D. Ga. 1996); contra, e.g., In re Creative Goldsmiths of Washington D.C., Inc., 119 F.3d 1140 (4th Cir. 1997); Matter of Fernandez, 123 F.3d 241 (5th Cir. 1997).

2. Does the State waive its Eleventh Amendment immunity when it files a proof of claim?

The Eleventh Amendment only provides a shield from federal court jurisdiction to "unconsenting states." Seminole, 116 S.Ct. at 1131. The Eleventh Amendment permits a state to consent to federal suits. Cases are divided as to whether a State consents to bankruptcy court jurisdiction and waives its Eleventh Amendment immunity by filing a proof of claim. Compare In re Creative Goldsmiths of Washington D.C., Inc., 119 F.3d 1140 (4th Cir. 1997) (proof of claim not waiver); In re Sacred Heart Hospital of Norristown, 204 B.R. 132, 140-42 (E.D. Pa. 1997) (proof of claim not waiver) with In re Fennelly, 1997 WL 332169 (U.S.D.C. N.J. 1997) (claim as waiver).

3. Which governmental authorities are "states" for purposes of the Eleventh Amendment?

While sovereign immunity can apply to federal, state and local governmental entities, the Eleventh Amendment only applies to "states." It can be problematic to determine whether a governmental entity with both state and local characteristics is an arm of the state for purposes of the Eleventh Amendment. There is a helpful discussion of this problem in In re NVR L.P., 206 B.R. 831, 844-48 (Bankr. Md. 1997) which holds that Maryland county clerks were protected by the Eleventh Amendment from a declaratory judgment motion in bankruptcy but only in their capacity as collectors of state taxes.

4. Can the proceeding be brought against a particular state official?

Seminole discusses the intricate body of Eleventh Amendment law governing the circumstances under which a federal suit against state officials will be allowed. In general,

- the Eleventh Amendment bars a damages action against a public servant in his or her official capacity;
- injunctive relief is not barred;
- monetary relief that is "ancillary" to the prospective injunctive relief is not barred.

Accordingly, it would seem that under Ex parte Young, 209 U.S. 123 (1908), a debtor could maintain an action in bankruptcy court against a state official the agency's continuing stay violation. Cf. Seminole, 116 S.Ct. at 1133. In re Zywickzynski, 210 B.R. 924
5. Can the bankruptcy cause of action be brought against the State in state court?

Recall that the Eleventh amendment only protects the State from federal court litigation; it does not protect the State from litigation in state courts. Congress can create a federal remedy against a state that is enforceable in state court.

Under 28 U.S.C. 1334(b), state courts have concurrent jurisdiction over proceedings under title 11 or arising in or related to bankruptcy cases. Accordingly, it would seem that a bankruptcy trustee could bring a bankruptcy-related action against a state in state court. See generally Elizabeth Gibson, Sovereign Immunity in Bankruptcy: The Next Chapter, 70 Am.Bankr. L.J. 195, 203-208 (1996).

VIII. BUYING CLAIMS AGAINST THE DEBTOR

Rule 3001(e) deals with transfers of claims against the debtor. There are also several recent cases that deal with questions arising from such transfers.

A. Creditor's Buying Claims To Block Confirmation

In In re Figter Ltd., 118 F.3d 635 (9th Cir. 1997), a secured creditor purchased 21 of the 34 unsecured claims against the debtor in a Chapter 11 apartment case. In refusing to disallow or designate the claims under section 1126(e), the court noted that the creditor had offered to purchase all of the claims, was not the proponent of a competing claim, and was not a competing apartment owner. The standard in section 1126(e) is good faith. The Ninth Circuit found that the mere fact that the creditor/purchaser wanted to block confirmation of the debtor's plan was not, by itself, bad faith. Figter concluded: "[W]hen all is said and done, the bankruptcy court must simply approach each good faith determination with a perspicacity derived from the data of its informed practical experience in dealing with debtors and creditors." Accord In re Waterville Valley Town Square Associates, Ltd., 208 B.R. 90 (Bankr. N.H. 1997); In re Crosscreek Apartments Ltd., 211 B.R. 641 (Bankr. E.D.Tenn. 1997); In re Three Flint Hill Limited Partnership, 1997 WL 609193 (Md. 1997). In Crosscreek and Three Flint Hill, the creditor/purchaser was also a plan proponent. See generally Barry Zaretsky, Buying Claims to Block Plan Confirmation, 7/17/97 NYLJ 3.

Figter also considered the debtor's argument that the creditor who purchased 21 claims was entitled to only one vote. The court rejected this argument; focusing on section 1126(c), the court concluded that a creditor who purchases 21 claims can vote 21 claims.
B. Insider's Purchase of Claims to Facilitate Confirmation

See section 1129(a) (10)"without including any acceptance of the plan by an insider"; In re Three Flint Hill Limited Partnership, 1997 WL 609193 (D.C. Md. 1997).

C. Bankruptcy Consequences of Insiders Purchasing Claims Without Full Disclosure

In re Olson, 191 B.R. 99 (Bankr. Minn. 1996) allowed such claims only to the amounts paid by the insiders and then subordinated that reduced claim. In re Papercraft Corporation, 211 B.R. 813 (W.D. Pa. 1997) held that the bankruptcy court was without authority to adopt a per se rule prohibiting claims purchases by insiders without full disclosure and limiting any claims purchased in violation of this rule to the amount paid. The court further indicates that "a rule already exists to address inequitable conduct by insiders' trading in a debtor's claim, section 510."

D. Sua Sponte Disallowance?

In re Olson, 120 B.R. 98 (8th Cir. 1997), involved insiders who purchased II of the claims against the estate and moved to dismiss the case. No creditor objected to the transfer. The bankruptcy court sua sponte ordered the clerk not to substitute the insiders for the selling creditors and declined to dismiss. The Eighth Circuit reversed. Comparing the prior and current versions of Rule 3001(e), the court stated, "The language of the rule is mandatory and directs the court to substitute the name of the transferee for that of the transferor in the absence of a timely objection from the transferor." A concluding footnote adds

Nor do we see any "abuse of process" on the part of Viking here. Viking and the Olson children simply pursued their own economic self-interest. If they made misrepresentations to their assignors, the wronged parties could have objected to the Bankruptcy Court or could have pursued their remedies under state law . . . . The claims transferors have taken neither of these steps. We think people should be allowed to decide for themselves whether to seek redress for an alleged injury.

IX. BUYING ASSETS FROM THE DEBTOR

A. Breakup Fees

For unreported cases in which bankruptcy fees have been approved, see The Daily Bankruptcy Review. Cf. Sather, Shakespeare for Lawyers: Stalking Horse, 15 ABIJ 37 (May 1996).

B. Risk of Successor Liability After Chapter 11 Sales

Section 363(f) authorizes the bankruptcy trustee or a debtor in possession to sell free and clear of "any interest in such property of an entity other than the debtor." Secured creditors have interests in property.

Section 363(f) does not expressly authorize the sale of property free and clear of "claims." In re Fairchild Aircraft Corp., 184 B.R. 910, 918 (Bankr. W.D. Tex. 1995) held that a section 363(f)(3) does not extinguish in personam liabilities.

Section 1141(c) does expressly deal with claims - "free and clear of all claims." Accordingly, it would seem that a sale pursuant to a confirmed plan may afford a buyer more protection that a section 363 sale.

Arguably, the protection from successor liability of a purchaser pursuant to a plan is limited by the term "claim." Confirmation of a plan discharges "claims." It would seem that successor liability protection is similarly limited. See In re Schwinn Bicycle Co., 210 B.R. 747 (Bankr. N.D. Ill. 1997). See generally David Kuney, Successor Liability in Sales of a Debtor's Assets: The Problem of the "Mere Continuation Exception". 6 J. Bankr. L. & Prac. 269 (March-April 1997); Michael Reed, Successor Liability and Bankruptcy Sales, 51 Bus. Law. 653 (1996).

C. Mootness

The Second Circuit has concluded that it lacks jurisdiction to review an unstayed sale order except on the limited issue of whether the sale was made to a good faith purchaser. In re Gucci, 105 F.3d 837 (2d Cir.), cert. denied, 117 S.Ct. 1552 (1997); see generally Martin I. Klein, Appellate Court Review of Bankruptcy Sales, 4/17/97 NYLJ 1. There are also two 1997 Second Circuit decisions holding that the purchaser was in "good faith." See In re Colony Hill Associates, 111 F3d 269 (2d Cir. 1997); In re Gucci, 1997 WL 594687 (2d Cir. 1997). See also Dick's Clothing & Sporting Goods, Inc. v. Phar-Mor, Inc., 212 B.R. 283 (N.D. Ohio 1997).

Note the phrase "affect the validity" of the sale in section 363(m). A possible reading of section 363(m) is that an appeal from an unstayed sale may proceed for purposes other than affecting the validity of the sale. The Tenth Circuit seems to so read section 363(m) in In re BCD Corporation, 119 F3d 852 (10th Cir. 1997). The court there refused to rule that the appeal was moot, concluding that the debtor still had the sale proceeds so it could fashion appropriate equitable relief; the court then affirmed the sale on the merits.
THE REPORT OF THE
NATIONAL BANKRUPTCY REVIEW COMMISSION

Final Report
October 20, 1997

Hon. Joe Lee
Judge, United States Bankruptcy Court
Eastern District of Kentucky

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SECTION G
BANKRUPTCY: THE NEXT TWENTY YEARS

National Bankruptcy Review Commission
Final Report

October 20, 1997
NATIONAL BANKRUPTCY REVIEW COMMISSION

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Chapter 1: Consumer Bankruptcy - System Administration

1.1.1 National Filing System

A national filing system should be established and maintained that would identify bankruptcy filings using social security numbers or other unique identifying numbers.

1.1.2 Heightened Requirements for Accurate Information

The Bankruptcy Code should direct trustees to perform random audits of debtors' schedules to verify the accuracy of the information listed. Cases would be selected for audit according to guidelines developed by the Executive Office for United States Trustees.

1.1.3 False Claims

Courts should be authorized to order creditors who file and fail to correct materially false claims in bankruptcy to pay costs and the debtors' attorneys' fees involved in correcting the claim. If a creditor knowingly filed a false claim, the court could impose appropriate additional sanctions.
1.1.4 Rule 9011

The Commission endorses the amended Rule 9011 of the Federal Rules of Bankruptcy Procedure, to become effective on December 1, 1997, which will make an attorney's presentation to the court of any petition, pleading, written motion, or other paper a certification that the attorney made a reasonable inquiry into the accuracy of that information, and thus will help ensure that attorneys take responsibility for the information that they and their clients provide.

1.1.5 Financial Education

All debtors in both Chapter 7 and in Chapter 13 should have the opportunity to participate in a financial education program.

Chapter 1: Consumer Bankruptcy - Property Exemptions

1.2.1 Elimination of Opt Out

A consumer debtor who has filed a petition for relief under the Bankruptcy Code should be allowed to exempt property as provided in section 522 of the Code. Subsection (b)(1) and (2) of section 522 should be repealed.

1.2.2 Homestead Property

The debtor should be able to exempt the debtor's aggregate interest as a fee owner, a joint tenant, or a tenant by the entirety, in real property or personal property that the debtor or a dependent of the debtor uses as a residence in the amount determined by the laws of the state in which the debtor resides, but not less than $20,000 and not more than $100,000. Subsection (m) of section 522 should be revised to reflect that all exemptions except for the homestead exemption shall apply separately to each debtor in a joint case.

1.2.3 Nonhomestead Lump Sum Exemption

With respect to property of the estate not otherwise exempt by other provisions, a debtor should be permitted to retain up to $20,000 in value in any form. A debtor who claims no homestead exemption
Recommendations to Congress

should be permitted to exempt an additional $15,000 of property in any form.

1.2.4 All professionally-prescribed medical devices and health aids necessary for the health and maintenance of the debtor or a dependent of the debtor should be exempt.

1.2.5 Rights to Receive Benefits and Payments

All funds held directly or indirectly in a trust that is exempt from federal income tax pursuant to sections 408 or 501(a) of the Internal Revenue Code should be exempt.

1.2.6 Rights to Payments

Rights to receive future payments (e.g., social security benefits, life insurance) should be exempt, and the debtor’s right to receive an award under a crime victim’s reparations law or payment for a personal bodily injury claim of the debtor or the debtor’s dependent should be exempt.

Chapter 1: Consumer Bankruptcy - Reaffirmation Agreements and the Treatment of Secured Debt

1.3.1 11 U.S.C. § 524(c) should be amended to provide that a reaffirmation agreement is permitted, with court approval, only if the amount of the debt that the debtor seeks to reaffirm does not exceed the allowed secured claim, the lien is not avoidable under the provisions of title 11, no attorney fees, costs, or expenses have been added to the principal amount of the debt to be reaffirmed, the motion for approval of the agreement is accompanied by underlying contractual documents and all related security agreements or liens, together with evidence of their perfection, the debtor has provided all information requested in the motion for approval of the agreement, and the agreement conforms with all other requirements of subsection (c).

Section 524(d) should be amended to delineate the circumstances under which a hearing is not required as a prerequisite to a court approving an agreement of the kind specified in section 524(c): a hearing will not be required when the debtor was represented by counsel in negotiations on the agreement and the debtor’s attorney has signed the affidavit as provided in section 524 (c), and a party in
interest has not requested a judicial valuation of the collateral that is the subject of the agreement. If one or more of the foregoing requirements is not met, or in the court’s discretion, the court shall conduct a hearing to determine whether an agreement that meets all of the requirements of subsection (c) should be approved. Court approval of an agreement signifies that the court has determined that the agreement is in the best interest of the debtor and the debtor’s dependents and does not impose undue hardship on the debtor and the debtor’s dependents in light of the debtor’s income and expenses.

The Commission recommends that the Advisory Committee on Bankruptcy Rules of the Judicial Conference prescribe a form motion for approval of reaffirmation agreements that contains information enabling the court and the parties to determine the propriety of the agreement. Approval of the motion would not entail a separate order of the court.

1.3.2 An additional subsection should be added to section 524 to provide that the court shall grant judgment in favor of an individual who has received a discharge under section 727, 1141, 1228, or 1328 of this title for costs and attorneys fees, plus treble damages, from a creditor who threatens, files suit, or otherwise seeks to collect any debt that was discharged in bankruptcy and was not the subject of an agreement in accordance with subsections (c) and (d) of section 524.

1.3.3 No Ride-Through

Section 521(2) should be amended to clarify that a debtor with consumer debts that are secured, as determined by the provisions of title 11, by property of the estate must redeem the property or obtain court approval of an agreement under section 524(c) of title 11 in order to retain the property postdischarge, except for a security interest in real or personal property that is the debtor’s principal residence.

1.3.4 Security Interests in Household Goods

Household Goods Worth Less Than $500

Section 522(f) should provide that a creditor claiming a purchase money security interest in exempt property held for personal or household use of the debtor or a dependent of the debtor in household furnishings, wearing apparel, appliances, books, animals, crops, musical instruments, jewelry, implements, professional books, tools of the trade or professionally prescribed health aids for the debtor or a
member of the debtor’s household must petition the bankruptcy court for continued recognition of the security interest. The court shall hold a hearing to value each item covered by the creditor’s petition. If the value of the item is less than $500, the petition shall not be granted; if the value is $500 or greater, the security interest would be recognized and treated as a secured loan in Chapter 7 or Chapter 13.

1.3.5 Characterization of Rent-to-Own Transactions

Consumer rent-to-own transactions should be characterized in bankruptcy as installment sales contracts.

Chapter 1: Consumer Bankruptcy - Discharge, Exceptions to Discharge and Objections to Discharge

1.4.1 Credit Card Debt

Except for credit card debts that are excepted from discharge under section 523(a)(2)(B) (for materially false written statements respecting the debtor’s financial condition) and section 523(a)(14), (debts incurred to pay nondischargeable taxes to the United States), debts incurred on a credit card issued to the debtor that did not exceed the debtor’s credit limit should be dischargeable unless they were incurred within 30 days before the order for relief under title 11.

1.4.2 Debts Incurred to Pay Nondischargeable Federal Tax Obligations

Section 523(a)(14) should remain unchanged to except from discharge debts incurred for federal taxes that would be nondischargeable under section 523(a)(1).

1.4.3 Criminal Restitution Orders

Section 523(a)(13) should be expanded to apply to all criminal restitution orders.

1.4.4 Family Support Obligations

Sections 523(a)(5), (a)(15), and (a)(18) should be combined. The revised 523(a)(5) should provide that all debts actually in the nature of support, whether they have been denominated in a prior court order as alimony, maintenance, support, property settlements, or otherwise,
are nondischargeable. In addition, debts owed under state law to a state or municipality in the nature of support would be nondischargeable in all chapters.

1.4.5 Dischargeability of Student Loans

Section 523(a)(8) should be repealed.

1.4.6 Issue Preclusive Effect of True Defaults

For complaints to establish nondischargeability on grounds set forth in section 523(c), the Bankruptcy Code should clarify that issues that were not actually litigated and necessary to a prior judgment shall not be given preclusive effect.

1.4.7 Vicarious Liability

Section 523(c) should be amended such that intentional action by a wrongdoer who is not the debtor cannot be imputed to the debtor.

1.4.8 Effect of Lack of Notice on Time to Bring Objection to Discharge

Creditors that did not receive notice of a bankruptcy should get an extension of time to file an objection to or seek revocation of a discharge.

1.4.9 Settlement and Dismissal of Objections to Discharge

Section 727 should be amended to provide that (a) any complaint objecting to discharge may be dismissed on motion of the plaintiff only after giving notice to the United States trustee, the case trustee and all creditors entitled to notice, advising them of an opportunity to substitute as plaintiff in the action; (b) any motion to dismiss a complaint objecting to discharge must be accompanied by an affidavit of the moving party disclosing all consideration given or promised to be given by the debtor in connection with dismissal of the complaint; and (c) if the debtor has given or promised to give consideration in connection with dismissal of the complaint, the complaint may not be dismissed unless the consideration benefits the estate generally.
Chapter 1: Consumer Bankruptcy - Chapter 13 Repayment Plans

1.5.1 *Home Mortgages*

A Chapter 13 plan could not modify obligations on first mortgages and refinanced first mortgages, except to the extent currently permitted by the Bankruptcy Code. Section 1322(b)(2) should be amended to provide that the rights of a holder of a claim secured only by a junior security interest in real property that is the debtor’s principal residence may not be modified to reduce the secured claim to less than the appraised value of the property at the time the security interest was made.

1.5.2 *Valuation of Collateral*

A creditor’s secured claim in personal property should be determined by the property’s wholesale price.

A creditor’s secured claim in real property should be determined by the property’s fair market value, minus hypothetical costs of sale.

1.5.3 Payments on secured debts that are subject to modification should be spread over the life of the plan, according to fixed criteria for interest rates.

1.5.4 *Unsecured Debt*

Payments on unsecured debt should be determined by guidelines based on a graduated percentage of the debtor’s income, subject to upward adjustment to meet the section 1325(a)(4) requirement that creditors receive at least the present value of whatever they would have received in a Chapter 7. The trustee or an unsecured creditor should be authorized to file an objection to any plan that deviates from the guidelines, and a court would determine whether the deviation was appropriate in light of all the circumstances.

1.5.5 *Consequences of Incomplete Payment Plans*

The Bankruptcy Code should provide that a case under Chapter 13 that otherwise meets the standards for dismissal shall be converted to Chapter 7 after notice and a hearing unless a party in interest objects on the basis that the debtor had been granted a discharge in a Chapter
7 case commenced within six years of the date on which the conversion would take place, in which case the Chapter 13 case will be dismissed. In addition, the debtor may object to conversion without grounds, in which case the Chapter 13 case will be dismissed. The standards for modification, dismissal, and discharge in Chapter 13 would not otherwise change.

Section 362 should be amended to provide that the filing of a petition by an individual does not operate as a stay if the individual has filed two or more petitions for relief under title 11 within six years of filing the instant petition for relief and if the individual has been a debtor in a bankruptcy case within 180 days prior to the instant petition for relief. On the request of the debtor, after notice and a hearing, the court may impose a stay for cause shown, subject to such conditions and modifications as the court may impose.

1.5.6  In Rem Orders

Section 362 should be amended to provide that the filing of a petition by an individual does not operate as a stay with respect to property of the estate transferred by that individual to another individual who was a debtor under title 11 within 180 days of the filing of the instant petition, unless the court grants a stay with respect to such property after notice and a hearing on request of the debtor.

