Hot Issues in Chapters 7 and 13

CONCURRENT SESSION

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I. Introduction

The equitable doctrines of *in pari delicto* and judicial estoppel are asserted by defendants (or putative defendants) attempting to limit the ability of a debtor or a bankruptcy trustee to pursue claims against third parties. The application of the affirmative defense of *in pari delicto* impacts a trustee's ability to litigate claims against those who contributed to the demise of a debtor and to recover on such claims for the benefit of innocent creditors. Judicial estoppel prevents a debtor from pursuing a claim that was not disclosed in the bankruptcy prior to discharge.

II. *In pari delicto*

The equitable doctrine of *in pari delicto* is a common-law maxim that refers to a plaintiff's participation in the same wrongful conduct as the defendant. "The purpose of the *in pari delicto* doctrine is to deter future misconduct by denying relief to one whose losses were substantially caused by his own fraud or illegal conduct." *Pantely v Garris, Garris & Garris, P.C.*, 180 Mich.App. 768, 447 N.W.2d 864 (1989). The principle underlying this doctrine is that courts will not aid a plaintiff whose cause of action is based upon an illegal act. "A plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing." *Kapila v Bennett (In re Pearlman)* (Bankr. M.D. Fla. 2012). In other words, *in pari delicto* prevents a plaintiff from recovering damages when the plaintiff and defendant have participated equally in the illegal conduct that precipitated the lawsuit. The remedy employed by courts is to not provide relief to either party and simply leave them as they are. When applied in a bankruptcy proceeding, the affirmative defense of *in pari delicto* prevents a trustee from pursuing a claim against a culpable third party on the basis that the illegal conduct of the debtor must be imputed to the trustee.

Section 541(a)(1) of the Bankruptcy Code provides that property of the debtor estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." These "legal or equitable interests" include any causes of action the debtor may have. *Official Comm. of Unsecured Creditors of PSA, Inc., et al. v Edwards*, 437 F.3d 1145 (11th Cir. 2006) *(*citing *Official Comm. of Unsecured Creditors v R.F. Lafferty & Co.*, 267 F.3d 340 (3rd Cir.2001)). The Bankruptcy Code confers standing upon a trustee to file any suit that a debtor could have filed outside of bankruptcy. 11 U.S.C. § 323. However, any claim filed by a trustee is subject to the same affirmative defenses that could have been asserted against the debtor. *See Edwards*, *supra* at 1150.

In *Edwards, supra*, the U.S. Court of Appeals for the Eleventh Circuit opined that the bankruptcy trustee is subject to the same defenses that were available against the debtor. Among those defenses is *in pari delicto*. The debtor in *Edwards* operated a massive Ponzi scheme and defrauded thousands of investors. The trustee filed suit against several defendants claiming they aided the debtor in defrauding the investors; in turn, the defendants asserted the defense of *in pari delicto*. Relying on legislative history to the Bankruptcy Code, the trustee argued that the *in pari delicto* defense was not available because it was dependent on the personal malfeasance of the debtor and as a consequence, was not effective against the estate. The trustee further argued that "his recovery would ultimately inure to the benefit of innocent creditors instead of the wrongful debtor. . ." *Edwards, supra* at 1151.

The Court disagreed with the trustee and dismissed his suit. In dismissing the suit, the *Edwards* Court reasoned:

> A bankruptcy trustee stands in the shoes of the debtor and has standing to bring any suit that the debtor could have instituted when the debtor filed for bankruptcy, and there is no suggestion in the text of the Bankruptcy Code that the trustee acquires rights and interests greater than those of the debtor. . .If a claim of [the

> debtor] would have been subject to the defense of *in pari delicto* at the commencement of the bankruptcy, then the same claim, when asserted by the trustee, is subject to the same affirmative defense.

The *Edwards* case was a matter of first impression for the Eleventh Circuit, but it relied on the opinions of other circuits in concluding that the defense of *in pari delicto* could be asserted against a bankruptcy trustee. The Sixth Circuit's decision in the case of *Terlecky v Hurd (In re Dublin Sec.)*, 133 F.3d 377 (6th Cir. 1997) was one of the opinions relied upon by the Eleventh Circuit.

In *Terlecky v Hurd*, the trustee disputed application of the doctrine of *in pari delicto*, arguing that it was against public policy and that it wasn't the corporate debtors who were at fault, but the individuals who operated the businesses. The Court of Appeals disagreed and upheld the district court's dismissal of the claims pursuant to *in pari delicto*. The Court reasoned as follows:

> Neither of these two arguments is sufficient, however, to foreclose use of *in pari delicto* principles in a case such as this. First, by dismissing the trustee's suit against the attorneys and law firms, the district court did not insulate the defendants from all civil liability. In fact, as the court noticed judicially, the defendants here are also named as defendants in other actions filed by the creditors seeking compensation for the allegedly fraudulent activity in which the defendants engaged.
>
> Also, while the trustee argues that the individual officers of the debtors acted adversely to the corporate interest and that their wrongdoing should not, therefore, be imputed to the corporate entity, he recognizes "that the officers and directors so dominated and controlled the corporation that the corporation had no separate mind, will, or existence of its own." Consequently, the officers and directors were the "alter egos" of the debtor corporations and any malfeasance on their parts is directly attributable to the debtors themselves.

Courts in the Sixth Circuit, however, have not always upheld the application of *in pari delicto* against trustees. In the case of *Terlecky v Abels*, 260 B.R. 446 (S.D. Ohio 2001), the district court drew a distinction between the trustee standing in the debtor's shoes versus the

shoes of an innocent creditor in deciding not to apply the defense of *in pari delicto*. The court concluded that the doctrine of *in pari delicto* did not preclude the trustee from pursuing a fraudulent conveyance claim. The court reasoned that the trustee did not stand in the shoes of the wrongdoing debtors seeking to recover property supposedly owed to the estate. Rather, the trustee stood in the shoes of a creditor who had standing to pursue a fraudulent conveyance claim. The trustee was not barred by *in pari delicto* because the fraudulent conveyance claims fell under the trustee's avoidance powers in the Bankruptcy Code. The Second[1] and Third[2] Circuits, as well as Florida bankruptcy courts, have likewise concluded "that the *in pari delicto* defense is inapplicable when a trustee brings an action under sections 544(a), 544(b), or 548, but the defense applies under section 541." *Tolz v. Proskauer Rose LLP (In re Fuzion Technologies Group, Inc.*), 332 B.R. 225 (Bankr. S.D. Fla. 2005).[3]

As explained by the district court in *Terlecky v Abels*, actions by bankruptcy trustees fall under two categories. "The first involves claims brought by the trustee as successor to the debtor's interest. The second involves claims brought under one or more of the trustee's avoiding powers." *Id.* at 453. With respect to the first category, the trustee stands in the shoes of the debtor and as a consequence, can only assert claims available to the debtor and the trustee is subject to the same affirmative defenses that could be raised against the debtor's claims. As for the second category, when the trustee stands in the place of a creditor who would have standing to pursue a fraudulent conveyance under state law, *in pari delicto* does not bar the trustee from pursuing those claims. *Id.* at 453.

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[1] See *Podell & Podell v. Feldman (In re Leasing Consultants, Inc.*), 592 F.2d 103 (2nd Cir. 1979)

[2] See *McNamara v PFS (In re Personal & Bus. Ins. Agency)*, 334 F.3d 239 (3rd Cir. 2003)

[3] See also *Kapila v Bennett (In re Pearlman)* (Bankr. M.D. Fla. 2012)

In another case, the Sixth Circuit declined to apply *in pari delicto* against the trustee because he had filed his claim as an ERISA fiduciary and not as a bankruptcy trustee. *McLemore v Regions Bank*, 682 F.3d 414 (6th Cir. 2012). In clarifying the trustee's role in this case, the court stated:

> The Trustee sues as an ERISA fiduciary representing the plans' interests, rather than as a bankruptcy trustee suing to enlarge the debtor's estate. Any funds that the Trustee recovers as an ERISA fiduciary inure to the ERISA plans' benefit, rather than to the benefit of the estate's creditors. For the purposes of the Trustee's ERISA claim, therefore, he "steps into the shoes" of the plans, rather than those of the criminal debtors. Though the doctrines may bar suit where a bankruptcy trustee seeks to enlarge the estate of a wrongdoing debtor, this case presents a different scenario: the Trustee's claims exist between the victims of the wrongdoing the plans and an alleged wrongdoer.

The Court also noted that the application of equitable doctrines such as *in pari delicto* is limited to the purpose it is intended to serve. To discern the intended purpose, federal courts defer to the common law. In Michigan, as in most states, the purpose of the *in pari delicto* doctrine is rooted in public policy and bars recovery by a plaintiff when he is equally at fault for the wrongdoing. The Michigan Supreme Court discussed this doctrine in the case of *Orzel v Scott Drug Company*, 449 Mich. 550, 537 N.W.2d 208 (1995):

> When a plaintiff's action is based on his own illegal conduct, and the defendant has participated equally in the illegal activity, a similar common-law maxim, known as the "doctrine of *in pari delicto*" generally applies to also bar the plaintiff's claim:
>
> [A]s between parties *in pari delicto*, that is equally in the wrong, the law will not lend itself to afford relief to one as against the other, but will leave them as it finds them. *Orzel* citing 1A CJS, Action, § 29, p. 388.

