

Checking In with the Supremes

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Checking In With The Supremes

American Bankruptcy Institute
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Executive Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency), 702 F.3d 553 (9th Cir. 2012), cert. granted sub nom. *Executive Benefits Ins. Agency v. Arkison*, 133 S. Ct. 2880, 186 L. Ed. 2d 908 (U.S. June 24, 2013) (No. 12-1200)

Factual Background

Bellingham Insurance Agency (“BIA”) became insolvent and ceased operating on January 1, 2006. Two weeks later, BIA irrevocably assigned a large commission due from a client to Peter Pearce, a longtime employee. Moreover, the CEO of BIA used BIA funds to incorporate Executive Benefits Insurance Agency (“EBIA”), which received \$373,291 in commission income between January and June 2006. Some of that money was deposited by Peter Pearce, and EBIA deposited the rest into an account held jointly by EBIA and a related company. BIA filed a Voluntary Petition for Relief under Chapter 7 in the U.S. Bankruptcy Court for the Western District of Washington. The Trustee, Peter Arkinson, brought a fraudulent conveyance action against EBIA. The defendant requested a jury trial in the district court, but did not object to the bankruptcy court’s jurisdiction over all pretrial matters. The Bankruptcy Court granted summary judgment for the Trustee, holding that the deposits into the EBIA account were fraudulent conveyances, and that EBIA was a “mere successor” of BIA.

Procedural Posture

EBIA appealed to the District Court. The District Court affirmed, holding that the deposits to the EBIA account were fraudulent transfers, and that EBIA was liable for BIA’s debts as a corporate successor. EBIA then appealed to the Ninth Circuit. Prior to oral argument, EBIA argued for the first time that under *Stern v. Marshall*, the bankruptcy court lacked Article III constitutional authority to enter a final judgment. The Ninth Circuit rejected the defendant’s position and affirmed.

The Ninth Circuit began by supporting the EBIA argument that *Stern v. Marshall* denied the bankruptcy court constitutional authority to render final judgment. The Court found:

This quotidian bankruptcy case presents a novel question: can a non-Article III bankruptcy judge enter a final judgment in a fraudulent conveyance action against a nonclaimant to the bankruptcy estate? Federal law empowers bankruptcy judges to do so, but we hold that the Constitution forbids it.

The Executive Benefits Insurance Agency suffered an adverse final judgment in a fraudulent conveyance at the hands of a bankruptcy judge. But our decision today is no reprieve, because we also hold that the company consented to the adjudication of the fraudulent conveyance claim by a bankruptcy judge by failing to object until the case reached this court. Thus, unencumbered by constitutional doubts, we review the entry of summary judgment de novo, and affirm.

In re Bellingham Ins. Agency, Inc. 702 F.3d 553, 556 (9th Cir. 2012).

However, that conclusion did not result in a victory for EBIA. The Ninth Circuit went to summarize its holding as follows:

Fraudulent conveyance claims are “quintessentially suits at common law” designed to “augment the bankruptcy estate.” *Granfinanciera*, 492 U.S. at 56, 109 S.Ct. 2782. Thus, Article III bars bankruptcy courts from entering final judgments in such actions brought by a noncreditor absent the parties’ consent. But here EBIA consented to the bankruptcy court’s jurisdiction, rendering that

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court's entry of summary judgment in favor of the Trustee constitutionally sound.
That judgment was also correct.

In re Bellingham Ins. Agency, Inc., 702 F.3d 553, 572-73 (9th Cir. 2012).

Question Presented

The Supreme Court granted certiorari in the case, in which it has been asked to decide: (1) whether a party's implied consent to a bankruptcy court's entry of final judgment on a fraudulent conveyance claim can waive the party's right to have the claim adjudicated by an Article III court under *Stern v. Marshall*, 131 S. Ct. 2594 (2011); and (2) whether the bankruptcy court's authority under 28 U.S.C. § 157(b) to "hear and determine" all core proceedings arising under title 11 and to "enter appropriate orders and judgments" includes the authority to issue proposed findings of fact and conclusions of law in core proceedings that Article III requires that the district court decide in the first instance.

Oral argument was held on January 14, 2014.

[Will need to be supplemented to cover Supreme Court decision]

In re Clark, 714 F.3d 559 (7th Cir. 2013), cert. granted sub nom. *Clark v. Rameker*, 134 S. Ct. 678, 187 L. Ed. 2d 544 (U.S. Nov. 26, 2013) (No. 13-299)

Factual Background

In 2010, Petitioners Brandon Clark and Heidi Heffron-Clark (“Debtors” or “Petitioners”) filed a petition under chapter 7 of the Bankruptcy Code in the United States Bankruptcy Court for the Western District of Wisconsin. The Debtors claimed an exemption of approximately \$300,000 in an individual retirement account (“IRA”), which was a beneficiary or inherited IRA (“Inherited IRA”) that Heidi Heffron-Clark established when she inherited her deceased mother’s IRA in 2001. Such Inherited IRAs must make mandatory distributions but the funds in them are not subject to tax until distribution.