After notice and a hearing, a bankruptcy court should be empowered to issue in rem orders barring the application of a future automatic stay to identified property of the estate for a period of up to six years when a party could show that the debtor had transferred such real property or leasehold interests or fractional shares of property or leasehold interests to avoid creditor foreclosure or eviction. A subsequent owner of the property or tenant of the leasehold who files for bankruptcy (or the same owner or holder in a subsequent filing) should be permitted to petition the bankruptcy court for the imposition of a stay to protect property of the estate, which the court would be required to grant to protect innocent parties who were not a part of a scheme to transfer the property to hinder foreclosure or eviction.

1.5.7  Retention of the “Superdischarge”

Congress should retain 11 U.S.C. § 1328(a), which permits a debtor who completes all payments under the plan to discharge all debts
provided for by the plan or disallowed under section 502 of title 11 except for those listed in section 1328(a)(1) - (3).

1.5.8 Debtors who choose Chapter 13 repayment plans should have their bankruptcy filings reported differently from those who do not. Debtors who complete voluntary debtor education programs should have that fact noted on their credit reports.

1.5.9 Trustees should be encouraged to establish credit rehabilitation programs to help provide better, cheaper access to credit for those who participate in repayment plans.

Chapter 2: Treatment of Mass Future Claims in Bankruptcy

2.1.1 Definition of Mass Future Claim

A definition of “mass future claim” should be added as a subset of the definition of “claim” in 11 U.S.C. § 101(5). “Mass future claim” should be defined as a claim arising out of a right to payment, or equitable relief that gives rise to a right to payment that has or has not accrued under nonbankruptcy law that is created by one or more acts or omissions of the debtor if:

1) the act(s) or omission(s) occurred before or at the time of the order for relief;
2) the act(s) or omission(s) may be sufficient to establish liability when injuries ultimately are manifested;
3) at the time of the petition, the debtor has been subject to numerous demands for payment for injuries or damages arising from such acts or omissions and is likely to be subject to substantial future demands for payment on similar grounds;
4) the holders of such rights to payments are known or, if unknown, can be identified or described with reasonable certainty; and
5) the amount of such liability is reasonably capable of estimation.

The definition of “claim” in section 101(5) should be amended to add a definition of “holder of a mass future claim,” which would be an entity that holds a mass future claim.
2.1.2 Protecting the Interests of Holders of Mass Future Claims

The Bankruptcy Code should provide that a party in interest may petition the court for the appointment of a mass future claims representative. When a plan includes a class or classes of mass future claims, the Bankruptcy Code should authorize a court to order the appointment of a representative for each class of holders of mass future claims. A mass future claims representative shall serve until further order of the bankruptcy court.

The Bankruptcy Code should provide that a mass future claims representative shall have the exclusive power to file a claim or claims on behalf of the class of mass future claims (and to determine whether or not to file a claim), to cast votes on behalf of the holders of mass future claims and to exercise all of the powers of a committee appointed pursuant to section 1102. However, a holder of a mass future claim may elect to represent his, her, or its own interests and may opt out of being represented by the mass future claims representative.

The Bankruptcy Code should provide that prior to confirmation of a plan of reorganization, the fees and expenses of a mass future claims representative and his or her agents shall be administrative expenses under section 503. Following the confirmation of a plan of reorganization, and for so long as holders of mass future claims may exist, any continuing fees and expenses of a mass future claims representative and his or her agents shall be an expense of the fund established for the compensation of mass future claims.

The Bankruptcy Code should provide that a mass future claims representative shall serve until further orders of the bankruptcy court declare otherwise, shall serve as a fiduciary for the holders of future claims in such representative’s class, and shall be subject to suit only in the district where the representative was appointed.

2.1.3 Determination of Mass Future Claims

Section 502 should provide that the court may estimate mass future claims and also may determine the amount of mass future claims prior to confirmation of a plan for purposes of distribution as well as allowance and voting. In addition, 28 U.S.C. § 157(b)(2)(B) should specify that core proceedings include the estimation or determination of the amount of mass future claims.
2.1.4 Channeling Injunctions

Section 524 should authorize courts to issue channeling injunctions.

2.1.5 Plan Confirmation and Discharge; Successor Liability

Sections 363 and 1123 should provide that the trustee may dispose of property free and clear of mass future claims when the trustee or plan proponent has satisfied the requirements for treating mass future claims. Upon approving the sale, the court could issue, and later enforce, an injunction to preclude holders from suing a successor/good faith purchaser.

Chapter 2: Transnational Insolvency

2.2.1 Adoption of the UNCITRAL Model Law for Cross-Border Insolvencies

2.2.2 Retention of provisions for additional relief

2.2.3 Amendment of title 28 to add jurisdiction over the Model Law provisions

2.2.4 Conforming amendments to the definitions of foreign proceeding and foreign representative in section 101(23)-(24)

2.2.5 Exclusion from the application of the Model Law of consumers resident in the United States if their debts are within the limits for Chapter 13

2.2.6 Recognition vel non of foreign tax claims to be left to evolving caselaw and treaty negotiations

2.2.7 28 U.S.C. § 1410 should be amended to provide that the various bases for venue may be used in the alternative as a matter of choice, i.e., the word “only” should be deleted from the section; additionally there should be a catch-all venue choice related to the interest of justice and convenience of the parties

Chapter 2: Partnerships
2.3.1 *Defining the term “General Partner”*

A “general partner” should be defined under 11 U.S.C. § 101 as any entity that as a result of an existing or former status as an actual or purported general partner in an existing, former, predecessor, or affiliated partnership, is liable under applicable nonbankruptcy law for one or more debts of the partnership.

2.3.2 *Consent of Former Partners*

The Bankruptcy Code and Rules should be amended to clarify that, notwithstanding Recommendation 1 (defining “general partner”), a former general partner of a partnership is not, absent a specific court order to the contrary, required to consent to a voluntary petition by a partnership, to be served with a petition or summons in an involuntary case against a partnership, or to perform the duties of disclosure or procedural duties imposed on a general partner of a debtor partnership.

2.3.3 *Bankruptcy Court Jurisdiction*

The court in which a partnership case is pending should have jurisdiction under 28 U.S.C. § 1334(b) to determine who is or may be liable as a general partner for the debts of the partnership and may determine the rights among the general partners with respect to the debts of the partnership. Such matters should constitute core proceedings under 28 U.S.C. § 157(b).

2.3.4 *Liability of General Partner for Deficiency in Partnership Case*

If there is a deficiency of property of the partnership estate to pay in full all allowed claims in a case under title 11, the estate should have a claim against each general partner to the extent that, under applicable nonbankruptcy law, such general partner is personally liable for such deficiency. The amount of the deficiency claim should not be reduced on account of any right of contribution or indemnity among general partners. The claim should be estimated if its determination would unduly delay the administration of the case. Any action or proceeding to enforce liability under this section should be commenced no later than four years after the entry of the order for relief in the case concerning the partnership.
2.3.5 **Power of the Court to Assure Payment of the Deficiency**

Renumbered section 723(b) of the Bankruptcy Code should be amended to provide that the court in a partnership case may, after notice and a hearing, order any general partner that is not a debtor in a case under this title (1) to provide the estate, in such amount as the court shall determine to be appropriate under the circumstances, with indemnity for, or assurance of payment of, any deficiency recoverable from such general partner, or (2) not to incur obligations or transfer property except under specified circumstances.

2.3.6 **Trustee’s Recovery against the Estate of a Debtor General Partner**

Renumbered section 723(c) of the Bankruptcy Code should be amended to provide that notwithstanding section 728(c), the trustee of a partnership has a claim against the estate of each general partner in such partnership that is a debtor in a case under title 11 for (1) the full amount of all claims allowed in the case concerning the partnership for which such general partner would otherwise be personally liable as a general partner under applicable nonbankruptcy law; and (2) administrative claims which have been assessed against such general partner. Notwithstanding section 502 of this title, there shall not be allowed in such partner’s case a claim against the partner on which both the general partner and the partnership are liable, except to the extent that such claim is allowable and secured only by property of such general partner and not by property of such partnership.

2.3.7 **Repeal of the “Jingle Rule” in All General Partner Bankruptcy Cases**

Chapter 5 of the Bankruptcy Code should be amended in order to provide that the claim of a trustee of a partnership debtor, or the claim of a creditor of a nondebtor partnership, is entitled to share in the distribution in a general partner’s bankruptcy case in the same manner and to the same extent as any other claim of the same class of a creditor of such general partner.

2.3.8 **Allocation of Expenses of Administration of a Partnership Case**

Chapter 5 of the Bankruptcy Code should be amended to provide that the expenses of administration of a partnership case under section 503 of the Bankruptcy Code may be assessed against general partners or paid from the property constituting recoveries from general partners under this section and from other property of the estate in such
proportions as the court shall determine are fair and reasonable after notice and hearing.

2.3.9 Distribution of Recoveries from General Partners

Renumbered section 723 of the Bankruptcy Code should be amended to provide that notwithstanding section 726 of the Bankruptcy Code (except as provided in Recommendation 2.3.8 above), the trustee should apply any recovery obtained from a general partner or the estate of a general partner only to the payment of deficiencies on claims for which such general partner is personally liable as a general partner under applicable nonbankruptcy law. Any property constituting recoveries from general partners or the estates of general partners under this Recommendation not applied to the proper deficiencies as herein provided or to administration expenses (as provided in Recommendation 2.3.8 above), should be equitably distributed by the trustee to such general partner or to such general partners' estates as may be ordered by the court after notice and hearing.

2.3.10 Distribution of Property of the Partnership Estate

Renumbered section 723 of the Bankruptcy Code should be amended to provide that notwithstanding section 726 of the Code, and except as set forth in Recommendation 2.3.8 above (treatment of expenses of administration), the trustee should distribute property of the partnership estate which is not recovered from general partners or the estates of debtor general partners to allowed claims against the partnership in accordance with otherwise applicable provisions of this title without considering distributions of property from general partners or general partners' estates.

2.3.11 Trustee's Power to File Involuntary Cases

Section 303(b)(3) of the Bankruptcy Code should be amended to permit the trustee of a partnership in a case commenced under title 11 to file an involuntary petition against a general partner without regard to the number of creditors, nature of the claims or dollar amount of the claims otherwise required under section 303(b)(1) and (2).

2.3.12 Appointment of Committee of General Partners

Chapter 11 of the Bankruptcy Code should be amended to provide that, on request of a party in interest, the court may authorize the
Recommendations to Congress

United States trustee to appoint a committee of general partners that is fairly representative of the interests of all general partners.

2.3.13 General Partner Liability on Nonrecourse Partnership Debt under 11 U.S.C. § 1111(b)

Section 1111(b) of the Bankruptcy Code should be amended to clarify that, except as otherwise provided in a confirmed plan of a partnership debtor or the order confirming the plan, a general partner is not liable on a nonrecourse claim against the partnership except to the extent that the general partner is personally liable on such claim under applicable nonbankruptcy law.

2.3.14 'Temporary' Injunction of Proceedings or Acts against Nondebtor General Partners

The Bankruptcy Code should be amended to permit the court for cause, upon motion of a party in interest and after notice and hearing, to temporarily enjoin actions of creditors or general partners of a debtor partnership against nondebtor general partners or their property on account of partnership obligations. No injunction should be granted under this Recommendation unless the nondebtor general partner (1) consents to the jurisdiction of the bankruptcy court; (2) makes or undertakes to make the disclosures required by Recommendation 2.3.18 below; and (3) the order granting the injunction precludes the protected general partner from incurring obligations or transfers of property except under specified circumstances.

2.3.15 Relief from the Temporary Injunction

The Bankruptcy Code should be amended to provide that the court, upon request of a party in interest and after notice and hearing, may, for cause, grant relief from the temporary injunction provided pursuant to Recommendation 2.3.14. The relief available would include the termination, annulment, modification or conditioning a continuation of the injunction.

2.3.16 'Postconfirmation' Injunction of Proceedings or Acts against Nondebtor General Partners Who Contribute to Plans

The Bankruptcy Code should be amended to permit the court, in connection with the confirmation of a plan of reorganization in a partnership case, to enjoin partnership creditors and general partners
from actions or proceedings against a general partner or its property to collect on partnership-related claims where the general partner has contributed or made an enforceable commitment to contribute an amount to the payment of debts in accordance with the plan or the order confirming the plan. The court, after notice and hearing, must determine that the plan complies with otherwise applicable requirements for confirmation in light of the personal assets of the nondebtor contributing partners and that the injunction will not discriminate unfairly or inequitably with respect to creditors of the partnership or the claims of the general partners for contribution or indemnity.

2.3.17 Revocation of Injunction

The Bankruptcy Code should be amended to provide that the injunction issued with respect to any nondebtor general partner under Recommendation 2.3.16 above should be terminated or revoked on the request of a party in interest if, after notice and hearing, the court determines (1) that the protected nondebtor general partner has failed to perform a material commitment under the plan; (2) that the order confirming the plan in which the injunction was issued is revoked under sections 1144 or 1230 of the Code; or (3) that the nondebtor general partner has procured the injunction by fraud. The Bankruptcy Code should be further amended to provide that a request for revocation for fraud under provision (3) should be made at any time within two years after the date of the entry of the confirmation order.

2.3.18 Duty of Disclosure by Nondebtor General Partners

The Bankruptcy Code should be amended to provide that, unless otherwise ordered by the court for cause, each nondebtor general partner shall, within 30 days after the entry of the order for relief in a partnership case or within such time as the court shall fix, produce information concerning such partner's financial condition and affairs similar to that provided by a debtor, together with such additional information and periodic reports as may be required by the court from time to time.

2.3.19 Access to Disclosed Information

The Bankruptcy Code should be amended to provide that the trustee, debtor in possession or other entity designated by the court in a partnership bankruptcy case should maintain and promptly provide
to parties in interest in the case, on reasonable request, certain important information regarding the nondebtor general partners of the debtor partnership.

2.3.20 Treatment of LLC Member or LLC Manager Under the Bankruptcy Code

Debtor LLC members in member-managed LLCs should be treated like general partners under the Bankruptcy Code. Similarly, debtor managers of manager-managed LLC’s should be treated like general partners under the Bankruptcy Code. This treatment should be limited to three aspects of the LLC member or LLC manager relationship: (1) continuity of LLC after LLC member’s or manager’s bankruptcy filing; (2) transferability of LLC ownership interest; and (3) management rights in the LLC.

2.3.21 Exclusion of a Partnership or LLC Relationship from Treatment under 11 U.S.C. § 365

The Bankruptcy Code should be amended to exclude partnership and LLC governing documents and relationships from treatment under 11 U.S.C. § 365. A new section concerning partnership and LLC governing documents and relationships should be added to the Bankruptcy Code.

2.3.22 Ipso Facto Provisions in Partnership or LLC Governing Documents Rendered Unenforceable

*Ipso facto* provisions relating to partnerships, LLCs, and the rights or interests of partners or LLC members or managers should not be enforceable under the Bankruptcy Code. *Ipso facto* provisions include any provision in a partnership agreement, LLC operating agreement, or applicable nonbankruptcy law that operates to terminate or modify the rights of a partner or LLC member based on insolvency, financial condition, commencement of a voluntary or involuntary case under title 11, or appointment of a trustee or custodian. Non-*ipso facto* provisions that limit a partner’s or LLC member’s rights, relationship, interest, or permit expulsion on the basis of something other than insolvency, financial condition, commencement of a voluntary or involuntary case under title 11, or the appointment of a receiver would remain enforceable.
Property of the Estate, Transferability, and Valuation of a Partnership or LLC Interest

“Property of the estate” for a partner or LLC member should include all rights attendant with the partnership or LLC interest, including management rights, voting rights, and economic rights (including goodwill, the right to share in profits and losses, and any other right to payment). Except as provided below, the Recommendation does not alter the effect of section 541(a)(6), to the extent it is applicable. In the case of an individual partner or LLC member who (1) continues employment (in whatever capacity) with the partnership or LLC after the order for relief, and (2) whose estate receives or is more likely than not going to receive the “buyout price” as defined below, all partnership or LLC interest amounts arising, accruing, or payable after the order for relief are deemed to be on account of personal services rendered by the partner or LLC member and do not become property of the estate. There should be a presumption, in a case of an individual debtor, that the estate is more likely than not going to receive the “buyout price,” upon which presumption the parties should be entitled to rely and function until the court orders to the contrary, after notice and hearing, on motion of the trustee or any party in interest.

The court should have the power to authorize a sale under section 363 of the partnership or LLC interest and order the admission of the buyer to the partnership or LLC with all rights and duties the debtor had, except that if the governing documents preclude transfer under a non-ipso facto provision, the anti-transfer clauses will be given effect, but only if the partnership or LLC pays the “buyout price” to the estate. The court should retain the power to (1) fashion reasonable payment terms which balance the needs of the estate for receipt of cash as rapidly as possible with the needs of the entity for liquidity and working capital to conduct its operations in a prudent manner; and (2) ensure receipt of the buyout price by the estate.

The “buyout price” means the highest price (including a calculation or appraisal method), if any, provided in the governing documents in the case of a buyout of an interest not on account of the bankruptcy of, insolvency of, financial condition of, commencement of a voluntary or involuntary case under title 11 for, or appointment of a trustee or custodian for, a partner or LLC member or manager. If no such price is provided, the court should determine a fair buyout value.
2.3.24 Treatment of Partnership and LLC Management Rights

During any period when an estate administered in a bankruptcy case includes a partnership or LLC interest, the management and voting rights of the partner or LLC member are to be exercised as follows:

- A debtor in possession under Chapter 11 or a debtor under either Chapter 12 or Chapter 13 should exercise all management and voting rights, subject to the applicable non-ipso facto provisions of the partnership or LLC governing documents and applicable nonbankruptcy law, and the other applicable provisions of the Bankruptcy Code;

- Where (a) there is more than one general partner or LLC managing entity and at least one of such partners or entities is not a debtor in a case under the Bankruptcy Code, and (b) a Chapter 7 or Chapter 11 trustee has been appointed, then the trustee should not exercise any management rights except to the extent necessary to constitute a quorum or to meet a minimum majority required by the governing documents or applicable nonbankruptcy law;

- In all other cases where a Chapter 7 or Chapter 11 trustee has been appointed, the trustee shall exercise all management and voting rights.

Regardless of the foregoing, in all cases where (1) an individual debtor continues to function as a partner or member after the order for relief, and (2) the estate receives or is more likely than not going to receive, the “buyout price,” then the individual should have the sole power to exercise management and voting rights attributable to periods after the order for relief.

2.3.25 11 U.S.C. § 523 and Imputed Conduct or Liability

11 U.S.C. § 523 should be amended to provide that nothing in this section shall preclude the discharge of a general partner from a debt (otherwise nondischargeable in a copartner’s or agent’s bankruptcy case) arising solely as a result of imputing to the general partner the conduct or liability of a copartner or agent.
2.3.26 Subordination of Claims Arising from the Purchase or Sale of a Partnership Interest

11 U.S.C. § 510(b) should be amended to subordinate the claims “arising from the rescission of a purchase or sale” of their partnership interests or “for damages arising from the purchase or sale” of their partnership interests to all claims and interests that are senior or equal to the claim or interest represented by such security or other interest in the bankruptcy case of a general partner.

Chapter 2: General Issues in Chapter 11

2.4.1 Clarifying the Meaning of “Rejection”

The concept of “rejection” in section 365 should be replaced with “election to breach.”

Section 365 should provide that a trustee’s ability to elect to breach a contract of the debtor is not an avoiding power.

Section 502(g) should be amended to provide that a claim arising from the election to breach shall be allowed or disallowed the same as if such claim had arisen before the date of the filing of the petition.

2.4.2 Clarifying the Option of “Assumption”

“Assumption” should be replaced with “election to perform” in section 365.

2.4.3 Interim Protection and Obligations of Nondebtor Parties

A court should be authorized to grant an order governing temporary performance and/or providing protection of the interests of the nondebtor party until the court approves a decision to perform or breach a contract.

Section 503(b) should include as an administrative expense losses reasonably and unavoidably sustained by a nondebtor party to a contract, a standard based on nonbankruptcy contract principles, pending court approval of an election to perform or breach a contract.
if such nondebtor party was acting in accordance with a court order
governing temporary performance.

2.4.4 *Contracts Subject to Section 365; Eliminating the “Executory” Requirement*

Title 11 should be amended to delete all references to “executory” in
section 365 and related provisions, and “executoriness” should be
eliminated as a prerequisite to the trustee’s election to assume or
breach a contract.