The doctrine of *in pari delicto* is often discussed in conjunction with Michigan's "wrongful-conduct rule" and remains viable in Michigan even after the advent of pure comparative negligence. *Ameriwood Industries International Corporation v Arthur Andersen & Co.*, 961 F. Supp. 1078 (W.D. Mich. 1997). While still viable, Michigan does recognize

exceptions to the bar of *in pari delicto* such as varying degrees of guilt and public policy considerations. The Michigan Court of Appeals discussed these exceptions in the *Pantely, supra* case:

> And indeed in cases where both parties are in delicto concurring in an illegal act, it does not always follow that they stand in pari delicto; for there may be and often are, very different degrees in their guilt. One party may act under circumstances of oppression, imposition, hardship, undue influence, or great inequality of condition or age; so that his fuilt may be far less in degree than that of his associate in the offense. And besides, there may be on the part of the court itself a necessity of support the pubic interest or public policy in many cases, however reprehensible the acts of the parties may be. Citing 1 Story, Equity Jurisprudence (14th ed), Sec. 423, pp. 399-400.

In a recently filed amicus curiae brief[4], the National Association of Bankruptcy Trustees (NABT) argued that the doctrine of *in pari delicto* should not bar claims brought by trustees pursuant to § 541, partly because it is against public policy and inequitable. There is a significant public policy interest in allowing trustees to sue culpable third parties who helped bring about the debtor's demise. Such third parties are often professionals employed by the debtor, such as accounts, attorneys, and auditors, who could have prevented the misconduct. Allowing a trustee to pursue such claims would act as a means to deter similar future misconduct. As noted by the court in *Fuzion, supra* at 234, since the doctrine of *in pari delicto* is

[4] *Brief of Amicus Curiae National Association of Bankruptcy Trustees in Support of Appellant USACM Liquidating Trust and Reversal*, filed in the case *USACM Liquidating Trust v Deloitte v Touche, LLP*, case no. 11-15626 in the U.S. Court of Appeals for Ninth Circuit.

"founded on public policy, it may give way to a supervening public policy." The *Fuzion* court, referencing the Ninth Circuit's decision in *FDIC v. O'Melveny & Myers*[5] after remand from the Supreme Court, summed it up nicely when it reasoned:

> While a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver, or similar innocent entity that steps into the party's shoes pursuant to court order or operation of law. Moreover, when a party is denied a defense under such circumstances, the opposing party enjoys a windfall. This is justifiable as against the wrongdoer himself, not against the wrongdoer's innocent creditors.

Another important public purpose served by a bankruptcy trustee is marshaling the assets of the estate and distributing them among the creditors as mandated by 11 U.S.C. § 704(a)(1). In order to accomplish this task, it is often necessary for trustees to sue culpable third parties. Barring those claims based on *in pari delicto* thwarts a trustee's efforts and results in a loss of assets that could have been distributed among innocent creditors.

III. Judicial Estoppel

"Judicial estoppel is an equitable concept invoked at a court's discretion and designed to prevent the perversion of the judicial process." *Parker v Wendy's International, Inc.*, 365 F.3d 1268 (11th Cir. 2004)[6]. In the Sixth Circuit, "judicial estoppel bars a party from (1) asserting a position that is contrary to one that the party has asserted under oath in a prior proceeding, where (2) the prior court adopted the contrary position either as a preliminary matter or as part of a final disposition." *Browning v Levy*, 283 F.3d 761 (6th Cir. 2002). In the bankruptcy context, judicial

[5] *FDIC v O'Melveny & Myers,* 61 F.3d 17, 19 (9th Cir. 1995).

[6] See also *New Hampshire v Maine*, 532 U.S. 742, 121 S.Ct. 1808, 149 L.Ed.2d 968 (2001).

estoppel prevents a debtor from pursuing a cause of action that was not disclosed in the debtor's schedules or disclosure statements. *Hamilton v State Farm Fire & Casualty Co.*, 270 F.3d 778 (9th Cir. 2001). Judicial estoppel, however, "must be applied in such a way as to deter dishonest debtors, whose failure to fully and honestly disclose all their assets undermines the integrity of the bankruptcy system, while protecting the rights of creditors to an equitable distribution of the assets of the debtor's estate." *Reed v City of Arlington*, 650 F.3d 571 (5th Cir. 2011).

While courts seem ready, willing and able to apply judicial estoppel against debtors who fail to disclose a pending or potential pre-petition cause of action, several circuits have declined to apply the doctrine against the trustee. The Eleventh, Tenth, Seventh and Fifth Circuits have all held (or at least suggested) that a bankruptcy trustee can pursue an unscheduled or otherwise undisclosed judgment or cause of action for the benefit of creditors.

In *Reed*, the debtors concealed a sizeable judgment that had been awarded to the debtor husband prior to his jointly filed bankruptcy case. The Fifth Circuit Court of Appeals determined that the debtors were judicially estopped from collecting the judgment due to their failure to schedule it as an asset or otherwise disclose it. The trustee, however, was not judicially estopped and could pursue collection of the judgment for the benefit of the creditors. The Court concluded that while the debtor "was properly estopped for his dishonesty, his post-petition misconduct [did] not adhere to the Trustee, who received the judgment asset free and clear of a defense that arose exclusively from [the debtor's] post-petition actions." *Id.* at 574.

Like the debtors in *Reed*, the debtor in *Parker, supra* failed to list a pre-petition discrimination lawsuit in her bankruptcy schedules. The Eleventh Circuit concluded that the debtor's unscheduled cause of action belonged not to the debtor, but to the bankruptcy estate and the trustee. As a consequence, the trustee was the real party in interest and as such, was not

judicially estopped from pursuing the claim. The Court concluded that the trustee was neither tainted nor burdened by the debtor's dishonest conduct of failing to disclose her lawsuit.

In support of the conclusions reached in those cases, both the *Reed* court and the *Parker* court noted that pre-petition causes of action are property of the bankruptcy estate. 11 U.S.C. § 541(a)(1). For this reason, it is the trustee, not the debtor, who is the real party in interest and the only one with standing to pursue claims belonging to the estate. Both courts also pointed out that unscheduled property remains property of the estate even after the case has been closed. 11 U.S.C. § 544(d); *see also Lopez v. Specialty Restaurants Corp. (In re Lopez*), 283 B.R. 22 (9th Cir. BAP 2002). "Failure to list an interest on a bankruptcy schedule leaves that interest in the bankruptcy estate." *Parker, supra.*

In suggesting that the trustee should be able to pursue a claim that the debtor would otherwise be judicially estopped from pursuing, the Seventh Circuit stated:

> Judicial estoppel is an equitable doctrine, and using it to land another blow on the victims of bankruptcy fraud is not an equitable application. Instead of vaporizing assets that could be used for the creditors' benefit, district judges should discourage bankruptcy fraud by revoking the debtors' discharges and referring them to the United States Attorney for potential criminal prosecution.

Biesek v Soo Line Railroad Company, 440 F.3d 410, 413 (7th Cir. 2006). The Court reasoned that the debtor's pre-bankruptcy claim was part of the estate and belonged to the trustee, not the debtor. The Court further noted that "decisions that have relied on judicial estoppel assume that the tort claim belongs to the debtor." *Id.* The Court questioned this assumption and reiterated that "pre-bankruptcy claims are party of debtors' estates." As property of the estate and not the debtor, judicial estoppel would not be the appropriate remedy.

The Tenth Circuit in *Eastman v Union Pacific Railroad Company*, 493 F.3d 1151 (10th Cir. 2007) also suggested that "the district court's application of judicial estoppel against the

trustee was inappropriate, at least to the extent [the debtor's] personal injury claims were necessary to satisfy his debts. *Id.* at 1155 n. 3. The Court so reasoned because "the trustee as the real-party-in-interest had not engaged in contradictory litigation tactics." *Id.*

IV. Conclusion

The equitable doctrines of *in pari delicto* and judicial estoppel serve a legitimate public policy when applied against debtors who have acted illegally or have knowingly concealed an asset. Such illegal or dishonest conduct on the part of a debtor clearly undermines the integrity of our judicial system. However, when these doctrines are applied against bankruptcy trustees, one can argue that no such legitimate public policy is served. Several circuits are of the opinion that it is inequitable to employ these doctrines against trustees as it only results in injury to creditors.

Trustees are statutorily bound to "collect and reduce to money the property of the estate for which such trustee serves..." 11 U.S.C. § 704(a)(1). Applying *in pari delicto* and judicial estoppel against a trustee significantly frustrates this statutory obligation and diminishes assets that would have otherwise been available for distribution among innocent creditors. *In pari delicto* and judicial estoppel contradict the ends the bankruptcy system seeks to achieve when these doctrines are applied to trustees. These ends are an equitable distribution of the estate among creditors. Often times, the only way to achieve an equitable distribution is to pursue a cause of action against a third party. When a trustee is prevented from pursuing such claims as the result of *in pari delicto* or judicial estoppel, the ends the system seeks to achieve are thwarted and assets go uncollected.

Are Those Taxes Discharged?—The Other Hanging Paragraph

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I. According to 11 U.S.C. §523(a)(1)(B), tax liabilities are not subject to discharge if the debtor fails to file a return or the debtor filed a late return within 2 years of filing bankruptcy.

a. 11 USC § 523 - Exceptions to discharge

(a) A discharge under section 727, 1141, 1228 (a), 1228 (b), or 1328 (b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507 (a)(3) or 507 (a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, or equivalent report or notice, if required—

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

b. Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), the Bankruptcy Code did not provide a definition for a return, so case law filled the gap.

   i. In U*nited States v. Hindenlang (In re Hindenlang)*, 164 F.3d 1029, 1033 (6th Cir. 1999), *cert. denied*, 528 U.S. 810 (1999) the court adopted the "Beard test" which arose in *Beard v. Commissioner of Internal Revenue*, 82 T.C. 766, 777 (T.C. 1984).

   ii. The *Hindenlang* court determined that the taxpayers late filed return, which as filed after the IRS had already made its own assessment, served no purpose and therefore did not qualify as a return.

   iii. The court adopted a four part test to determine if whether a document would qualify as a return. The document must:

      a. purport to be a return;

      b. be executed under penalty of perjury;

      c. contain sufficient data to allow calculation of tax; and

      d. represent an honest and reasonable attempt to satisfy the requirements of the tax law.

