Concurrent Session

When Circuits Collide: Circuit Splits

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PROJECTED DISPOSABLE INCOME FOR ABOVE MEDIAN DEBTORS

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The Statute: 11 U.S.C. § 1325(b)

Section 1325(b) of the Bankruptcy Code lists conditions under which a bankruptcy court may not approve a chapter 13 plan:

> (b)(1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan–-
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> . . .
>
> (B) the plan provides that all of the debtor's **projected disposable income** to be received in the applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.
>
> (2) For purposes of this subsection, the term "**disposable income**" means current monthly income[1] received by the debtor . . . less amounts reasonably necessary[2] to

[1] The term "current monthly income" is defined in § 101(10A) --

The term "current monthly income" –

> (A) means the average monthly income from all sources that the debtor receives (or in a joint case the debtor and the debtor's spouse receive) without regard to whether such income is taxable income, derived during the 6-month period ending on –
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> (i) the last day of the calendar month immediately preceding the date of the commencement of the case if the debtor files the schedule of current income required by section 521(a)(1)(B)(ii)
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> . . . and
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> (B) includes any amount paid by any entity other than the debtor (or in a joint case the debtor and the debtor's spouse), on a regular basis for the household expenses of the debtor or the debtor's dependents (and in a joint case the debtor's spouse if not otherwise a dependent) . . . .

11 U.S.C. § 101(10A) (West 2008).

[2] Section 1325(b)(3) goes on to state:

(3) Amounts reasonably necessary to be expended under paragraph (2), other than subparagraph (A)(ii) of paragraph (2), shall be determined in accordance with subparagraphs (A) and (B) of section 707(b)(2), if the debtor has current monthly income, when multiplied by 12, greater than–

(A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

(B) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

(C) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $ 575 per month for each individual in excess of 4.

11 U.S.C. § 1325(b)(3) (West 2008).

be expended—-

(A) (i) for the maintenance or support of the debtor or a dependent of the debtor . . . ; and

(ii) for charitable contributions . . . in an amount not to exceed 15 percent of gross income of the debtor for the year in which the contributions are made; and

(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

11 U.S.C. § 1325(b) (West 2008) (emphasis added).

What IS "Projected Disposable Income"?

1. Should income be determined from Form 22C, Schedule I, or other sources?

2. Should above-median debtors be allowed to deduct IRS Local Standards deduction(s) as part of their means test?

Issue 1: Determining Debtor's Income

Before BAPCPA, monthly disposable income was basically the difference between a debtor's Schedule I income and Schedule J expenses. However, BAPCPA amended 11 U.S.C. § 1325(b)(2) to define disposable income in terms of current monthly income, which is calculated by the "means test" on Form 22C. As a result, the meaning of the word "projected" in 11 U.S.C. § 1325(b)(1) is now an open question.

Post-BAPCPA, courts have taken one of three main approaches to determine projected disposable income:

a. the "**Mechanical Application**" approach, which simply multiplies a debtor's current monthly income, as determined on Form 22C, by the applicable number of months in the plan period; or

b. the "**Forward-Looking**" approach, which allows for consideration of the debtor's actual financial circumstances at the time of plan confirmation.

c. A substantial subset of the "Forward-Looking" courts take a "**Rebuttable Presumption**" approach, holding that while disposable income is presumed to be the same as projected disposable income, a party in interest may rebut this presumption by showing a change in the debtor's financial situation.[3]

Circuit Views

The **Ninth Circuit Court of Appeals** held that the Mechanical Application approach is correct in *Maney v. Kagenveama (In re Kagenveama)*, 541 F.3d 868 (9th Cir. 2008).

The **Eighth Circuit Court of Appeals** favored the Forward-Looking approach in *Coop v. Frederickson (In re Frederickson)*, 545 F.3d 652 (8th Cir. 2008), as did Bankruptcy Appellate Panels in two other Circuits: the **First Circuit B.A.P.** in *Kibbe v. Sumski (In re Kibbe)*, 361 B.R. 302 (B.A.P. 1st Cir. 2007) and the **Sixth Circuit B.A.P.** in *Hildebrand v. Petro (In re Petro)*, 395 B.R. 369, as well as *Hildebrand v. Thomas (In re Thomas)*, 2008 Bankr. LEXIS 3664 (B.A.P. 6th Cir. Oct. 31, 2008).

The **Tenth Circuit Court of Appeals** applied the Rebuttable Presumption approach in *Hamilton v. Lanning (In re Lanning)*, 545 F.3d 1269 (10th Cir. 2008).

As may be seen on the accompanying survey chart, bankruptcy courts in circuits where the law is not yet settled remain divided, although a clear majority favor consideration of factors beyond the Form 22C means test calculation.

A. Mechanical Application

Courts taking the Mechanical Application approach hold that the term "disposable income," as used in § 1325(b)(1)(B), is specifically defined in § 1325(b)(2) and (b)(3). For a debtor with above-median income, Section 1325(b)(3) directs that the amounts "reasonably necessary to be expended" shall be determined in accordance with Section 707(b)(2)(A) and (B). Section 707(b)(2)(A), in turn, codifies the so-called "means test" calculated on Form 22C. For these courts, determining projected disposable income is simply a matter of multiplying the means test result by the number of months in the applicable plan period. However, using the

[3] A small minority of "Forward-Looking" courts have held that debtor's current monthly income, as calculated on Form 22C, plays no part in determining projected disposable income. *See, e.g., In re Riggs*, 359 B.R. 649, 653 (Bankr. E.D. Ky. 2007) ("Debtors' projected disposable income must be determined by references to their Schedules I and J.").

Mechanical Application may result in (i) a debtor paying creditors less than the difference between the amounts on Schedules I and J; or (ii) plan payments that are significantly greater than a debtor can afford due to a post-petition reduction in circumstances.

The leading Mechanical Application case is *Maney v. Kagenveama (In re Kagenveama)*, 541 F.3d 868 (9th Cir. 2008). In *Kagenveama*, debtor's Form 22C showed a negative projected disposable income of $4.04, but Schedules I and J showed a positive disposable monthly income of $1,523.89. The Court of Appeals reasoned that BAPCPA changed only the disposable income calculation, not the relationship between "disposable income" and "projected disposable income" in § 1325. *Id.* at 873. The *Kaganveama* court expressly rejected both the Forward-Looking and Rebuttable Presumption approaches, noting that Congress was aware that BAPCPA could produce less than favorable results for unsecured creditors in some above-median chapter 13 cases. *Id.* at 875. The Court of Appeals also "stress[ed] that nothing in our opinion prevents the debtor, the trustee, or the holder of an allowed unsecured claim [from] request[ing] modification of the plan after confirmation pursuant to § 1329." *Id.* at 877.

B. Forward-Looking Approach

Courts taking a Forward-Looking approach posit that "projected disposable income" is different from "disposable income," and, therefore, the calculation of projected disposable income can be different from the calculation of disposable income. These courts take a flexible approach in determining projected disposable income.

This is the position taken by the First Circuit B.A.P. in *Kibbe v. Sumski (In re Kibbe)*, 361 B.R. 302 (B.A.P. 1st Cir. 2007). The debtor in *Kibbe* was a below-median income debtor who obtained a higher paying job just prior to her petition date. Based solely on Form 22C calculations, the debtor argued that she had no disposable income and therefore no projected disposable income to pay unsecured creditors. On the other hand, Schedules I and J indicated a monthly disposable income of $2,382.00. The bankruptcy court held that the debtor's projected disposable income should be determined strictly by Schedules I and J, but the B.A.P. took a more nuanced position, concluding "If circumstances dictate that neither Form B22C nor Schedules I and J accurately portray the debtor's income (less the Income Exclusions) projected over the plan commitment period, the bankruptcy court must make a fact-based determination at the time of confirmation, whether by way of the parties' agreement or the taking of evidence. Said most directly, the object is not to select the right form, but to reach a reality-based determination of a debtor's capabilities to repay creditors." *Id.* at 314-15.

The Eighth Circuit Court of Appeals also took a Forward-Looking approach in *Coop v. Frederickson (In re Frederickson)*, 545 F.3d 652 (8th Cir. 2008). The Court of Appeals first noted that

[A] debtor's "disposable income," as calculated on Form 22C, is not the same as the debtor's actual "projected disposable income." Thus, a distinction can be drawn between a debtor's "disposable income," which is calculated solely on the basis of historical numbers and regional averages, and a debtor's "projected disposable income," which necessarily contemplates a forward-looking number. Under this interpretation, bankruptcy courts will continue to have some discretion over the calculations of each individual debtor's financial situation, with the result that the debtor's "projected disposable income" will end up more closely aligning with reality.

Id. at 659 (internal citation omitted). The *Frederickson* debtor's Form 22C calculation resulted in a negative disposable monthly income of $95.49, but Schedules I and J demonstrated monthly disposable income of $606.00. The Court of Appeals held that the Form 22C disposable income calculation is the "starting point for determining the debtor's 'projected disposable income,' but that the final calculation can take into consideration changes that have occurred in the debtor's financial circumstances as well as the debtor's actual income and expenses as reported on Schedules I and J." *Id.*

The Sixth Circuit B.A.P. took a similar position in both *Hildebrand v. Petro (In re Petro)*, 395 B.R. 369 (B.A.P. 6th Cir. 2008), and *Hildebrand v. Thomas (In re Thomas)*, 2008 Bankr. LEXIS 3664 (B.A.P. 6th Cir. Oct. 31, 2008). Clearly rejecting the Mechanical Application approach, the B.A.P. held that a bankruptcy court "*may not* confirm the plan if the court finds that debtor's schedules or other credible evidence require a reassessment of disposable income as determined by the means test under § 1325(b)(2) and (b)(3)." *Id*. at *21. However, the B.A.P. did not articulate a specific methodology for making this reassessment.

That is not to say that Schedule[s] I and J provide the total answer either. Schedule[s] I and J capture a snapshot as of the date of filing for relief under the Bankruptcy Code. Thus, anticipated changes in income, such as those that result from retirement or bonuses, may not be accurately reflected on Schedules I and J. <u>A debtor's projected disposable income should be calculated based on the realities of the debtor's circumstances as of confirmation and as reasonably anticipated to be during the length of the plan</u>.

In re Petro, 395 B.R. at 377-78 (emphasis added).

C. Rebuttable Presumption

Some of the Forward-Looking courts, in rejecting the Mechanical Application approach, have replaced it with a rebuttable presumption. These courts hold that projected disposable income is presumed to be the same as disposable income, as determined on Form 22C, but that a party in interest may rebut this presumption by showing a change in the debtor's financial situation.

The Tenth Circuit Court of Appeals laid out the Rebuttable Presumption process and rationale in *Hamilton v. Lanning (In re Lanning)*, 545 F.3d 1269 (10th Cir.

2008). The debtor in *Lanning* had recently lost her job and obtained new employment at a lower rate of pay. As a result, Form 22C calculated her monthly disposable income as $1,114.98, but Schedules I and J indicated monthly disposable income of only $149.03.

The *Lanning* court raised both interpretive and practical concerns about the Mechanical Approach. First, as a matter of statutory interpretation, the Mechanical Approach essentially ignores all of the forward-looking phrases in § 1325(b): "as of the effective date of the plan," "to be received in the applicable commitment period," and "will be applied to make payments." *Id.* at 1279. Second, as a practical matter –

> [T]he mechanical approach advocated by the Trustee would effectively foreclose bankruptcy protection to debtors like Ms. Lanning, who lack adequate income going into the commitment period to pay the amount of disposable income on Form 22C, while at the same time permitting above-median debtors who have greater income at the time of plan confirmation to pay less to unsecured creditors than they are able to. While the latter situation could be rectified by post-confirmation modification of the plan under 11 U.S.C. § 1329, the former situation cannot be addressed in this manner because the plan would be infeasible and therefore unconfirmable in the first place.