2.4.5 *Prebankruptcy Waivers of Bankruptcy Code Provisions*

Section 558 of the Bankruptcy Code should provide that except as
otherwise provided in title 11, a clause in a contract or lease or a
provision in a court order or plan of reorganization executed or issued
prior to the commencement of a bankruptcy case does not waive,
terminate, restrict, condition, or otherwise modify any rights or
defenses provided by title 11. Any issue actually litigated or any issue
resolved by consensual agreement between the debtor and a
governmental unit in its police or regulatory capacity, whether
embodied in a judgment, administrative order or settlement
agreement, would be given preclusive effect.

2.4.6 *Prepackaged Plans of Reorganization; Section 341 Meeting of Creditors*

Section 341 should provide that upon the motion of any party in
interest in a Chapter 11 case that entails a prepackaged plan of
reorganization, the court may waive the requirement that the U.S.
trustee convene a meeting of creditors.

2.4.7 *Authorization for Local Mediation Programs*

Congress should authorize judicial districts to enact local rules
establishing mediation programs in which the court may order non-
binding, confidential mediation upon its own motion or upon the
motion of any party in interest. The court may order mediation in an
adversary proceeding, contested matter, or otherwise in a bankruptcy
case, except that the court may not order mediation of a dispute arising
in connection with the retention or payment of professionals or in
connection with a motion for contempt, sanctions, or other judicial
disciplinary matters. The court should have explicit statutory
authority to approve the payment of persons performing mediation
functions pursuant to the local rules of that district’s mediation
program who satisfy the training requirements or standards set by the local rules of that district. The statute should provide further that the details of such mediation programs that are not provided herein may be determined by local rule.

2.4.8 Court Review of Appointments to Creditors’ Committees

Subsection (a)(2) of 11 U.S.C. §1102, “Creditors’ and equity security holders’ committees,” should be amended to read as follows:

(2) On request of a party in interest and after notice and a hearing, the court may order a change in membership of a committee appointed under subsection (a) of this section if necessary to ensure adequate representation of creditors or of equity security holders. On request of a party in interest, the court may 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. The United States Trustee shall appoint any such committee.

2.4.9 Employee Participation in Bankruptcy Cases

Changes to the Official Forms, the U.S. Trustee program guidelines and the Federal Rules of Bankruptcy Procedure, are recommended to the Administrative Office of the U.S. Courts, the Executive Office of the U.S. Trustee, and the Rules Committee, as appropriate, in order to improve identification of employment-related obligations and facilitate the participation by employee representatives in bankruptcy cases. The Official Forms for the bankruptcy petition, list of largest creditors, and/or schedules of liabilities should solicit more specific information regarding employee obligations. The U.S. Trustee program guidelines for the formation of creditors’ committees should be amended to provide better guidance regarding employee and benefit fund claims. The appointment of employee creditors’ committees should be encouraged in appropriate circumstances as a mechanism to resolve claims and other matters affecting the employees in a Chapter 11 case.
2.4.10  Enhancing the Efficacy of Examiners and Limiting the Grounds for Appointment of Examiners in Chapter 11 Cases

Congress should amend section 327 to provide for the retention of professionals by examiners for cause under the same standards that govern the retention of other professionals.

The Advisory Committee on Bankruptcy Rules of the Judicial Conference should consider a recommendation that Federal Rule of Bankruptcy Procedure 2004(a) be amended to provide that “On motion of any party in interest or of an examiner appointed under section 1104 of title 11, the court may order the examination of any entity.”

Congress should eliminate section 1104(c)(2), which requires the court to order appointment of an examiner upon the request of a party in interest if the debtor’s fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes or owing to an insider, exceed $5,000,000.

2.4.11  Valuation of Property

A creditor’s secured claim in personal property should be determined by the property’s wholesale price.

A creditor’s secured claim in real property should be determined by the property’s fair market value, minus hypothetical costs of sale.


Congress should make clear that bankruptcy courts can authorize sales of property of the estate free of creditors’ interests regardless of the relationship between the face amount of any liens and the value of the property sold.

2.4.13  Release of Claims Against Nondebtor Parties

Congress should amend sections 1123 and 524(e) to clarify that it is within the discretion of the court to allow a plan proponent to solicit releases of nondebtor liabilities. Creditors that agree in a separate document to release nondebtor parties will be bound by such releases, whereas creditors that decline to release their claims against nondebtor parties will not be bound to release their claims.
2.4.14 **Exclusion of Payroll Deductions from Property of the Estate**

Congress should amend 11 U.S.C. § 541(b) to clarify that funds deducted from paid wages within 180 days prior to the date of the commencement of a case under title 11, held by a debtor/employer, and owed by employees to third parties, other than a federal, state or local taxing authority, do not fall within the definition of "property of the estate."

2.4.15 **Absolute Priority and Exclusivity**

11 U.S.C. § 1129(b)(2)(B)(ii) should be amended to provide that the court may find a plan to be fair and equitable that provides for members of a junior class of claims or interests to purchase new interests in the reorganized debtor.

11 U.S.C. § 1121 should be amended to provide that on the request of a party in interest, the court will terminate exclusivity if a debtor moves to confirm a non-consensual plan that provides for the participation of a holder of a junior claim or interest under 1129(b)(2)(B) but does not satisfy the condition set forth in section 1129(b)(2)(B)(i).

2.4.16 **Classification of Claims**

Section 1122 should be amended to provide that a plan proponent may classify legally similar claims separately if, upon objection, the proponent can demonstrate that the classification is supported by a "rational business justification."

2.4.17 **Prepetition Solicitation for a Prepackaged Plan of Reorganization**

The standards and requirements provided in the Bankruptcy Code for postpetition solicitation should be applicable to solicitation for a plan of reorganization within 120 days prior to filing a Chapter 11 petition by a company that is subject to and in compliance with the public periodic reporting requirements of the Securities Exchange Act of 1934. Notice of such prepetition solicitation should be served on the Securities and Exchange Commission. If a company solicits for a plan of reorganization but does not file for bankruptcy, the bankruptcy requirements and standards should be applicable if the company does not complete an exchange offer or any other transaction on the basis of such solicitation.
2.4.18 Postpetition Solicitation for a Prepackaged Plan of Reorganization

Section 1125(b) should be amended to provide that the acceptance or rejection of a plan may be solicited after the commencement of a case under title 11 but before the court approves a written disclosure statement from those classes that were solicited for the plan prior to the filing of the bankruptcy petition.

2.4.19 Elimination of Prohibition on Nonvoting Equity Securities

Congress should amend section 1123(a)(6) to eliminate the requirement that the charter of the reorganized corporate debtor prohibit the issuance of nonvoting equity securities. Section 1123(a)(6) should otherwise remain unchanged.

2.4.20 Postconfirmation Plan Modification

11 U.S.C. § 1127(b) should be amended to permit modification after confirmation of a plan until the later of 1) substantial consummation or 2) two years after the date on which the order of confirmation is entered. All other restrictions on postconfirmation plan modification in section 1127(b) should remain unaltered.

Chapter 2: Small Business Proposals

2.5.1 Defining the term “Small Business”

A “small business debtor” is any debtor in a case under Chapter 11 (including any group of affiliated debtors) which has aggregate noncontingent, liquidated secured and unsecured debts as of the petition date or order for relief of five million dollars ($5,000,000) or less and any single asset real estate debtor as defined in 11 U.S.C.§ 101(51B), regardless of the amount of such debtor’s liabilities.

2.5.2 Flexible Rules for Disclosure Statement and Plan

Give the bankruptcy courts authority, after notice and hearing, to waive the requirements for, or simplify the content of, disclosure statements in small business cases where the benefits to creditors of fulfillment of full compliance with Bankruptcy Code § 1125 are
outweighed by cost and lack of meaningful benefit to creditors which would exist if the full requirements of § 1125 were imposed;

The Advisory Committee on Bankruptcy Rules of the Judicial Conference ("Rules Committee") shall be called upon to adopt, within a reasonable time after enactment, uniform safe-harbor standard forms of disclosure statements and plans of reorganization for small business debtors, after such experimentation on a local level as they deem appropriate. These forms would not preclude parties from using documents drafted by themselves or other forms, but would be propounded as one choice that plan proponents could make, which, if used and completed accurately in all material respects, would be presumptively deemed upon filing to comply with all applicable requirements of Bankruptcy Code §§ 1123 and 1125. The forms shall be designed to fulfill the most practical balance between (i) on the one hand, the reasonable needs of the courts, the U.S. Trustee, creditors and other parties in interest for reasonably complete information to arrive at an informed decision and (ii) on the other hand, appropriate affordability, lack of undue burden, economy and simplicity for debtors; and

Repeal those provisions of 11 U.S.C. § 105(d) which are inconsistent with the proposals made herein, e.g., those setting deadlines for filing plans.

Amend the Bankruptcy Code to expressly provide for combining approval of the disclosure statement with the hearing on confirmation of the plan.

2.5.3 Reporting Requirements

To create uniform national reporting requirements to permit U.S. Trustees, as well as creditors and the courts, better to monitor the activities of Chapter 11 debtors, the Rules Committee shall be called upon to adopt, with a reasonable time after enactment, amended rules requiring small business debtors to comply with the obligations imposed thereunder. The new rules will require debtors to file periodic financial and other reports, such as monthly operating reports, designed to embody, upon the basis of accounting and other reporting conventions to be determined by the Rules Committee, the best practical balance between (i) on the one hand, the reasonable needs of the court, the U.S. Trustee, and creditors for reasonably complete information and (ii) on the other hand, appropriate affordability, lack of undue burden, economy and simplicity for debtors. Specifically, the
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Rules Committee, shall be called upon to prescribe uniform reporting as to:

a. the debtor's profitability, i.e., approximately how much money the debtor has been earning or losing during current and relevant recent fiscal periods;

b. what the reasonably approximate ranges of projected cash receipts and cash disbursements (including those required by law or contract and those that are discretionary but excluding prepetition debt not lawfully payable after the entry of order for relief) for the debtor appear likely to be over a reasonable period in the future;

c. how approximate actual cash receipts and disbursements compare with results from prior reports;

d. whether the debtor is or is not (i) in compliance in all material respects with postpetition requirements imposed by the Bankruptcy Code and the Bankruptcy Rules and (ii) filing tax returns and paying taxes and other administrative claims as required by applicable nonbankruptcy law as will be required by the amended statute and rules and, if not, what the failures are, how and when the debtor intends to remedy such failures and what the estimated costs thereof are; and

e. such other matters applicable to small business debtors as may be called for in the best interests of debtors and creditors and the public interest in fair and efficient procedures under Chapter 11.

2.5.4 Duties of the Debtor in Possession

The debtor is required to:

a. append to the voluntary petition or, in an involuntary case, to file within three days after the order for relief, either (A)(i) its most recent balance sheet, statement of operations and cash-flow statement and (ii) its most recent federal income tax return or (B) a statement made under penalty of perjury that no such financial statements have been prepared or that no federal income tax return has been filed or (C) both;
b. attend meetings, at which the debtor is represented by its senior management personnel and counsel, scheduled by the court, the U.S. Trustee, or the Bankruptcy Administrator including, but not limited to initial debtor interviews, court-ordered scheduling conferences, and meetings of creditors convened under 11 U.S.C. § 341;

c. file all schedules and statements of financial affairs for small business debtors within the limits set by the Bankruptcy Rules, unless the court, upon notice to the U.S. Trustee and a hearing, grants an extension, which extension or extensions shall not, in any event, exceed thirty (30) days after the order for relief absent extraordinary and compelling circumstances;

d. comply with postpetition obligations, including but not limited to the duties to: file tax returns, maintain appropriate and reasonable current insurance as is customary and appropriate to the industry, and timely pay all administrative expense tax claims, except those being contested by appropriate proceedings being diligently prosecuted;

e. create within ten (10) business days of the entry of order for relief (or as soon thereafter as possible in case all banks contacted during the first ten (10) business days decline the business) separate deposit accounts with a bank or banks in which the debtor shall be required to timely deposit, until a plan is confirmed or the case is dismissed or converted or a trustee is appointed, after receipt, all taxes collected or withheld by it for governmental units. In compelling circumstances, the court may dispense with these requirements after notice and a hearing;

f. allow the U.S. Trustee or its designated representative to inspect the debtor's business premises, books and records at reasonable times on reasonable prior written notice to the debtor.

2.5.5 Deadlines for Plan Filing and Confirmation

In small business cases only, require that the disclosure statement, if any, and plan must be filed within 90 days after the entry of order for relief, unless extended as permitted below. During this 90-day period, only the debtor may file a plan unless on request of a party in interest made during this period and after notice and a hearing, the court, for cause, orders otherwise. In small business cases only, require the plan
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to be confirmed within 150 days after the entry of order for relief, unless extended as permitted below.

2.5.6 Burden of Proof for Extensions of Deadlines

Permit extensions of the deadlines for filing and approving disclosure statements, if any, and filing and confirming plans of reorganization only if the debtor, having duly noticed and appeared at the necessary extension hearing conducted and ruled upon prior to the expiration of the deadline, if any, and having carried the burdens of coming forward and persuasion, demonstrates by a preponderance of the evidence that it is more likely than not to confirm a plan of reorganization within a reasonable time. No such deadline may be extended unless a new deadline is imposed at the time the extension is granted. The Bankruptcy and Judicial Codes will require the U.S. Trustee, as the case may be, to be a recipient of notice of extension hearings and to participate actively therein, in order to assure, to the maximum extent feasible, that the interests of the public are protected when determinations are made as to whether small business debtors receive extensions and have proven by a preponderance of the evidence that it is more likely than not that they will confirm a plan within a reasonable time.

2.5.7 Scheduling Conferences

Require the bankruptcy court to promptly conduct at least one on-the-record scheduling hearing, on notice to the U.S. Trustee and the debtor’s 20 largest unsecured creditors to be sure that the deadlines discussed above are met except that no such hearing is required if an agreed order is filed by the debtor and U.S. Trustee and approved by the court after notice and hearing. The court shall also conduct such other scheduling hearings and status conferences as it deems fit and proper. Whenever possible, these hearings shall be schedules in conjunction with other mandatory events so as to minimize to the most reasonable practicable extent, the time of debtor personnel spent in court and at official meetings.

2.5.8 Serial Filer Provisions

Provide in the Bankruptcy Code that, with respect to any debtor (or any entity which has succeeded to substantially all the debtor’s assets or business) which files a second case while another case is pending in which such debtor is the (or one of the) debtor(s) or in the event that it again becomes a debtor in a Chapter 11 case within two years after
an order of dismissal of a Chapter 11 case in which it was the debtor has become a final order or a Chapter 11 plan has been confirmed, shall not be entitled to the section 362(a) stay unless, after it has become a debtor, it bears the burdens of coming forward and of persuasion, by a preponderance of the evidence, that (1) the new case has resulted from circumstances beyond the control of the debtor not foreseeable at the time the first case was filed and (2) it is more likely than not that it will confirm a feasible plan, but not a liquidating plan, within a reasonable time. In cases involving such debtors when the owners have transferred the business to a new legal entity, owned and arranged by them, the section 362(a) stay would apply on filing but would be lifted on a verified, ex parte motion of the U.S. Trustee, with the right to have it reimposed upon a showing of (1) and (2) above. The Federal Rule of Civil Procedure governing injunctions applies to the court's award of a stay to the debtor.

2.5.9 Expanded Grounds for Dismissal or Conversion and Appointment of Trustee

a. Modify section 1112 to read as follows:

(b)(1) Except as provided in subsection (c) of this section or in section 1104(a)(3) of this title, on request of a party in interest or the U.S. Trustee, and after notice and a hearing, the court shall convert a case under this chapter to a case under Chapter 7 of this title or shall dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, where movant establishes cause, except that such relief shall not be granted if the debtor or another party in interest objects and establishes both:

(A) that it is more likely than not that a plan will be confirmed within a time as fixed by this title or by order of the court; and

(B) if the cause is an act or omission of the debtor:

(i) that there exists a reasonable justification for the act or omission; and

(ii) that the act or omission will be cured within a reasonable time fixed by the court not to exceed 30 days after the court decides the motion unless the movant expressly consents to a continuance for a specific period of time or there are compelling circumstances beyond the control of the debtor which justify an extension.
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(2) For purposes of this subsection, cause includes:
(A) substantial or continuing loss to or diminution of the estate;
(B) gross mismanagement of the estate;
(C) failure to maintain appropriate insurance;
(D) unauthorized use of cash collateral harmful to one or more creditors;
(E) failure to comply with an order of the court;
(F) failure timely to satisfy any filing or reporting requirement established by this title or by applicable rule;
(G) failure to attend the section 341(a) meeting of creditors or an examination ordered under Bankruptcy Rule 2004;
(H) failure timely to provide information or attend meetings reasonably requested by the U.S. Trustee or;
(I) failure timely to pay taxes due after the order for relief or to file tax returns due after the order for relief;
(J) failure to file or confirm a plan within the time fixed by this title or by order of the court; and
(K) failure to pay any fees or charges required under Chapter 123 of title 28.

(3) The court shall commence the hearing on any motion under this subsection within 30 days after filing of the motion, and shall decide the motion within 15 days after commencement of the hearing, unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances prevent the court from meeting the time limits established by this paragraph.

b. Additional Grounds for Appointment of Trustee

Add the following new section to 11 U.S.C. § 1104:

(a)(3) where grounds exist to convert or dismiss the case under section 1112 of this title, but the court determines that the appointment of a Chapter 11 trustee is in the best interests of creditors and the estate.

2.5.10 Enhanced Powers of the United States Trustee and Bankruptcy Administrator

Add a new subclause (e) to 11 U.S.C. § 341, and amend 28 U.S.C. § 586 (the general statute governing the powers and duties of the U.S.
Trustee) and the Manual for Bankruptcy Administrators, (governing the duties of Bankruptcy Administrators) to require U.S. Trustees in every small business debtor case (except where they, in their reasonable discretion determine that the conduct enumerated below is not advisable in the circumstances):

(1)(a) to conduct an initial debtor interview ("IDI") with the debtor as soon as practicable after the entry of order for relief but prior to the first meeting scheduled under Bankruptcy Code § 341(a). At the IDI, the U.S. Trustee shall, at a minimum, begin to investigate the debtor's viability, inquire about the debtor's business plan, explain the debtor’s obligations to file monthly operating reports and other required reports, attempt to develop an agreed scheduling order, and inform the debtor of other Chapter 11 obligations;

(b) when determined by the U.S. Trustee to be appropriate and advisable, to visit the appropriate business premises of the debtor and ascertain the general state of the debtor's books and records and verify that the debtor has filed its tax returns. This visit should take place in connection with or reasonably promptly after the IDI (wherever possible, these events shall be combined with other events so as to minimize to the most reasonable practicable extent the amount of time of debtor personnel spent in court and at official meetings); and

(c) to review and monitor diligently on a continuous basis each debtor’s activities, with a view to identifying as promptly as possible those debtors which do not pass the test of being more likely than not to be able to confirm a Chapter 11 plan within a reasonable time; and

(2) in cases where, upon the basis of continuing review, monitoring or otherwise, the U.S. Trustee finds material grounds for any relief under Bankruptcy Code § 1112, to move the court promptly for relief.
Chapter 2: Single Asset Proposals

2.6.1  *Change the Present Statutory Definition of “Single Asset Real Estate” in two ways.*

First, the $4 million debt limit should be eliminated from the definition of “single asset real estate” debtor subject to section 362(d)(3).

Second, the definition of “single asset real estate” should be more carefully worded to exclude cases in which the real property is used by a debtor in an active business.

The definition, as proposed, incorporating both concepts, would read as follows:

undeveloped real property or other real property constituting a single property or project other than residential real property with fewer than 4 residential units on which is located a single development or project which property or project generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor, or by a commonly controlled group of entities substantially all of which are concurrently Chapter 11 debtors, other than the business of operating the real property and activities incidental thereto.

2.6.2  *Amend Code Section 362(d)(3) in Three Particulars*

a. Make clear that payments required by section 362(d)(3) may be made from rents generated from the property.

b. Provide that the interest rate with respect to which payments are calculated shall be the nondefault contract rate.

c. Amend the statute to provide that the payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines the debtor to be subject to section 362(d)(3).
2.6.3 Require Substantial Equity in order to Confirm a Lien-Stripping Plan Using the New Value Exception

In cases where the secured creditor has not made the election under section 1111(b)(1)(a)(i), a plan must satisfy the following requirements to be confirmed under the new-value exception following rejection by a class that includes the unsecured portion of a claim secured by real property: (1) The new value contribution must pay down the secured portion of the claim on the effective date of the plan so that, giving effect to the confirmation of the plan, sufficient cash payments on the secured portion of the claim shall have been made so that the principal amount of debt secured by the property is no more than 80 percent of the court-determined fair market value of the property as of the confirmation date; (2) the payment terms for the secured portion of the claim must both (i) satisfy all applicable requirements of section 1129 of the Code, and (ii) satisfy then-prevailing market terms in the same locality regarding maturity date, amortization, interest rate, fixed-charge coverage and loan documentation; and (3) the new value contribution must be treated as an equity interest that is not convertible to or exchangeable for debt.