II. The Other Hanging Paragraph.

a. In BAPCPA Congress provided a legislative definition of a "return", which differs from the case law definition.

b. BAPCPA provides:

> [f]or purposes of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.

c. The definition does not appear in §523(a)(1)(B), but inexplicably is contained in a paragraph with no alpha-numeric designation after §523(a)(19), which does not address taxes.

III. Post-BAPCPA Case Law.

a. The majority of courts have found that this hanging paragraph replaces the test set forth in *Hindenlang* and the decisions that have followed its holding. See *Shinn v. IRS (In re Shinn)*, 2012 Bankr. LEXIS 1218 (Bankr. C.D. Ill. 2012);

b. In *McCoy v. Mississippi State Tax Commission (In re McCoy)*, 666 F.3d 924 (5th Cir. 2012) the debtor filed a chapter 7 bankruptcy case in 2007 and received a discharge in 2008. The debtor had filed her state income

tax return late for the years 1998 and 1999. The Mississippi State Tax Commission took the position that the taxes for those years were not discharged. The debtor reopened her bankruptcy case and filed an adversary complaint in which she requested a declaration that the taxes were discharged. The Bankruptcy Court granted the Mississippi State Tax Commission's motion to dismiss and held that the late filed returns were not returns as defined by the Bankruptcy Code. The United States District Court affirmed the ruling of the Bankruptcy Court and the debtor appealed the case to the United States Court of Appeals for the 5th Circuit. The 5th Circuit affirmed the lower courts' decisions and ruled that a plain reading of the hanging paragraph indicates that a late filed return is not a "return" even though the debtor filed the returns more than two years before the filing of the bankruptcy case because the returns were not filed pursuant to the "applicable filing requirements". The Debtor filed a petition for writ of certiorari with the U.S. Supreme Court on April 2, 2012, and the Mississippi State Tax Commission filed a response on August 6, 2012.

c. The 5th Circuit cited several decisions that have interpreted the hanging paragraph in support of its ruling:

    - *Cannon v. United States (In re Cannon)*, 451 B.R. 204, 206 (Bankr. N.D. Ga. 2011) ("The cases that have addressed the impact of the undesignated paragraph added by BAPCPA to define 'return' [in § 523(a)] have concluded that a late return can

never qualify as a return unless it is filed under § 6020(a) safe harbor provision… The reasoning in those cases is persuasive.");

- *Links v. United States (In re Links*), 2009 WL 2966162, Nos. 08–3178, 07–31728, at *5 (Bankr. N.D. Ohio Aug. 21, 2009) ("The definition of 'return' under § 523(a)…necessarily encompasses the filing deadlines for submitting returns contained in the Internal Revenue Code so that a late filed return cannot qualify as a return for purposes of a dischargeability determination.");
- *Creekmore v.Internal Revenue Serv. (In re Creekmore)*, 401 B.R. 748, 751 (Bankr. N.D. Miss. 2008) ("The definition of 'return' in amended § 523(a) apparently means that a late filed income tax return, unless it was filed pursuant to § 6020(a) of the Internal Revenue Code, can never qualify as a return for dischargeability purposes because it does not comply with the 'applicable filing requirements' set forth in the Internal Revenue Code.");
- *Pansier v. Wisc. Dep't of Revenue*, 2010 WL 4025884, No. 10–C–0550, at *5 (E.D. Wis. Oct. 14, 2010) (observing that § 523(a)(*) strengthens the Seventh Circuit's pre-BAPCPA position that a late filed, post-assessment tax return cannot qualify as a return for discharge purposes).

d. Several other courts have followed the McCoy decision. See *Perry v. IRS*, 2012 Bankr. LEXIS 3808 (Bankr. M.D. AL. 2012); *Wogoman v. IRS*, 475

B.R. 239 (BAP 10th Circuit 2012); *Shinn v. IRS*, 2012 Bankr. LEXIS 1218 (Bankr. C.D. ILL 2012)

e. In *Shinn*, the court noted that the IRS was "taking an eyebrow-raising position" in which the IRS wanted the court not to follow the 5th Circuit's opinion in *McCoy*, but rather adopt the pre-BAPCPA holding of *Hindenlang* that "a 1040 is too late to be a return only if filed after the IRS has already assessed the tax liability." The court declined to adopt that position as it would amount to "judicial legislation" to accept the IRS' position due to the addition of the hanging paragraph.

IV. Safe Harbor

a. While the *McCoy* Court determined that the late filed returns, because they were not filed according to "applicable filing requirements", were not returns for discharge purposes, the 5th Circuit did recognize that the hanging paragraph contains a safe harbor provision.

b. The second sentence of the hanging paragraph states:

- [s]uch term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.

c. 26 U.S.C. § 6020(a) of the Internal Revenue Code provides:

- If any person shall fail to make a return required by this title or by regulations prescribed thereunder, but shall consent to disclose all information necessary for the preparation thereof, then, and in that case, the Secretary may prepare such return, which, being signed by such person, may be received by the Secretary as the return of such person.

d. "Section 6020(a) returns are those in which a taxpayer who has failed to file his or her returns on time nonetheless discloses all information necessary or the I.R.S. to prepare a substitute return that the taxpayer can then sign and submit.". *McCoy*, 666 F.3d 924 (5th Cir. 2012);

e. Section 6020(b) of the Internal Revenue Code provides:

- (1) Authority of Secretary to execute return—If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

  (2) Status of returns—Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.

f. "a § 6020(b) return is one in which the taxpayer submits either no information or fraudulent information, and the I.R.S. prepares a substitute

return based on the best information it can collect independently." *McCoy*, 666 F.3d 924 (5th Cir. 2012).

g. The "second sentence in [the hanging paragraph] carves out a narrow exception to the definition of "return" for § 6020(a) returns, while explaining that § 6020(b) returns, in contrast, do not qualify as returns for discharge purposes. Such a reading conforms with the plain language of the text" *McCoy*, 666 F.3d 924 (5th Cir. 2012).

V. How safe is the safe harbor?

a. The court in *Wogoman* discussed a Chief Counsel Notice issued by the IRS that sets forth "its litigation position on the dischargeability of tax liabilities" on late filed returns.

- The Notice indicated that the IRS prepares only a "minute" number of returns for taxpayer signature pursuant to §6020(a);
- The Notice stated that "'safe harbor' under §6020(a) is illusory because taxpayers have no right to demand that the IRS prepare a return for them under that provision."

ALLOCATION OF JOINT REFUNDS BETWEEN DEBTOR AND NON-DEBTOR SPOUSE AND DEFENSES TO TURNOVER OF TAX REFUNDS

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Most spouses file joint tax returns. When one spouse files bankruptcy but the other does not, issues of the allocation of tax refunds arise. Often the tax refunds are relatively small and issues concerning the portion of a joint refund which is property of the estate, and the portion that is the property of the non-filing spouse ("**NFS**"), are easily resolved. In an increasing number of cases, however, the size of the tax refunds makes these issues much more significant. Such situations often arise where one of the spouses had a business run as a sole proprietorship or through a tax "pass through" entity, such as an "S" corporation or an LLC.[2]

In the business setting, § 172 of the Internal Revenue Code allows taxpayers to carry back business net operating losses ("**NOL**") to prior years and seek refunds for taxes paid during those years. Tax refunds based on NOL carry backs are property of the bankruptcy estate. *Segal v Rochelle*, 382 U.S. 375 (1966). In the current economic downturn, many formerly profitable and taxpaying businesses are suddenly generating NOL which can be carried back to seek refunds of prior years' taxes paid and, in some cases, those refunds can be substantial. In situations where the debtor owns a "pass through" entity, the debtor and the NFS aggressively raise defenses to avoid turning over all or part of the tax refunds to the trustee. These materials discuss common defenses raised to a demand for turnover of the refunds and how tax refunds are allocated between the debtor and the NFS.

I. ENTIRETY PROPERTIES.

A. Where the debtor and the NFS file joint returns, refunds are issued by the taxing authorities, made payable jointly to the debtor and the NFS. As a result, issues arise as to whether the tax refunds are in the nature of entireties property and, therefore, exempt.

1. FEDERAL STATUTORY AUTHORITY.

[1] The author acknowledges the efforts of Rhoades McKee summer associate Timothy R. Dudley who greatly assisted in the preparation of these materials.

[2] In a "pass through" entity there is no tax at the business level, but rather the income/loss of the business is reflected on the owner's individual tax return.

(a) The statute authorizing the United States Treasury to make tax refunds, 26 U.S.C. § 6402, in pertinent part, states:

> (a) General rule.—In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c), (d), (e), and (f) refund any balance to such person. (Emphasis added).

That statute provides that the refund is the property of the person who made the tax overpayment. Providing more clarity is Rev. Rul. 74-611, 1974-2 C.B. 399, which provides:

> Joint return; overpayment credit against separate tax liability. An overpayment on a joint return filed by a husband and wife for a tax liability paid entirely by the wife may not be credited against the separate tax liability of the husband for a prior year.
>
> . . .
>
> Court decisions have consistently held that a husband and wife who file a joint return do not have a joint interest in an overpayment; each has a separate interest. See *Maragon v United States*, 153 F.Supp. 365 (Ct. Cl. 1957). For example, if one spouse goes bankrupt, only his share of the refund goes to the trustee in bankruptcy. *In re Wetteroff*, 324 F.Supp. 1365 (E.D. Mo. 1971), *aff'd*, 453 F2d 544 (8th Cor. 1972). (Emphasis added).
>
> . . .

Thus, a joint income tax return does not create new property interests for the husband or the wife in each other's income tax overpayment.