Id. at 1281-82. As a result, the Court of Appeals held that, "the starting point for calculating a Chapter 13 debtor's 'projected disposable income' is presumed to be the debtor's 'current monthly income,' as defined in 11 U.S.C. § 101(10A)(A)(i), subject to a showing of a substantial change in circumstances." *Id.* at 1282.

<u>Issue 2: Determining Above-Median Debtor's Expenses</u>

Courts are also split as to whether § 707(b)(2)(A)(ii)(I) permits debtors to take the IRS Local Standard deduction when they may have a payment (*i.e.*, a car or mortgage payment) lower than the Local Standard or no payment at all.

d. Some courts allow a debtor to deduct the Local Standard amount even where debtor is not making payments ("**Plain Language Approach**").

e. Other courts allow such deduction only where a debtor actually makes such payment, however small ("**IRM[4] Approach**").[5]

As explained below, resolution of the expense question involves interpretation of the word "applicable" as it is used in § 707(b)(2)(A)(ii)(I).[6] The cases that have reached

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4 This view is often termed the "IRM Approach" because courts taking this approach incorporate Internal Revenue Manual guidelines as part of their analysis.

5 A subsection of the IRM courts allow the Local Standard deduction or the amount of debtor's actual expense, whichever is less. *See, e.g., In re Rezentes*, 368 B.R. 55 (Bankr. D. Haw. 2007).

the appellate level have involved vehicle ownership expenses, but bankruptcy courts have applied similar reasoning to the question of housing expenses.

Circuit Views

The **Seventh Circuit Court of Appeals** applied the Plain Language Approach in *Ross-Tousey v. Neary (In re Ross-Tousey)*, 549 F.3d 1148 (7th Cir. 2008), as did the **Fifth Circuit Court of Appeals** in *Tate v. Bolen (In re Tate)*, No. 08-60953, 2009 U.S. App. LEXIS 12660 (5th Cir. June 10, 2009).[7] The **Sixth Circuit Bankruptcy Appellate Panel** also took the Plain Language approach in deciding *Hildebrand v. Kimbro (In re Kimbro)*, 389 B.R. 518 (B.A.P. 6th Cir. 2008).

In contrast, Bankruptcy Appellate Panels in two other Circuits used the IRM approach: the **Eighth Circuit B.A.P.** in *Babin v. Wilson (In re Wilson)*, 383 B.R. 729 (B.A.P. 8th Cir. 2008) and the **Ninth Circuit B.A.P.** in *Ransom v. MBNA America Bank (In re Ransom)*, 380 B.R. 799 (B.A.P. 9th Cir. 2007). District courts are also divided.

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6 11 U.S.C. 707(b) is the "Means Test" by which a court is to decide whether to dismiss or convert a chapter 7 case. Specifically, § 707(b)(2)(A)(ii)(I) states that

> The debtor's monthly expenses shall be the debtor's **applicable** monthly expense amounts specified under the National Standards and Local Standards, and the debtor's **actual** monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtor resides, as in effect on the date of the order for relief, for the debtor, the dependents of the debtor, and the spouse of the debtor in a joint case, if the spouse is not otherwise a dependent. Such expenses shall include reasonably necessary health insurance, disability insurance, and health savings account expenses for the debtor, the spouse of the debtor, or the dependents of the debtor. Notwithstanding any other provision of this clause, the monthly expenses of the debtor shall not include any payments for debts. In addition, the debtor's monthly expenses shall include the debtor's reasonably necessary expenses incurred to maintain the safety of the debtor and the family of the debtor from family violence as identified under section 309 of the Family Violence Prevention and Services Act, or other applicable Federal law. The expenses included in the debtor's monthly expenses described in the preceding sentence shall be kept confidential by the court. In addition, if it is demonstrated that it is reasonable and necessary, the debtor's monthly expenses may also include an additional allowance for food and clothing of up to 5 percent of the food and clothing categories as specified by the National Standards issued by the Internal Revenue Service.

11 U.S.C. § 707(b)(2)(A)(ii)(I) (West 2008) (emphasis added).

7 The Tenth Circuit Bankruptcy Appellate Panel applied the Plain Language approach to *Pearson v. Stewart (In re Pearson)*, 390 B.R. 706 (B.A.P. 10th Cir. 2008) to find in Debtors' favor, reversing the bankruptcy court's decision. Upon appeal by the United States Trustee, the Tenth Circuit Court of Appeals (i) dismissed the appeal as moot; (ii) vacated the B.A.P.'s opinion; and (iii) remanded to the B.A.P. "with instructions to vacate the bankruptcy court's ruling as to the vehicle-ownership-deduction issue and dismiss the [B.A.P.] appeal." *Pearson v. Stewart (In re Pearson)*, 309 Fed. Appx. 216 (10th Cir. 2009).

A. Plain Language Approach

Courts taking the "Plain Language Approach" argue that "applicable" refers to the "applicable" Local Standards for the debtor's geographic region and number of owned vehicles, regardless of whether debtor has the Local Standard deduction as an actual expense. These courts reason that such interpretation maintains a difference of meaning between "applicable monthly expense amounts" and "actual monthly expenses," as those phrases are used in the statute.

The Seventh Circuit Court of Appeals used the Plain Language Approach to decide *Ross-Tousey v. Neary (In re Ross-Tousey)*, 549 F.3d 1148 (7th Cir. 2008). When the *Ross-Tousey* debtors claimed the full $803 ownership allowance for two vehicles, the United States Trustee brought a motion to dismiss for abuse. The Bankruptcy Court found for the debtors, but the District Court found for the United States Trustee. In reversing the District Court, the Court of Appeals held "that a debtor who owns his car free and clear may take the Local Standard transportation ownership deduction under the section 707(b)(2)(A)(ii)(I) means test." *Id.* at 1162. In addition to statutory interpretation, the Court of Appeals also cited various policy considerations, including: (i) ownership costs associated with vehicles aside from loan or lease payments; (ii) debtors may need a replacement vehicle during the course of the bankruptcy; and (iii) the IRM approach could encourage debtors to borrow money in order to drive a newer or more expensive car and thus be able to claim the deduction. *Id.* at 1160-61.

With the recently published *Tate v. Bolen (In re Tate)*, No. 08-60953, 2009 U.S. App. LEXIS 12660 (5th Cir. June 10, 2009), the Fifth Circuit Court of Appeals also held that a debtor may claim a vehicle ownership expense even if the debtor is making no loan or lease payments for that vehicle. The *Tate* debtors claimed the $803.00 ownership allowance for two vehicles that they owned free and clear. Quoting *In re Tousey*, The Fifth Circuit Court of Appeals emphasized that "the plain language approach [is] 'more strongly supported by the language and logic of the statute.'" *Id.* at *7. The *In re Tate* court also noted that (i) the Internal Revenue Manual gives IRS agents substantial discretion in applying the IRM rules, which would be at odds with the bright line established by the means test; and (ii) a prior version of BAPCPA, which expressly incorporated the IRS "financial analysis" into § 707, was not passed. *Id.* at *10.

The Sixth Circuit B.A.P. also took this approach in deciding *Hildebrand v. Kimbro (In re Kimbro)*, 389 B.R. 518 (B.A.P. 6th Cir. 2008). The debtors in *Kimbro* subtracted their $112.18 car payment from the Local Standard of $471.18 to claim an ownership deduction of $358.82 for their first vehicle. They also deducted a $332.00 ownership expense for their second vehicle, which they apparently owned free and clear. *Id.* at 521. A divided Bankruptcy Appellate Panel analyzed the same policy and statutory language factors as would later be considered by the Seventh Circuit Court of Appeals and held that "a debtor may deduct an ownership expense for a vehicle regardless of whether the debtor has a debt or lease payment on that vehicle." *Id.* at 532.

Citing to *Kimbro*, the District Court for the Eastern District of Kentucky concluded "that a debtor is permitted to deduct from his current monthly income 'Ownership Costs' under the bankruptcy means test even where he owns his car free and clear of any debt." *Clippard v. Ragle (In re Ragle)*, 395 B.R. 387, 400 (E.D. Ky 2008).

IRM Approach

Courts taking the IRM Approach reason that the word "applicable" refers to relevancy. That is, the Local Standard vehicle ownership deduction is only applicable (or relevant) when the debtor is actually making a car payment. These courts look to the Internal Revenue Manual's guidelines for applying the Local Standards to taxpayers as part of their analysis. Bankruptcy appellate panels in two circuits have applied the IRM Approach: *Babin v. Wilson (In re Wilson),* 383 B.R. 729 (B.A.P. 8th Cir. 2008) and *Ransom v. MBNA America Bank (In re Ransom)*, 380 B.R. 799 (B.A.P. 9th Cir. 2007).

In addition to noting how the IRS applies the Local Standards, the Bankruptcy Appellate Panel in *Wilson* noted that the IRM Approach is consistent with BAPCPA's over-arching purpose that debtors pay as much as possible to their unsecured creditors. The *Wilson* debtors claimed vehicle ownership deductions of $471.00 for their first car and $332.00 for their second car, although they owned both vehicles outright. The court reasoned that, had the debtors not claimed those deductions, they would have paid their unsecured creditors nearly $26,000.00 over the course of a sixty month plan instead of the total of $250.00 they proposed paying their nonpriority unsecured creditors. *Wilson,* 383 B.R. at 732. The court held that "debtors who do not incur vehicle ownership expenses are not permitted to claim the IRS Standard deductions for such expenses because such expenses are not applicable under § 707(b)(2)(A)(ii)(I)." *Id.* at 734.

The debtor in *Ransom* claimed a $471.00 expense for his only vehicle, on which he was making no payments, which resulted in a calculated $210.55 in monthly disposable income. When the debtor proposed to pay $500.00 per month over the course of his sixty month plan, one of his unsecured creditors objected, pointing out that, were debtor not allowed the vehicle ownership expense, he should be able to fund his plan at $681.55 per month. *Ransom*, 380 B.R. at 801. The *Ransom* court rejected debtor's equitable argument, in part because debtors with old or high mileage cars could possibly claim additional expenses based upon "special circumstances" under § 707(b)(2)(B). *Id.* at 808.

A District Court in the Eighth Circuit also held that "before the expense amount can be included in the debtor's allowed monthly expenses, the expense itself must actually be applicable to the debtor – in other words, the debtor must actually have a loan or lease payment obligation." *Fokkena v. Hartwick (In re Hartwick)*, 373 B.R. 645, 650 (D. Minn. 2007).

It is also the position of the U.S. Trustee Program that a debtor "cannot claim the vehicle ownership expense if the debtor does not have a secured loan or a lease on the vehicle." *www.usdoj.gov/ust/eo/bapcpa/docs/Disposable_Income_Ch13_UST_Policies.pdf* at 5.