Chapter 3: Jurisdiction

3.1.1 Establishing the Bankruptcy Court under Article III of the Constitution

The bankruptcy court should be established under Article III of the Constitution.

3.1.2 Transition to an Article III Bankruptcy Court

As of the enactment of legislation to establish an Article III bankruptcy court, sitting bankruptcy judges should be permitted to finish their current fourteen year terms. As vacancies are created through attrition (including expiration of current statutory term, appointment as an Article III judge, resignation, retirement prior to end of term for any reason, or death), Article III bankruptcy judges should be appointed by the President upon the advice and consent of the Senate to fill those positions. Sitting bankruptcy judges should be permitted to apply for any Article III judgeship positions while remaining on the bench.
Nothing in the Recommendation will affect the length of the current term, salary, retirement benefits, or other attributes of sitting bankruptcy judges.

During the transition period, bankruptcy jurisdiction should be treated in the following manner: as Article III bankruptcy judges are appointed, the jurisdiction provisions under 28 U.S.C. §§ 1334 and 157 should be transferred on a district-by-district basis to the Article III bankruptcy judge sitting in that district. Consequently, bankruptcy jurisdiction would reside in the Article III bankruptcy judge, including the power to refer and withdraw cases and proceedings. While a district is without an Article III bankruptcy judge, the Judicial Council for that circuit should be authorized to: (1) determine the need for an Article III bankruptcy judge in that district, and (2) if necessary, designate an Article III bankruptcy judge from another district (within the circuit) to sit in that district. In the event the judicial council determines a need for an Article III bankruptcy judge and one has not yet been appointed to sit within that circuit, the Chief Justice, upon receiving a certificate of necessity from the chief judge of the circuit, should be authorized to designate an Article III bankruptcy judge from another circuit to fulfill the request.

3.1.3 Bankruptcy Appellate Process

The current system which provides two appeals, the first either to a district court or a bankruptcy appellate panel and the second to the U.S. Court of Appeals, as of right from final orders in bankruptcy cases should be changed to eliminate the first layer of review.

3.1.4 Interlocutory Appeals of Bankruptcy Orders

28 U.S.C. § 1293 should be added to provide, in addition to the appeal of final bankruptcy orders, for the appeal to the courts of appeals of interlocutory bankruptcy court orders under the following circumstances: (1) an order to increase or reduce the time to file a plan under section 1121(d); (2) an order granting, modifying, or refusing to grant an injunction or an order modifying or refusing to modify the automatic stay; (3) an order appointing or refusing to appoint a trustee, or authorizing the sale or other disposition of property of the estate; (4) where an order is certified by the bankruptcy judge that (x) it involves a controlling issue of law to which there is a substantial difference of opinion, and (y) immediate appeal of the order may materially advance resolution of the litigation, and leave to appeal is
granted by the court of appeals; and (5) with leave from the court of appeals.

3.1.5 Venue Provisions under 28 U.S.C. § 1408

28 U.S.C. § 1408(1) should be amended to prohibit corporate debtors from filing for relief in a district based solely on the debtor's incorporation in the state where that district is located.

The affiliate rule contained in 28 U.S.C. § 1408(2) should be amended to prohibit a corporate filing in an improper venue unless such debtor's corporate parent is a debtor in a case under the Bankruptcy Code in that forum. Section 1408(2) should be amended as follows:

(2) in which there is pending a case under title 11 concerning such person's affiliate, as defined in section 101(2)(A) of title 11, general partner, partnership, or a partnership controlled by the same general partner.

The court's discretionary power to transfer venue in the interest of justice and for the convenience of the parties should not be restricted.

Chapter 3: Procedure

3.2.1 Minimum Amount to Commence a Preference Action under 11 U.S.C. § 547

11 U.S.C. § 547 should provide that $5,000 is the minimum aggregate transfer to a noninsider creditor that must be sought in a nonconsumer debt preference avoidance action.

3.2.2 Venue of Preference Actions under 28 U.S.C. § 1409

28 U.S.C. § 1409 should be amended to require that a preference recovery action against a noninsider seeking less than $10,000 must be brought in the bankruptcy court in the district where the creditor has its principal place of business. The Recommendation applies to nonconsumer debts only.
3.2.3 Ordinary Course of Business Exception Under 11 U.S.C. § 547(c)(2)(B)

11 U.S.C. § 547(c)(2)(B) should be amended to provide a disjunctive test for whether a payment is made in the ordinary course of the debtor's business if it is made according to ordinary business terms. The ordinary course of business defense to a preference recovery action under section 547(c)(2) should provide as follows:

(2) to the extent that such 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 and such transfer was—

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or

(B) made according to ordinary business terms[.]

3.2.4 Ad Valorem Tax Priority under 11 U.S.C. § 724(b)

11 U.S.C. § 724(b) should be amended to exempt from subordination properly perfected, nonavoidable liens on real or personal property of the estate arising in connection with an ad valorem tax. Section 724(b) should also require the trustee to marshal unencumbered assets of the bankruptcy estate and surcharge secured claims, if warranted by the circumstances, under section 506(c) prior to subordinating any tax liens under the statute.

3.2.5 Burden of Proof for Tax Proceedings

The Bankruptcy Code should be amended to clarify that the burden of proof/persuasion rules and concomitant presumptions in tax controversies which would be applicable under nonbankruptcy law are equally applicable in bankruptcy court proceedings to determine tax liabilities under 11 U.S.C. §§ 502 and 505.

3.2.6 Exception of Tax Refunds Setoffs under 11 U.S.C. § 362(b)

11 U.S.C. § 362(b) of the Bankruptcy Code should be amended to allow a governmental unit to setoff an income tax refund that arose prior to the commencement of a Chapter 7 or Chapter 13 case against an 'undisputed' income tax liability of an individual debtor that arose prior to the commencement of the case.
Chapter 3: Administration

3.3.1 United States Trustee Program

The Director of the Executive Office for United States Trustees should hold the position of Assistant Attorney General.

The United States Trustee regions should match the number, size and configuration of the federal judicial circuits.

3.3.2 Personal Liability of Trustees

Trustees appointed in cases under Chapter 7, 11, 12 or 13 of the Bankruptcy Code should not be subject to suit in their individual capacity for acts taken within the scope of their duties as delineated in the Bankruptcy Code or by order of the court, as long as the applicable order was issued on notice to interested parties and there was full disclosure to the court.

Chapter 7, 12 and 13 trustees only should be subject to suit in the trustee’s representative capacity and subject to suit in the trustee’s personal capacity only to the extent that the trustee acted with gross negligence in the performance of the trustee’s fiduciary duties. Gross negligence should be defined as reckless indifference or deliberate disregard of the trustee’s fiduciary duty.

A Chapter 11 trustee of a corporate debtor only should be subject to suit in the trustee’s representative capacity and subject to suit in the trustee’s personal capacity only to the extent that the trustee has violated the standard of care applicable to officers and directors of a corporation in the state in which the Chapter 11 case is pending.

Debtors in possession should remain subject to suit to the same extent as currently exists under state or federal law.

3.3.3 Qualification of Professionals under 11 U.S.C. § 1107(b)

Section 1107(b) should be amended to provide that a person should not be disqualified for employment under § 327 solely because such person holds an insubstantial unsecured claim against or equity interest in the debtor. Section 327 and § 101(14) should remain unchanged.
3.3.4 National Admission to Practice

Admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, should entitle an attorney, on presentation of a certificate of admission and good standing in another district court, to appear in the other bankruptcy court without the need for any other admission procedure.

The Recommendation will not affect requirements (if any) to associate with local counsel. Similarly, the Recommendation will not change the requirements under state law governing the practice of law and the maintenance of an office for the practice of law. The Recommendation will only amend the local bankruptcy rule or practice requirements governing special admission of attorneys to the bankruptcy court who are otherwise not admitted to the bar of the district court in the district where the bankruptcy court is located to appear in a particular bankruptcy case.

3.3.5 Fee Examiners

The Bankruptcy Code should explicitly preclude the appointment of fee examiners as an improper delegation of the court's duty to review and award compensation under 11 U.S.C. § 330. The Recommendation does not affect the court's authority under 11 U.S.C. § 1104(c) to appoint an examiner to investigate and report on certain aspects of a Chapter 11 case, for example, a potential fraudulent transfer or a particularly complicated claims estimation.

3.3.6 Attorney Referral Services

11 U.S.C. § 504 should be amended to permit an attorney compensated out of a bankruptcy estate to remit a percentage of such compensation to a bona fide, nonprofit, public service referral program. Such attorney referral program must be operating in accordance with state laws and ethical rules and guidelines governing referrals. The Recommendation does not affect the requirement that all compensation arrangements be disclosed in the application for retention under Fed. R. Bankr. P. 2014 and in the application for compensation under Fed. R. Bankr. P. 2016(a).
Chapter 4: Data Compilation and Dissemination

4.1.1 Establish as policy that all data held by bankruptcy clerks in electronic form, to the extent it reflects only public records as defined in Bankruptcy Code § 107, should be released in electronic form to the public, on demand.

4.1.2 Establish and fund a pilot project to aggregate the data from sources, particularly bankruptcy clerks, and make that data available to the public in electronic form, on demand.

4.1.3 Secure limited-duration appointment of a coordinator, who, with the head of the AO’s office and the head of EOUST, would be charged with the duty of:
   (1) Making recommendations to increase the accuracy of the debtor’s petitions, schedules and statements.
   (2) setting the data-collection goals.
   (3) coordinating the bankruptcy data-collection efforts of the central reporting agencies.
   (4) reporting on an annual basis to the Congress, the Chief Justice, and the President.

4.1.4 Establish a bankruptcy data system in which (1) a single set of data definitions and forms are used to collect data nationwide and (2) all data for any particular case are aggregated in the same electronic record.

4.1.5 Maximize the number of documents filed electronically and maximize open-to-the-public remote electronic access to all data for free, or at the lowest possible cost.

Chapter 4: Taxation and the Bankruptcy Code

4.2.1 Clarify provisions of the Bankruptcy Code on providing reasonable notice to governmental units.

4.2.2 Amend the Bankruptcy Code to prescribe that to the extent that a tax claim presently is entitled to interest, such interest shall accrue at a stated statutory rate.
4.2.3 The Commission should submit to the Advisory Committee on Bankruptcy Rules of the Judicial Conference ("Rules Committee") a recommendation that the Federal Rules of Bankruptcy Procedure require that notices demanding the benefits of rapid examination under 11 U.S.C. § 505(b) be sent to the office specifically designated by the applicable taxing authority for such purpose, in any reasonable manner prescribed by such taxing authority.

4.2.4 Conform §346 of the Bankruptcy Code to IRC 1398(d)(2) election; also conform local and state tax attributes that are transferred to the estate to those tax attributes that are transferred to the bankruptcy estate under IRC §1398.

4.2.5 Amend 11 U.S.C. §507(a)(8) and 523(a)(1) to provide for the tolling of relevant periods in the case of successive filings. Thus, in the event of successive bankruptcy filings, the time periods specified in §507(a)(8) shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of the prior case.

4.2.6 Amend 11 U.S.C. §507(a)(8)(ii) to toll the 240-day assessment period for both pre- and post assessment offers in compromise.

4.2.7 Amend the Bankruptcy Code to require "small business debtors" to create and maintain separate bank accounts for trust fund taxes and nontax deductions from employee paychecks. Also, any proposal should provide for sanctions for failure to comply with this Bankruptcy Code requirement.

4.2.8 Amend 11 U.S.C. §1141(d)(3) to except from discharge taxes unpaid by businesses entities, which nonpayment arose from fraud.

4.2.9 Amend 11 U.S.C. §362(a)(8) to confine its application to proceedings before the Tax Court for tax periods ending on or prior to the filing of the petition in the bankruptcy case and to permit appeals from Tax Court decisions.

4.2.10 Application of the periodic payment provisions of §1129(a)(9)(C) to secured tax that would be entitled to priority absent their secured status.

4.2.11 Amend 11 U.S.C. §545(2) to overrule cases that have penalized the government due to certain benefits for purchasers provided for in the lien provisions of the Internal Revenue Code.
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4.2.12 Amend 11 U.S.C. §503 and 28 U.S.C. §960 to eliminate the need for a governmental unit to make a “request” to the debtor to pay tax liabilities that are entitled to payment as administrative expenses.

4.2.13 Amend 11 U.S.C. §§502(a)(1) and 503(b)(1)(B) to provide that postpetition ad valorem real estate taxes should be characterized as an administrative expense whether secured or unsecured and such taxes should be payable as an ordinary course expense.

4.2.14 Amend the Bankruptcy Code to overrule Investors of The Triangle v. Carolina Triangle Ltd. Partnership (In re Carolina Triangle Ltd. Partnership), 166 B.R. 411 (9th Cir. B.A.P. 1994), and to ensure that postpetition ad valorem real-estate taxes are a reasonable and necessary cost of preservation of the estate.

4.2.15 Amend the Bankruptcy Code to establish that ad valorem taxes are incurred by the estate and, therefore, are entitled to administrative expense priority status.

4.2.16 & Amend the Bankruptcy Code to conform the treatment of state and local tax claims to that treatment provided for federal tax claims by, among others, amending 11 U.S.C. § 346 to conform state and local tax attributes to the federal list in IRC § 1398.

4.2.17 Clarify IRC §1398 to provide that the bankruptcy estate’s income is subject to alternative minimum tax and capital gains tax treatment if otherwise applicable.

4.2.18 Amend the Bankruptcy Code to provide that the term “assessed or assessment” as used in 11 U.S.C. §§362(b)(9) and 507(a)(8) shall mean “that time at which a taxing authority may commence an action to collect the tax.”

4.2.19 Clarify 11 U.S.C. §726(a)(1) to provide that a taxing authority must file a claim for a priority tax before the final order approving the trustee’s report is entered by the court.

4.2.20 Conformity of Chapter 13 plans with provisions of the Bankruptcy Code: Requirement to file returns.
4.2.23 Whether an income tax return prepared by the taxing authority should be considered a filed income tax return for purposes of the Bankruptcy Code.

4.2.24 Dismissal and injunction against filing subsequent case where court determines that a Chapter 13 debtor is abusing the bankruptcy process.

4.2.25 Create a method by which a trustee may obtain a safe harbor and certainty regarding the nature, amount, and consequences of debt discharged.

4.2.26 Amend IRC §1398(e)(3) to provide that a debtor should be treated as an employee of the bankruptcy estate as to payments by the estate of estate assets to the debtor for services performed.

4.2.27 & 4.2.28 Tax treatment of the sale by the estate of a debtor's homestead:

4.2.28 Availability of capital gain exclusion on sale of residence to the trustee of an individual debtor.

4.2.29 Whether changes are needed in IRC §§108 and 382 with respect to the issuance of stock for debt.

4.2.30 Whether IRC §1001 should be modified to provide for parallel tax treatment of recourse and nonrecourse debt.

4.2.31 Tax treatment of abandonment of property by an estate to the debtor.

4.2.32 Application of §505(b) discharge to estate as well as to the debtor, successor to the debtor, and trustee where taxing authority does not audit.

4.2.33 Bifurcation for claim filing purposes of a corporate tax year that straddles the petition date.

4.2.34 Requirement of periodic payment for deferred payments of tax under §1129(a)(9) and designation of interest rate used while making those deferred payments.

4.2.35 Authority of bankruptcy courts to grant declaratory judgments on prospective tax issues in Chapter 11 plans of reorganization.
4.2.36 Whether payment of prepetition nonpecuniary loss tax penalties in Chapter 11, 12, and 13 cases should be subordinated to payment of general unsecured claims.

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Chapter 4: Chapter 9 - Municipal Bankruptcy Relief


The securities contract liquidation provisions in 11 U.S.C. §§ 555, 556, 559 & 560 should be applicable in Chapter 9 cases and should be added to the list contained in section 901(a).

4.3.2 Chapter 9 Petition as Order for Relief

Section 921(d) should be deleted. Section 921(c) authorizes the court to dismiss a Chapter 9 petition for (1) lack of good faith; or (2) failure to meet the requirements of title 11. Deletion of section 921(d) will eliminate the statutory conflict between section 301 providing that a voluntary petition constitutes an order for relief and section 921(d) authorizing the court to order relief only if the petition is not dismissed under section 921(c). Deletion of section 921(d) will also conform Chapter 9 to all other chapters of the Bankruptcy Code where a voluntary petition is the order for relief.

4.3.3 Eligibility of Municipalities to Serve on Creditors' Committees

11 U.S.C. § 101(41) should be amended to permit municipalities to serve on creditors' committees in Chapter 9 cases under the provisions of 11 U.S.C. § 1102.

4.3.4 Elimination of 11 U.S.C. § 921(b)

Section 921(b) should be deleted. Bankruptcy judges should be appointed to preside over Chapter 9 cases in the same manner as they are appointed to supervise all other cases under the Bankruptcy Code.
4.3.5 Inclusion of “Employees” in 11 U.S.C. § 922(a)

11 U.S.C. § 922(a)(1) should be amended to provide stay protection to nonresident “employees” of municipalities that have filed for Chapter 9 relief. Section 922(a)(1) should read:

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against an officer, employee, or inhabitant of the debtor that seeks to enforce a claim against the debtor.[]

4.3.6 Treatment of Municipal Obligations in Chapter 9

Chapter 9 should be amended to provide comparable protection to all types of tax-exempt obligations sold in the municipal marketplace. The Recommendation will not affect the right of a municipality to use special revenues for the provision of necessary municipal services.

Chapter 4: Chapter 12 - Bankruptcy Relief for Family Farmers

4.4.1 Sunset Provision and Chapter 12 Eligibility

The sunset provision should be eliminated. Chapter 12 should be made a permanent addition to the Bankruptcy Code. Section 101(18) should be amended to increase the aggregate debt limits to $2,500,000. The other eligibility requirements in section 101(18) should remain unchanged.

4.4.2 Direct Payment Plans

28 U.S.C. § 586(e) should be amended to clarify that the calculation of the standing trustee’s percentage fee should be based upon the aggregate of those payments “made under the plan” on account of claims impaired or modified by operation of bankruptcy law regardless of who makes the payment.
ISSUES AND PROBLEMS
IN
CHAPTER 13 CASES

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# ISSUES AND PROBLEMS IN CHAPTER 13 CASES

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SECTION H
I. VALUATION AFTER RASH

In June, the United States Supreme Court's decision in Associates Commercial Corporation v. Rash, 117 S. Ct. 1879 (1997), brought to an end a five-year battle over $9,125. In an 8-1 opinion, the Supreme Court held that when a debtor under Chapter 13 of the United States Bankruptcy Code (the "Code") proposes to cram down a plan of reorganization over the objection of a secured creditor, the creditor's collateral must be valued at its replacement cost.

Section 506(a) of the Code is the provision that deals with valuing secured claims. This section states:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

In an en banc decision, the Fifth Circuit in In re Rash, 90 F.3d 1036 (5th Cir. 1996) had held that the first sentence of Section 506(a) instructed courts to focus upon valuation from the creditor's perspective, using as a starting point the amount the creditor would receive if it exercised its state law remedies by repossessing and selling the collateral.

The Supreme Court reversed. In an opinion by Justice Ginsberg, the court rejected the Fifth Circuit's approach to section 506 and stated that "[t]he full first sentence of § 506(a), in short, tells a court what it must evaluate, but it does not say more; it is not enlightening on how to value collateral." 117 S. Ct. at 1885 (1997). The Court then looked to the second sentence of Section 506(a) for enlightenment on how value should be determined. Because value should be determined "in light of the purpose of the valuation and of the proposed disposition or use of such property," a bankruptcy court must look to the proposed disposition or use of the property when considering the appropriate value for a particular piece of collateral.

The Court concluded its opinion by stating:

In sum, under § 506(a), the value of property retained because the debtor has exercised the § 1325(a)(5)(B) "cram down" option is the cost the debtor would incur to obtain a like asset for the same "proposed . . . use." Id. at 1886.

But the Court attached a footnote to this last sentence of the opinion which emphasized that determining replacement value will be a fact intensive inquiry.
Because this concluding footnote in the Rash decision is likely to be the focus of significant future litigation, it is set forth below in its entirety.