(b) The foregoing establishes that the taxing authorities do not make refunds to joint tax payers with an intent to create a tenancy by the entireties. Indeed, they provide that there is not a unity in interest between spouses. One rationale for the issuance of joint tax refund checks is explained as follows:

> The check for refund of a joint return overpayment must be endorsed by both spouses. By requiring the joint payees to endorse the check, both parties are put on notice that a refund check was issued. This informs each payee that he or she may be entitled to part or all of the fund amount.

Federal Tax Coordinator, Second Edition, ¶T-5702(d), citing *Chief Counsel Advice 201012033; Field Service Advice 200144030*.

2. **JUDICIAL AUTHORITY**.

(a) **OTHER JURISDICTIONS**.

(i) A handful of courts have considered this issue in the past two years. All have found that a joint refund was not held by the husband and wife as tenants by the entirety. The most recent of these is *Estate of Hunt v. Hunt*, No. E2011-01563-COA-R3-CV, 2012 WL 917158 (Tenn. Ct. App. March 15, 2012), which examined the question in the context of a dispute over the refund between a widow and her husband's estate. The court noted that under Tennessee law, creation of a tenancy by the entirety requires the four unities – interest, title, time and possession – and that this required an instrument of conveyance and intent to transfer the grantor's interest into entireties property. *Id*. at *7. A joint tax refund is not an instrument of conveyance. *Id*. Filing of a joint tax return also does not change the underlying nature of the funds. *Id*. at *8.

In *In re McKain*, 455 B.R. 674 (Bankr. E.D. Tenn. 2011), the court rejected the Chapter 7 debtor's argument that he and his wife held a joint tax refund as tenants by the entireties because there was not support for this claim under Virginia law. *Id*. at 686. The check did not include tenancy by the entirety language, did not refer to the couple as husband and wife, and did not include survivorship language. *Id*.

In *Direct TV, Inc. v. O'Palko*, No. AW-03-1631, 2010 WL 2991676 (D. Md. 2010) – a case involving whether a joint tax refund was subject to garnishment by one of the spouse's creditors – the district court determined a refund from a joint tax return was not held by the husband and wife as tenants by the entirety under Maryland law. *Id*. at *1. *See also In re Rice*, 442 B.R. 140, 143 (Bankr. M.D. Fla. 2010) (spouses filing a joint return have separate interests in any overpayment).

In *In re Carlson*, 394 B.R. 491, 495-96 (BAP 8th Cir. 2008), the court considered the claim of an interest in a tax refund by a spouse who did not pay any of the withholdings to which the joint income tax was attributable. The court held the spouse had no ownership interest in the tax refund and further held that the depositing of the joint refund check into a joint banking account did not transform the funds into joint property. The court noted that both the IRS and the Minnesota Department of Revenue treat a refund as credited to the taxpayer who made the overpayment of the tax. It determined that a refund based on the husband's income was not held by the spouses as tenants by the entireties. Citing *In re Wetteroff*, 453 F.2d 544 (8th Cir. 1972), *cert. denied* by *Wetteroff v Grand*, 409 U.S. 934 (1972).

(b) **MICHIGAN AUTHORITY**. In Michigan, pursuant to MCL § 557.151, certain types of personal property are given the status of entireties property, including a general catchall description of "other evidence of indebtedness."

(i) **JOINT CHECK AS "OTHER EVIDENCE OF INDEBTEDNESS"**. Arguments have been raised that in Michigan a joint check is "other evidence of indebtedness" entitling it to entireties property status. In *Jahn v Regan,* 584 F.Supp. 399 (E.D. Mich. 1984), the court noted that under Michigan law, a tenancy by the entireties can only be created in personal property by statute. With respect to MCL § 557.151, Judge Pratt rejected the plaintiffs' assertion that a joint tax refund constituted "other evidence of indebtedness."

(ii) **JOINT BANK ACCOUNT AS "OTHER EVIDENCE OF INDEBTEDNESS"**. Technically, monies on deposit in a bank account represent a debt owing from the bank to the depositor. As a result, it has been argued that a joint bank account constitutes "other evidence of indebtedness" under the Michigan statute.

Michigan courts have specifically held that certain financial holdings, such as joint bank accounts, do not constitute "other evidence of indebtedness" as used in MCL §557.151. *McMahon v. Holland*, 260 Mich. 246, 244 N.W. 462 (1932); *American National Bank & Trust Company of Michigan v. Modderman*, 37 Mich. App. 639, 195 NW 2d 342 (1972). See also *In re Carlson, supra,* at 495-96.

B. **ARE JOINT TAX REFUNDS PROTECTED AS BEING PART OF THE "MARITAL ESTATE" OF THE DEBTOR AND THE NFS?** The debtor and the NFS sometimes contend that one-half of a joint tax refund may be retained by the NFS on the grounds that it is part of the couple's "marital estate." While that argument may have more traction in a community property state, courts in non-community property states that have addressed the issue have rejected such an argument. *In re Crowson*, 431 B.R. 484 (10th Cir. BAP 2010), held that under Wyoming law, reliance on domestic relations law to determine the division of a joint tax refund was unwarranted because the policy underlying such laws is inconsistent with the policy underlying bankruptcy law. The laws of marital dissolution require a just and equitable division of the property between spouses based upon the means and needs of each, while in bankruptcy the concern is whether the debtor has a property interest that is available for distribution to creditors. An NFS might have a greater need for the debtor's property in a marital dissolution setting. *See also In re Carlson, supra,* at 495.

II. METHODS OF ALLOCATING JOINT TAX REFUNDS BETWEEN THE DEBTOR AND THE NFS.

A. FOUR BASIC METHODS.

1. THE WITHHOLDING RULE

Under the withholding rule, rights to the refund are apportioned in proportion to each spouse's tax withholdings from the relevant year.[3] Courts that follow the withholding rule reason that the return of excess payments should go to the spouse who made the payments. *See In re Carlson*, 394 B.R. 491, 494 (8th Cir. BAP 2008). This is because filing a joint tax return does not alter property rights between spouses. *In re Lyall v. Lyall*, 191 B.R. 78 (E.D. Va. 1996). The withholding rule has been criticized because it assumes overpayments are the sole cause of refunds when tax credits and quarterly estimated tax payments, which are ignored under this rule,

[3] *See In re Carlson*, 394 B.R. 491 (8th Cir. BAP 2008); *In re Kleinfeldt*, 287 B.R. 291 (10th Cir. BAP 2002); *In re Gartman*, 372 B.R. 790 (Bankr. D.S.C. 2007); *In re Edwards*, 363 B.R. 55 (Bankr. D. Conn. 2007); *In re Lock*, 329 B.R. 856 (Bankr. S.D. Ill. 2005); *In re Smith*, 310 B.R. 320 (Bankr. N.D. Ohio 2004); *In re McFarland*, 170 B.R. 613, 620 (Bankr. S.D. Ohio 1994); *In re Ballou*, 12 B.R. 611 (Bankr. D. Kansas 1981).

can also be a significant factor. *See Hundley v. Marsh*, 459 Mass. at 85 ("Ignoring the existence of credits in distributing the refund . . . produces a distorted picture of the refund's origin.").

2. THE INCOME RULE

The income rule divides rights to the refund not from withholdings but from income during the relevant year. *See In re Kestner*, 9 B.R. 334 (Bankr. E.D. Va. 1981). It has been criticized for the same reasons as the withholding rule and appears not to have been followed since the 1980s.

3. THE 50/50 RULE

The 50/50 rule is a bright-line rule that divides joint returns equally between the spouses.[4] Underlying principles include marriage as a shared partnership, equitable division of marital assets during divorce, and respect for contributions of a homemaker spouse.[5] *Hundley*, 459 Mass. at 81-82 (Mass. 2011); *In re Innis*, 331 B.R. 784, 787 (Bankr. C.D. Ill. 2005). It is also based on the fact that spouses are jointly and severally liable for the tax. *Id.* ("Attendant to the burden of tax liability should be the benefit of sharing in a tax refund."). Courts that follow this rule also rely on the fact that it is clear and easy to follow, eliminates uncertainty, reduces litigation, simplifies litigation when it is necessary, and reduces the incentive to exaggerate or fabricate evidence. *Innis*, 331 B.R. at 789-90.

Some courts that follow the 50/50 rule employ a rebuttable presumption that a joint refund is owned equally and that the presumption can be overcome by evidence demonstrating a basis for separate financial management. *See, e.g.*, *In re Barrow*, 306 B.R. 28, 31 (Bankr. W.D.N.Y. 2004); *In re Garbett*, 410 B.R. 280, 286; *In re Marciano*, 372 B.R. 211, 216 (Bankr. S.D.N.Y. 2007). Factors these courts consider include: whether bills were paid out of joint accounts, whether spouses were jointly responsible for paying bills, whether thy had any personal accounts, and how the tax refund has traditionally be used. *In re McKain*, 455 B.R. 674, 689 (Bankr. E.D. Tenn. 2011). Other courts have held that the refund should always be split equally regardless of the circumstances. *See, e.g.*, *In re Innis*, 331 B.R. at 789; *In re Glenn*, 430 B.R. 56, 62 (Bankr. N.D.N.Y. 2010).

Courts have criticized this rule by arguing that in the case of a debtor who earns all or most of a couple's income, the refunded money should be included in the bankruptcy estate, and that "there is no reason for a different result simply because the Debtor, for a short period of time, deposited his money with the government, and later filed a joint return." *In re Lyall*, 191 B.R. at 85. It has also been criticized for relying on state marital dissolution laws, whose goal is

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[4] *See In re Glenn,* 430 B.R. 56 (Bankr. N.D.N.Y. 2010); *In re Trickett,* 391 B.R. 657 (Bankr. D. Mass. 2008); *In re Marciano,* 372 B.R. 211 (Bankr. S.D.N.Y. 2007); *In re Innis,* 331 B.R. 784 (Bankr. C.D. Ill. 2005); *In re Barrow,* 306 B.R. 28 (Bankr. W.D.N.Y. 2004); *In re Hejmowski,* 296 B.R. 645 (Bankr. W.D.N.Y. 2003); *Loevy v. Aldrich (In re Aldrich),* 250 B.R. 907 (Bankr. W.D. Tenn. 2000).