Calculating PDI - Case Law Review*

Circuit	Court	Date	Debtor Name	Citation	Approach			
					Mech.	Forward	Presump.	I&J
1	Bk	2/24/2009	Burbank	2009 Bankr. LEXIS 387	X			
1	Bk	12/30/2008	Michaud	2008 Bankr. LEXIS 3568		X		
1	Bk	8/19/2008	Lane	394 BR 248				X
1	BAP	2/20/2007	Kibbe	361 BR 302		X		
1	Bk	12/21/2006	Teixeira	358 BR 484			X	
2	Bk	3/12/2009	Mendelson	2009 Bankr. LEXIS 683		X		
2	Bk	1/22/2009	Rahman	400 BR 362		X		
2	Bk	12/8/2008	Almonte	397 BR 659		X		
2	DC	12/3/2008	Baldwin	2008 US Dist Lexis 98352			X	
2	Bk	7/25/2008	Koch	391 BR 230		X		
2	Bk	5/20/2008	Frock	2008 Bankr. LEXIS 1657		X		
2	Bk	5/20/2008	Riggins	2008 Bankr. LEXIS 1656		X		
2	Bk	5/16/2008	Bentley	387 BR 422		X		
2	Bk	5/14/2008	Vining	2008 Bankr. LEXIS 1534		X		
2	Bk	4/28/2008	Schneider	2008 Bankr. LEXIS 1369		X		
3	Bk	12/10/2008	Wenning	19 CBN 120	X			
3	Bk	9/17/2008	Roberts	2008 Bankr. LEXIS 2600	X			
3	Bk	3/5/2008	Liverman	2008 Bankr. LEXIS 776			X	
3	Bk	1/28/2008	May	381 BR 498			X	
3	Bk	9/7/2007	Bardo	379 BR 524	X			
3	Bk	2/13/2007	Brady	361 BR 765	X			
4	Bk	3/2/2009	Kelly	2009 Bankr. LEXIS 860		X		
4	Bk	12/16/2008	Faison	2008 Bankr. LEXIS 3997	X			
4	Bk	12/14/2008	Buck	2007 Bankr. LEXIS 4272	X			
4	DC	9/30/2008	Musselman	394 BR 801	X			
4	Bk	9/23/2008	Shelor	2008 Bankr. LEXIS 3974	X			
4	Bk	8/20/2008	Minahan	394 BR 116		X		
4	Bk	5/29/2008	Hoskings	2008 Bankr. LEXIS 1785	X			
4	Bk	3/10/2008	Linn	2008 Bankr. LEXIS 792		X		
4	Bk	3/3/2008	Wilson	397 BR 299			X	
4	Bk	1/23/2008	Simms	2008 Bankr. LEXIS 224	X			
4	Bk	4/11/2007	Watson	366 BR 523	X			
4	Bk	6/30/2006	Alexander	344 BR 742	X			
5	DC	4/24/2009	Cooper	2009 Bankr. LEXIS 897	X			
5	DC	10/14/2008	Spalding	2008 us dist lexis 81682		X		
5	Bk	7/3/2008	Gonzalez	2008 Bankr. LEXIS 2056		X		
5	Bk	4/4/2008	Louviere	2008 bankr lexis 2316		X		
5	Bk	3/6/2006	Hardacre	338 BR 718		X		
6	BAP	10/31/2008	Thomas	2008 Bankr. LEXIS 3664		X		
6	Bk	10/21/2008	Niehoff	2008 Bankr. LEXIS 2893				X
6	BAP	10/17/2008	Petro	395 BR 369		X		
6	Bk	9/30/2008	Terrell	2008 Bankr. LEXIS 2777		X		
6	Bk	8/25/2008	Marchionna	393 BR 512		X		
6	Bk	3/21/2008	Anderson	383 BR 699	X			
6	Bk	3/13/2008	French	383 BR 402			X	
6	Bk	10/10/2007	Spurgeon	378 BR 197			X	
6	Bk	5/18/2007	McGillis	370 BR 720	X			
6	Bk	3/30/2007	Kolb	366 BR 802	X			
6	Bk	3/19/2007	Grant	364 BR 656			X	
6	Bk	3/14/2007	Upton	363 BR 528				X
6	Bk	2/27/2007	Riggs	359 BR 649				X
6	Bk	1/29/2007	Zimmerman	2007 Bankr. LEXIS 410			X	
6	Bk	6/12/2006	Risher	344 BR 833		X		

*List of cases is not exhaustive.

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7	Bk	3/24/2009	Smith	2009 Bankr. LEXIS 558	X			
7	Bk	2/9/2009	Delp	2009 Bankr. LEXIS 247		X		
7	Bk	1/23/2009	Johnson	400 BR 639		X		
7	Bk	12/16/2008	Brandon	2008 Bankr. LEXIS 3425	X			
7	Bk	11/19/2008	Royal	2008 Bankr. LEXIS 3499			X	
7	Bk	11/12/2008	Spruch	2008 Bankr. LEXIS 3110	X			
7	Bk	10/15/2008	Hilton	2008 Bankr. LEXIS 2874			X	
7	Bk	9/17/2008	Hedge	394 BR 463	X			
7	Bk	8/22/2008	Schley	2008 Bankr. LEXIS 2214	X			
7	Bk	8/11/2008	Cruz	2008 Bankr. LEXIS 2540	X			
7	Bk	7/3/2008	Simpson	2008 Bankr. LEXIS 3966	X			
7	Bk	6/20/2008	Greer	388 BR 889	X			
7	Bk	5/14/2008	Spraggins	2008 Bankr. LEXIS 1512	X			
7	Bk	10/31/2007	Ross	377 BR 599	X			
7	Bk	7/31/2006	Demonica	345 BR 895				X
7	Bk	6/21/2006	Fuller	346 BR 472				X
8	**App**	10/27/2008	Frederickson	545 F3d 652		X		
9	**App**	6/5/2008	Kagenveama	541 F3d 868	X			
10	**App**	11/13/2008	Lanning	545 F3d 1269			X	
10	Bk	3/22/2006	Jass	340 BR 411			X	
11	Bk	12/19/2009	Mulally	2007 Bankr. LEXIS 4363	X			
11	Bk	12/14/2009	Hughey	2007 Bankr. LEXIS 4378	X			
11	Bk	1/14/2009	Becquer	2009 Bankr. LEXIS 374			X	
11	Bk	11/30/2008	Dean	2008 Bankr. LEXIS 3776		X		
11	Bk	9/9/2008	Raulerson	395 BR 157			X	
11	Bk	9/9/2008	Tennyson	2008 Bankr. LEXIS 3816		X		
11	Bk	8/20/2008	Neclerio	2008 Bankr. LEXIS 2242	X			
11	Bk	1/24/2008	Strickland	2008 bankr lexis 701			X	
Category totals:					31	29	15	6
						Forward - total cases: 53		

*List of cases is not exhaustive.

Exemptions and Objections: A Trustee's Dilemma

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On April 27, 2009, the Supreme Court granted *certiorari* in the matter of *Schwab v. Reilly*, 534 F.3d 173 (3d Cir. 2008)("*Schwab*"), to resolve two questions: (1) where a debtor claims an exemption equal to the full value of an asset, is the exemption limited to the specific amount claimed as exempt, or is the asset "fully exempt" regardless of its true value; and (2) must a trustee who wishes to sell such an asset object to the exemption within the thirty day period of Rule 4003, even though the type and amount of the exemption may be within the appropriate exemption statute?

Rule 4003 of the Federal Rules of Bankruptcy Procedure states that "a party in interest may file an objection to the list of property claimed as exempt within 30 days after the meeting of creditors[.]" However, Rule 4003 also allows courts to grant parties in interest an extension to the thirty day objection period for cause. Section 522 of Title 11 of the United States Code ("the Bankruptcy Code") states: "Unless a party in interest objects, the property claimed as exempt on such a list is exempt."

The Supreme Court granted *certiorari* in *Schwab* due to the split among the Circuit Courts in interpreting the Court's earlier decision in *Taylor v. Freedland and Kronz*¸ 503 U.S. 638 (1992). In that case, the Supreme Court reviewed a situation in which the debtor claimed as exempt proceeds she expected to win in a lawsuit against her former employer, with a value listed as "unknown." 503 U.S. at 640. The trustee failed to object, the suit later settled for $110,000, and the trustee then sought to recover those funds as part of the bankruptcy estate. *Id.* at 641. The Supreme Court held that the trustee's failure to object to the exemption within the statutorily

prescribed time period prevented him from challenging the exemption after the expiration of that period. *Id.* at 642. The Court reasoned:

> Deadlines may lead to unwelcomed results, but they prompt parties to act and they produce finality. [. . .] If Taylor did not know the value of the potential proceeds of the lawsuit, he could have sought a hearing on the issue, see *Rule 4003(c)*, or he could have asked the Bankruptcy Court for an extension of time to object, see *Rule 4003(b)*. Having done neither, Taylor cannot now seek to deprive Davis and respondents of the exemption.

Id. at 644. In addressing the trustee's contention that such a holding will cause debtors to claim property as exempt on the chance that a trustee will fail to object, the Court noted that both debtors and their attorneys face penalties for improper conduct, and that those penalties will serve to limit the bad-faith filing of claims of exemptions. *Id.* The Circuits are split in their interpretation of *Taylor*.

Are Assets Fully Exempt or Exempt to the Extent Scheduled?

In *In re Hyman*, the debtors claimed a homestead exemption of $45,000 and sought to have the full value of their residence exempted. 967 F.2d 1316, 1319 (9th Cir 1992). The Court declined to exempt the full value of the residence, however, reasoning that the debtors "did not sufficiently notify others that they were claiming their entire homestead as exempt property; their schedule only gave notice that they claimed $45,000 as exempt, which is the proper amount of their homestead allowance[.]" *Id.* Noting that the trustee "could well have suffered the bankruptcy judge's ire had he objected[,]" the Court further reasoned that "it is important that trustees and creditors be able to determine precisely whether a listed asset is validly exempt simply by reading a debtor's schedules. Given that the debtor controls the schedules, we construe any ambiguity against him." *Id.* Thus, the Ninth Circuit has concluded that a trustee is not legally required to object to the exemption of a specific scheduled value in order to later recover proceeds in excess of the exemption.

The Court of Appeals for the Eleventh Circuit in *In re Green* interprets and applies *Taylor* differently. *Green* involved facts similar to those in *Taylor*, with the major difference being that the debtor valued her lawsuit at one dollar instead of merely "unknown." *See In re Green*, 31 F.3d 1098, 1100 (11th Cir. 1994). The Court there followed *Taylor* strictly, noting that the trustee "may not wait until the value of the contingent claim is established before deciding whether to object; instead, he must object within the period allowed by Bankruptcy Rule 4003." *Id.* Under this reasoning, and "[b]ecause Green exempted the full value of her lawsuit, and because the Trustee did not object to her claim, she is entitled to the entire settlement fund." *Id.* Whereas the Court of Appeals for the Ninth Circuit would limit the exemption to the value of the exemption claimed, the Court of Appeals for the Eleventh Circuit interprets the exemption of the full value of the asset as rendering the asset itself as fully exempt.

This split among the Circuit Courts has resulted in a wide array of contradictory lower court decisions and a lack of uniformity in the application of *Taylor*. *See, e.g.*, *In re Jones*, 357 B.R. 888, 898 (Bankr. M.D. Ga. 2005)("*Taylor* allows a debtor to exempt a property in its entirety, even if its value exceeds the amount specified in the exemption statute in the absence of an objection by the trustee"); *In re Sherbahn*, 170 B.R. 137, 140 (Bankr. N.D. Ind. 1994) ("The extent of that exemption is determined by the value claimed exempt which the debtor placed in its schedule of exemptions."); *In re Zupansic*, 259 B.R. 388, 390 (M.D. Fla. 2001)("Trustee is barred from challenging the value of property claimed exempt *only* when the listed exemption equals the stated value of property, which would effectively render the entire asset exempt.") In *Schwab*, the Supreme Court must address whether a debtor who claims an exemption equal to the claimed value of an asset effectively is exempting the entire asset, regardless of what its actual value may be, or whether that asset is exempt only in the amount claimed as exempt on the debtor's schedule.

Are Trustees Required to Object to Properly Completed Claims of Exemption?