Our recognition that the replacement-value standard, not the foreclosure-value standard, governs in cram down cases leaves to 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. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is its retail value, an adjustment to that value may be necessary: A creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties, inventory storage, and reconditioning. Cf. 90 F.3d at 1051-52. Nor should the creditor gain from modifications to the property—e.g., the addition of accessories to a vehicle—to which a creditor's lien would not extend under state law.

Future litigation is likely to focus on the sentence that is underscored. More specifically, future litigation is likely to focus on the words in that sentence in bold print: - "inventory storage." Cf. In re Mulvania, 1997 WL 619201 (BAP) 9th Cir. 1997) ("this language [fn. 6] does not require a court to deduct costs of sale when determining the replacement value of a secured claim.")

There have been four reported cram down valuations decisions since Rash:

1. In re Roberts, 210 B.R. 325 (Bankr. N.D. Iowa 1997) used NADA retail, relying on Rule 3001(f): "[T]he presumption of the prima facie validity of the Bank's claim in Rule 3001(f) applies to this valuation hearing arising in the context of Chapter 13 plan confirmation. Debtor has the burden of coming forward with sufficient evidence to rebut that presumption." Id. at 328.

2. In In re McElroy, 210 B.R. 833 (Bankr. Or. 1997) considered expert testimony from a car appraiser and a used car dealer. The court stated "valuation should be based on prices paid in the market that is accessible to the debtors, which includes, without limitation, sales between private parties." The court concluded that the value of the car was $1,570. The Kelley Blue Book valued the car at $2,700 wholesale and $4,670 retail.

3. In re Russell, 211 B.R. 12 (Bankr. E.D.N.C. 1997) held that the replacement value was the $7,900 retail value in the NADA guide: "[T]he NADA retail value does not appear to include any extra value for items not retained by Mr. Russell." Id. at 13. "To require a
reduction of retail costs in determining value, as some have suggested is required by footnote 6, would be inconsistent with the specific holding in Rash." Id. Judge Small found that the debtor's evidence that he could buy a similar car for less through newspaper ads was not credible. "The debtor introduced a single newspaper advertisement placed by a used car dealer for a similar automobile at an asking price of $7,500. The court does not find this evidence persuasive. Mr. Russell did not inspect the advertised automobile, and his knowledge of the automobile's condition came solely from the advertisement." Id. at 12.

(4) In In re Franklin, 1997 WL 631343 (Bankr. M.D. Fla. 1997), the court concluded that Rash did not require it to change its practice of looking to the average of wholesale and retail "as a starting point."

II. CRAM DOWN INTEREST RATES

A. Statutory Provisions

1129(b)(2)

For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides:

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
(iii) for the realization by such holders of the indubitable equivalent of such claims.

**1225(a)(S)(B) and (C) and 1325(a)(S)(B) and (C)**

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder; and . . .

**B. 1997 Case Law From Circuits**

According to Judge Yacos, the "case law with regard to an appropriate discount rate for cramdown purposes has blossomed into a 'many-colored splendor' of conflicting and sometimes indecipherable formulas." In re Computer Optics, Inc., 126 B.R. 664, 671 (Bankr. N.H. 1991). The case law on methods of calculation of cram down interest rates is collected in reported cases such as In re River Valley Assoc., 161 B.R. 127, 135-36 (Bankr. E.D. Pa. 1993), aff'd, 181 B.R. 795 (E.D. Pa. 1995) and law review commentary such as Judge John Pearson, Dillon Jackson & Tim Nohr, Ending the Judicial Snipe Hunt: The Search for the Cramdown Interest Rate, 4 ABI L. Rev. 35 (1996).

While the reported decisions from the bankruptcy courts reflect diverse views, the Circuit Court opinions are essentially uniform. Eight of the circuits - Third, Fourth, Sixth, Seventh, Eighth, Ninth, Tenth and Eleventh - have issued opinions approving a comparable loan or "coerced loan" approach to "present value", i.e., measuring cram down interest rate by what the secured creditor could have obtained had it foreclosed and reinvested the proceeds in loans of equivalent duration and risk. Two circuits, Eighth and Ninth, have recognized measuring cram down interest rate by a riskless base rate plus risk factors, as a possible alternative to the comparable loan approach. Only the Second Circuit has rejected the comparable loan approach.

**1. Second Circuit**

In In re Valenti, 105 F.3d 55 (2d Cir. 1997), a Chapter 13 car case, I presented the appellant's oral argument in Valenti; the appellant lost. Valenti is the only Circuit court decision on this question that I have argued. Valenti is the only appellate decision on this question that directly and expressly rejects comparable loans ("forced loans") as a possible measure of present value:
We believe that courts adopting the "forced loan" approach misapprehend the "present value" function of the interest rate. The objective of section 1325(a)(5)(B)(ii) is to put the creditor in the same economic position that it would have been in had it received the value of its allowed claim immediately. The purpose is not to put the creditor in the same position that it would have been in had it arranged a "new" loan.

Are the second and third sentences of the above quotation consistent? What if the creditor would have arranged a new loan if it had received the value of its allowed claim immediately?

In the Second Circuit's view, the "forced loan" approach necessarily and improperly includes a profit for the lender. Valenti instead "hold(s) that the market rate of interest under section 1325(a)(5)(B)(ii) should be fixed at the rate on a United States Treasury instrument with a maturity equivalent to the repayment schedule under the debtor's reorganization plan "with a risk adjustment -- "a range of one to three per cent is reasonable in this Circuit."

2. Fifth Circuit

In Matter of Smithwick, 121 F.3d 211 (5th Cir. 1997), Chapter 13 debtors filed a plan that provided for a cram down interest rate of 11%, based on a local rule which required a formula approach to Chapter 13 cram down interest -- 2% plus The Wall Street Journal prime rate. The bankruptcy court confirmed and the district court affirmed. In reversing, the Fifth Circuit adopted the coerced loan approach, with the rebuttable presumption that the contract rate is the rate for a new loan. In dictum, Judge Jones noted that Smithwick is "consistent with the approach we have taken in Chapter 11 cases." But cf. Financial Security Assurance Inc. v. T-H New Orleans Limited Partnership, 116 F3d 790, 799 (5th Cir. 1997).

III. HOME MORTGAGE PLAN PROVISIONS

A. Background

(1) 1322(b)(2)("modify the rights of holders of secured claims, other than a claim secured only by a security interest in property that is the debtor's principal residence")

(2) 1322(c)(1), (2)

B. Strip Down v. Strip Off

(1) F has a first mortgage on D's house to secure its $100,000 claim. If the value of the house is $20,000, can D's Chapter 11 or 13 plan strip F's secured claim to $20,000?

(2) Same facts except that S has a second mortgage. Can D's Chapter 11 or 13 plan strip off S's claim as an unsecured claim? The cases are divided. Compare In re Lam, 211 B.R. 36 (BAP 9th Cir. 1997) (yes) and In re Cervelli, 1997 WL 662535 (Bankr. N.J. 1997) (yes) with In re Barnes, 207 B.R. 588 (Bankr. N.D. Ill. 1997) (no) and In re Fraize, 208 B.R. 311 (Bankr. N.H. 1997) (no); In re Mattson, 210 B.R. 157 (Bankr. Minn. 1997) (no) (relying on section 1322(c)(2) Judge Kressel in Mattson permits a strip off the second mortgage because the last payment under the mortgage was due before the final payment under the plan. Accord. In re Young, 199 B.R. 643 (Bankr. E.D. Tenn. 1996), contra In re Witt, 113 F.3d 508 (4th Cir. 1997).

C. Home and Office

M's $312,000 claim was secured by real property valued at $260,000 which D used both as his personal residence and office. Can D's Chapter 11 or 13 plan lien strip? See In re Livesay, 199 B.R. 705, 709 (BAP 9th Cir. 1996) (no) ("he [debtor] has not shown that this use has added significant value to the property or that the bank relied on the additional security offered by his home office. In the absence of that proof, we are not prepared to say the bank had sufficient security in assets that were not part of the debtor's principal residence that the bank should be denied the protection of section 1123(b)(5)"")

D. Multiple Family Residence

M has a first mortgage on D's principal residence which is a two-family dwelling. Can D's Chapter 11 or 13 plan modify M's mortgage? What if D and spouse and children live in one unit and D's brother-in-law lives in the other unit, rent-free? See Lomas Mortgage, Inc. v. Louis, 82 F.3d 1 (1st Cir. 1996); In re De Costa, 204 B.R. 1, 4 (Bankr. Mass. 1996); see also In re Brunson, 201 B.R. 351 (Bankr. W.D. N.Y. 1996).

E. "Secured Only"

What constitutes additional collateral? The debtor's mortgage included "all buildings and improvements thereon; together with the hereditaments and appurtenances and all other rights thereunto belonging, or in anywise now or hereafter appertaining, and the reversion and reversions, remainder and remainders, rents, issues, profits thereon, and all plumbing, heating and lighting fixtures, and equipment now or hereafter attached to or used in connection..."
with such premises." Reversing the bankruptcy court, *PNC Mortgage Co. v. Dicks* 199 B.R. 674 (N.D. Ind. 1996) held:

The record on appeal from the bankruptcy court betrays no evidence that the PNC mortgage was drafted to secure consumer purchases unrelated to the debtor's home or to enable the debtor to engage in some form of business adventure. Rather, the evidence before the court leads inexorably to the conclusion that the items of collateral described in the PNC mortgage are nothing more than enhancements capable of becoming component parts of the debtor's principal residence, and that such items of collateral are of little independent value relative to the residence property.

IV. OTHER CHAPTER 13 ISSUES

A. Dismissal After Motion to Convert

1307(b)

On request of the debtor at any time, if the case has not been converted under section 706,1112, 94 1208 of this title, the court shall dismiss a case under this chapter. Any waiver of the right to dismiss under this subsection is unenforceable.

1307(c)

Except as provided in subsection (e) of this section, on request of a party in interest or the United States trustee and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title.

*In re Patton*, 209 B.R. 98 (Bankr. E.D. Tn 1997) holds that a Chapter 13 debtor has an absolute right to dismiss. In so ruling, the court looks to (i) the "plain language" of section 1307(b)("shall") and section 1307(c)("may"), (ii) legislative history, (iii) purpose of the statute, and (iv) case law.

*In re Greenberg*, 200 B.R. 763 (Bankr. S.D.N.Y. 1996) also holds that the Chapter 13 has an absolute right to dismiss. The court then adds "a dismissal with conditions does not violate the debtor's absolute right to dismiss."
In re Casteel, 207 B.R. 185 (Bankr. E.D. Ark. 1997) also grants the debtor's motion to dismiss but states in *dictum* that a Chapter 13 debtor who files his petition or plan in bad or otherwise abuses the bankruptcy process does not have a right to dismiss.

**B. Disposable Income**

1. **Tithing**

D files for Chapter 13. They have regularly tithed 10% of their gross income to the church. Can D continue to tithe in this amount under the plan? In re Andrade, 1997 WL 643802 (Bankr. E.D. Cal. 1997), held that some reasonable charitable contribution was permissible by tithing that equaled debtor's payments under the plan was not reasonable. In so ruling, the court reviews three lines of cases: (i) tithing protected by First Amendment, (ii) tithing never a "reasonably necessary" expense under section 1325(b) and (iii) reasonable tithing permissible.

2. **Live-in-Companions**

D has a Chapter 13 plan and a "live-in companion." Is this "companion"'s income included in "disposable income." In re Halper, 1997 WL 611681 (Bankr. N.J. 1997), a case under section 523(a)(15), held that "all income that flows into a debtor's immediate household is relevant to the determination of a debtor's ability to meet his obligations under a property settlement agreement." The court noted the relationship between sections 523(a)(15) and 1325(b), concluded that most courts include a non-debtor's spouse's income under section 1325(b), but conceded that it was not able to find a reported case that included the income of a live-in companion. See also section 523(a)(8).

**C. Vesting of Property On Confirmation**

1327(b), 1306

1327(b)

Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

1306 Property of the estate.

(a) Property of the estate includes, in addition to the property specified in section 541 of this title--
(1) all property of the kind specified in such section that the
debtor acquires after the commencement of the case but before the
case is closed, dismissed, or converted to a case under chapter 7,
11, or 12 of this title whichever occurs first; and

(2) earnings from services performed by the debtor after the
commencement of the case but before the case is closed, dismissed,
or converted to a case under chapter 7, 11, or 12 of this title,
whichever occurs first.

Creditor objects to confirmation of 13 plan and moves to convert. The debtor
then files a motion to dismiss. Does the debtor have an absolute right to dismiss? Recent cases
suggest three somewhat different answers to the question.

1. Plan Provision

D's Chapter 13 plan provided that "all property shall remain property of the estate
and shall vest in the debtor only upon dismissal, discharge, or conversion." After confirmation,
the IRS levied against the debtor's wages to collect postconfirmation taxes. Looking to section
1327(b) ("Except as otherwise provided in the plan", Matter of Clark, 207 B.R. 559 (Bankr. S.D.
Ohio 1997) holds that the IRS violated the automatic stay.

2. No Plan Provision

After confirmation of a Chapter 13 plan, the debtor incurred but ignored parking
tickets. The City of Chicago towed and thrashed D's car. There was no provision in D's plan that
property remain property of the estate. In reversing the bankruptcy court, the district court in In
re Fisher, 203 B.R. 958 (N.D. Ill. 1997) held that property which was the debtor's property
preconfirmation vests in the debtor on confirmation and so the actions of the City of Chicago to
collect on its postpetition claim did not violate the automatic stay. In dictum, the court reconciles
sections 1327(b) and 1306 by concluding that property acquired postconfirmation is property of
the estate.


In dictum in Matter of Heath, 115 F.3d 521 (7th Cir. 1997) Judge Posner
.compares a Chapter 13 plan provision that property remain property of the estate "to that of a
child, a mental incompetent or a married woman in the age of coverture" because "any dispute
over that income, including the dispute with the corner grocer, would be for the trustee, not the
debtor, to litigate." Id. at 523. Judge Posner concludes "It would presumably be an abuse of
discretion for the bankruptcy judge to confirm a plan that retained more of the property in the
hands of the trustee than was reasonably necessary to fulfill the plan, though we need not decide
that in this case." Id. at 524.
D. Release of Lien on Payment of Amount of Secured Claim

Section 349(b)

(b) Unless the court, for cause, orders otherwise, a dismissal of a case other than under section 742 of this title--

(1) reinstates--

(A) any proceeding or custodianship superseded under section 543 of this title;

(B) any transfer avoided under section . . .

(C) any lien voided under section 506(d) of this title;

(2) vacates any order, judgment, or transfer ordered, under section . . . and

(3) revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case under this title.

Section 1322(b)(2)

(b) Subject to subsections (a) and (c) of this section, the plan may . . .

(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims

Section 1325(a)(5)

(5) with respect to each allowed secured claim provided for by the plan--

(A) the holder of such claim has accepted the plan;

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and
(ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim;

The Chapter 13 plan provides "Upon payment of the secured portion of any claim, the property securing such claim shall vest in the debtors, free and clear of any lien, claim or interest of a secured creditor." An undersecured creditor with a lien on a vehicle worth approximately $16,500 securing a debt of $24,000 objects to confirmation, arguing that the provision violates section 1325(a)(5)(B) and circumvents section 349. Recent cases have resolved that argument differently. Compare In re Johnson, 1997 WL 655292 (Bankr. N.D. Ill. 1997) (confirmed) and In re Zakowski, 1997 WL 637396 (Bankr. E.D. Wisc. 1997) (collateral can not vest in debtor free and clear lien prior to completion of plan and discharge).

"[A] bankruptcy court is a court of equity" is not a mantra that makes the Bankruptcy Code dissolve.

Matter of Milwaukee Cheese Wisconsin, Inc., 112 F.3d 845, 858 (7th Cir. 1997).
TAXES IN BANKRUPTCY

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SECTION I
I. TAXES IN BANKRUPTCY

1-1 Taxes and Bankruptcy

In the event that the IRS is totally uncooperative during a collection negotiation and the taxpayer has no basis to seek injunctive relief, consideration should be given to recommending that the client seek the protections granted by the Bankruptcy Code. The Bankruptcy Code provides that upon the filing of a bankruptcy petition an Automatic Stay is entered prohibiting the continuation of litigation or efforts to collect any debt without the express approval of the Bankruptcy Court.¹ This Automatic Stay has been held to apply to the Internal Revenue Service.²

1-2 Automatic Stay

Therefore, the initiation of any type of bankruptcy proceeding will preclude the Internal Revenue Service from continuing to levy upon wages or other assets of the taxpayer. The Supreme Court has held that the IRS could be ordered to return property which had been seized prior to bankruptcy.³ Therefore, if the IRS seizes an asset, your client can still seek the intercession of the Bankruptcy Court to stop a sale and get his property back.

1-3 Assertion of Trust Fund Recovery Penalty

The Government has taken the position that Section 362 of the Bankruptcy Code does not prohibit the assertion of the Trust Fund Recovery Penalty against responsible persons during the pendency of a Chapter 11 case. Most courts have upheld the IRS position.⁴

1-4 Payments During Bankruptcy

The Supreme Court has held that a bankruptcy court may approve a Chapter 11 plan of reorganization which provides that payments on behalf of the debtor are to be applied to trust fund taxes first.⁵ The bankruptcy courts have the power to make such direction

¹11 USC § 362.
²Bostwick v. United States, 521 F2d 741 (CA8 1975).
pursuant to 11 USC § 305 which grants the power to enter any order necessary to the successful completion of a plan. The Supreme Court did not decide the issue of whether payments in a Chapter 11 bankruptcy are voluntary or involuntary.

1-5 Prebankruptcy Payments of Trust Fund Taxes

In Begier v. Internal Revenue Service⁶ the Supreme Court held that government may not be required to turn over prebankruptcy federal tax deposits to the bankruptcy estate. Such payments are a trust for the government and as such may not be determined to be preferential payments.

PRACTICE TIP

If your client is about to file for bankruptcy, it would be wise to pay as much as possible to trust fund taxes. The payments would benefit corporate officers by reducing the potential Trust Fund Recovery Penalty and would not be subject to a determination that they were preferential payments pursuant to the bankruptcy code.

1-6 Improper Postbankruptcy Payments of Trust Fund Taxes

The Supreme Court held in Nordic Village⁷ that even though a company officer improperly paid trust fund taxes subsequent to the filing of a Chapter 7 Bankruptcy, the IRS was not subject to a judgment for return of the assets since the IRS enjoyed sovereign immunity. Therefore, the officer reduced his potential personal liability for a Trust Fund Recovery Penalty by improperly paying corporate trust fund taxes post Chapter 11 filing. The 1994 revision of the Bankruptcy Code provides that the IRS may now be sued to recover a preference and reverses the holding in Nordic Village.

1-7 Priority Taxes

The Bankruptcy Code gives the following types of federal, state and local taxes priority:

(1) Income taxes which are less than three years old, computed from the date the return was due, not the end of the tax year. Any income or gross receipts tax assessed within 240 days before the petition was filed are nondischargeable. The 240 day period is extended if the taxpayer makes an offer of settlement within 240 days after assessment of such tax. The key here is the date the tax was assessed and not the date of the return. In addition, any tax assessable after the date of the petition is not dischargeable;


(2) Any withholding tax (Trust Fund Taxes) for which the debtor is liable in any capacity. Thus, whether the debtor is liable for trust fund taxes as an employer or, pursuant to IRC § 6672, as a responsible officer of a corporation, the tax liability is not dischargeable regardless of the age of the debt;

(3) Other employment related taxes if within three years of the filing date;

(4) Excise taxes which are less than three years old;

(5) Certain customs duties; and

(6) Any compensatory penalty on any of the foregoing.

1-8 Dischargeable Taxes

As a result of 11 USC §§ 523 and 507 the following taxes are dischargeable in Chapters 7 and 11:

(1) Tax penalties for nonfiling, late payment, late deposit and late estimated payments if the taxes to which they relate are dischargeable.

(2) Income taxes which are:
   (a) Over three years old;
   (b) Have been filed at least two years prior to the petition; (11 USC 523(a)(1)(B)) and/or
   (c) Have been assessed as an audit deficiency for at least 240 days (11 USC 507(a)(8)(A)).

(3) Estate and gift taxes which are over three years old.