[5] Services as a homemaker have been rejected as constituting "reasonable equivalent value" under 11 U.S.C. §548. *In re Kelsey*, 270 B.R. 776, 781 (10th Cir. BAP 2001).

to fairly allocate property between spouses, which may conflict with the Bankruptcy Code's goal of creating equity among the spouses' creditors. *In re Carlson, 394 B.R. at* 495, 497.

4. THE SEPARATE FILINGS RULE

The separate filings rule is the most complicated and has been adopted by only a few courts. It divides the return based on each spouse's hypothetical liability had he or she filed individually. *See Hundley*, 459 Mass at 82; *see also In re Crowson*, 431 B.R. at 490-96 (adopting IRS's method of allocating overpayments between taxpayers who file joint returns). It involves several steps: First, a court must determine each spouse's contribution to total payments, which include out-of-pocket payments such as withholdings and estimated tax payments and tax credits.[6] Second, the ratio of each spouse's hypothetical individual liability to the sum of both spouse's hypothetical individual liabilities is applied to the joint liability to determine each spouse's share. Third, each spouse's share of the joint refund is determined by the amount his or her contribution exceeded his or her share of the joint tax liability determined under step two. Some courts have rejected this rule, saying, for example, "crafting a rule that requires the parties and the courts to delve into the gnarly minutiae of hypothetical tax returns, on a case by case basis, would be a mistake." *In re Innis*, 430 B.R. at 788; *see also In re Lyall*, 191 B.R. at 86 n.3 ("Although this method is accurate, it is also time-consuming and basically unnecessary. This Court finds that dividing a joint tax refund in accordance with withholdings strikes a balance between absolute precision and the need for equity and efficiency."). Although the *Hundley* and *Crowson* courts chose to use the "IRS method" based on Revenue Rulings and the IRS Manual, those sources did not mandate the results reached by those courts. *IHC Health Plans v Commis*, 325 F.3d 1191 (10th Cir. 2003) (Court not bound by IRS regulations or revenue rulings); *United States v Mead Corp*., 533 U.S. 218 (2001) (an agency manual is entitled to only whatever deference is due based on its persuasiveness).

C. DETERMINING THE PROPER APPROACH

According to the United States Supreme Court, the determination of property rights in the assets of a bankruptcy creditor's estate is a matter of state law. *Butner v United States*, 440 U.S. 48, 54 (1979). Therefore, a court determining how a refund from a joint tax return should be apportioned between the creditor and his or her spouse should look first to state law. Many well-reasoned opinions have done so. *See, e.g*., *In re McKain*, 455 B.R. at 687 (Bankr. E.D. Tenn. 2011); *In re Crowson*, 431 B.R. at 489; *In re Carlson* 394 B.R. at 494; *In re Innis*, 331 B.R. at 788; *In re Marciano*, 372 B.R. at 214-15; *In re Garbett*, 410 B.R. at 286.[7]

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[6] This can involve complicated calculations based on the tax circumstances of the specific tax return in question. *See Crowson,* 431 B.R. at 492-96. But courts that follow this rule reason that "simplicity cannot come at the expense of the debtor's nonfiling spouse." *Id*. at 496.

[7] Some courts, however, have failed to consider relevant state law. *See, e.g*., *In re Larish*, 149 B.R. 117 (Bankr. M.D. Tenn. 1993); *In re McCory*, No. 10-36998, 2011 WL 4005455, *5 (Bankr. N.D. Ohio 2011); *In re Lyall*, 191 B.R. 78 (E.D. Va. 1996)); *In re Kleinfeldt*, 287 B.R. 291 (10th Cir. BAP 2002).

The question then becomes which body of state law is relevant. "Bankruptcy courts range broadly on the subject of how to make this determination." *In re Marciano*, 372 B.R. at 214.[8]

Key for many courts is whether a state is a community property, separate property or entireties state. *See, e.g.*, *In re Crowson*, 431 B.R. at 489; *In re Garbett*, 410 B.R. at 287 (50/50 rule consistent with tenancy in the entireties scheme for all marital property); *In re Carlson*, 394 B.R. 491 (8th Cir. 2010) (withholding rule consistent with separate property scheme).

In the absence of a state law directly addressing the issue, courts have looked to state law that might merely provide some clue, such as statutes governing ownership of joint bank accounts held by spouses and domestic relations statutes. *In re McKain*, 455 B.R. at 686-87. The First Circuit simply decided to ask and certified the question to the Massachusetts Supreme Court. *See Hundley*, 459 Mass. at 78. If there is no guidance from state statutes or state case law, courts then look to federal circuit courts and bankruptcy courts in the jurisdiction, and then other jurisdictions.

1. MICHIGAN LAW

In Michigan, as in most states, no statute or court decision directly governs the ownership of a refund from a joint tax return.[9] However, Michigan does have a statute, Mich. Comp. Laws § 205.30a, that offers significant guidance. Section 205.30a provides that "all or a portion of the refund claimed by the joint taxpayers is subject to interception to satisfy a liability or liabilities of 1 or both spouses." § 205.30a(4)(a). The nondebtor spouse, however, may apply for his or her share of the refund. § 205.30a(4)(c). In allocating the refund, the state Treasury Department is to allocate the income to the spouse who earned the income, though each spouse will be allocated the personal exemptions he or she would be entitled to claim if separate federal returns had been filed, and dependency exemptions are prorated according to the income of the spouse. § 205.30a(5)(b)-(c).

This system appears to be most similar to the separate filings rule and least consistent with the 50/50 rule. Massachusetts has a similar statute, which was a basis for the court's decision to follow the separate filings rule in *Hundley*. In *Hundley*, the Massachusetts Supreme Court noted a statute that addressed ownership of joint state income tax refund in the context of the state's program for "set-off debt collection." 459 Mass. at 82. Under that provision, the state could intercept joint state income tax refunds to satisfy unpaid state or local taxes and debts owed to state agencies, even if only one spouse was the debtor. *Id*. at 82-83. The nondebtor spouse could then contest the interception. *Id*. at 83. If an interception was challenged, the state

[8] Courts in Virginia, for example, have at times followed the income rule, *In re Kestner*, 9 B.R. 334 (Bankr. E.D. Va. 1981), the withholding rule, *In re Lyall*, 191 B.R. 78 (E.D. Va. 1996), and the 50/50 rule, *Bass v. Hall*, 79 B.R. 653 (W.D. Va. 1987).

[9] However, the Sixth Circuit has considered the ownership of a joint refund in the context of a refund issued following a marriage separation. *United States v. McPhail*, 149 F. App'x 449 (6th Cir. 2005). The court held that it must look to the source of payment, not the person who incurred the liability, thereby seeming to follow the withholding rule. *Id*. at 453. It appears this case arose out of Ohio, but there was no citation to state law.

department of revenue would determine the nondebtor's portion of the refund based on his or her hypothetical return had he or she filed married by separately. *Id*. This, the court held, was consistent with the separate filings rule.

Following the withholding rule or separate filing rule rather than the 50-50 rule is also consistent with the fact that Michigan is not a community property state. *See Dart v. Dart*, 460 Mich. 573 (1999).

2. **ALLOCATING TAX CREDITS**.

The 10th Circuit Bankruptcy Appellate Panel, which first developed the separate filings rule, allocates tax credits based on a formula derived from IRS revenue rulings 80-7 and 87-52. *In re Crowson*, 431 B.R. 484, 492-96 (10th Cir. BAP 2011).

As for the Earned Income Credit, the court first determines what the first spouse's Earned Income Credit would be had he or she filed a return reflecting only his or her income.[10] This hypothetical separate credit is then divided by the sum of the couple's hypothetical separate credits. *Id*. at 493. This ratio is then multiplied by the couple's actual Earned Income Credit from the joint return. *Id*. The result is the first spouse's contribution to the actual EIC. *Id*.

The same formula was applied by the *Crowson* Court to the Additional Child Tax Credit and the Rebate Recovery Credit. *Id*. at 494, 495.[11]

The few courts that have adopted the separate filings rule have mostly adopted the *In re Crowson* formula. *See In re Palmer*, 449 B.R. 621, 626-27 (Bankr. D. Mont. 2011); *In re Duarte*, No. 10-78606-reg, 2011 WL 2746186, *8 (Bankr. E.D.N.Y. July 12, 2011); *In re Evans*, 449 B.R. 827, 831-32 (Bankr. N.D. Ga. 2010).

The Massachusetts Supreme Court, however, disagreed with allocating the child tax credit based on an income-based ratio. *See Hundley v. Marsh*, 459 Mass. 78, 87 n.13 (Mass. 2011). In Hundley, the court allowed the parties in further proceedings to offer evidence as to what portion of the child tax credit is property of which party. It criticized the *Crowson* approach, noting that a nonearning spouse may have contributed greatly in the care and raising of the couple's children and should receive the benefit of some or all of the child tax credit. *Id*. at 87.

[10] The formula uses the EIC tables and same number of qualifying dependents the couple used in the joint return. *In re Crowson*, 431 B.R. 484, 492 (10th Cir. BAP 2011).

[11] For most taxpayers, the Child Tax Credit is not refundable because it can only reduce tax liability to zero. *Id*. at 494 (citing 26 U.S.C. § 24(d)). The Additional Child Tax Credit makes part of the Child Tax Credit refundable. *Id*.

Attorney Fees, Scheduled Debt Subject to Discharge, or Something Else Entirely?