The Third Circuit Court of Appeals used *Taylor* as guidance in *Schwab*. 534 F.3d at 178. The Court held that, once the 30-day period within which to object had passed, "the property became fully exempt from the bankruptcy estate regardless of its ultimate market value." *Id*; *see* 11 U.S.C. § 522(l). In so holding, the Court noted that:

> "it is important to us that Reilly valued the business equipment at $10,718 and claimed the exemption in the same amount. Such an identical listing put Schwab on notice that Reilly intended to exempt the property fully. At that point, had Schwab doubted Reilly's valuation of her business equipment, he should have had the property appraised and/or sought a hearing pursuant to Rule 4003(c). Alternatively, [. . .] he could have requested an extension before that deadline passed."

Id. In its reasoning, the Court also recognized that "there is a split of authority on this issue among courts that have considered it." *Id.* The Court "read *Taylor* to mean that, where the debtor signals her intention to exempt certain property in its entirety by listing an identical entry for the property's value and the amount of the exemption, the trustee must object pursuant to Rule 4003 lest the property be rendered fully exempt." The Court of Appeals concluded that "where the debtor lists a value for the property and claims an exemption in the same amount, the trustee is on notice of the debtor's valuation and has ample time to seek confirmation that the debtor's claimed value represents the true worth of the asset." *Id.* at 180.

In their Writ of *Certiorari*, Petitioners take issue with several of the Third Circuit Court of Appeals' conclusions. The Petitioners claim that the holding in *Schwab* "places every Chapter 7 Trustee in a position that [. . .] he will have to object to properly-taken exemptions or ask for extensions of time to do so, causing unnecessary expenses to parties, trustees, bankruptcy estates and bankruptcy courts." Further, Petitioners urge that "[t]he Third Circuit's reading of *Taylor* will not only create waste by imposing new trustee duties not already specified by Congress in the bankruptcy statute, but will also improperly increase the amount of exemptions created by Congress." Finally,

Petitioners argue that the Third Circuit holding requires trustees to infer a debtor's intent from a debtor's schedules, and notes the "impracticality of requiring a trustee to discern the 'intent' of a debtor in claiming exemptions." The opposition points out that the value the debtor (Reilly) provided as the amount of her exemption was neither arbitrary nor the product of bad faith. Further, the trustee (Schwab) was able to obtain an appraisal of the exempt items within the 30 day objection period.

The split among the Circuits as to the appropriate interpretation of *Taylor* and its application requires resolution by the Supreme Court in order to effectuate the very uniformity and finality contemplated in that decision. Whereas the current posture of this issue lends itself to the wide array of interpretations that now exist, a decision in this matter should ultimately lay to rest the question of when an asset becomes fully exempt and whether a trustee must object to those exemptions in an amount equal to the claimed value.

CIRCUIT SPLITS

Circuit Split

Does the "hanging paragraph" of 11 U.S.C. § 1325(a) permit a debtor to surrender a car purchased within 910 days before the petition in full satisfaction of the underlying debt? Or is the creditor entitled to assert an unsecured claim for a deficiency balance remaining after liquidation of the collateral?

Relevant Statutory Provision

I. The "hanging paragraph" provides:

For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

II. Under 11 U.S.C. § 506, a bifurcation of a secured claim is prohibited under the following circumstances: (1) the creditor has a purchase money security interest; (2) in a motor vehicle acquired for the debtor's personal use; and (3) the debt secured by the vehicle was incurred within 910 days of the filing of the petition. If these requirements exist, bifurcation is not permitted of a secured claim described in § 1325(a)(5).

MAJORITY (OR DEFICIENCY POSITION) VIEWPOINT

A secured creditor is entitled to assert an unsecured claim for a deficiency balance remaining after liquidation of the collateral despite the hanging paragraph. At last year's ABI Mid-Atlantic Bankruptcy Workshop this was described as the Minority viewpoint. What changed in the interim is the cases decided following the first of the cases described below, in which Judge Easterbrook of the Seventh Circuit Court of Appeals weighed in with his support of what was then the minority position.[1]

A. ***In re Wright*, 492 F.3d 829 (7th Cir. 2007)**

Facts: Debtors Craig and LaChone Wright purchased a 2006 Dodge Magnum on August 10, 2005. They subsequently filed a chapter 13 petition on October 18, 2006, less than 910 days following the purchase of the vehicle, which was worth less than the $18,845.88 the Wrights now owed on the vehicle loan. The chapter 13 plan filed by the Wrights called for the Wrights to surrender the vehicle in full satisfaction of the $18,845.88 debt. The vehicle lender objected to the Wrights Plan, arguing that the hanging paragraph did not entitle the Wrights to surrender their vehicle in full satisfaction of the underlying debt

[1] Because the facts in each of the "hanging paragraph" cases are nearly identical, they will be stated only in the Seventh Circuit Court of Appeals' *In re Wright* decision, and assumed in each of the cases described thereafter.

Procedural Posture: U.S. Bankruptcy Court for the Northern District of Illinois sustained the lender's objection to the Wrights' Plan. The Debtors appealed that ruling directly to the Seventh Circuit Court of Appeals.

Issue: Does the hanging paragraph's edict not to consider section 506 prevent a secured creditor from dividing its claim into secured and unsecured components?

Rationale: Although it is true that section 506(a) provides for the division of claims into unsecured and secured components, that section is not the only source of authority for a deficiency when the collateral is sold for an amount less than the loan balance. The Court of Appeals found that the underlying contract (which provided for a deficiency judgment in such circumstances) should govern in the absence of section 506, because *Butner v. United States*, 440 U.S. 48 (1979) held that state law determines rights and obligations when the Bankruptcy Code does not supply a federal rule. Courts which rule to the contrary assume that contracts and state law are inoperative unless implemented by the Bankruptcy Code. This is mistaken.

Rule: Because section 506 is not the only means for bifurcating a claim, courts may look to the underlying contract and state law in determining whether a secured creditor is entitled to a deficiency claim when a debtor surrenders a "910 day" vehicle.

B. ***Wells Fargo Financial Acceptance v. Rodriguez (In re Rodriguez)*, 375 B.R. 535 (9th Cir. BAP 2007)**. The Bankruptcy Appellate Panel of the Ninth Circuit Court of Appeals agreed with the *Wright* court's analysis, but added a twist of its own. It noted that section 1325 is titled "Confirmation of a Plan". The various sub-sections of section 1325 "are operative and effective only upon confirmation of a plan…they do not apply to pre-petition or post-petition, pre-confirmation surrenders, nor to post-confirmation surrenders." *Id.* at 543. As a result, upon confirmation of the debtor's plan, the court noted that the estate would no longer have an interest in the vehicle. Therefore, section 506 would have no impact whatsoever, because there would be no "allowed claim of a creditor secured by a lien on property in which the estate has an interest." Thus rendering section 506 inoperative is of no consequence to Plan confirmation. *See id.* at 544, *citing* 11 U.S.C. 506(a)(1).

C. ***Capital One Auto Finance v. Osborn*, 515 F.3d 817 (8th Cir. 2008).** The Eighth Circuit Court of Appeals in *Osborn* echoed the rationale of *In re Wright* (still referring to it as the "minority" position), adding only the argument that section 1325(a)(5) (the section referred to in the hanging paragraph) does not provide that an allowed secured claim is satisfied by the debtor surrendering the collateral.

D. ***Americredit Financial Services, Inc. v. Long*, 519 F.3d 288 (6th Cir. 2008)**. The Sixth Circuit Court of Appeals did not adopt the Seventh Circuit Court of Appeals' rationale in *Wright* wholesale. Instead, it reached two (related) conclusions on its own. First, it was an "oxymoron" to even discuss an allowed secured claim without reference to section 506, because it was 506 which creates an allowed secured claim; second, in a refreshing departure from the "plain meaning" juggernaut, because a "literal interpretation of the statute would create an unintended and illogical result, we decline to adopt a literal

interpretation." *See id.* at 297. In support of this departure from a literal interpretation, the Court cited to the common law doctrine of the "equity of the statute", and the assertion that "the hanging paragraph was intended to protect secured creditors…" The Court of Appeals opined that such a literal interpretation "would not serve the policy or purpose of the amendment". *See id.* at 298. As a result, the court found that the debtor could not surrender his vehicle in full satisfaction of the underlying debt.

E. ***DaimlerChrysler Financial Services Americas LLC v. Ballard (in re Ballard)*, 526 F.3d 634 (10th Cir. 2008).** In this decision, the Tenth Circuit Court of Appeals overturned the decision of its own Bankruptcy Appellate Panel, which had found that the hanging paragraph did prevent a secured creditor from asserting an unsecured claim for a deficiency balance after a debtor surrendered her vehicle. The Tenth Circuit Court of Appeals hewed closely to the rationale of the Seventh Circuit Court of Appeals' analysis in *Wright*. The *Ballard* court did go slightly further in its analysis of the link between section 1325(a)(5) and 506 than the *Wright* court did. The *Ballard* court reasoned that "nothing in 1325(a)(5) suggests that section 506(a) determines the meaning of the phrase 'allowed secured claim' in that section". *See Ballard* at 641. In the absence of such a link between the two sections, the *Ballard* court found that the most natural reading of the phrase was one which described both a claim allowed under the Code [section 502], and secured by a lien [state law]. The *Ballard* court still referred to cases holding the opposite view as the "majority", despite five Courts of Appeal now weighing in on the side of the "minority", and no Court of Appeal backing the "majority". *See In re Ballard*, 526 F.3d at 638.

F. ***Tidewater Finance Co. v. Kenney*, 531 F.3d 312 (4th Cir. 2008)**. In *Kenney*, the Fourth Circuit Court of Appeals echoed the reasoning of the Seventh Circuit Court of Appeals in *Wright*, adding little of its own analysis. Interestingly, with the Kenney decision now making the split among the various Courts of Appeal 6 to 0, the *Kenney* court still described the courts which held that a secured creditor was prohibited from asserting an unsecured deficiency claim by the hanging paragraph as the "majority". *See id.* at 317.

G. ***DaimlerChrysler Financial Services Americas LLC v. Barrett (In re Barrett)*, 543 F.3d 1239 (11th Cir. 2008).** In *In re Barrett*, the Eleventh Circuit Court of Appeals surveyed the field, outlined the state of the case law, and proclaimed that "[i]n light of the foregoing, it seems safe to say that the previous minority view is now the majority view". *See id.* at 1246. The *Barrett* court felt little need to pile on, and added no new rationale for finding that the debtors could not surrender their vehicle in full satisfaction of the underlying debt.

H. ***DaimlerChrysler Financial Services Americas LLC v. Miller (In re Miller)*, 2009 U.S. App. LEXIS 12185 (5th Cir. 2009)**. The most recent Court of Appeals decision to agree that a creditor is entitled to an unsecured claim for the deficiency amount despite the language in the hanging paragraph forbidding consideration of section 506 performed two services. First, the *Miller* court went out of its way to disassociate its holding from that of the Sixth Circuit Court of Appeals in *Americredit Financial Services, Inc. v. Long*, 519 F.3d 288 (6th Cir. 2008). The *Miller* court defended the "plain meaning" school of statutory interpretation against the "equity of the statute" doctrine the Long court

invoked in its own renunciation of the view that the hanging paragraph prevented a secured creditor from asserting a claim for a deficiency judgment. The *Miller* court also dropped the now inaccurate "majority" and "minority" labels, adopting the more descriptive terms "full-satisfaction position" and "deficiency position".