COMMENT: A taxpayer must not have filed a fraudulent return or otherwise tried to willfully evade payment of the tax. (11 USC 523(a)(1)(C))

1-9 Dischargeability of Penalties

Section 523(a)(7)(A) ("Subparagraph "A") of the Bankruptcy Code is generally viewed as a codification of the pre-Code position of the government regarding the dischargeability of penalties, i.e. that all non-compensatory (i.e. punitive) penalties are dischargeable only if

*11 USC § 507.
the related tax is dischargeable." However, Congress went further and made an additional category of tax penalties dischargeable under section 523(a)(7)(B) ("Subparagraph (B)"). Subparagraph (B) provides for a discharge of a tax penalty "imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition."

Courts addressing the interpretation of the interaction of the two subparagraphs have held that Subparagraph (B) as enacted is unambiguous as a matter of statutory construction and can discharge certain penalties even if the underlying tax is not discharged, thus overriding the general approach of Subparagraph (A). The analysis continues by addressing what is the "transaction or event" which begins the running of the three year period of Subparagraph (B). Courts have variously held that the "transaction or event" is the due date or the filing date of the return. Such "events" can easily pre-date a bankruptcy petition filing by more than three years, making penalties related to such tax years dischargeable. This is of particular interest where there is a long-standing dispute with the IRS ending in an assessment of tax which is non-dischargeable but which relates to a year in which the due date or filing date precede the petition filing date by three years.

1-10 Cases Considering Section 523(a)(1)(C)

   • nonfiler for the years 1974 through 1981
   • "he knew he was liable for the taxes and he had the wherewithal to pay his taxes during some" of the years in question
   • indicted and convicted of under section 7203 for criminal failure to file
   • failed to abide by his sentencing order by not filing returns in the future
   • failed to set aside any money to pay liabilities over the years; he failed to pay income taxes or file returns until he was forced to do so by the terms of his criminal sentence
   • had a profitable business
   • had no other debts or obligations to service with his income

   The issue in this case was the proper standard to apply in determining dischargeability—criminal versus civil standard of willfulness. The District Court and the
Sixth Court held that the standard for 523(a)(1)(C) purposes was a civil standard and the IRS was not required to prove the discharge. The Court adopted the definition of "willfully attempted to evade" to mean the same thing as willful in 26 U.S.C. § 6672—a "voluntary, conscious, and intentional evasion of tax liabilities." Toti was not an honest debtor and could not receive a discharge because "he had the wherewithal to file his return and pay his taxes, but he did not fulfill his obligation."

The District Court focused on the definition of the word "evade." This is not defined in the bankruptcy code and the dictionary definition is "to fail to pay or to minimize taxes in violation of the law." Thus, the debtor's attempt to block the collection of taxes which have already been assessed is sufficient to prevent the discharge.


B. United States v. Childers, 846 F.2d 74 (4th Cir. 1988).
   • Debtor admitted that he made false statements in tax collection information forms which substantially underreported his income available to pay his tax liabilities.

   The debtor alleged in subsequent civil litigation with the United States that his tax liabilities were discharged in earlier 1982 chapter 7 case. The court concluded this could not be true because 11 U.S.C. §523(a)(1)(C) exempts from discharge any debt for a tax with respect to which the debtor . . . . willfully attempted in any manner to evade or defeat such tax.

C. In re Bruner, 1994 WL 461310 (B.Ct., W.D. La., 1994).
   • taxpayers filed joint returns in earlier years and knew they had to file
   • they were financially able to pay the liabilities they owed

   The court relied on the Hass and Jones cases to state the following proof to the IRS to prove the nondischargeability of a tax liability: (i) the debtors had a duty under the law (ii) the debtors knew they had that duty and (iii) the debtors voluntarily and intentionally violated that duty. The proof of an affirmative act by the debtors is not required—the purpose of 523 is to prevent the use of the Bankruptcy Code as part of a dishonest scheme to evade tax liability, while at the same time providing relief to the honest debtor. If a person fails to file and pay his liability, then he is not an honest debtor entitled to a discharge.

   • family trust case with fraudulent transfers to the trusts to avoid IRS/creditor claims
   • the debtor specifically admitted that the reason the assets were transferred to the trust was to prevent the tax liens from attaching to the realty.

   This court was the court that wrote the original Toti opinion and therefore continued its application of a civil standard based on the Jones case. Evasion of payment by way of fraudulent transfer falls within the scope of the term "in any manner" in the statute.

   Bankruptcy Court—136 B.R. 690 (B.Ct. E.D. Mich. 1991) where is was also held that the transfers into trust to avoid the IRS collection prevented the granting of a discharge.

   • delinquent returns
• returns filed with no payments
• no withholding and quarterly ES payments
• income in each of the years was in excess of $100,000
• constitutional tax protestors who sent tax protestor related letters to the IRS and generally refused to cooperate with IRS agents, attempted to revoke their social security numbers, refused to identify themselves to the IRS, hid documents relating to the filing of the income tax returns
• criminally charged and convicted of failure to file
The court agreed with the IRS that a civil test of willfulness is applicable and that test is the voluntary, conscious and intentional test suggested by the IRS—no evidence of an affirmative act is required under 11 U.S.C. §523.

F. Haas v. IRS, 48 F.3d 1153 (11 Cir. 1995).
• for the years 1977 through 1985 the debtors filed income tax returns but did not make any payments thereon
• debtors did not conceal assets, engage in dubious transfers of assets, falsify or destroy books or records, or misstate the amount of income in the tax returns filed
• the debtor simply used his income to pay personal and business expenses rather than pay the taxes that were due.

The correct test for dischargeability is a civil and not a criminal standard. The IRS must prove the nondischargeability of a tax liability by showing: (i) the debtors had a duty under the law (ii) the debtors knew they had that duty and (iii) the debtors voluntarily and intentionally violated that duty. The section 523 test for willfulness is the same as that under 26 U.S.C. §6672 so the IRS need not prove any bad motive or a specific intent to defraud the government in order to succeed. Because Haas "chose not to pay the taxes and instead used his financial resources for other purposes. . . Haas wilfully attempted to evade these taxes."

("Summary of Section 523(a)(1)(C) Litigation—Is There Really A Discharge For Tax Liabilities?" prepared for American Bar Association by Walter B. Thurmond, January 25, 1995)

1-11 Avoiding Unreasonable Revenue Officers

If a tax is nondischargeable, a debtor remains liable for all pre-and post-petition interest upon that tax. If the tax which a debtor owes is not among the ones excepted from discharge by the Bankruptcy Code, the tax is dischargeable. Therefore, in given circumstances, it may be to the benefit of a taxpayer having limited nonexempt assets to file a bankruptcy and liquidate her tax liability as opposed to trying to deal with an unreasonable Revenue Officer. Even though a tax is discharged, the IRS may retain a lien claim on certain exempt pre-petition property.

II.  CHAPTER 13

2-1  Forcible Payment Plan

Because approval is not required, a Chapter 13 bankruptcy gives an individual taxpayer the ability to force a payment plan upon the Internal Revenue Service over its objection. Instead of having to deal with an unreasonable Revenue Officer, the taxpayer presents his or her other case to a Federal Bankruptcy Judge who has the ability to force the IRS to accept extended payments. All of this makes a Chapter 13 Bankruptcy particularly attractive when the taxpayer has sufficient income to allow repayment of the IRS tax liability within five years. The major disadvantages of Chapter 13 are the adverse affect upon the taxpayer's credit rating and the administration fee taken by the trustee for collecting the plan payments. On the other hand, in most cases, the taxpayer may avoid paying interest to the IRS.

PRACTICE TIP

A major benefit of a Chapter 13 Bankruptcy is that an individual taxpayer has the ability to force a payment plan upon the IRS. A disadvantage of Chapter 13 Bankruptcy is the adverse effect it has upon a taxpayer's credit rating.

2-2  Partial Payment of Liabilities

A Chapter 13 plan may provide for partial payment of Dischargeable Taxes. For example, if the taxpayer had limited assets and income, the plan might provide for a payment of 10% of Dischargeable taxes. In some districts judges will accept 0% plans for non-priority taxes.

2-3  Super Discharge

In order for income taxes to be dischargeable in a Chapter 7 case a debtor must have filed her tax returns for the years in question at least more than two years prior to filing the bankruptcy petition.13 In a Chapter 7 case a debtor who has not filed his returns at all, or has filed them within two years prior to the bankruptcy, cannot discharge those taxes even though the tax has been assessed more than 240 days. In a Chapter 13, however, if a tax meets all the other criteria for dischargeability, it may be wiped out or reduced in a Chapter 13 plan.14 That a return need not be filed in order to make a tax dischargeable under Chapter 13 is apparent from a careful reading of the priority language of the Bankruptcy Code. A taxpayer's failure to file a return, or if she filed it less than two years prior to the bankruptcy, renders the tax nondischargeable under Chapter 7 pursuant to section


523(a)(1), but this code section does not apply in Chapter 13.\textsuperscript{15} Bankruptcy Code §1322(a)(2) requires only that the Chapter 13 plan provide for full payment of priority taxes under section 507(a)(8). Referring to section 507(a)(8), nowhere does the language include within the category of priority tax one for which a tax return was filed late or not filed. Hence, the failure to file a return does not render that tax a priority tax. Compare section 1322 with section 523 (exceptions to discharge) which renders tax for which no return was filed or which was filed less than two years prior, nondischargeable under Chapter 7 (section 727).\textsuperscript{18}

Where the taxpayer filed a fraudulent return and engaged in activity which is deemed to be willful evasion of a tax obligation, any tax arising in connection with such return or evasion is ordinarily not dischargeable in Chapter 7.\textsuperscript{17} The discharge available in Chapter 13 does not exclude the claims in this category (fraud or evasion), and therefore they are dischargeable to the extent any other secured or unsecured claim may be discharged, depending on the particular plan. As long as the Chapter 13 plan provides for full payment of priority claims provided by section 507, the discharge is allowable as to tax claims.\textsuperscript{18} Section 507 does not include tax claims based on fraud or evasion; therefore, the plan need not provide for full payment of them, unless the tax claims fall within some other category provided in section 507.\textsuperscript{19}

Regardless of whether a tax obligation is found to be based on fraudulent returns, the debtor's dishonest prepetition conduct in regard to his tax obligations may be taken into consideration on the issue of bad faith.\textsuperscript{20}

2-4 \hspace{1cm} \textbf{Post-Bankruptcy Actions}

Once a discharge has been entered by the Bankruptcy Court, submit a written request to Special Procedures Branch that the IRS abate the tax. The Service will abate the liability by preparing a Form 3870. The author has found that the IRS is very inefficient in preparing post-bankruptcy abatements. Many clients have had levies made on their wages or bank accounts after a bankruptcy. You must aggressively pursue abatement. If all else

\begin{itemize}
\item \textbf{In re Daniel,} 170 B.R. 466 (Bankr. S.D. Ga. 1994) at page 468 (exceptions to discharge do not apply to a §1328(a) discharge.)
\item \textbf{In re Bailey Bradley,} 36 B.R. 655 (Maryland 1984).
\item Bankruptcy Code §523(a)(1)(C).
\item Bankruptcy Code §1322(a)(2).
\item \textbf{In re Muina,} 75 B.R. 192 (S.D. Florida 1987).
\item A discussion of factors to be considered in determining the good and bad faith of the plan may be seen in \textbf{re Coburn,} 1994 B.R. LEXIS 1875 (B.R. D. Oregon 1994).
\end{itemize}
fails, the client may request that the Bankruptcy Court hold the IRS in contempt of court. Until the IRS begins protecting the rights of bankrupts, you should warn your clients that the IRS may take illegal levy action notwithstanding the bankruptcy. If the taxpayer has taken reasonable steps to notify the IRS of the bankruptcy and discharge, the taxpayer may have a potential cause of action for reckless violation of the Code [IRC § 7433].

III. SANCTIONS UNDER THE BANKRUPTCY CODE

3-1  
Litigating Tax Liabilities

The Bankruptcy Courts can become a forum for litigating the amount of tax liabilities. If the taxpayer has failed to initiate a Tax Court case within 90 days of the Notice of Deficiency, he normally may not litigate a grossly overstated assessment unless the full balance is paid. If the taxpayer is financially unable to pay the deficiency, he has lost the ability to litigate a refund suit. A taxpayer with limited funds may, however, initiate a bankruptcy and object to the claim of the IRS. The Bankruptcy Court would then have jurisdiction to determine the liability.

EXAMPLE: 1. The author's client was a college professor who failed to petition to Tax Court within 90 days of a Notice of Deficiency. The IRS assessed a deficiency in excess of $45,000 disallowing most expenses and depreciation of a rental property for three years. A Revenue Officer arrived at the taxpayer's home and began demanding full payment of the taxes. The professor lacked the monies to pay the tax liabilities. The Revenue Officer refused his request for an audit reconsideration even though the deficiency was grossly overstated. The professor signed a payment agreement of about $400 per month. Because the payments were small, the liability continued to increase with accrued interest and penalties. After several years, the IRS demanded larger payments which the professor could not afford to pay. The professor filed a Chapter 13 bankruptcy. When the IRS filed its claim, an objection to claim was filed with the court. The IRS then reopened the audit and abated most of the improper deficiency. If the IRS had refused to reopen the audit, the Bankruptcy Court could have heard evidence and reduced the IRS claim.

3-2  
Litigation Remedy

Any disputed tax may be litigated in Bankruptcy Court. The taxpayer could dispute employment tax audits, Trust Fund Recovery Penalties, other penalties and tax deficiencies. If the issue has been previously litigated before another judicial forum, the Bankruptcy Court would not have jurisdiction. If the taxpayer has never sought a court resolution, the matter may be litigated without paying the full liability.

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²¹In re Price, 130 BR 259 (ND Ill 1991), 42 F 3d 1068 (CA 7 1994); In re Abernathy, 93-1 USTC ¶ 50,108 (BC ND Ill 1993); In re Kolb, 137 BR 29 (ND Ill 1992).
Advantages of Litigating Before Bankruptcy Court

Because of the automatic stay [11 USC § 362], the IRS may not take administrative collection actions during the pendency of a bankruptcy. The client may litigate a tax controversy without the fear of imminent seizures or levies. Many bankruptcy judges give the debtor every opportunity to prove his case and review tax controversies in an equitable manner. If your client has a legitimate tax dispute but cannot afford to pay the liability in order to litigate it, consider litigation in bankruptcy court. If the taxpayer prevails, she may choose to dismiss the bankruptcy if she has few other debts.

Summary

Although bankruptcy is not a cure-all, it may be a viable alternative to dealing with unreasonable Revenue Officers. In the proper circumstances, bankruptcy can be used to:

1. Eliminate tax liability; and/or
2. Reduce tax liability; and/or
3. Reduce penalties; and/or
4. Secure an extended plan for payment of the tax liabilities; and/or
5. Litigate tax controversies.

Caveat

Prior to the initiation of any of these proceedings, however, the practitioner should thoroughly research the applicable bankruptcy statutes and, of course, the client should be fully advised of the adverse effects of a bankruptcy on his credit rating. If you incorrectly recommend a bankruptcy, the client might look to you for financial redress.
CHECKLIST NO. 1
DISCHARGEABILITY-AT-A-GLANCE
PERSONAL INCOME TAXES
CHAPTER 7

Personal income taxes are dischargeable in a Chapter 7 if each of the following elements exist:

* The tax year in question is more than three years prior to filing the bankruptcy;
* The tax in question has been assessed more than 240 days prior to filing the bankruptcy;
* The tax return for the year in question was filed at least more than two years prior to the bankruptcy filing;
* The tax return in question was non-fraudulent and there is no showing of willful evasion of payment of a lawful tax;
* The claim is unsecured; (If secured, the tax is discharged as to the debtor personally (in personam liability) but the lien is still valid as to any property it has attached to (in rem liability).

CHAPTER 13

The personal income tax is dischargeable in Chapter 13 if (1) the tax claim is unsecured and the taxing entity fails to file a timely proof of claim, or (2) in the alternative, if each of the following elements exist:

* The tax year in question is more than three years prior to the filing of the bankruptcy;
* The tax in question has been assessed more than 240 days prior to filing the bankruptcy;
* The tax in question is personal income tax;
* The tax claim is unsecured. (If secured, the tax is discharged as to the debtor personally (in personam liability) but the lien is still valid as to any property it has attached to (in rem liability).
CHECKLIST NO. 2

PAYROLL WITHHOLDING TAXES

CHAPTER 7

Payroll withholding taxes are never dischargeable (wiped out) in a Chapter 7 (unless, of course, there are assets in the estate to liquidate and pay the claim). However, the question of whether or not the debtor is or is not the responsible officer and thus personally liable for the 100% penalty is a matter the bankruptcy court has jurisdiction to determine. And the court has jurisdiction to determine the amount of the claim, unless it has already been adjudicated by a prior court of competent jurisdiction (i.e. the tax court).

CHAPTER 13

Payroll withholding taxes are ordinarily not dischargeable in a Chapter 13 adjustment of debts. However, where the taxing entity fails to file a timely proof of claim and the tax claim is unsecured, it is extinguished.

CHECKLIST NO. 3

SALES TAXES

CHAPTERS 7 and 13

If the sales tax is a true sales tax (a tax imposed on the buyer and computed based on the amount of the purchase, where the tax is to be collected by the retailer and forwarded to the taxing entity) most courts hold that it is a nondischargeable trust fund tax.

Where, however, the sales tax is actually an excise tax (a tax imposed on the retailer for the privilege of doing business, computed on the amount of the purchase) it is dischargeable if the event on which the tax arose is more than three years prior to the filing of the bankruptcy. It is important to note that what is called a sales tax in some states is actually an excise tax under bankruptcy law (such as, for example, California's so-called sales tax). The dischargeability of the tax does not depend on what it is called by the state, but rather by the actual nature of the tax as determined by the bankruptcy court.

Note that where in a Chapter 13 the taxing entity fails to file a timely proof of claim and the claim is unsecured, it is discharged.
CHECKLIST NO. 4

EMPLOYMENT TAXES

CHAPTERS 7 and 13

The employment tax (the employer's contribution to the payroll withholding) is dischargeable under certain circumstances. Such taxes may be dischargeable if over three years old, or if over 90 days old, or entirely dischargeable, depending on how the Bankruptcy Code is interpreted. Scarce case law leaves this issue unsettled. The one case extant which deals with this issue held that any such tax over 90 days old prior to bankruptcy is dischargeable. However, Collier's on Bankruptcy makes a flat statement that such taxes are dischargeable only if over 3 years old, without citing authority.

CHECKLIST NO. 5

DISCHARGEABILITY-AT-A-GLANCE

PENALTIES

CHAPTER 7

The majority rule is that penalties that are punitive in nature only (which includes most penalties such as penalties for non-filing, late-filing, non-payment, late-payment, etc.) are dischargeable if:

* The penalty is attached to a tax which is dischargeable;

or

* The transaction or event giving rise to the penalty is more than three years before the bankruptcy filing.

A non-dischargeable penalty is one which is for reimbursement to the taxing entity for pecuniary loss, or is a penalty that represents the actual tax owed, such as the 100% penalty for payroll withholding. The typical penalties assessed against taxpayers are not in these categories.

**Note:** The 240-day assessment period is not applicable to tax penalties. Hence, it makes no difference when the penalty was assessed, as long as it meets one of the two criteria listed above it is dischargeable.

**Note:** The minority rule is that a penalty is dischargeable only if the tax is dischargeable, regardless of how old the penalty is.

**Note:** Penalties, even in Chapter 7, are not priority claims, but are included in exceptions to discharge under § 507.
CHAPTER 13

Penalties are not priority claims and are dischargeable to the same extent as general unsecured claims in Chapter 13, regardless of when the penalties were imposed.

SOURCE: "DISCHARGING TAXES IN BANKRUPTCY"
Chapters 7, 11 and 13
Morgan D. King J.D.

Kings Press, 1995
DISPOSITION OF TAX PROPOSALS

MADE TO

THE NATIONAL BANKRUPTCY REVIEW COMMISSION
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Paul Asofsky
Co-Chair with Robert E. McKenzie
of the ABA Task Force
on the National Bankruptcy Review Commission
DISPOSITION OF TAX PROPOSALS MADE TO THE COMMISSION

1. (100). The Justice Department and Commissioner Shepard proposed that section 724(b) of the Bankruptcy Code be repealed, thus affording secured status to all tax lien claims. Complete repeal was generally opposed by the private bar, although some commentators, including the ABA Task Force, would have dealt with the question by charging a secured creditor with the real property tax under section 506(c). The Commission ultimately gave the taxing authorities most, though not all, of what they wanted. Under the Commission proposal, "[B]ankruptcy Code section 724(b) should be amended to exempt from subordination properly perfected, nonavoidable liens on real or personal property of the estate arising in connection with an ad valorem tax. Section 724(b) should also require the trustee to marshall unencumbered assets of the bankruptcy estate and surcharge secured claims, if warranted by the circumstances, under section 506(c) prior to subordinating any tax liens under the statute." Very few people except the local taxing authorities will be happy with this proposal, and it can be anticipated that this will be a fertile ground for controversy before the appropriate committees of Congress.