The issue of post-petition payment of flat fee attorney fees declared on the 2016(b) in Chapter 7 cases

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Overview

The United States Trustee (UST) in the Eastern District of Michigan has been filing motions for the return of payments to Debtors in several Chapter 7 cases, pursuant to 11 USC 329 when attorney fees are reported as owing post-petition on the Statement of Attorney For Debtors Pursuant to F. R. Bankr. P. 2016(b). The UST cites several cases in support of his motion and, though not fully resolved at the time these materials are being drafted, he seems to present what will ultimately be a prevailing position.[1]

Topics:

- Disclaimer!
- The Issue
- The Code
- The Rule
- The Cases and Discussions
- Solution?

Disclaimer!

This discussion, both practically and academically, is far more complicated and vast than that which could be adequately addressed herein and therefore, these materials are limited by design to the issues currently being litigated in the Eastern District of Michigan. The author has, however, attempted to include additional resources for those who wish to explore this discussion further.

The Issue

Is it permissible for a Debtor's attorney, in a Chapter 7 consumer bankruptcy case for which he or she is charging the Debtor a flat fee, to collect only a portion of the fees (and in some cases costs) pre-petition and the balance post-petition?

It is the position of the UST that this is not permissible and is, in fact, in contravention of the bankruptcy code. Based on this author's research, it appears that the UST has filed motions for disgorgement of fees in at least one Chapter 7 case assigned to each judge in the Eastern District of Michigan.

The facts and circumstances of each case vary, but the common denominator appears to be that in each case the Debtor(s) were charged a flat fee and did not pay their attorney fees in

[1] Based on this author's review of the audio files of several hearings on these motions.

full prior to the filing of the petition. In some cases, the Debtor didn't pay any of the fees or costs prior to filing and in others the Debtor paid at least a portion of the fees and costs. Most of the 2016(b)s appeared to have been filed accurately and in most cases it appears that SOFA #9 matched. However, it does not appear that the Debtors' counsel were listed as creditors in any of the cases.

The Code

11 USC 329. Debtor's transactions with attorneys. 11 USC 329 states, in pertinent part, "(a)Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation." Subsection (b) goes on to address excessiveness of fees and to whom any refunds may be ordered to be made.[2]

11 USC 329 is the code section the UST relies on in bringing his motions. Arguably, on its face, this code section does not prohibit payment of attorneys' fees post-petition and therefore does not appear to be the most appropriate place to start the discussion. It seems more appropriate to start the discussion not with whether a debt is remains owing to a Debtor's counsel at the time of filing, but whether collection of that debt is a violation of the automatic stay and, ultimately, the discharge injunction.[3]

Therefore, let us continue the discussion with a review of Federal Rules of Bankruptcy Procedure 2016(b).

The Rule

Federal Rule of Bankruptcy Procedure 2016(b) states that:

> Every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 14 days after the order for relief, or at another time as the

[2] See also FRBP 2017 Examination of Debtor's Transactions with Debtor's Attorney. This author notes that the UST's motion is unclear to the extent he brings his motions under 11 USC 329(a) or (b) but the lack of reference to FRBP 2017 implies that the appropriate examination is of 329(a), while later allegations contained in the motions tend to point to 329(b).

[3] Note that some sources have discussed the discharge of post-dated checks collected by counsel prior to filing. Without an extensive review of the matter, this author questions whether this method constitutes a violation of the automatic stay and discharge injunction or if such actions are permissible pursuant to 11 USC 362(b)(11).

> court may direct, the statement required by §329 of the Code including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney, but the details of any agreement for the sharing of the compensation with a member or regular associate of the attorney's law firm shall not be required. A supplemental statement shall be filed and transmitted to the United States trustee within 14 days after any payment or agreement not previously disclosed.

On its face, it appears that the rule provides for the situation in which counsel may receive additional compensation after the filing of the petition, as it clearly states "a supplemental statement shall be filed….after any payment or agreement not previously disclosed." However, the author notes that the attorney for the UST accurately argued in one hearing that this rule applies to all chapters of bankruptcy, not just Chapter 7 cases, thus this particular portion of the rule makes provisions for other chapters, but not Chapter 7. What is interesting in noting that argument, in the context of consumer bankruptcy cases, is that revised 2016(b) statements are not filed in Chapter 13 cases upon the payment of additional compensation.

Not to be coy, but it appears that the code and the rules, cited in the motions, aren't enough. So, let's skip ahead and take a look at the allegations and arguments.

The Cases and Discussions

Dischargeability of Unpaid Pre-Petition Attorney Fees.

The UST asserts that *In re Rittenhouse*, 404 F3d 395 (6th Cir 2005) establishes that attorney fees arising pre-petition are dischargeable in bankruptcy. This is an accurate assertion by the UST. The Court clearly states, "We join three other circuits in concluding that pre-petition attorney fees are dischargeable…." The only arguable conflict between the pending motions and *Rittenhouse* being that the legal issue before the circuit court was "concerning the interpretation of 11 USC 523" and whether a debt arising from pre-petition attorneys fees falls within one of the exceptions to discharge enumerated within that code section; not whether post-petition collection of attorneys fees is an issue properly raised under 11 USC 329. *See also the line of cases cited in the last footnote herein.*

Failure to Schedule Unpaid Pre-Petition Attorney Fees.

It appears that another common issue raised in the UST's motions is counsels' failure to list the unpaid attorneys' fees on Schedule F. Any attorney accepting clients for the purposes of representing said client under any chapter of Title 11 must know that the debtors must list everything they own and everyone they owe money to. That being said, while the UST's assertions are correct, this seems to be an unintentional omission on the attorney's part – unintentional in the sense that the counsel likely did not think of the unpaid attorneys' fees as being "a debt" anymore than it is local custom to list pre-paid magazine subscriptions as assets on Schedule B or a cell phone contract on Schedule G. No question that a debt is a debt, however this author submits that such omission may be more properly treated as a point of practice improvement.

Counseling Client Appropriately and Conflict of Interest Between Debtor and Attorney.

The UST motions also question, in part, each attorney's ethical fiber and professionalism in alleging that "[b]ased on information and belief, the Debtor was not counseled that any legal fees due after the order for relief were dischargeable…."[4] and going on to allege that there is "no way that [counsel] could have effectively counseled the client that the fees were dischargeable." It is unknown if each attorney, who's case is enduring such a motion, did counsel their respective debtors on the dischargeability of unpaid attorney fees, however, these allegations seem unreasonably harsh as they appear to be "stock" allegations.

Perhaps a "CYA" form or letter should become uniform in the process, adding yet another document to the already overly-extensive process that isn't even part of the Petition and Schedules. To note, since the issue raised in these materials has come to light, it has been the practice of this author to require the Debtors to initial the balance due of $0.00, reflected on the 2016(b), and to testify to the same during the 341 Meeting of Creditors, regardless of whether the Trustee asks questions in this regard. While seemingly minute, these CYA actions do needlessly add time to an already lengthy and involved process that often ends up reducing the hourly fees earned by counsel significantly.[5]

"While any legal matter raises a concern about assuring payment, in a circumstance of financial crisis there is a profound conflict between the lawyer's interest in assurance of payment

[4] These allegations appears in at least 3 of the 5 motions reviewed by the author in preparation of these materials; citation to which are intentionally omitted by the author as not adding any substance to this discussion.

[5] The author intentionally omits a further discussion of the amount of time it takes to properly counsel, prepare, and administer even the "simplest" of Chapter 7 cases as the "simple" case is never simple until it is put into the nice and neat package called the Petition and Schedules. The behind-the-scenes work performed by an attorney or his or her staff is highly underestimated and often undervalued.

and the client's interest in the application of scarce resources to other pressing needs." *Fees and Inherent Conflicts of Interest*, Westbrook; 1 Am. Bankr. Inst. L. Rev. 287, 297 (1993). There has always been, and always will be, at least one inherent conflict between any client and attorney. This conflict may only be eliminated by a) clients who have unlimited sums of money or b) attorneys who have no need for said money. In bankruptcy, the balancing act on the teeter-totter of client interests and attorneys' needs is more delicate as the client's needs are directly related to his or her financial resources and need for said attorney.

As has been submitted in defense of the UST motions, the cases at issue in this discussion were filed without full payment for a variety of reasons. For reasons that, despite the practice of this author, are clearly legitimate and logical issues facing those in need of debtors' counsels' services: wage garnishments, bank garnishments, car repossessions, court orders for payment and/or show cause hearings….all issues that directly impact a potential debtor's ability to hire an attorney to address the very issues requiring the attorney's services in the first place. It is a circular issue and penalizing the [honest] debtor attorney for the client's failure to act before the crisis occurred is asking counsel to un-ring the bell.

Conflict should be expected, not be viewed as the exception. That being said, it is Congress, as so many of the courts have pointed out, who has the power to alleviate such conflict. However, it seems to this author, that as Congress has failed in this regard, perhaps the courts should be inclined to interpret the code more liberally.

See also *Practical, Legal and Ethical Issues Concerning Attorney Fees in Chapter 7 Consumer Cases* by Clarkson McDow, U.S Trustee Region 4[6]

Solution?

While it is the practice of this author's firm to collect all attorney fees and costs prior to filing, there may be circumstances in which that is not possible, as is the argument set forth by several of the attorneys defending the UST motions. A potential, though less time and cost efficient, solution would be to do away with "flat fee" cases.

Counsel would collect the highest amount of fees possible, pre-petition, under the terms of an hourly fee retainer agreement and determine how much of the case can be legitimately prepared prior to the initial filing. Considerations: the attorney's hourly rate, how much time is required to thoroughly investigate a Debtor's assets and liabilities in contemplation of filing, whether counsel would have been paid for a sufficient amount of time to provide appropriate bankruptcy counsel, and whether such a practice by the regional bar as a whole would ultimately

[6] Presented to the Fee Committee of the ABI at the Annual Meeting of the ABI on Saturday, May 1, 2010. Materials may be obtained from:
http://www.abiworld.org/committees/newsletters/profcomp/vol7num1/chap7.pdf.

defeat the very basic concept of a fresh start by driving up attorney fees across the board due to additional attorney hours necessitated by the "bifurcation" of the case preparation, additional record keeping, collection activities, potential for collection suits, etc., etc., etc.