MINORITY (OR FULL SATISFACTION POSITION) VIEWPOINT

A. ***In re Pinti*, 363 B.R. 369 (Bankr. S.D.N.Y. 2007)**. The longest and perhaps most strongly argued of the cases arguing in favor of a debtor's right to submit her vehicle in full satisfaction of the underlying debt pursuant to the hanging paragraph is *In re Pinti*. *In re Pinti* was decided by Bankruptcy Judge Cecilia G. Morris little more than three months before the Seventh Circuit Court of Appeals decided *In re Wright*, the case which the vast majority of Courts of Appeal now follow. The primary difference between *In re Wright* and *In re Pinti* comes down to each court's interpretation of the U.S. Supreme Court decisions.

The *Wright* court relies upon *Butner v. United States*, 440 U.S. 48 (1979) for the proposition that "state law determines rights and obligations when the Code does not supply a federal rule". *See In re Wright*, 492 F.3d at 832. *Pinti*, on the other hand, maintains that while a deficiency may be *calculated* pursuant to state law, "the creditor is seeking allowance of the deficiency *as a bankruptcy claim*. The Bankruptcy Code, and not state law, determines whether and to what extent such claim should be allowed in the bankruptcy estate". *See In re Pinti* at 380 (emphasis added). As support for this contention, *Pinti* cites to *U.S. v. Ron Pair Enters., Inc.*, 489 U.S. 235 (1989) for the proposition that section 506 "governs the definition and treatment of secured claims". *See Pinti*, 363 B.R. at 382 (*citing U.S. v. Ron Pair Enters., Inc.*, 489 U.S. at 238-239). *Pinti* also looks to another Supreme Court decision for the proposition that "[t]he value of the allowed secured claim is governed by section 506(a) of the Code". *See id.* at 381 (*quoting Assocs. Commercial Corp. v. Rash*, 520 U.S. 953, 956-957 (1997)).

At bottom, *Wright* holds that a deficiency claim may be determined by state law even without section 506. *Pinti* holds that without 506, there can be no mechanism for the allowance of an unsecured claim in bankruptcy.

Circuit Split

Does a Student Loan lender ("Lender") have the right to collect that portion of its debtor's non-dischargeable debt after the debtor has successfully completed a chapter 13 plan which listed the debt at an amount below what the Lender asserted in its proof of claim, if Lender did not object to the plan?

The Supreme Court is presently deciding whether or not to grant *cert.* to the appellant in ***Espinoza v. United Student Aid Funds, Inc.*, 545 F.3d 1113 (9th Cir. 2008).**

Facts: Francisco Espinoza filed a chapter 13 petition and proposed plan that provided for repayment of $13,250.00 in student loans to United Student Aid Funds, Inc. ("Lender"). Lender filed a proof of claim in the case for $17,832.15. Despite written notice from the chapter 13 Trustee that the amount of its claim differed from the amount listed in the debtor's plan, the Lender did not object to the Debtor's plan. Following the Debtor's successful completion of the Plan and the court's grant of a discharge, the Lender began intercepting Espinoza's income tax refunds to satisfy the unpaid portion of the loan.

Procedural Posture: Espinoza petitioned the court for an order holding the Lender in contempt for violating the discharge injunction. The Lender cross-moved for relief from the order confirming the plan, arguing that the order had been entered in violation of Lender's rights under the Code and Rules. The bankruptcy court held that the Lender had violated the discharge injunction by intercepting Espinoza's income tax refunds, and ordered the Lender to cease all collection activity against Espinoza, and held that the plan became final when it was confirmed. The district court reversed, holding that the Lender was denied due process because it was not served with a summons and complaint as required by FRBP 7001(6), 7003 and 7004.

Issue

May a debtor obtain a discharge of a student loan by including it in a chapter 13 plan, if the creditor fails to object after notice of the proposed plan?

Rationale:

The Ninth Circuit Court of Appeals reasoned that because the Lender was served with notice of the proposed plan, it had full and fair opportunity to object on the ground that there had been no finding of undue hardship. Instead, the Lender accepted payments for the duration of the plan, and then attempted to claim it was not bound by the plan. The Court of Appeals also opined that a bankruptcy discharge order is a final judgment; once the time to appeal has run, it can be reconsidered only under the limited circumstances provided by FRCP 60(b). Because the Lender received actual notice of the proposed plan and failed to object, due process was not violated .

Rule

Where a student loan lender receives notice of the amount a debtor intends to pay in a chapter 13 plan, and the lender does not object to the plan, it is bound by the discharge injunction and the order confirming the plan unless that final order is appealed pursuant to FRCP 60(b).

Case contrary to *Espinoza*

***Whelton v. Educational Credit Management Corp.*, 432 F.3d 150 (2d Cir. 2005).**

Facts: Debtor Christopher Whelton and his wife filed for relief pursuant to chapter 13 of the Code. They listed $103,830.83 owing to Educational Credit Management Corp. (the "Lender"), as an unsecured, non-priority claim for an educational loan. In this case the Lender filed a proof of claim in an amount only slightly less than what the Debtor scheduled. However, in their plan the Debtors included a statement to the effect that confirmation of the plan would constitute a finding that excepting the educational loans from discharge would impose an undue hardship on the debtors. The Lender received a copy of the debtors' plan, but did not object to the plan.

Procedural Posture: The bankruptcy court found that the debtors' "discharge by declaration" was inconsistent with the Code, outside the scope of relief, and should not have been confirmed. The court also found that the debtors' failure to serve a summons and complaint on the Lender deprived Lender of proper notice of the debtors' intent to discharge the student loans, and thus constituted an abrogation of the Lender's due process rights. The district court affirmed the bankruptcy court.

Issue: Is a discharge by declaration contained in a chapter 13 plan enforceable as against a student loan creditor?

Rationale:

The Second Circuit Court of Appeals commenced its analysis by citing *Tenn. Student Assist. Corp. v. Hood*, 541 U.S. 440 (2004) for the proposition that student loan creditors deserve "greater procedural protection" because student loans are not automatically dischargeable. *See Whelton v. Educational Credit Management Corp.*, 432 F.3d at 153 (*citing Tenn. Student Assist. Corp. v. Hood*, 541 U.S. at 451). The court further cited to *Tenn. Student* for the proposition that a debtor is required to file an adversary proceeding, which requires service of a summons and complaint, in order to discharge student loan debt. The Court of Appeals found that the debtor's actions constituted a sort of "practice by ambush". The Court of Appeals concluded by reasoning that the debtors' failure to serve the Lender with a summons and complaint, the debtors' "liability on the loan[s] survives the purported discharge." *See Whelton v. Educational Credit Management Corp.*, 432 F.3d at 156.

Rule:

A debtor must commence an adversary proceeding by serving a student loan creditor with a summons and complaint in order to escape liability on its non-dischargeable student loans. Conclusory declarations in a chapter 13 plan will not serve to overcome the stricture of section 523(a)(8) or FRBP 7001, 7003 and 7004.

Circuit Split

Is a Debtor/Trustee prevented by the automatic stay from appealing the decision of a non-bankruptcy forum where the action was originally commenced against the debtor?

(The facts are similar enough in each of these cases so that only the court's rationale for its holding will be set forth).

MAJORITY VIEW- YES

A. ***In re Capgro Leasing Associates*, 169 B.R. 305 (Bankr. E.D.N.Y. 1994)**. *Capgro* is merely one of the better known of the majority of the cases holding that the automatic stay prevents a debtor from appealing the decision of a non-bankruptcy forum where the action was originally commenced against the debtor. The *Capgro* court's rationale is that even a debtor's own appeal is, in the exact words of the statute, a "continuation…of a judicial…action or proceeding against the debtor…" *See* 11 U.S.C. § 362(a)(1). And because the automatic stay is not solely for the debtor's protection, but also benefits creditors, "a debtor may neither unilaterally waive nor limit the scope of the automatic stay". *See In re Capgro Leasing Associates*, 169 B.R. at 310 (*citing Commererzanstalt v. Telewide Sys., Inc*., 790 F.2d 206, 207 (2d Cir. 1986)).

The *Capgro* court noted that courts that held to the contrary relied upon FRBP 6009, which reads, in its entirety:

> With or without court approval, the trustee or debtor in possession may prosecute or may enter an appearance and defend any pending action or proceeding by or against the debtor, or commence and prosecute any action or proceeding in behalf of the estate before any tribunal.

FRBP 6009.

Capgro reads FRBP 6009 to furnish the trustee with "the discretion to decide whether to litigate actions as it sets forth, and to do so without court approval". *See Capgro* at 312. However, the *Capgro* court found that despite the trustee's ability to decide *whether* to litigate an action, FRBP 6009 does not enable the trustee to determine *when* such an action may commence. The bankruptcy court must do this by deciding whether to lift the automatic stay.

B. ***Parker v. Bain*, 68 F.3d 1131 (9th Cir. 1995).** In *Parker*, the Ninth Circuit Court of Appeals agreed with the *Capgro* holding, adding its own gloss to the analysis: "Rule 6009 does not trump the automatic stay. It simply clarifies that the trustee or debtor in possession has standing to, and may, litigate appropriate actions on behalf of the estate without prior approval of the bankruptcy court. Its scope extends only to litigation that is not subject to the automatic stay, or to which the bankruptcy court has granted relief from the stay." *See Parker v. Bain*, 68 F.3d at 1136.

MINORITY VIEW

A. ***Autoskill Inc. v. Nat'l Educational Support Systems, Inc.*, 994 F.2d 1476 (10th Cir. 1993).** In *Autoskill*, the Tenth Circuit Court of Appeals did in fact interpret the "plain language" of FRBP 6009 to authorize the trustee to continue or "pursue litigation without…release of stay under section 362". *See Autoskill Inc. v. Nat'l Educational Support Systems, Inc.*, 994 F.2d at 1486. The *Autoskill* court relied almost entirely on FRBP 6009 as the basis for a trustee's ability to pursue litigation without obtaining relief from stay. *Accord Carpenter v. Farm Credit Svcs. of Mid-America, ACA*, 654 N.E.2d 1125 (Ind. 1995); *Chaussee v. Odd Lyngholm (In re Odd Lyngholm)*, 24 F.3d 89 (10th Cir. 1994);

B. ***In re Mid-City Parking, Inc.*, 332 B.R. 798 (Bankr. N.D. Ill. 2005).** *Mid-City Parking* is the latest, and one of the few, courts to find that the debtor/trustee does not, in fact, need relief from the automatic stay to prosecute an appeal of a judgment of a non-bankruptcy forum if the action was originally taken against the debtor. Unlike the few other cases to oppose the *Capgro* line of cases, however, *Mid-City Parking* does not rely upon FRBP 6009. Instead, Bankruptcy Court Judge Jacqueline Cox addressed the issue with her own fresh analysis of the issue. First, Judge Cox pointed out that very few of the majority cases take into consideration the difference between a debtor in possession and a trustee. In fact, many of them use the two terms interchangeably. Of course, section 1107 of the Code allows a debtor who remains in possession to have "all the rights, other than the right to compensation under section 330 of this title, and shall perform all the functions and duties…of a trustee serving in a case under this chapter". *See In re Mid-City Parking, Inc.*, 332 B.R. at 811 (quoting 11 U.S.C. § 1107(a)). The spotlight is then turned on section 362(a), where the court notes that the stay applies to "all entities". The court observed that among the many items to be included in the Code's definition of an entity (person, estate, trust, governmental unit, and United States Trustee), case trustee is not among them. Although a trustee may be a natural person, "he does not act in that capacity while administering the estate" *See id.* He acts as a legal entity which is not included within the Code's definition of an "entity". But the court does not rest its argument on this basis.

Before proceeding to the heart of its analysis, the court proceeds to point out a major weakness in cases relying upon FRBP 6009 as justification for a trustee not requiring relief from the automatic stay. Not even the *Capgro* court had mentioned this weakness in those decisions which relied upon FRBP 6009 to reach a conclusion contrary to *Capgro*. That is the Rules Enabling Act (the "REA"), which provides that a civil procedure rule cannot overcome a statutory mandate such as section 362(a). The existence of the REA prevents the elevation of FRBP 6009 over the substance of section 362(a).