2. (104). The Government Working Group originally proposed that the deemed filed rule now applicable in chapters 9 and 11 be extended to other bankruptcy chapters. The ABA Task Force opposed the proposal and the Advisory Committee
recommended that it be dropped as unimportant. The Commission did not act on the
proposal.

3. (105, 106 and 109). Commissioner Shepard and various governmental
taxing authorities pushed hard for more specific notice requirements to governmental units.
In addition, Commissioner Shepard proposed some stiff sanctions for failure to comply with
the notice requirements, including extending a governmental authority’s time period to object
to discharge or to move to revoke a discharge. Insofar as these proposals required more
specific notice to governmental units sent to persons and places of their choosing, the
proposals proved to be noncontroversial. The ABA Task Force supported them and the
Advisory Committee unanimously approved a package of Justice Department rules changes
embodying these proposals. The Commission sent these on to the Rules Committee for
consideration. The ABA Task Force strenuously opposed Commissioner Shepard’s sanctions
as well as a proposal that would have specifically required an individual debtor to notify a
governmental unit of a possible claim for trust fund taxes. These proposals were not part of
the Justice Department’s rules package and were not approved by either the Advisory
Committee or the Commission.

4. (107 and 108). Commissioner Shepard made several proposals
requiring debtors to schedule the tax basis of their assets. These proposals were opposed by
the ABA Task Force and by the Association of the Bar of the City of New York. The
Advisory Committee recommended that they be withdrawn and the Commission did not act on them.

5. (211). The Department of Justice, the IRS and Commissioner Shepard proposed that the burden of proof as to tax matters be the same in the bankruptcy court as in applicable nonbankruptcy tribunals. The ABA Task Force supported this position, although it proposed a narrow exception for situations in which a trustee was contesting the tax claim. The Commission adopted the proposals, but not the ABA Task Force’s proposed exception.

6. (212). Taxing authorities made a proposal that there be added as grounds for conversion or dismissal in chapter 11, 12 and 13 cases the failure to file prepetition tax returns, the failure to file postpetition tax returns and the failure to file postpetition returns and pay postpetition taxes. By a divided vote, the Advisory Committee recommended that this proposal be adopted. The Commission did not vote on it but it will be part of the Advisory Committee’s report that is sent to Congress.

7. (213). The IRS, the Department of Justice and Commissioner Shepard proposed repeal of the chapter 13 superdischarge. The ABA Task Force vigorously opposed such repeal. The Commission rejected outright repeal of the superdischarge. [By a vote of four to four it failed to act on a proposal by Commissioner Jones to except taxes attributable to a fraudulent return from the superdischarge.]

8. (214). The governmental taxing authorities generally urged amendments to section 1129(a)(9)(C) which would have had the effect of requiring level
payments of deferred taxes under section 1129 and to provide a statutory interest rate. These proposals were generally supported by the private bar, in particular the ABA Task Force. The Commission adopted these proposals by (a) requiring level payments without specifying the appropriate periodic intervals, (b) setting the normal tax deficiency rate under section 6621(a)(2) of the Internal Revenue Code as the uniform rate and (c) providing that the six-year deferral period run from the date of the order for relief, rather than from the date of assessment. The Commission thus essentially adopted the Advisory Committee's compromise. IRS was opposed to the 6621(a)(2) rate insofar as it deprived them of "hot" interest on large corporate underpayments. Cf. I.R.C. § 6621(c). The ABA Task Force would have started the six-year period on the effective date of the plan rather than the date of the order for relief. On the other hand, taxes assessed before the petition date would now be subject to the full six-year stretch out beginning on the date of the order for relief, a change opposed by some of the local tax authorities.

9. (215). The governmental taxing authorities sought the right to set off prepetition refunds against prepetition tax claims. Many districts now give governmental taxing authorities that right under local rules or standing orders. The IRS went further and requested that the Commission give it the right to set off postpetition refunds against prepetition tax claims. The ABA Task Force opposed all of these setoff proposals. The Commission adopted the government's proposals by allowing setoffs of prepetition refunds
against prepetition liabilities, but did not adopt the IRS proposal to set off postpetition refunds against prepetition liabilities.

10. (216). Commissioner Shepard proposed that debtors seeking prompt assessments under section 505(b) of the Bankruptcy Code comply with applicable notice requirements of taxing authorities. The ABA Task Force supported this proposal with the proviso that such local rules be filed in prominent places. The Commission adopted the proposal with safeguards of the type sought by the Task Force.

11. (217). Commissioner Shepard proposed that section 1231(b) of the Bankruptcy Code be repealed, so that no separate taxable entity would be created upon the filing of a family farmer bankruptcy. This proposal was uniformly endorsed by all parties and was adopted by the Commission.

12. (217A). The ABA Task Force proposed that the Bankruptcy Code be amended to provide debtors with a short year termination election for state and local tax purposes identical to that provided by section 1398(d)(2) of the Internal Revenue Code. The Commission adopted the Task Force’s proposal. The Commission also . . . [add all 1398 rules]

13. (218). The Government Working Group originally proposed that the Commission should submit to the Advisory Committee on Bankruptcy Rules of the Judicial Conference a recommendation that Federal Rule of Bankruptcy Procedure 1007 require a debtor to disclose on schedules when initially filed whether or not any tax audits are pending,
and to file amended schedules and statements as necessary, with written notice thereof to state and local taxing authorities, to provide adequate notice to state taxing authorities and other creditors of a federal tax audit. Additionally, the Government Working Group proposal recommended that Bankruptcy Code section 523(a) be amended to provide that the failure to substantially comply with Bankruptcy Rule 1007 renders nondischargeable a state or local government claim associated with a debtor's noncompliance. The ABA Task Force agreed with the proposed amendments to Bankruptcy Rule 1007 but opposed the proposed amendment to Bankruptcy Code 523(a). Neither the Advisory Committee nor, in the end, the Commission, acted on this proposal.

14. (219). Commissioner Shepard proposed that by statute or rule, parties seeking contempt sanctions against governmental units for violation of the automatic stay make a meaningful attempt to resolve the problem in a nonlitigious manner before filing such action and bear the burden or proof of such attempt. The ABA Task Force opposed this provision. The Advisory Committee recommended that the proposal be withdrawn and the Commission did not act on it.

15. (311). The IRS, the Department of Justice and Commissioner Shepard proposed statutory amendments that would toll the running of the priority tax periods of section 507(a)(8) for previous bankruptcy cases plus an additional six months. The ABA Task Force agreed that a suspension was appropriate for the time during which a previous bankruptcy case was pending, but opposed any additional period in excess of 30 days. The
Advisory Committee proposed an extension for the time during which a previous bankruptcy case was pending but did not deal with the add-on. The Commission adopted this proposal.

16. (312). The tax authorities sought an amendment to the Bankruptcy code to "make clear" that on default under a confirmed plan, the taxing authority retains the rights of a governmental authority collecting taxes, and is not relegated to default remedies under the plan. The ABA Task Force opposed this proposal, but the Advisory Committee recommended it by a vote of seven to three. The Commission did not vote on this proposal, but it will be part of the Advisory Committee's report sent to Congress.

17. (313, 313A). Governmental authorities sought to amend section 507(a)(8)(ii) to provide a tolling of the 240-day period in a case where an offer in compromise is outstanding regardless of whether the offer was made before or after the assessment. The private bar supported this amendment, the Advisory Committee recommended it and the Commission adopted it as a consensus item. There was some effort on the part of the IRS to have the tolling principle apply to installment agreements as well as offers in compromise, but this was roundly opposed by the private bar. The Advisory Committee rejected the proposal. The Commission did not vote on this aspect of the proposal, but rejection thereof will be part of the Advisory Committee's report sent to Congress.

18. (314). The IRS proposed that section 508(a)(8)(A)(iii) be clarified so that priority will be denied for taxes attributable to fraudulent and unfiled returns only when
the taxing authority's ability to assess those taxes resulted solely from the taxpayer's fraud or failure to file. The proposal would provide priority status to those tax claims still assessable at the time of the filing of the petition for reasons that are totally unrelated to the debtor's fraud or failure to file. The ABA Task Force opposed this recommendation. The Advisory Committee adopted it by a vote of seven to three. The Commission did not vote on the proposal but it will be part of the Advisory Committee's report sent to Congress.

19. The Small Business Working Group proposed that companies on the small business track be required to establish and maintain a separate bank account for postpetition taxes and nontax deductions from employee paychecks. The ABA Task Force supported this proposal and the Commission adopted it.

20. One of the most hotly debated issues before the Commission was whether the Supreme Court's decision in *United States v. Energy Resources Co.*, 495 U.S. 545 (1990) should be repealed. Under the *Energy Resources* decision the bankruptcy judge may approve an allocation of tax payments under section 1129(a)(9)(C) to trust fund liabilities pursuant to the plan if the court finds that such an allocation is necessary for the success of the reorganization. All governmental taxing authorities supported repeal of *Energy Resources*. All private bar representatives opposed such repeal. With the two academic members siding with the private bar members, the Advisory Committee rejected repeal. In the rush of business, the Commission did not vote on the repeal of *Energy*
Resources but rejection thereof will be part of the Advisory Committee’s report sent to Congress.

21. (329 and 433). Commissioner Shepard had proposed that the tax jurisdiction of the bankruptcy court be confined to the power of the appropriate nonbankruptcy tribunal. This would have imported into the bankruptcy court various local procedural rules, including periods of limitations and other bar dates. It would have required debtors to exhaust administrative remedies before showing up in bankruptcy court. Also, Commissioner Shepard would have explicitly barred bankruptcy courts from issuing declaratory judgments in tax matters. The ABA Task Force not only opposed all of Commissioner Shepard’s proposals, but it also proposed explicitly giving declaratory judgment jurisdiction over the tax consequences of the plan of reorganization to the bankruptcy court. The Advisory Committee discarded the proposals that would have limited the bankruptcy court’s jurisdiction, and the Commission never specifically took them up. The Commission, moreover, by a narrow four-three majority, adopted the Task Force’s proposal to give declaratory judgment jurisdiction to the bankruptcy court. It can reasonably be anticipated that the governmental taxing authorities at all levels will oppose this proposal before the Congress.

22. (331). The IRS proposed that a penalty computed with reference to a tax liability is discharged only when the underlying tax is discharged. Under present law, penalties attributable to an old tax can be discharged even if the tax liability cannot be
discharged, for example, because the deficiency is attributable to fraud. The ABA Task Force opposed this proposal, and it was rejected by the Advisory Committee by a vote of six to four. The Commission did not vote on this proposal, but rejection thereof will be part of the Advisory Committee’s report sent to Congress.

23. (333). The governmental taxing authorities proposed that chapters 12 and 13 contain provisions that a tax lien cannot be discharged before completion of plan payments. The ABA Task Force opposed this proposal and instead proposed that a debtor be permitted to buy off a tax lien to the extent of the government’s secured claim once a value for the underlying property is determined in the case. Under the ABA Task Force’s proposal, such lien would not be reinstated even if the case is subsequently dismissed or plan payments not made. The Advisory Committee was evenly divided on the government’s proposal, and thus made no recommendation. It voted six to four to adopt the ABA Task Force proposal. The Commission did not vote on this proposal, but it will be part of the Advisory Committee’s report sent to Congress.

24. (334). Commissioner Shepard proposed that a trustee or debtor in possession not be able to avail himself of bona fide purchaser status for the purpose of avoiding federal tax liens. The ABA Task Force agreed with this proposal. The Advisory Committee adopted it unanimously and it was adopted as a consensus proposal by the Commission.
25. (335). The IRS and the Justice Department proposed to provide the same treatment under Bankruptcy Code section 507(a)(8) for non-trust fund excise and employment taxes as currently provided for income and gross receipts taxes. The effect of this proposal would have been to import the three-year and 240-day rules of section 507(a)(8) into the excise and employment tax arenas. The ABA Task Force opposed this proposal on the ground that the extension of these time periods was not needed with respect to these types of taxes. The Advisory Committee agreed with the ABA Task Force and rejected the proposal by a vote of six to four. The Commission did not vote on this proposal but rejection thereof will be part of the Advisory Committee's report sent to Congress.

26. (339). Commissioner Shepard proposed that the bankruptcy court be required to abstain from determining dischargeability of any tax claim where there are no assets to administer or where the debtor's request for a determination of tax liability is not accompanied by a demonstration that the debtor has an interest in the property of the estate. The ABA Task Force opposed this proposal. The Advisory Committee recommended that this proposal be withdrawn and it was never acted on.

27. (414). [Duty to file partnership tax returns]

28. (414A). The ABA Task Force proposed that sections 728(c) and 728(d) of the Bankruptcy Code be repealed. The Advisory Committee approved this proposal and the Commission also adopted it as a consensus recommendation. [cross-reference to 12]
29. (415A). The ABA Task Force proposed that the appropriate provisions of subchapter K of the Internal Revenue Code be amended to provide that the basis of a bankrupt or insolvent partner in his partnership interest be increased to the extent of any amount of discharge of indebtedness income that is excluded from gross income under section 108(a)(1) of the Internal Revenue Code. The proposal sought to clarify that the decision of the Court of Appeals in *Babin v. Commissioner*, 23 F.3d 1032 (6th Cir. 1994) did not apply to taxable years after the effective date of the Bankruptcy Tax Act of 1980. In the meetings of the Advisory Committee, the IRS representatives reported that the National Office agreed with the ABA Task Force, but stated that that was the result under present law, i.e., *Babin* does not apply after 1980. Although the Service has not issued a public announcement to this effect, the Service representatives unequivocally stated that they would entertain requests for technical advice in a proper case. The Advisory Committee, with the concurrence of the private representatives, dropped the ABA Task Force proposal. As such, Congress will not have to deal with the question of retroactivity of any amendment to the statute.

30. (415B). The ABA Task Force submitted a proposal that would authorize the Bankruptcy Court to designate a trustee in a chapter 7 or chapter 11 case as the Tax Matters Partner under section 6231(a)(7) of the Internal Revenue Code. Neither the Advisory Committee nor the Commission acted on this proposal.

31. (421-4). [Postpetition taxes as ordinary course]
32. (425). The Commission entertained a number of proposals dealing with the tax consequences of abandonment. It adopted a proposal by the ABA Task Force treating abandonment as a disposition by the debtor immediately before the filing of the bankruptcy petition, but awaiting imposition of any tax liability until the property was ultimately disposed of. The proposal thus treats the tax liability resulting from an abandonment as a prepetition eighth priority tax claim, but allows the estate to use the debtor's tax attributes to reduce the liability and protect the debtor by allowing his nonexempt assets to be used by the bankruptcy estate in satisfaction of the liability.

33. (432). Governmental taxing authorities sought repeal of the decisions in *In re L. J. O'Neill Shoe Co.*, 64 F.2d 1146 (8th Cir. 1995) and *In re Pacific-Atlantic Trading Co.*, 64 F.3d 1292 (9th Cir. 1995), which required bifurcation of the tax liability attributable to the year of filing into administrative and prepetition liabilities. Such governmental taxing authorities sought to have the entire liability for the filing year treated as an administrative expense. The private bar was divided in its response to this proposal. The Commission adopted a compromise proposal which would generally treat the filing year liability of a corporation as an administrative expense, but give to the debtor an election similar to that given to individuals by section 1398(d)(2) of the Internal Revenue Code, to terminate their taxable year on the day before bankruptcy. If the debtor makes such an election, it will have to file another return, but the tax liability shown on the first short-year
return will be subject to the six-year stretch out under section 1129(a)(9)(C) of the
Bankruptcy Code.

34. (4312). The ABA Task Force proposed a fresh start NOL for a
corporation emerging from chapter 11. Under the ABA proposal, an electing corporation
would be treated as having sold all of its assets on the effective date for an amount equal to
their fair market value in a manner similar to a section 338 election. The debtor would then
be given a five-year NOL carryforward based upon a section 382(l)(6) amount to the extent
that NOLs were still available after absorbing gains from the deemed sale. This proposal
was thought by the ABA Task Force to redress some of the perceived imbalance created by
the repeal of the stock for debt exception in 1993. The Commission adopted this proposal.

35. (438A). The ABA Task Force proposed that section 505(b) protection
be afforded to the estate as well as the trustee, the debtor and a successor to the debtor in
cases where governmental authorities do not give notice of audit within the time period
required by section 505(b), thus overruling Matter of Fonndiller, 125 B.R. 805 (N.D.-Cal.
1991); In re Rode, 119 B.R. 697 (Bankr. E.D.-Mo 1990); and Matter of West Texas
Marketing Corp., 54 F.3d 1194 (5th Cir. 1995). Commissioner Shepard had first proposed
this amendment, but the Commission in its early actions showed no signs of taking it up.
The Advisory Committee, by a vote of six to three, recommended the proposal, and the
Commission voted to adopt it.

36. (441). [Filing returns as condition for chapter 13 relief]
37. (441A). The IRS and Commissioner Shepard had proposed that a chapter 13 debtor be required to pay priority taxes even if no proof of claim was filed by a governmental taxing authority. The ABA Task Force opposed this proposal. By a vote of seven to two with one abstention, the Advisory Committee rejected the proposal. The Commission did not vote on the proposal, but rejection thereof will be part of the report of the Advisory Committee sent to Congress.

38. (503A). Commissioner Shepard and the IRS proposed that priority taxes paid through a chapter 13 plan include interest on deferred payments in a manner similar to chapter 11 deferred payments. The ABA Task Force opposed this proposal. By a vote of eight to two the Advisory Committee rejected the proposal. The Commission did not vote on this proposal, but rejection thereof will be part of the Advisory Committee report sent to Congress.

39. (602). The ABA Task Force proposed that section 523(a)(1)(C) of the Bankruptcy Code be amended to make clear that the term "willfully attempt in any manner to evade or defeat such tax" requires a showing by a taxing authority in the bankruptcy case of an affirmative act or acts of misconduct and a state of mind requirement. By a vote of seven to three, the Advisory Committee recommended the proposal. The Commission did not vote on this proposal, but it will be part of the Advisory Committee’s report sent to Congress.

40. (604A). The ABA Task Force proposed that section 505 and related provisions of the Bankruptcy Code be amended to provide that whenever the common parent
of a consolidated group is under the jurisdiction of the Bankruptcy Court, the Bankruptcy Court has jurisdiction to determine the tax liability of all members of the consolidated group in a proceeding to determine the tax liability of the common parent, and that payment provisions applicable to the common parent, such as the priority of such tax liability under section 507(a)(8) and the deferred payment provisions of section 1129(a)(9)(C), apply equally to such members. Neither the Advisory Committee nor the Commission acted on this proposal.

41. (701). The ABA Task Force proposed that Bankruptcy Code section 1125(b) be amended to provide that the bankruptcy court shall not approve a disclosure statement unless it contains (a) a discussion of the material federal and state tax consequences of the plan to the debtor and any entity created pursuant to the plan, and (b) with respect to each class of claims or interests, a discussion of the material federal income tax consequences of the plan to a hypothetical investor typical of the holders of claims or interests of the relevant class. The Commission adopted this proposal.

42. (703 and 704). The ABA Task Force proposed that nonpecuniary loss tax penalties be subordinated in chapter 11 to the claims of unsecured creditors and proposed to extend such subordination to administrative claims as well as to prepetition tax claims. The ABA Task Force proposals would have overruled the decisions of the Supreme Court in United States v. Reorganized CF&I Fabricators of Utah Inc., 116 S.Ct. 2106 (1996) and United States v. Noland, 116 S.Ct. 1524 (1996). Governmental taxing authorities opposed
both of these proposals. The Commission adopted the ABA Task Force proposal with respect to prepetition tax penalties but did not take a position as to postpetition tax penalties. The Advisory Committee was evenly divided on the extension of subordination to such postpetition penalties, and thus made no recommendation.

43. (101). A number of taxing authorities proposed that in chapter 9 cases there should be required as a condition of confirmation that all prepetition taxes be paid in full in cash in a manner as set forth in 11 U.S.C. § 1129(a)(9)(C) (the six-year payout). The effect of this amendment would be only to require the payment of trust fund taxes in chapter 9. The private bar largely ignored this proposal. The Advisory Committee adopted it as a consensus recommendation. Professor Lawrence King, an advisor to the Commission, raised constitutional objections to this proposal, and the Commission did not act on it. It thus became the only "consensus" recommendation of the Advisory Committee that was not approved by the Commission. The proposal will be part of the Advisory Committee's report sent to Congress.