Under 11 U.S.C. § 522(b)(1),¹ debtors may elect to exempt certain property from the bankruptcy estate.² Among other things, debtors may exempt “[r]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.” 11 U.S.C. §§ 522(b)(3)(C), 522(d)(12).³

In addition, § 522(b)(4)(C) provides that “[a] direct transfer of retirement funds from 1 fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986, under section 401(a)(31) of the Internal Revenue Code of 1986, or otherwise, shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.”

In the bankruptcy court, the chapter 7 trustee and a judgment creditor (Resul and Zinije Adili, d/b/a Kegonsa Plaza) objected to the claimed exemption. The bankruptcy court found that funds in an Inherited IRA were not “retirement funds” and sustained the objection. *In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011).

Procedural Posture

On appeal by the Debtors, the district court reversed, finding that the Bankruptcy Code provisions did not distinguish between IRAs and Inherited IRAs. *Clark v. Rameker*, 466 B.R. 135 (W.D. Wis. 2012).

The chapter 7 trustee and the judgment creditor then appealed to the United States Court of Appeals for the Seventh Circuit, which reversed the district court and held that funds in a non-spousal Inherited IRA were not “retirement funds” and therefore are not subject to exemption. *In re Clark*, 714 F.3d 559 (7th Cir. 2013).

The Seventh Circuit distinguished between IRAs that are inherited by a spouse, which may be exempted, from those inherited by others, which may not. The court pointed out that

¹ All statutory citations are to the Bankruptcy Code found at Title 11 of the United States Code, unless otherwise indicated.

² Generally, debtors may elect either the exemption scheme for the state in which they reside or the federal exemptions set forth in 11 U.S.C. § 522(d), unless that state has “opted out” of the federal exemption scheme. 11 U.S.C. § 522(b)(1) and (2). A majority of states have “opted out” of the federal exemptions.

³ Sections 522(b)(3)(C) and 522(d)(12), which have identical language, were added in 2005 to ensure that debtors have the same exemption in these retirement funds, regardless of whether they elect the state or federal exemptions.

when an IRA is inherited by a spouse, the new owner may roll it over into his or her own IRA (to which he or she may continue making contributions), may not withdraw any of the money before age 59 ½ without paying a penalty, and must begin withdrawals by the year in which the owner turns 70 ½. The court believed that in that situation, the funds remain “retirement funds.”

By contrast, when an IRA is inherited by a son or daughter of the original owner, significantly different rules apply. No new contributions can be made, and the balance cannot be rolled over or merged with any other account. The Inherited IRA must begin making distributions within a year of the original owner’s death, and in some cases must complete all distributions within five years. Moreover, unlike the original owner, the new owner is not required to wait until retirement age and may freely use the funds for current consumption without penalty, subject to paying taxes on any funds withdrawn. Thus, the payout is not tied to the new owner either reaching retirement age or retiring. The court therefore concluded that such accounts are not “retirement funds” and are not eligible for the exemption.

The court also sought to distinguish contrary authority. The United States Court of Appeals for the Fifth Circuit had held that Inherited IRAs are subject to exemption, taking the view that “retirement funds” under sections 522(b)(3)(C) and (d)(12) are not limited to the debtor’s own retirement funds – unlike other exemptions, which specifically require that the property be “the debtor’s” interest – but that the applicability of the term depends upon the original nature of the funds. The Fifth Circuit also noted that section 522(b)(4)(C) explicitly provides that a direct transfer of retirement funds from a tax-exempt account does not prevent the exemption from applying. See *Chilton v. Moser (In re Chilton)*, 674 F.3d 486 (5th Cir. 2012). The Fifth Circuit relied in part on *Doeling v. Nessa (In re Nessa)*, 426 B.R. 312 (B.A.P. 8th Cir. 2010). The district court in *Clark v. Rameker* had also relied on the *Nessa* decision.