These two points, unique to the decisions on both sides of the stay waiver issue, are merely preamble to the *Mid-City Parking* court's primary analysis. *Mid City Parking* addresses a central assertion of *Capgro*: "because the stay is not solely for the debtor's protection, a debtor may neither unilaterally waive nor limit the scope of the automatic stay". See *In re Mid-City Parking, Inc.*, 332 B.R. at 815 (*quoting Capgro*, 169 BR at 310). The *Mid-City Parking* court points out that a case trustee is necessarily a fiduciary for all creditors. If a trustee is to exercise its powers pursuant to sections 1107 and 323 (trustee is a representative of the estate and has the capacity to sue and be sued), one

must ask whether Congress intended to constrain the exercise of the trustee's powers by section 362(a). If the trustee may not unilaterally waive or limit the scope of the automatic stay, how can we explain that section 362(a) exists to allow the trustee to perform its estate administration duties (including section 323), and not to restrain, hinder or delay him in executing those duties.

But the *Mid-City Parking* court saves its most incisive analysis for the logic of the *Capgro* decision itself: if the trustee is subject to section 362(a)(1), why should it not be subject to the other seven (7) subsections of 362(a)? If he were, Judge Cox opines, section 362 (a)(3) would prevent the trustee from reorganizing or liquidating the estate absent relief from the automatic stay. And other subsections would render many other actions routinely taken by the trustee void *ab initio* unless the trustee obtained stay relief for all of them.

The *Mid-City Parking* court held that a trustee may waive the protections of the automatic stay "when the actions that would otherwise violate the stay are in furtherance of his statutory duties of administering the bankruptcy estate, including appealing judgments against the debtor's estate in nonbankruptcy forums." See *In re Mid-City Parking, Inc*., 332 B.R. at 820.

Circuit Split

Does section 105(a) permit a bankruptcy court to permanently enjoin post-confirmation lawsuits against non-debtors , or does section 524(e) be construed as an absolute bar against permanent injunctive relief for all non-debtors?

The various courts' decisions on this issue have been described as a "split" (*see, e.g., Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973 (1st Cir. 1995)). However, analysis of the cases reveals less a divergence of opinion on this matter, than a continuum of holdings based upon varying facts, and a gradual evolution of opinion. This continuum of holdings and evolution in jurisprudence regarding third party releases could be represented as a convergence, or synthesis, of attitudes toward releases of third party, non-debtor parties.

As a result, this section will be structured as more of a brief essay on this evolution, and less of a case-by-case presentation as set forth above.

Three early cases are often cited for the proposition that releases of non-debtor third parties are prohibited. *See In re American Hardwoods, Inc.*, 885 F.2d 621 (9th Cir. 1989); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990); and *In re Boston Harbor Marina Co.*, 157 B.R. 726 (Bankr. D. Mass. 1993). *In re Western Real Estate* lays down a fairly hard line on the issue, opining that section 105(a), sometimes used as a justification for an injunction or release, "may not be exercised in a manner that is inconsistent with the other, more specific provisions of the Code". *See Western Real Estate* at 601. That other, more specific section of the Code is section 524(e), which reads, in relevant part: "[a] discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity, for such debt". *See* 11 U.S.C. § 524(e). Even the *Western Real Estate* court, however, notes that the Fourth Circuit Court of Appeals' decision in *In re A.H. Robins Co.*, 828 F.2d 1023 (4th Cir. 1987) was acceptable.[2] In *Robins,* the court justified third party releases pursuant to the court's power in 105(a) when there is unity of interest between the debtor and the threatened third party, and the debtor's inevitable, burdensome involvement in the ancillary litigation can justify preemptive injunctive relief. See *Western Real Estate* at 599.

In American Hardwoods, the court made a similar analysis. It started out by acknowledging the section 105(a) empowers a court to issue permanent injunctions after confirmation "to protect the debtor and the administration of the bankruptcy estate." *See American Hardwoods* at 625. The court stopped short, however, of permanently enjoining a creditor from enforcing a state court judgment against a nondebtor guarantor of a contract liability. Like *Western Real Estate*, the American Hardwoods court cited a court's inability to use section 105(a) to evade the edict of section 524(e). It also opined that a permanent

[2] In *A.H. Robins*, a decision involving mass tort litigation of thousands of women injured by that company's Dalkon Shield intra-uterine device, the Fourth Circuit Court of Appeals found that "[w]hatever the result might be as to the application of § 524(e) in other cases, *we do not think that section must be literally applied in every case as a prohibition on the power of the bankruptcy courts*… In this situation, where the Plan was overwhelmingly approved, where the Plan in conjunction with insurance policies…gives a second chance for even late claimants to recover…and where the entire reorganization hinges on the debtor being free from indirect claims such as suits against parties who would have indemnity or contribution claims against the debtor, *we do not construe § 524(e) so that it limits the equitable power of the bankruptcy court to enjoin the questioned suits*." 880 F.2d at 702 (emphasis added).

injunction is in fact a type of discharge, making section 524(e) all the more relevant. Even the *American Hardwoods* court, however, recognized the ability of a court to issue such a permanent injunction when faced with "unusual facts" such as those in *A.H. Robins*. *See American Hardwoods* at 627.

The *Boston Harbor Marina* court also declined to approve releases contained in the debtor's plan, citing the usual concerns about section 524(e). But *Boston Harbor Marina* went out of its way to agree with previous decisions that such a release was proper in the context of the discharge of mass torts as in *A.H. Robins*. The court went even further, however, also maintaining that principles of contract law can also permit the release of non-debtor parties, provided there is consideration for the release, and its effect is limited to creditors who accept the plan provision containing the release." *See Boston Harbor Marina* at 730-731.

Thus, even the three early decisions, each declining to grant third party releases, made a point of stating that such release would be proper in certain circumstances.

The hole opened up by *A.H. Robins* was further expanded by the Second Circuit Court of Appeals in *In re Drexel Burnham Lambert Group, Inc*., 960 F.2d 285 (2d Cir. 1992). There the court examined a settlement agreement by which the debtor settled a government civil enforcement action against the debtor. The settlement agreement contained an injunction against the number of lawsuits that could be brought against former Drexel directors and officers. The court found that the injunction was a key component of the settlement agreement, and that without the injunction, "the directors and officers would be less likely to settle." *See id*. at 293. The court held that it was permissible to enjoin a creditor from suing a third party "provided the injunction plays as important part in the debtor's reorganization plan". *See id.*

In *In re Heron, Burchette, Ruckert & Rothwell*, 148 B.R. 660 (Bankr. D. D.C. 1992), the court was faced with a debtor law firm's chapter 11 plan which included a permanent injunction barring any actions by interested parties against the debtor's partners on claims related to the debtor's affairs. The Heron court did not find section 524(e) to pose a bar to such an injunction, because that section:

> is merely declarative of the effect of a discharge under section 524. It does not affect the ability of the court to issue a permanent injunction under section 105(a) that affects the liability of a non-debtor on the debtor's debt. Such an injunction exists apart from a discharge under section 524. Section 524(e) contains no language of prohibition and should not be interpreted to limit the court's power under section 105(a).

In re Heron, Burchette, Ruckert & Rothwell, 148 B.R. at 687.

Because the partners of the debtor law firm were undertaking obligations to creditors in place of their original obligations, they provided "the entire funding of the debtor's plan". *See id*. The court found the injunction necessary to the debtor's reorganization because the partners would not participate absent the injunction, and because the injunction was "the *sine qua non* of the debtor's reorganization." *See id*. at 689.

More recently, the issue of third party releases was addressed by the Second Circuit Court of Appeals in *In re Metromedia Fiber Network, Inc*., 416 F.3d 136 (2d Cir. 2005). Here the court begins to circumscribe the ease with which such releases had previously been granted, as in *Drexel*. The *Metromedia Fiber* court began by providing reasons to justify a court's reluctance to approve nondebtor releases: (1) no provision of the Code, aside from section 105, offers a justification for nondebtor releases; and (2) a nondebtor release "is a device that lends itself to abuse". *See id*. at 142. In *Metromedia Fiber*, the debtor's contention that the relevant third party had made a "material contribution" to the estate was insufficient to merit the release.[3] The *Metromedia Fiber* court further opined that "[n]o case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique". *See id.*

Most recently, in *In re Adelphia Communications Corp*., 364 B.R. 518 (Bankr. S.D.N.Y. 2007), the court summed up the evolution referred to above by stating that "the applicable law authorizing the approval of channeling injunctions and third party releases has become increasingly restrictive, and now permits such relief only under limited circumstances--most significantly, where they are critical to the reorganization of the debtor." *See id*. at 529. The *Adelphia* court saw no such importance in the channeling injunction (which would have prohibited directors and officers of Adelphia from proceeding against the insurers to pursue claimed entitlements under the policies) sought by the debtor, and declined to approve it.

[3] Although there were insufficient grounds to justify the release, the court found that the issue was equitably moot, and so left the injunction undisturbed.

Testimony of

Harvey R. Miller [1]

before the

Subcommittee on Commercial and Administrative Law

of the

House Judiciary Committee

111th Congress, 1st Session

for Hearings on

"Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?"

March 11, 2009

I greatly appreciate the opportunity to testify in these oversight hearings as to why chapter 11 of the Bankruptcy Code has been seriously impaired and may no longer be an effective process to preserve jobs through the rehabilitation and reorganization of distressed businesses.

I am a practicing attorney and senior member of the international law firm of Weil, Gotshal & Manges, LLP (WGM) that maintains its principal office in New York City. For

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[1] Senior Partner, Weil, Gotshal & Manges LLP, New York, New York. The views expressed in this testimony are expressed solely on behalf of myself and not on behalf of any other person or entity.

the past 50 years[2], I have specialized in the laws relating to debtor-creditor relationships with an emphasis on restructuring, rehabilitating and reorganizing distressed business entities. I created the Business Finance and Restructuring group at WGM. I have represented debtors, secured and unsecured creditors, trustees, creditors' committees, and served as a trustee in cases under the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.)[3].

I am currently an Adjunct Professor of Law at the New York University School of Law, where I have taught a seminar on chapter 11 bankruptcy and reorganization law since 1975. I also am an Adjunct Lecturer in Law at the Columbia University School of Law, where I have taught a course on Corporate Reorganization and Bankruptcy Law, for the past eight years.

It is my understanding that the Subcommittee is concerned as to why it appears that chapter 11 of title 11 of the United States Code (Bankruptcy Code) is no longer serving the objective of enabling the rehabilitation and reorganization of distressed businesses that would preserve jobs, the interests of the communities in which each business operates and serve the national interest. A concern that is crystallized by the recent failure of the retail store chain of Circuit City to reorganize with the attendant loss of over 34,000 jobs and other consequences yet to be realized.

I commend the Subcommittee for its concern. The nation is engulfed in an economic crisis the likes of which have not occurred since the Great Depression of the 1930s. Bold action is necessary to protect and preserve the nation's economic foundation. In a credit-intensive world, it is essential to have a means to deal with excess credit and the resultant failures

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[2] During the period of September 1, 2002 to March, 2007, I was a Vice Chairman and Managing Director of Greenhill & Co., LLC, an investment banking firm located in New York City.

[3] Since approximately 1973, I have been a conferee and member of the National Bankrutpcy Conference and I also am a fellow of the American College of Bankruptcy.

of distressed businesses. Bankruptcy reorganization had served as that means. In 1978, with the support of the financial community, Congress recognized the need for an effective bankruptcy reorganization process and enacted the Bankruptcy Reform Act of 1978, that included a new chapter to deal with business reorganizations. Chapter 11 of the Bankruptcy Code was conceived to implement the objective of saving businesses while balancing the needs of the debtors and the rights of creditors and interest holders.