44. (325). The governmental taxing authorities sought an exception to section 1142(d)(3) to except from discharge taxes unpaid by a business debtor where the nonpayment arose from fraud. The Advisory Committee agreed and the Commission adopted the proposal as a consensus item. The proposal may not accomplish much, as there is no agreement on what constitutes fraud for this purpose.
45. (326). The governmental taxing authorities made a proposal to confine the automatic stay for Tax Court proceedings provided by section 362(a)(8) to tax periods ending on or prior to the filing of the petition in the bankruptcy case, and further, to permit appeals from Tax Court decisions. The amendment would overrule the decision of the Tax Court in *Halpern v. Commissioner*, 96 T.C. 895 (1991). The Advisory Committee considered *Halpern* to be bad law and approved of the proposal. The Commission adopted it as a consensus item.

46. (332). The governmental taxing authorities sought an amendment that would require secured tax claims to meet the payment provisions applicable to section 1129(a)(9)(C). In the absence of an explicit provision, it is arguable that the debtor could stretch payment of a secured tax claim out over a period greater than six years. The Advisory Committee agreed with this proposal and it was adopted by the Commission as a consensus item.

47. (435A). The Advisory Committee adopted a proposal that the time period for making a short year election under I.R.C. section 1398(d)(2) (an by implication, Bankruptcy Code section 346, assuming that it is amended to conform with section 1398(d)(2)) to provide that the time period commences on the date the order for relief is entered. The statue now measures such period from the date the petition is filed. This poses severe problems for debtors in involuntary cases who are contesting the petition. This
proved to be noncontroversial. The Advisory Committee recommended it and the Commission adopted it as a consensus item.

48. (437). The Advisory Committee recommended that I.R.C. section 1398 be amended to provide that the bankruptcy estate’s income be subject to the special rates applicable to alternative minimum taxes and capital gains. Arguably, under present law, those provisions are not imported into I.R.C. section 1398 because of the cross-reference to I.R.C. section 1. This is clearly an oversight. The Commission adopted the recommendation as a consensus proposal.

49. (505). [Meaning of "assessed" or "assessment"]

50. (711). The Advisory Committee made an original proposal that section 726(a)(1) be amended to provide that a tardily filed claim for a priority tax would be allowed if filed before the date on which the court approves the final report and accounting of the trustee, rather than the date on which the trustee commences distribution, as under present law. This will prevent disruption of the distribution process in chapter 7. The proposal was noncontroversial and was adopted as a consensus item by the Commission.

51. (513A). The Advisory Committee proposed that an income tax return prepared by a taxing authority not be considered a filed income tax return for purposes of the Bankruptcy Code. The Commission adopted this as a consensus proposal [brief statements of the effect of this proposal].
52. (700). The Advisory Committee proposed that sections 1307 and 1112 of the Bankruptcy Code be amended to give bankruptcy judges discretion to dismiss cases with prejudice to refiling under chapter 13 or 11 for a period determined by the court. Among the factors that could be taken into account in exercising this discretion would be the extent to which new debts to creditors, including tax debts, have accrued during the present case or prior cases. The Commission adopted this proposal as a consensus item.

53. (714). The Advisory Committee proposed that payments of estate assets to the debtor for services performed are to be treated as ordinary income to the debtor with a corresponding deduction to the estate, rather than as a distribution. This proposal was adopted by the Commission as a consensus item.

54. (411 and 436A). [Sale of residence by trustee]

55. (713). The Advisory Committee made a recommendation, which the Commission adopted as a consensus item, to overrule Commissioner v. Tufts, 461 U.S. 300 (1983). Use of property to satisfy a nonrecourse debt would have the same tax treatment as use of property to satisfy a nonrecourse debt, whether or not the taxpayer is in bankruptcy. Under present law, if the debt is recourse, the tax treatment of the transaction is bifurcated. The taxpayer recognizes gain or loss to the extent of any difference between the adjusted basis of the property surrendered and its fair market value. Any amount by which the debt exceeds such fair market value is treated as discharge of indebtedness income, to which the relief provisions of section 108 of the Internal Revenue Code and 346 of the Bankruptcy
Code can apply. On the other hand, if the debt is nonrecourse, any difference between the amount of the debt and the adjusted basis of the property is a gain from the sale or other disposition of the property, upon which a tax liability may arise. No exclusion from gross income is available because the income is not characterized as income from the discharge of indebtedness. The proposed change has far-reaching implications and will undoubtedly provoke a great deal of debate before the tax writing committees of Congress.

56. (336). Commissioner Shepard proposed an amendment to the Bankruptcy Code that acts taken in violation of the automatic stay be deemed voidable but not void. The Advisory Committee recommended that this proposal be withdrawn and the Commission did not act on it.

57. (338). Commissioner Shepard proposed that the decision of the Supreme Court in Begier v. United States, ___ U.S. ___ (1990) be codified. Under Begier, a trust fund tax paid prior to filing cannot be recovered as a preference. The Advisory Committee recommended that the proposal be withdrawn, and the Commission did not act on it. Begier remains as the law.

58. (412). The Advisory Committee briefly considered a proposal that no penalty tax be imposed on the withdrawal from Keogh plans or individual retirement accounts in bankruptcy. The Advisory Committee recommended that the proposal be withdrawn. The Commission did not act on it.
59. (428). Commissioner Shepard suggested an amendment that individual estates be permitted to switch to the accrual method of accounting so as to be able to deduct administrative expenses on the estate's final return. The Advisory Committee recommended that the proposal be withdrawn. The Commission did not act on it.

60. (438B). Some governmental taxing authorities urged that section 505(b) be amended to provide that a request for determination of administrative period taxes be made not more than once with respect to each taxing authority, and then only at the end of the case. Present law permits separate requests to be made in respect of each tax period or return during the case. The Advisory Committee rejected the proposal. The Commission did not act on this proposal, but the rejection is part of the Advisory Committee's report sent to Congress.

61. (4121). [Date of discharge for purposes of applying attribute reduction rules]
ETHICAL ISSUES
FOR THE BANKRUPTCY PRACTITIONER

Hon. Conrad K. Cyr
Judge, United States Court of Appeals
First Circuit
Bangor, Maine
Introduction

Given the subject matter of this session, it is perhaps fitting that I begin with a modest disclaimer of sorts. Although Judge Lee and I have collaborated for more than three decades in various and sundry educational and legislative reform efforts having to do with bankruptcy law, procedure, and administration, as well as the ongoing effort to restructure the bankruptcy courts themselves, I can recall no prior occasion on which we were ever asked to discuss the subject of ethics. Whether that has to do with our demonstrated lack of qualifications, or is better explained by the recently heightened interest in the subject, I must leave to your judgment. However that may be, we have reacted on this occasion in much the same manner we did more than twenty-five years ago when we initially embarked on the enterprise to reform the federal bankruptcy laws and establish a bankruptcy court system appropriately suited to the needs of its increasingly important mission and its burgeoning dockets. Among the very first things we did back then in the early 1970s, in behalf of the National Conference of Bankruptcy Judges, was to retain legislative counsel — the very same able and respected counsel who appears on this program with us today — Murray Drabkin, Esquire, a fine professional whose ethical standards and judgment are as steadfast as his legal acumen is keen. I have no doubt that Murray will keep Judge Lee and me on the straight and narrow throughout this program as well.

Discussion

By way of further preamble, let me explain that my present mission is to sketch out a broad framework for today's panel discussion, hopefully with a view to affording some sense not only of the breadth of the ethical uncertainties confronting present-day insolvency practitioners, but
of their inherent complexity and the difficulties involved in their resolution under existing generalized ethical codes and disciplinary rules originally designed to guide the practice of law in more traditional forms of civil litigation.

The term "ethics," from the Greek "ethika," encompasses the moral principles and aspirations of a particular culture or profession, as informed by the moral code of the individual citizen or practitioner. Thus, the subject of ethics is not coextensive with either the applicable professional disciplinary rules or the relevant provisions of the Bankruptcy Code or Bankruptcy Rules governing bankruptcy proceedings and administration, no matter how important and relevant those prescriptive rules and statutes may be for attorneys, accountants, and the various fiduciaries who engage in insolvency practice. Instead, the role of ethics is to guide professional conduct in circumstances where statutory, regulatory, and disciplinary standards are silent, ambiguous or conflicting. It is at such junctures that the ethical professional — in whatever field of practice — needs to consult available ethical precepts and any related sources which may reliably inform the determination as to whether the contemplated professional representation or service may be undertaken and, if so, in what manner and on what terms.

It is important to note also that the recently heightened formal attention to ethics education among insolvency practitioners likely has been spurred, at least in substantial part, by the peculiar exposure and vulnerability of insolvency practitioners to the numerous, serious ethical dilemmas brought on by unforeseen, and even unforeseeable, conflicts of interest, and by the shifting interests, that may develop during the course of a proceeding under the Bankruptcy Code among the broadly-grouped multiple entities and interests commonly represented by trustees, receivers, debtors in possession, creditor committees, and by their respective counsel. This often ominous exposure and
vulnerability to ethical challenge, on the part of even the best-intentioned insolvency practitioner, is particularly acute in business reorganization proceedings. Moreover, I would suggest that the attendant jeopardy derives, in very substantial measure, from the comparative dearth of sufficiently focused ethical canons and disciplinary precepts that even identify, let alone prescribe, appropriately particularized aspirational standards for the ethical guidance of professionals engaged in this area of insolvency practice.

For these and other reasons, then, I would suggest that it is of paramount importance that greater attention be centered on the extraordinarily large void presently left to normative decisionmaking by the individual insolvency practitioner. All too frequently insolvency practitioners are confronted with the need to make predictive ethical assessments for which discernible guidance, if available through reference to any authoritative source at all, can seldom be considered definitive, given only the generalized prescriptive standards designed for application in conventional civil actions. Consequently, it often appears, as the current legal literature tends to confirm, see, e.g., Appendix I, infra at p. a, that insolvency practitioners may be left with two unacceptably extreme options.

First, there is what might be described as the "Prudent Pilgrim's Option," — founded on the bedrock rationale that "The game is not worth the candle!" — which holds that the contemplated representation or action ought never be ventured absent authoritative guidance in the form of a clear endorsement comparable to the lawyer's fondest and rarest ally, an opinion or ruling "on all fours." While the Prudent Pilgrim is almost certain to remain in good professional standing,

3 See, e.g., Phelan & Penn, Bankruptcy Ethics, An Oxymoron, 5 Am. Bankr. Inst. L. Rev. 1 (Spring 1997) ("It has been said that the most important thing to remember when participating in a chapter 11 is the sequence in which you double-cross your allies.").
prosperity may prove elusive. On the other extreme, the "Imprudent Pioneer's Option" — which hues to the golden rule: "Nothing Ventured Nothing Gained!" — invites its adherents to conclude that what is not plainly prohibited may be freely undertaken. Although the Imprudent Pioneer, for a while at least, can be expected to prosper at the bar, there may well come the time when continued prosperity may require recourse to other pursuits. Notwithstanding their diametric opposition, however, it is nonetheless clear that the advocates of both schools of thought, as well as the vast majority of professionals who would espouse more moderate approaches, would stand to benefit greatly from a reasonably definitive and organized exploration of the "ethical wilderness" areas into which present-day insolvency practitioners at times may be called upon to venture during their professional practice.

It is also important, however, not to exaggerate the dimensions of this ethical wilderness, especially since certain baseline normative guides to responsible professional behavior do exist, which may on occasion satisfactorily resolve any perceived void, or at least substantially alleviate any genuine ethical concerns regarding the appropriateness of a contemplated representation or action. We start with the barebones. First and foremost, as officers of the court, counsel are professionally obligated to explore and assess with due care the ethical propriety of any representation or action either in contemplation, or during the course of, a bankruptcy proceeding. Normally, at least three general sources should be consulted in search of normative standards to be applied in arriving at these professional assessments. First, any generally applicable disciplinary rules and standards relating to the practice of law within the particular geographic region, court, or field of practice; second, any aspirational standards, such as those espoused by the various organized bar groups. Finally, I would strongly urge that ethically responsible counsel should consult the internal
moral monitor which guides their conduct as members of an honorable profession which has been entrusted with the right of self-regulation.

In the limited time remaining, I will discuss examples of unlikely extrinsic sources which seem to me to afford clear authoritative guidance in assessing the ethical propriety of actions by counsel in proceedings under, or in contemplation of, a bankruptcy proceeding. Appendix II and Appendix III contain two rather recent federal enactments — sections 156 and 157 of Title 18, United States Code, respectively entitled "Knowing Disregard of Bankruptcy Law or Rule" (section 156) and Bankruptcy Fraud (section 157). On their face, these statutes purport simply to criminalize certain conduct undertaken in relation to debtors, creditors, and insolvent estates. Yet I think it is inescapable that these statutes inevitably fill any real or perceived ethical void in relation to their subject matter, at least pending their displacement by more finely tuned ethical prescriptions which might be adopted by the bench or the organized bar for specific application to the field of insolvency practice. Moreover, these statutes are particularly noteworthy not so much for their literal reach in delineating the relevant ethical landscape as for their preemptive effect upon the role left to traditional ethical standards adopted and internally policed by the legal profession itself. Since there can be no question that it is a baseline ethical commandment that all insolvency practitioners, most assuredly including attorneys, must comply with state and federal criminal laws, neither can there be any serious question that no less would be expected of lawyers by the courts or bar grievance committees.

The first of these criminal statutes, Title 18 United States Code, section 156, applies exclusively to "bankruptcy petition preparers" — not including the debtor's attorney — who charge a fee for preparing a document for filing in a bankruptcy case, which document in turn results in the dismissal of a bankruptcy case due to a knowing attempt by the preparer to disregard any requirement
of the Bankruptcy Code or Rules. See Appendix II, at p. b, infra. At first glance it might be thought highly improbable that a criminal statute, by whose express terms attorneys for debtors are excluded from coverage, should be considered relevant either to the formulation or the application of ethical standards governing the practice of law by attorneys in the insolvency field. However, unless one is prepared to explain away or disregard both the language and the pertinent legislative history of this statute, there appears to be no alternative but to conclude that the only reason Congress excluded the debtor's attorney from coverage under this criminal statute is that attorneys — unlike the covered layperson "petition preparer" — are already subject to ethical regulation adequate to the task. See infra Appendix III, at p. d. Against this backdrop, even our Imprudent Pioneer surely would feel constrained to inquire how likely it is that attorneys who prepare bankruptcy documents will be held to a lesser ethical standard, by their professional peers on the grievance committee or the bankruptcy courts before which they practice, than the layperson preparer is required to meet in order to avoid criminal prosecution? See infra Exhibit III at p. d.

In a related vein, it may be extremely important as well to anticipate the reach of another new criminal statute, Title 18, United States Code, section 157, which makes it a felony for any person — thus plainly encompassing bankruptcy professionals, including inter alia attorneys and accountants — to make a false statement, promise or claim, or file a petition or other document in a bankruptcy case, with intent to execute or conceal a scheme to defraud, without regard to whether the scheme predated the initiation of the proceeding. See 18 U.S.C. § 157 (1995). One would suppose, therefore, that it is reasonable to anticipate that this statute poses a powerful deterrent to fraudulent schemes involving counsel and debtors who would attempt, for example, to execute what later may be perceived by others to have been an overly aggressive asset divestiture plan antedating
the filing of a petition for relief under the Bankruptcy Code. This statute certainly appears to reject the longstanding laissez faire assumption that it is perfectly all right to devise and execute a prepetition asset divestiture plan designed to deprive unsecured creditors of their legal right to payment of their valid claims — as though it were merely the ethical counterpart of a testator’s estate plan for minimizing estate or inheritance taxes. That the latter analogy is inapposite requires little demonstration: neither any potential heir nor tax claimant holds an enforceable claim against the testator at the time the estate plan is adopted. Whereas existing unsecured creditors hold enforceable claims at the time insolvent debtors divert their assets pursuant to prepetition asset-divestiture plans secretly implemented for the purpose of hindering their unsecured creditors from recovering their claims. Even though so-called creative asset-divestiture planning of this sort has been considered more a matter of astute legal maneuvering than of ethics, 18 U.S.C. § 157 appears to represent a sharp rejection of such “gamesmanship” in anticipation of bankruptcy. Thus, Congress apparently is siding with the layman’s view that such efforts are malum in se, by rendering it malum prohibitum under 18 U.S.C. § 157.

Once again, the significance of this recent legislative development lies not so much in the likelihood that it was designed to deter the prohibited conduct — recognizing in particular that sophisticated schemes to defraud can seldom be executed without expert professional advice and assistance — but that it greatly heightens the prospect that legislative reformers, bent on conforming criminal statutes in this area more closely to the business mores of the community, may be emboldened to believe that existing professional standards can be raised by the bootstraps through recourse to the criminal laws.
Appendix I

§ 156. Knowing disregard of bankruptcy law or rule

(a) Definitions — In this section —

"bankruptcy petition preparer" means a person, other than the debtor's attorney or an employee of such an attorney, who prepares for compensation a document for filing.

"document for filing" means a petition or any other document prepared for filing by a debtor in a United States bankruptcy court or a United States district court in connection with a case under this title.

(b) Offense — If a bankruptcy case or related proceeding is dismissed because of a knowing attempt by a bankruptcy petition preparer in any manner to disregard the requirements of title 11, United States Code, or the Federal Rules of Bankruptcy Procedure, the bankruptcy petition preparer shall be fined under this title, imprisoned not more than 1 year, or both. (Added Pub.L. 103-394, Title III, § 312(a)(1)(B), Oct. 22, 1994, 108 Stat. 4140.)

HISTORICAL AND STATUTORY NOTES

References in Text

The Federal Rules of Bankruptcy Procedure, referred to in subsec. (b), are set out in Title 11, Bankruptcy.

Effective Date

Section effective on Oct. 22, 1994, and not to apply with respect to cases commenced under Title 11 of the United States Code before Oct. 22, 1994, see section 702 of Pub.L. 103-394, set out as a note under section 101 of Title 11, Bankruptcy.

Separability of Provisions

If any provision of or amendment made by Pub.L. 103-394 or the application of such provision or amendment to any person or circumstance is held to be unconstitutional, the remaining provisions of and amendments made by Pub.L. 103-394 and the application of such provisions and amendments to any person or circumstance shall not be affected thereby, see section 701 of Pub.L. 103-394, set out as a note under section 101 of Title 11, Bankruptcy.
§ 157. Bankruptcy fraud

A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so —

(1) files a petition under title 11;

(2) files a document in a proceeding under title 11; or

(3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title,

shall be filed under this title, imprisoned not more than 5 years, or both.


HISTORICAL AND STATUTORY NOTES

Effective Date

Section effective on Oct. 22, 1994, and not to apply with respect to cases commenced under Title 11 of the United States Code before Oct. 22, 1994, see section 702 of Pub.L. 103-394, set out as a note under section 101 of Title 11, Bankruptcy.

Separability of Provisions

If any provision of or amendment made by Pub.L. 103-394 or the application of such provision or amendment to any person or circumstances is held to be unconstitutional, the remaining provisions of and amendments made by Pub.L. 103-394 and the application of such provisions and amendments to any person or circumstance shall not be affected thereby, see section 701 of Pub.L. 103-394, set out as a note under section 101 of Title 11, Bankruptcy.

Legislative History

Appendix III

Section 308. Bankruptcy petition preparers.

This section adds a new section to chapter 1 of title 11 United States Code to create standards and penalties pertaining to bankruptcy petition preparers. Bankruptcy petition preparers not employed or supervised by any attorney have proliferated across the country. While it is permissible for a petition preparer to provide services solely limited to typing, far too many of them also attempt to provide legal advice and legal services to debtors. These preparers often lack the necessary legal training and ethics regulation to provide such services in adequate and appropriate manner. These services may take unfair advantage of persons who are ignorant of their rights both inside and outside the bankruptcy system. This section requires all bankruptcy preparation services to provide their relevant personal identifying information on the bankruptcy filing. It requires copies of all bankruptcy documents to be given to the debtor and signed by the debtor. The section also provides that if the petition is dismissed as the result of fraud or incompetence on the preparer's account, or if the preparer commits an inappropriate or deceptive act, the debtor is entitled to receive actual damages, plus statutory damages of $2,000 or twice the amount paid to the preparer, whichever is greater, plus reasonable attorney's fees and costs in seeking such relief. The bankruptcy preparer is also subject to injunctive action preventing the preparer from further work in the bankruptcy preparation business.