"When you have the law on your side, you want a new judge; when you have the facts, you want an experienced one." -Caralyce M. Lassner

This philosophy has seemed to hold true...until now. While this author is not usually given to blanket statements regarding the fairness or unfairness of "the system", she is quite dissatisfied to realize that all the cases, regardless of how diligent counsel may have been in crafting a code-compliant/client-friendly retainer agreement, do seem to find one way or another to determine unpaid fees under flat fee agreements to be dischargeable[7].

As Debtor's counsel are an important and integral part of the bankruptcy court system, it is really too bad that no one has found a way to balance this fundamental and long-standing issue. As the Ninth Circuit stated, "[T]he very administration of the bankruptcy system requires that attorneys for Chapter 7 debtors must have a legally enforceable right for their postpetition services that were contracted for before the filing of the petition." *In re Hines*, 147 F3d 1185, 1191 (9th Cir. 1998).

[7] *In re Rittenhouse*, 404 F3d 395 (6th Cir. 2005); *In re Fickling*, 361 F3d 172 (2nd Cir. 2004); *In re Bethea*, 352 F3d 1125 (7th Cir. 2003); *In re Biggar*, 110 F3d 685 (9th Cir. 1997); *In re Haynes*, 216 BR 440 (Bankr. D. Colo. 1997); *In re Symes*, 114 BR 114 (Bankr. D. Ariz. 1994); *In re Hill*, 355 BR 260 (Bankr. Or. 2006); *In re Waldo*, 417 BR 854 (Bankr. E.D. Tenn. 2009); *In re Lawson*, 437 BR 609 (Bankr. E.D. Tenn. 2010).

Time is Money & So Is Postage:

Limiting Notice in Chapter 13 Cases

Time is Money & So Is Postage:
Limiting Notice in Chapter 13 Cases

By Scott W. Dales[1]

I. INTRODUCTION

Benjamin Franklin, the quintessential American inventor, founding father, and impish wag, famously wrote, "Time is money."[2] As the first American postmaster general and a publisher who depended on the mail to deliver his newspapers, Franklin also understood the cost of postage. In this, Franklin and most Chapter 13 attorneys have much in common. Thanks to Fed. R. Bankr. P. 2002(a), Chapter 13 practitioners frequently find themselves paying hundreds of dollars to the postal system to serve numerous motions, plan amendments, fee applications, and notice of other case activities to slumbering creditors who have not filed proofs of claim, and whose deadline for filing claims expired long ago.

Such practitioners may be forgiven if, in frustration over the costs of giving such notice, they justifiably paraphrase *Oliver Twist's* Mr. Bumble[3] by muttering "Bankruptcy Rule 2002 is an ass." By requiring notice to "all creditors" -- even those who can no longer file a timely proof of claim and who will therefore not be affected by any resulting order -- Bankruptcy Rule 2002 does indeed seem foolish. This is why in recent months some practitioners have asked the courts to enter orders limiting notice in Chapter 13 cases. These requests seem to pit the practicalities of practice against fidelity to the rules. As explained below, however, the Federal Rules of

[1] The author expresses his thanks to Jahel Nolan, Esq. and Theresa Symon for their assistance in preparing this article.
[2] Benjamin Franklin, *Advice to a Young Tradesman* (1748).
[3] Charles Dickens, *Oliver Twist* (1838)

Bankruptcy Procedure and the United States Bankruptcy Code, read together, may provide some response to Mr. Bumble's complaint.

II. THE PROBLEM

Many creditors, especially those who have written-off a debt or whose claim is small, do not bother to file claims in Chapter 13 cases before the deadline has passed.[4] Creditors who do not file claims cannot, by definition, have an allowed claim,[5] and therefore cannot participate in distributions made by a trustee.[6] In contrast to Chapter 7, where a trustee may pay an untimely claim after all timely claims are satisfied, an untimely Chapter 13 claim usually meets with an objection. *Compare* 11 U.S.C. § 726(a) *with id*. § 502(b)(9). It is not uncommon in a Chapter 13 case, therefore, to have more "creditors" (as that term is defined) than holders of allowed claims. Whether an entity is a "creditor" does not depend upon the filing of a proof of claim, but instead the term "creditor" means:

> (A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;
>
> (B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or
>
> (C) entity that has a community claim.

11 U.S.C. § 101(10); *see also* Fed. R. Bankr. P. 9001 (incorporating Bankruptcy Code definitions into the Bankruptcy Rules).

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[4] The deadline is generally 90 days after the first date set for the meeting of creditors under 11 U.S.C. § 341; *see also* Fed. R. Bankr. P. 3002(c).

[5] 11 U.S.C. § 502(a) (a claim, "proof of which is filed under section 501 of this title, is deemed allowed" absent objection).

[6] *See* Fed. R. Bankr. P. 3021 ("distribution shall be made to creditors whose claims have been allowed . . .").

In Chapter 13 cases, however, Bankruptcy Rule 2002 does not distinguish between "creditors" and holders of allowed claims.[7] The Rule provides, in relevant part, that "the clerk, or some other person as the court may direct, shall give the debtor, the trustee, all creditors and indenture trustees at least 21 days' notice by mail" of various events and filings in a case, including the meeting of creditors, the deadline for filing claims, proposed sales or settlements, plan modifications and fee applications. These last two items seem to account for the majority of the noticing activity in a Chapter 13 docket, and therefore goad debtors' counsel into seeking ways to minimize the costs associated with these common requests.

As just noted, Bankruptcy Rule 2002(a) casts a broad net in the general notice provisions:

> Except as provided in subdivisions (h), (i), (l), (p), and (q) of this rule, the clerk, or some other person as the court may direct, shall give the debtor, the trustee, all creditors and indenture trustees at least 21 days' notice by mail of:
>
> (1) the meeting of creditors under § 341 or § 1104(b) of the Code, which notice, unless the court orders otherwise, shall include the debtor's employer identification number, social security number, and any other federal taxpayer identification number;
>
> (2) a proposed use, sale, or lease of property of the estate other than in the ordinary course of business, unless the court for cause shown shortens the time or directs another method of giving notice;
>
> (3) the hearing on approval of a compromise or settlement of a controversy other than approval of an agreement pursuant to Rule 4001(d), unless the court for cause shown directs that notice not be sent;
>
> (4) in a chapter 7 liquidation, a chapter 11 reorganization case, or a chapter 12 family farmer debt adjustment case, the

[7] *See* Fed. R. Bankr. P. 2002(h) (discussed below, which authorizes the court to limit notice to Chapter 7 creditors who have filed proofs of claim).

> hearing on the dismissal of the case or the conversion of the case to another chapter, unless the hearing is under § 707(a)(3) or § 707(b) or is on dismissal of the case for failure to pay the filing fee;
>
> (5) the time fixed to accept or reject a proposed modification of a plan;
>
> (6) a hearing on any entity's request for compensation or reimbursement of expenses if the request exceeds $1,000;
>
> (7) the time fixed for filing proofs of claims pursuant to Rule 3003(c); and
>
> (8) the time fixed for filing objections and the hearing to consider confirmation of a chapter 12 plan.

Fed. R. Bankr. P. 2002(a). In addition, the Rule requires 28 days' notice by mail of important events in a reorganization case, including the time for filing objections and the hearing to consider confirmation of a Chapter 13 plan. It would be self-defeating for a debtor to seek to limit notice of confirmation-related events to creditors who have filed claims because doing so would jeopardize the binding effect of the plan under 11 U.S.C. § 1327, the Due Process Clause, and the Supreme Court's pronouncement in *United Student Aid Funds, Inc. v. Espinosa*, 130 S.Ct. 1367, 1378 (2010). For this reason, most attempts to limit notice occur in the Chapter 13 plan itself, or in a post-confirmation motion or in a motion which seeks an order taking effect post-confirmation.

Practitioners are quick to point out that the Bankruptcy Rules give the court considerable flexibility in matters involving notice. For example, "[t]he court may from time to time enter orders designating the matters in respect to which, the entity to whom, and the form and manner in which notices shall be sent except as otherwise provided by these rules." Fed. R. Bankr. P. 2002(m). Bankruptcy Rule 9007 is to similar effect:

> When notice is to be given under these rules, the court shall designate, if not otherwise specified herein, the time within which, the entities to whom, and the form and manner in which the notice shall be given . . .

Fed. R. Bankr. P. 9007; *see generally* 11 U.S.C. § 102 (rule of construction for "notice and hearing"). Both Bankruptcy Rules 2002(m) and 9009, however, limit the court's authority by reference to more specific provisions in the rules, for example by including the phrases "if not otherwise specified herein" and "except as otherwise provided by these rules."

In Chapter 13 cases, Bankruptcy Rule 2002(h) may also impinge upon the court's authority to limit notice only to creditors who have filed claims. It does so, by negative inference, because it authorizes this very relief, but only in Chapter 7 cases:

> (h) NOTICES TO CREDITORS WHOSE CLAIMS ARE FILED. *In a chapter 7 case*, after 90 days following the first date set for the meeting of creditors under § 341 of the Code, the court may direct that all notices required by subdivision (a) of this rule be mailed only to the debtor, the trustee, all indenture trustees, creditors that hold claims for which proofs of claim have been filed . . .

Fed. R. Bankr. P. 2002(h) (emphasis added). The advisory committee note explains, using language equally applicable across all chapters, that "[t]he elimination of notice to creditors who have no recognized stake in the estate may permit economies in time and expense."