Unfortunately, the balancing of interests that was enacted in 1978 has been upset through a series of amendments of the Bankruptcy Code, culminating in the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (BAPCPA), that have clawed back Bankruptcy Code protections that had been enacted to assist and enable a debtor to rehabilitate and reorganize its business.

The Erosion Of The Chapter 11 Paradigm

The world of restructuring and reorganization has dramatically changed from that which existed in 1978. This change has been precipitated by globalization, the expansion and predominance of secured creditors, claims trading, technological advances in all areas, particularly communications and access to information, a shift from a manufacturing to a service economy, and major business consolidations. The change was accentuated by the very robust economy that the United States enjoyed during the period from 2003 to mid-2007. Unprecedented low interest rates and overwhelming liquidity radically diminished the fear of loss and enhanced greed for higher and higher returns. The result was reckless spending and highly risky lending and investing. The availability of easy credit provided by financial institutions and the entry of hedge funds into the lending market enabled weak companies to

increase their leverage without taking necessary actions to correct deficiencies in their operations and potential financial problems.

Starting in the beginning of 2008, the crack in the economy that had emerged as the subprime crisis increased, began to widen. The first victims of this growing financial instability were retail organizations. However, during the interim period, there had been a continuing decline in major restructuring and reorganization cases, largely due to the excessive liquidity in the marketplace and the easy access to covenant-free or low-covenant borrowing. The top five bankruptcy cases in 2006 totaled only $13 billion in assets, compared with $101.3 million in 2005. In a twelve-month period ending September, 2006, chapter 11 cases filed by businesses rose in number to slightly over 6,000 cases, continuing the lowest level since the mid-1990s. Corporate default rates, likewise, declined significantly to an unprecedented low level in 2007, approximately 0.51%.

Thus, in the context of the changes in the economic environment and the declining use of chapter 11, the question arose as to whether the chapter 11 paradigm that had originated in the railroad reorganization cases that followed the Civil War, had any continued viability. Professors Douglas G. Baird and Robert K. Rasmussen boldly stated:

> To the extent we understand the law of corporate reorganizations as providing a collective forum in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial stress, we may safely conclude that its era has come to an end.[4]

Today, chapter 11 is not a process in which a debtor and creditors work together to rehabilitate a debtor. Why has this occurred? The answer is multi-faceted. In the legislative process that occurred from 1973 to the passage of the Bankruptcy Reform Act of 1978, the goal

[4] See Douglas G. Baird and Robert K. Rasmussen, "The End of Bankruptcy," 55 Stan. L. Rev., 751, 753 (2002).

of rehabilitation of distressed debtors was the primary rationale to support the need for business reorganization reform legislation. Subsequent to the enactment of the Bankruptcy Reform Act, and during the mid to late 1980s, a new and often conflicting theme began to emerge in response to the belief of special interest groups that chapter 11 cases were weighted in favor of debtors. This theme emphasized as a prime objective of chapter 11, the maximization of creditor recoveries. While it could be argued that the objectives are not mutually exclusive, the effort to give primacy to creditor recoveries has given rise to confusion in the chapter 11 process. Thus, chapter 11, more often than not, is used as a means to validate and sterilize the sale of a debtor's assets. This is accomplished by the use of section 363(b) of the Bankruptcy Code to effect a expeditious sale of all or substantially all of the debtor's assets, early in the case, to expedite distributions, essentially, to secured creditors. The process provides early gratification of the secured creditors and gives buyers the benefit of asset sales that are blessed by a court and, often, are free and clear of liens, encumbrances and claims pursuant to section 363(f) of the Bankruptcy Code.

The chapter 11 process, as contemplated in 1978, has been overwhelmed by marginalization of the debtor in possession, expansion of creditor (particularly secured creditor) control, the increasing imposition of creditor-designated chief restructuring officers (CROs), claims trading, more complex debt and organizational structures, and short-term profit motivation. Resultantly, an objective of a successful rehabilitation, the preservation of going-concern value and the emergence of a rehabilitated stand-alone debtor, has been eclipsed in most cases.[5]

[5] Of course, there are always exceptions that prove the rule. Those exceptions involve cases dealing with sick, old-line asset-based industries or businesses beset by mass tort litigation or organized labor issues, and pension and employee benefits liabilities.

The 1978 Bankruptcy Code was intended to be flexible legislation to meet the needs of a debtor confronting economic distress and default, as well as serve the interests of all those affected by business failure, including the debtor, creditors, employees, the community in which the debtor operated, and the public interest. The reorganization provisions of the Bankruptcy Code were enacted to deal with the reluctant debtor by providing inducements to initiate formal reorganization cases before the debtor's assets had been dissipated and the possibility of reorganization minimized, as had occurred under the former Bankruptcy Act. To achieve that objective, Congress enacted the administrative provisions of the Bankruptcy Code, which provided protections for the debtor, including the automatic stay, the ability to use, sell or lease property, including cash collateral and other collateral security of a secured creditor, the ability to assume or reject executory contracts and unexpired leases of non-residential real property, and, importantly, the ability to obtain credit and offer to lenders material enhancements for lending to a debtor in possession.

In 1978, Congress intended that the debtor in possession would be the driving force of a chapter 11 reorganization. Supported by a fair but sympathetic bankruptcy court, the debtor/debtor in possession did become the leading actor in the chapter 11 reorganization scenario during the 1980s, to a point that it created a backlash from creditors. The hue and cry went out that bankruptcy courts were debtor-oriented and every benefit of the doubt went to the debtor. That situation did not prevail for very long. The drive to make chapter 11 more inviting to distressed debtors was inadequate to eliminate all special interest legislation. Despite valiant efforts by reformers, section 1110 of the Bankruptcy Code carried forward from the former Bankruptcy Act, special protections for sellers, financiers and lessors of certain types of equipment relating to aircraft and vessels. Using that piece of special interest legislation as a

foundation, other creditor groups pressed Congress for legislative containment of the bankruptcy court and the powers of the debtor/debtor in possession. Congress responded generously to the "needs" of these special interest groups.

The clawback of debtor protection provisions began. Virtually every group with an effective lobbyist came forward and was able to obtain special interest legislation that included protections for personal property equipment lessors, commercial property owners, shopping center owners and lessors, financial institutions, government agencies, unions, and retirees, to name just a few.

The biggest special interest victory is the ill-conceived BAPCPA. While it is primarily directed at consumer bankruptcies, BAPCPA contains provisions relating to chapter 11 reorganizations and affects the delicate balance between the interests of debtors and creditors that are the essence of reorganization. Among them are the mandatory cap on a debtor's exclusive period to file a plan of reorganization; enhanced protections for trade and reclamation creditors; a mandatory cap on the period within which to assume or reject unexpired leases of non-residential real property; expanded protection for utilities; and the mandatory appointment of a chapter 11 trustee in certain circumstances as well as the relaxation of the ability to recover voidable preferences, among others.

BAPCPA fulfilled a long-standing desire on the part of special interest groups to limit the discretion of the bankruptcy court and thereby reduce the flexibility of the court to meet the needs of rehabilitation and reorganization of a debtor. Complimenting the extended adoption of special interest legislation has been the emergence of coercive debtor in possession financing under section 364 of the Bankruptcy Code, that has been aggravated by the current credit crunch.

The Effect Of The Changing Economic Environment And The Bankruptcy Code Amendments On Circuit City That Doomed Its Reorganization

The contraction of unsecured credit.

The retail reorganization cases of the 1980s and 1990s, including those of Federated Department Stores and R.H. Macy & Co., among others, involved the restructuring of large amounts of unsecured credit. A good portion of unsecured credit represented the claims of vendor/suppliers who populated the creditors' committees in those cases. Such creditors had an abiding interest in the reorganization of the retail chain so that they would have a continuing customer. As globalization progressed and the search for cheaper production costs drove production of goods offshore, the nature of the supplier chain changed. More and more domestic producers went out of business. The vendor/supplier community was offshore and merchandise inventory increasingly came from foreign sources that required letter of credit financing. The result was (a) the diminishment of the long-standing vendor/supplier relationship that actively supported the survivorship of its customer, and (b) the loss of a large creditor constituency favoring reorganization over liquidation.

The emergence of secured inventory financing.

In the retail reorganization cases of the 1980s and 1990s, the retailers' merchandise inventories, generally, were unencumbered and represented a major tangible asset to enable the retailer to obtain attractive credit terms from its vendor suppliers. Retailers rejected requests by lenders for liens against their merchandise inventory on the grounds that if the liens were granted, they would not be able to get adequate vendor supplier credit. As the effects of globalization and the changes in the supply chain occurred, *supra*, that argument fell on deaf ears, particularly as retailers increased their borrowings and leverage ratios to support expansion.

As a consequence, by the beginning of the instant economic crisis for retailers, starting in 2007, generally retailers had granted liens and encumbrances against their merchandise inventories to their lenders. This changed the dynamic in the relationship between the lender, usually a syndicate of financial institutions, and the retailer. Customer/banker relationships had likewise changed. Many financial institutions that had previously worked with a debtor in the effort to rehabilitate and reorganize a retail customer no longer maintained that type of relationship and support, and were often compelled to write down the value of distressed loans and, sometimes, dispose of the loans.

As secured lenders, the financial institutions and the members of lender syndicates adopted a more distant and shorter term relationship with the retail debtor, they became more focused upon realizing recoveries from their collateral security. Most financial institutions look at a retailer's merchandise inventory as being liquid, i.e., easily convertible into dollars. In that context, the financial institutions are not interested in a long chapter 11 reorganization case. They are interested in a quick recovery and exit from the chapter 11 process. Because the financial institutions, generally, have liens against the merchandise inventory and all other assets of the borrower, such as Circuit City, the ability of the borrower to obtain alternative financing to support a rehabilitation process under chapter 11 is extremely limited. The ability to prime the existing secured creditor under section 364(d) of the Bankruptcy Code is more illusory than real.

Consequently, the only source of financing is the pre-chapter 11 lender. In the case of Circuit City, the lenders' syndicate led by the Bank of America. From the perspective of the Bank of America syndicate, as stated, its objective was to get paid, with interest, costs and fees. The primary source for its quick recovery was the proceeds from the merchandise

inventory. Therefore, the bank had to consider how that merchandise inventory could be converted into dollars. The inventory-secured lender does not want the merchandise inventory. It wants dollars. To obtain dollars, the inventory has to be liquidated in place, i.e., in the store locations. Pursuant to section 365(d)(4)(B) of the Bankruptcy Code, Circuit City had a maximum of 210 days from the filing date of its chapter 11 case to assume or reject the unexpired leases of non-residential real property, i.e., the approximately 700-800 retail store locations. The liquidation of the merchandise inventory takes a substantial amount of time. As a result, the Bank of America and other similarly situated secured lenders want to be sure that there is adequate time to use the store locations to liquidate the merchandise inventory and obtain the full recovery of their loans.

In those situations, lenders such as the Bank of America who become debtor in possession financiers often impose conditions of that financing that require refinancing by date certain or the commencement of liquidation of the borrower's assets and, particularly, the merchandise inventory to ensure that such is completed before the retailer must reject or otherwise vacate the retail store locations.

Debtor In Possession (DIP) Financing.