The Seventh Circuit distinguished *Chilton* in part by asserting that the phrase “IRA” in “Inherited IRA” designates the funds’ source, not their current status. The Seventh Circuit raised two analogies. In the first, the decedent withdrew the retirement funds from the IRA before death and then transferred the funds to her daughter. In that case, the court asserted that the exemption clearly would not apply. In the second, a debtor inherited a domicile that used to be her mother’s residence and then claimed the homestead exemption even though the debtor never lived in the house. Here, too, the court asserted that such an exemption would be impermissible. Finally, the Seventh Circuit did not mention or seek to explain § 522(b)(4)(C), which was added to the Bankruptcy Code in 2005 at the same time as section 522(b)(3)(C).⁴

In addition to the Petitioners, the chapter 7 trustee and the judgment creditor (collectively, “Respondents”) filed briefs. Further, *amicus curiae* briefs were filed by the National Association of Bankruptcy Trustees (“NABT”); the National Association of Consumer Bankruptcy Attorneys (“NACBA”); a group of retirement plans sponsored by the Tribune Company (including the Tribune Company 401(k) Savings Plan); Seymour Goldberg, a lawyer and tax professor emeritus; and G. Eric Brunstad Jr., another lawyer.

Question Presented

The Supreme Court granted certiorari in this case on November 26, 2013. It has been asked to decide whether funds held in an Inherited IRA are “retirement funds” subject to

⁴ The bankruptcy court below stated that section 522(b)(4)(C) only applies to retirement funds that lose their tax exemption as a result of a transfer, but that the funds at issue here were not “retirement funds” so that the provision did not apply. See 450 B.R. at 865. The district court mentioned this provision only in the context of discussing the *Nessa* decision. See 466 B.R. at 140.

MID-ATLANTIC BANKRUPTCY WORKSHOP 2014

exemption under 11 U.S.C. § 522(b). Respondents have limited this issue to “non-spousal” Inherited IRAs.

Oral argument was held on March 24, 2014.

***Law v. Siegel*, 134 S. Ct. 1188 (2014)**

Section 105(a) of the Bankruptcy Code provides that a bankruptcy court “may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a). Further, a bankruptcy court may have “inherent power . . . to sanction abusive litigation practices.” *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 375-376, 127 S. Ct. 1105, 166 L. Ed. 2d 956 (2007) (quotation and citation omitted). In *Law v. Siegel*, 134 S. Ct. 1188, 188 L. Ed. 2d 146 (2014), the United States Supreme Court held that neither the statutory power of § 105 nor a bankruptcy court’s inherent power could be used to contravene a specific statutory provision. The Court held that a bankruptcy court could not surcharge a debtor’s exempt funds to pay administrative expenses that were incurred as a result of the debtor’s fraud where the surcharge would contravene the express provisions of § 522(k).

Background – Exemptions, Surcharge and a Circuit Split

When a debtor files a petition, a bankruptcy estate is created that consists of “all legal or equitable interests of the debtor in property as of the commencement of the case.” § 541(a)(1). Property of the estate is used to satisfy pre-petition claims and administrative expenses of the bankruptcy. *See* §§ 507, 726, 1123, 1322. However, the Bankruptcy Code allows a debtor to exempt certain property, which then is excluded from property of the bankruptcy estate. *See* § 522. The legislative history indicates that the exemptions were provided “to protect a debtor from his creditors, [and] to provide him with the basic necessities of life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge.” H.R. Rep. No. 95-595, at 126 (1997), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6087. Exemptions are provided by federal law contained in the Bankruptcy Code or by state law. Some states have opted out of the federal bankruptcy exemption system and limit a debtor to state exemptions. *See* § 522(b)(2). An important exemption provided to a debtor is the homestead exemption that protects a portion of the equity in the debtor’s principal residence. The amount of equity that can be protected varies by state, with some being more generous than others. As applied in *Law*, a debtor can exempt \$75,000 as a homestead exemption in California. *See* Cal. Civ. Proc. Code § 704.730(a)(1). The Bankruptcy Code provides that exempt property “is not liable for payment of any administrative expense . . .” § 522(k).

A bankruptcy estate is finite and accordingly a gain for one of the competing interests in the estate generally comes at a loss to another. In cases where there is little or no equity in the bankruptcy estate, trustees, who generally must look to unencumbered assets for payment to administrative claimants and unsecured creditors, have little economic incentive to expend efforts on behalf of the estate. The Bankruptcy Code alleviates this issue by allowing a trustee to recover reasonable and necessary costs from property that is secured by an allowed claim to the extent that the trustee benefited the holder of the secured claim. § 506(c).