Under a well-worn rule of construction known by its Latin moniker, *expressio unius est exclusio alterius*, one might infer that by expressly authorizing the court to limit notice to holders of filed claims in Chapter 7 cases, the rules impliedly exclude similar relief in Chapter 13. The Supreme Court, in drafting the rule, considered the issue of limiting notice only to holders of allowed claims, and the high court indicated in Bankruptcy Rule 2002(h) that it will tolerate this limitation only in liquidation cases.

It is true, of course, that the courts must construe the Bankruptcy Rules "to secure the just, speedy, and inexpensive determination of every case and proceeding." Fed. R. Bankr. P. 1001. Perhaps in light of this rule of construction courts should not apply the *expressio unius* maxim to Bankruptcy Rule 2002(h) to preclude similar relief in Chapter 13 cases. Nevertheless, any rule of construction is not a license to ignore textual provisions, no matter how inconvenient or impractical: practitioners must still deal with the breadth of Bankruptcy Rule 2002(a)'s reference to "all creditors" as that term is defined. So, unless the court grants some relief from the mandate in Bankruptcy Rule 2002(a) to serve "all creditors," debtor's counsel may be required to advance funds for postage, copying, and staff time to send notices to all creditors, even those who, through act or omission, are not participating in the Chapter 13 case.

III. POSSIBLE SOLUTIONS

As noted above, the lion's share of post-confirmation noticing activity pertains to plan amendments and attorney fee applications. Thankfully, the applicable Bankruptcy Code sections and rules may ameliorate the expense and other burdens of having to give notice to creditors who have shown no interest in the case.

1. Post-Confirmation Amendments

During the three-to-five year lifespan of a Chapter 13 plan, a lot can happen to the debtors. They pay for weddings, their roofs leak, their hot water heaters quit, their cars are totaled. Family members join the household and increase their expenses, or leave the nest and generate disposable income. Debtors win at the casino, earn promotions, inherit money. They lose jobs, lives, overtime, and perhaps even suffer the indignity and expense of orthodontia (whether directly or vicariously). They get cancer.

Section 1329, together with Bankruptcy Rule 3015, helps debtors and their counsel address the effects these changes may have on their bankruptcy cases by authorizing plan amendments. In general, however, the Code limits post-confirmation amendments to adjustments of the amount or timing of payments:

> (a) At any time after confirmation of the plan but before the completion of payments under such plan, the plan may be modified, upon request of the debtor, the trustee, or the holder of an allowed unsecured claim, to --
>
> (1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;
>
> (2) extend or reduce the time for such payments;
>
> (3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan; or
>
> (4) reduce amounts to be paid under the plan by the actual amount expended by the debtor to purchase health insurance for the debtor (and for any dependent of the debtor if such dependent does not otherwise have health insurance coverage) . . .

11 U.S.C. § 1329(a). In addition to limiting plan amendments to payment-related adjustments, the Code incorporates other requirements by making Sections 1322(a), 1322(b), and 1323(c) and Section 1325(a) applicable to post-conformation amendment practice. *Id*. § 1329(b). More to the point for purposes of mitigating debtors' counsel's copying, postage and staff costs, Section 1329 also provides that "[t]he plan as modified becomes the plan unless, *after notice and a hearing*, such modification is disapproved." *Id*. (emphasis added).

Like many terms sprinkled throughout the wonderland of the Bankruptcy Code, the phrase "after notice and a hearing" means many things to many people. In fact, it may even mean no notice at all, depending upon the "particular circumstances." This is certainly more

cost-effective than notice to "all creditors." The chameleon-like quality of the phrase "after notice and a hearing" derives from the Bankruptcy Code's first, internal, and eminently flexible rule of construction:

> In this title –
>
> (1) "after notice and a hearing", or a similar phrase –
>
> (A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but
>
> (B) authorizes an act without an actual hearing if such notice is given properly and if --
>
> (i) such a hearing is not requested timely by a party in interest; or
>
> (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act . . .

11 U.S.C. § 102(1). This interpretative aid, among Section 102's other rules of construction, expressly applies to the Bankruptcy Rules. *See* Fed. R. Bankr. P. 9001(incorporating Bankruptcy Code definitions and rules of construction). So, to some extent, the bright line that Rule 2002 establishes for giving notice and an opportunity for hearing in specified matters could, depending upon the "particular circumstances," undermine the statutory directive empowering the courts to determine what notice is appropriate under the circumstances. Also, keep in mind that a federal statute trumps a federal procedural rule. *See* 28 U.S.C. § 2075; *In re Roberts*, 68 B.R. 1004 (Bankr. E.D. Mich. 1987). Therefore, perhaps Rule 2002 must yield to Section 102, at least with respect to Code provisions using the phrase "notice and a hearing" or something comparable.

Even without suspending or invalidating Rule 2002, however, other rules, combined with the license embodied in Rules 2002(m) and 9007, provide some relief from the burdens of giving

notice to all creditors, regardless of whether they have elected to participate. For example, with respect to post-confirmation plan amendments -- the source of much noticing activity and complaint -- Rule 3015(g) sensibly recognizes the court's authority to dispense with notice of immaterial changes:

> . . . The clerk, or some other person as the court may direct, shall give the debtor, the trustee, and all creditors not less than 21 days' notice by mail of the time fixed for filing objections and, if an objection is filed, the hearing to consider the proposed modification, *unless the court orders otherwise with respect to creditors who are not affected by the proposed modification*.

Fed. R. Bankr. P. 3015(g) (emphasis added). It requires no special insight or expertise to determine that a Chapter 13 "creditor" who has not filed a claim (and therefore is receiving no distribution) will be unaffected by a payment moratorium or any other reduction proposed under Section 1329, for example.

So, it seems reasonably clear that the court could and should authorize the proponent of a plan modification to serve the proposed modification only on creditors who have filed claims, and others who have requested notice or are necessarily affected, such as the Chapter 13 trustee.

2. Fee Applications

Debtors' attorneys understandably complain about the postage and other costs incurred in serving fee applications upon "all creditors," including those who have not filed proofs of claim. Fee applications, if properly supported by itemized time entries and a narrative explanation of the benefits of the work performed, commonly run many pages, often imposing substantial copying and postage expense. It is a fair inference that many solo practitioners and other small shops cannot afford copying machines that can produce double-sided or multi-faceted pages using less paper and, therefore, less postage. Providing notice of professional fee applications

can be expensive, and the expense seems magnified when one considers that, with respect to creditors who have not filed claims, giving notice is a waste of time and money.

First, it is worth remembering that Rule 2002 itself requires notice to all creditors only with respect to fee applications exceeding $1,000.00. *See* Fed. R. Bankr. P. 2002(a)(6). For smaller applications, at least, Rule 2002 is a rule of reason.

Second, again referring back to the applicable statute, Section 330 does not require fee applicants to give notice to "all creditors," but only to "parties in interest." Moreover, the applicable statute, in contrast to Rule 2002, uses the phrase "[a]fter notice … and a hearing," again implicating Section 102's first rule of construction which authorizes the court to consider the particular circumstances.

The phrase "parties in interest" is not defined in the Code, and is also subject to judicial interpretation. *In re Citi-Toledo Partners II*, 254 B.R. 155 (Bankr. N.D. Ohio 2000) (although the phrase "party in interest" appears in 46 different Bankruptcy Code sections and over 30 rules, it is not actually defined therein). Therefore, it is easy to conclude that creditors who are not sharing in estate assets (because they did not file proofs of claim) are not parties with any interest in the outcome of the fee application. These terms are eminently more flexible than Rule 2002's requirement that fee applicants give notice to all creditors.

Again, to the extent that Rule 2002(a)(6) requires notice to all creditors irrespective of interest, the requirement is inconsistent with statutory authority.

In contrast to seeking a separate order limiting notice, practitioners may consider including within their Chapter 13 plan a provision limiting post-confirmation notice. This approach offers some advantages. Pursuant to Section 1322(b)(11), a debtor may include within the plan "any other appropriate provision not inconsistent with this title." As discussed above,

limiting notice of post-confirmation amendments and fee applications to creditors holding allowed claims may be consistent with Title 11, although perhaps at odds with Rule 2002. Including it in the plan, therefore, may provide a statutory basis for limiting notice, assuming harmony with the rest of Title11.

Moreover, assuming the court agrees or at least confirms the plan containing such a provision, the plan will be binding on each "creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan." 11 U.S.C. § 1327(a). The plan, if confirmed, will conclusively establish the proper notice. There is one caveat, however: to the extent that such a provision purports to limit the court's authority to determine notice under the particular circumstances, a court might conclude that the plan is inconsistent with Title11, at least in that regard.

In a recent order addressing the issue in the Western District of Michigan, the Honorable Jeffrey R. Hughes has approved the following plan provision limiting notice:

> After the claims bar date, notice of plan amendments, professional fee applications, and motions filed by the debtor and/or counsel may only be given to creditors who have filed a claim or appearance. Creditors who have not filed a claim or appearance will not be given notice of plan amendments, fee applications or motions. The filed proof of service shall reflect such limited service with the Court. This provision for limited notice shall not apply to motions to dismiss the Chapter 13 case or to notices that a discharge has entered.

See Order Re: Debtors' May 2, 2012 Motion - Limit Notice, Case No. 11-07697-JRH, Doc. No. 62 (Bankr. W.D. Mich. Aug. 31, 2012). Notice to non-creditors, such as the standing trustee and the United States Trustee, is not affected by this provision.

IV. CONCLUSION

The point of this article is not to advocate ignoring Rule 2002(a) based on expediency, but only to suggest that the Rule is in tension with the Bankruptcy Rules in general, *see* Fed. R. Bankr. P. 1001 and 9001, and perhaps with the Congressional directive that bankruptcy courts approach matters of notice flexibly, and with an eye to the particular circumstances. In addition, at least with respect to two major categories of post-confirmation filings, the rules themselves provide some relief from the requirement of giving notice to all creditors, regardless of their interest.