Major chapter 11 cases require debtor in possession financing. The ability to use cash collateral under section 363(c) is limited and often vigorously opposed. Section 364 was incorporated into the Bankruptcy Code to induce lenders to extend credit to a debtor in possession or a trustee. Since 1978, secured financing has become predominant. As a consequence, a debtor's options for financing are limited. In the case of Circuit City, essentially, there was only one source of debtor in possession financing, i.e., the Bank of America syndicate. Generally, the financing of a chapter 11 case by the pre-chapter 11 secured creditors is

characterized as "defensive DIP financing." The term is a misnomer. Financings by pre-chapter 11 secured creditors have become offensive.

Negotiations over DIP agreements tend to be one-sided, with lenders structuring agreements to enhance influence and control. Most DIP agreements take the form of a revolving credit facility and, currently, more usually a term loan. The agreements will include regular reporting requirements to allow the lenders to frequently evaluate the debtor in possession's performance and to determine whether the financing should be terminated.

Despite some resistance by bankruptcy courts, DIP loan agreements may contain:

- Provisions requiring the debtor in possession to hire a CRO. CROs typically are vested with executive decision-making power, not responsible to the CEO, direct and exclusive access to a debtor's board of directors, and the ability to talk to lenders without reporting back to the debtor. CRO candidates, generally, are recommended by the lenders and must be acceptable to the lenders.

- Cash-flow covenants that are so restrictive that they can compel the sale of assets or downsizing. For example, it was argued that the management of United Airlines was compelled to terminate a good portion of its workforce and renegotiate its collective bargaining agreements in order to comply with the cash-flow requirements of its DIP agreement.

- Provisions giving the lender control over disposition of the debtor's assets.

- Drop-dead dates or terms that provides for successively lowered advances to encourage liquidation.

- Restrictive negative covenants that constrain management flexibility, as well as low threshold events of default.

- Provisions that provide for the sale of the debtor or its assets within the limited period of time.

- Provisions that subject the debtor's plan of reorganization to some form of lender control. Examples include not allowing the debtor to file a plan of reorganization without lender consent, conditioning debtor exclusivity on lender consent, requiring the file of a plan by a day certain, or specifying the contents of the plan.

- General release of all potential claims against the lender and payment of all fees and expenses of the lender.
- The payment of substantial fees and expenses, including the continuing obligations to pay the fees and expenses of the lenders' professionals without any requirement for bankruptcy court oversight.

In the cases of retailers, the control provisions are particularly troublesome because of the interaction between the DIP financing and the 210-day cap on the assumption or rejection of unexpired leases of non-residential real property. Such control provisions enable the secured creditor to take control of the reorganization process and replace the judgment and decision-making that was to be exercised by the debtor in possession with the power of domination of a self-interested creditor who uses the process to protect its interests.

The Bankruptcy Court in *In re Tenney Village Co., Inc.*, 104 B.R. 562, 567-68 (Bankr. D.N.H. 1989) was prescient. In rejecting a proposed DIP financing arrangement, it wrote:

> Under the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons usable against it for the bankruptcy estate's benefit, place the Debtor in bondage working for the Bank, seize control of the reins of reorganization, and steal or margin other creditors in numerous ways. The financing agreement would pervert the reorganization process from one design to accommodate all classes of creditors and equity interests to one specifically craft for the benefit of the Bank and the Debtor's principals who guaranteed its debt. It runs roughshod over numerous sections of the Bankruptcy Code. Under its rights of approval and supervision, the Bank would in effect operate the Debtor's business.

Finally, the costs of DIP financing are prohibitive. In the case of Circuit City, it appears that the DIP financing, which included a roll-up of the pre-chapter 11 outstanding loan balance, only provided Circuit City with a very limited amount of new money, probably in the area of $200 million, despite a face amount of the DIP financing of approximately $1.2 billion. The approximately $800 million of pre-chapter 11 indebtedness was simply rolled into the DIP

financing to become a cost and expense of the chapter 11 administration that would have to be satisfied at confirmation of any plan of reorganization. In addition, the DIP loan agreement restricted the extent to which Circuit City could draw on the loan facility. Nonetheless, Circuit City was required to pay fees based upon the face amount of the DIP loan facility, probably at an enhanced interest rate on that amount. Generally, DIP financing imposes an interest rate based upon LIBOR plus 1,000 bps. Usually a floor is stated for LIBOR, e.g. 3%. As a result, the effective interest rate will be in the teens. Interestingly, DIP financings are viewed as low-risk loans, yet they carry the highest interest rates, which together with additional costs and fees may preclude rehabilitation and reorganization. It has been reported that the fees and expenses paid by Circuit City for the approximately $200 million of new money, totaled approximately $44 million. The potential new money likely was inadequate to support the reorganization effort of Circuit City.

Claims Trading.

In 1991 the Federal Rules of Bankruptcy Procedure were amended to eliminate any meaningful restriction on the trading of claims against a debtor. The rationale was to provide liquidity to the holders of claims. The result has been a very active market in bankruptcy claims by distressed debt traders and hedge funds. In major cases, claims change hands with great rapidity. Debt is a saleable commodity.

Distressed debt traders and hedge funds have different objectives than those of vendor/suppliers. They are motivated by quick and sizeable returns on their investment. Because their entry price usually is much lower than the face amount of the acquired debt, they are more apt to favor the sale and dismemberment of a debtor, if it will yield faster and greater recoveries based upon the costs of purchasing claims. Unless they are extending loans to own

the debtor, a process that gained some favor in the mid-2000s, there is little or no interest in the rehabilitation of the debtor. In the case of Circuit City, it well may be that claims of the Bank of America syndicate were traded and, perhaps, acquirors took aggressive actions to have the Bank of America compel or influence the early termination of operations and the abandonment or the reorganization effort.

Conclusions

It is unfortunate that over 34,000 jobs have been lost as a result of the failure of Circuit City. Retailers are often the employer of last resort for a significant portion of the working population. I have been told that approximately 223,000 retail jobs were lost during 2008. I believe there only remain about 479,000 retail jobs in the United States. Undoubtedly, given the current economic circumstances, there will be more retail restructurings and, probably, retail chapter 11 cases. They will not be successful unless Congress takes remedial action to:

- Amend section 365(d)(4)(B) to remove the limit on the period within which a debtor in possession may assume or reject unexpired leases of non-residential real property. The Bankruptcy Code requires the lessee during the period to comply with the terms and provisions of the lease and to pay the rents required under the lease. Removal of the 210-day limitation will not prejudice lessors. Bankruptcy courts have been considerate and receptive to lessors who require early decisions as to assumption or rejection when necessary.

- Explore the enactment of enabling legislation during this economic crisis to provide debtor in possession financing for distressed businesses on reasonable terms and provisions while limiting the exercise of remedial rights by existing secured creditors.

- Explore means to limit the negative effects of excessive claims trading that hinder the ability to reorganize distressed businesses.

- Revisit the provisions of BAPCPA that tend to drain operating capital out of retail debtors in possession, such as section 366 (utility deposits), sections 503(b)(9) and 546(c) of the Bankruptcy Code.

- Restore to bankruptcy courts discretion to consider extensions of the time within which to assume or reject executory contracts and unexpired leases of non-residential real property and the exclusivity of a debtor to file a proposed plan of reorganization.

I appreciate the opportunity extended by the Subcommittee to testify in this hearing. I also subscribe to the testimony of Isaac M. Pachulski on behalf of the National Bankruptcy Conference.

The *Catapult* Conundrum

Stephen S. Mitchell
U.S. Bankruptcy Judge
Eastern District of Virginia

Statutory Text:

11 U.S.C. § 365. Executory contracts and unexpired leases

* * *

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment.

Issue:

Whether the statutory restriction on a trustee's assumption *or* assignment of a traditionally non-assignable contract (such as a personal services contract, federal government contract, or patent license) means that a debtor in possession may not perform and claim the benefit of the contract even though it has no intention of assigning it?

Majority View ("The Hypothetical Test"):

Relying on a strict construction of the Bankruptcy Code, the majority of courts at the circuit level to have considered the issue have concluded that a contract that under applicable nonbankruptcy law cannot be assigned likewise cannot be assumed. This reading – sometimes referred to as the "hypothetical test" – has been adopted by the following courts of appeal:

- *In re West Electronics., Inc*. 852 F.2d 79 (3d Cir. 1988) (Holding that chapter 11 debtor could not assume a federal government contract to supply missile launcher supply units to Air Force and government was therefore entitled to relief from the automatic stay to terminate the contract).

- *In re James Cable Partners*, 27 F.3d 534 (11th Cir. 1994) (Holding that if state law excused city from accepting performance of cable television franchise

agreement from party other than debtor, chapter 11 debtor was barred from assuming it in plan, but remanding for determination whether applicable non-bankruptcy law (other than the ordinance granting the franchise) actually barred assignment)

● *In re Catapult Entertainment*, *Inc.*, 165 F.3d 747 (9th Cir. 1999) (Chapter 11 plan could not assume non-exclusive patent license over licensor's objection).

● *In re Sunterra Corp*., 361 F.3d 257 (4th Cir. 2004) (Chapter11 debtor in possession could not assume nonexclusive licence of copyrighted software even if it did not intend to assign the license.)

Minority View ("The Actual Test"):

Only one circuit court (supported, however, by a respectable number of lower court opinions)[1] have held that assumption is barred only if there is an actual intent to assign the contact.

Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997), *cert. denied* 117 S.Ct. 2511, 138 L.Ed.2d 1014 (1997) (Holding that chapter 11 plan could assume patent license even though plan provided for debtor's stock to be sold to a direct competitor of the patent holder.)

Recent Ruling and Missed Opportunity for Supreme Court Review:

Recently, the Supreme Court declined the opportunity to resolve the split. *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc*., 556 U.S. — (March 23, 2009).

N.C.P. Marketing was a petition for certiorari to review a one-sentence summary affirmance by the U.S. Court of Appeals for the 9th Circuit of a district court opinion holding that under federal trade-mark law, a trade-mark license was non-assignable and that under *Catapult*, the licensor was entitled to an order compelling the chapter 11 debtor to reject the license. *In re N.C.P. Marketing Group, Inc.*, 337 B.R. 230 (D. Nev. 2005), *aff'd* 279 Fed.Appx. 561 (9th Cir. 2008).

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[1] *See, e.g.*, *In re Cajun Elec. Power Coop., Inc*., 230 B.R. 693 (Bankr. M.D. La. 1999); *Texaco Inc. v. Louisiana Land & Expl. Co.*, 136 B.R. 658 (M.D. La. 1992); *In re GP Express Airlines, Inc.*, 200 B.R. 222 (Bankr. N. Neb. 1996); *In re Am. Ship Bldg. Co.*, 164 B.R. 358 (Bankr. M.D. Fla. 1994); *In re Hartec Enters., Inc*., 117 B.R. 865 (Bankr. W.D. Tex. 1990), *vacated on other grounds*, 130 B.R. 929 (W.D. Tex. 1991)*; In re Cardinal Indus., Inc.*, 116 B.R. 964 (Bankr. S.D. Ohio 1990).

In explaining the denial of certiorari to review the ruling, Justices Kennedy and Breyer noted the importance of the issue but suggested that the case did not offer a clean vehicle for resolving the "hypothetical" versus "actual" split because that issue could not be reached without first resolving the antecedent issue of whether a trademark license was non-assignable as a matter of federal trademark law. As they explained:

> One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code's text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the nondebtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the nondebtor obtains the power to reclaim—and resell at the prevailing, potentially higher market rate—the rights it sold to the debtor.
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> The division in the courts over the meaning of §365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization. This petition for certiorari, however, is not the most suitable case for our resolution of the conflict. Addressing the issue here might first require us to resolve issues that may turn on the correct interpretation of antecedent questions under state law and trademark-protection principles. For those and other reasons, I reluctantly agree with the Court's decision to deny certiorari. In a different case the Court should consider granting certiorari on this significant question.