Bankruptcy courts have also surcharged exempt property, which would otherwise be unavailable to unsecured creditors, based on a debtor’s misconduct in the bankruptcy case. Two circuit courts have adopted this approach. *See, e.g. Malley v. Agin*, 693 F.3d 28, 29 (1st Cir. 2012) (allowing equitable surcharge of debtor’s exempt property where the debtor concealed non-exempt property from the Chapter 7 Trustee); *Latman v. Burdette*, 366 F.3d 774, 786 (9th Cir. 2004) (holding that a debtor’s fraudulent concealment of non-exempt assets warranted an offsetting equitable surcharge against otherwise exempt property in light of the exceptional circumstances in the case). As no provision of the Bankruptcy Code specifically provides for surcharge of a debtor’s exemptions for misconduct, courts relied on a broad interpretation of § 105(a), quoted above. Some courts and commentators believe that this interpretation of § 105(a) also is in accordance with the Supreme Court’s discussion of a bankruptcy court’s authority under § 105(a) in *Marrama*. There, the Supreme Court stated that “the broad authority granted to bankruptcy judges” under § 105(a) and the inherent power of a federal court to

sanction abusive litigation practices were adequate authorization for the bankruptcy court's decision to deny based on bad-faith conduct a debtor's motion to convert under § 706. *Marrama*, 549 U.S. at 375.

However, the Tenth Circuit Court of Appeals held that a debtor's exempt assets may not be surcharged under § 105(a) in the absence of a specific Bankruptcy Code provision authorizing surcharge when doing so is inconsistent with other provisions of the Bankruptcy Code. *In re Scrivner*, 535 F.3d 1258, 1262-63 (10th Cir. 2008). Thus, a circuit split existed as to whether a bankruptcy court could surcharge a debtor's exemptions pursuant to § 105(a) for debtor misconduct.

Facts and Procedural Posture

In *Law*, the debtor ("Law") filed a chapter 7 bankruptcy petition in 2004. 134 S. Ct. at 1193. The only significant asset of Law's bankruptcy estate was his residence in California. In a bankruptcy schedule, Law valued the home at \$363,348 and claimed a homestead exemption of \$75,000 pursuant to California's homestead exemption. *Id.* Law reported that the home was subject to two voluntary liens, a first in favor of Washington Mutual, and a second in favor of "Lin's Mortgage & Associates." *Id.* The two liens exceeded the property's nonexempt value. *Id.*

The Chapter 7 trustee (the "Trustee") commenced an adversary proceeding to avoid the second lien. *Id.* at 1193. Law had recorded a deed of trust for the second lien in 1999, which reflected a debt to an individual named "Lili Lin." *Id.* Two individuals claimed to be Lili Lin. One was a former colleague of Law's who disavowed any interest in the loan or deed of trust and also described numerous efforts by Law to involve her in sham transactions relating to the property and deed of trust. The second "Lili Lin" purportedly lived in China and claimed to be the beneficiary of the deed of trust. The Lili Lin of China extensively litigated the matter for five years. The Bankruptcy Court ultimately determined that the Lili Lin of China was a fabrication by Law. *See id.* As recounted by the Supreme Court, the Bankruptcy Court concluded

that no person named Lili Lin ever made a loan to [Law] in exchange for the disputed deed of trust. . . . The court found that the loan was a fiction, meant to preserve [Law's] equity in his residence beyond what he was entitled to exempt by perpetrating a fraud on his creditors and the court.

Id. (quotations and citations omitted).

Following a sale of the property, the Trustee filed a motion to surcharge the debtor's \$75,000 homestead exemption to defray his legal costs, amounting to more than \$500,000, to uncover the fraud. The Bankruptcy Court granted the Trustee's motion and surcharged the entirety of the \$75,000 exemption to be applied toward the Trustee's legal fees. *Id.*

The Ninth Circuit Bankruptcy Appellate Panel affirmed, holding that the Bankruptcy Court's factual finding was not clearly erroneous and that the Court had not abused its discretion by surcharging Law's exempt assets. *Id.*; BAP No. CC-09-1077-PaMkH, 2009 WL 7751415 (Oct. 22, 2009) (*per curiam*). It relied on *Latman*, 366 F.3d 774, which recognized a bankruptcy court's power to "equitably surcharge a debtor's statutory exemption" when a debtor engages in fraudulent conduct. *Id.* at 1194. The Bankruptcy Appellate Panel acknowledged that the Tenth Circuit had reached a result contrary to *Latman*, *see In re Scrivener*, 535 F.3d 1258, but nevertheless applied the rationale of *Latman*.

The Ninth Circuit affirmed and held that the surcharge was proper and warranted to protect the integrity of the bankruptcy process. *Law*, 134 S. Ct. at 1193-94; *In re Law*, 435 F.

App'x 697 (9th Cir. 2011). On June 17, 2013, the Supreme Court granted *certiorari*. 570 U.S. ___, 133 S. Ct. 2824, 186 L. Ed. 2d 883 (2013).

Question Presented

Notwithstanding § 522(k), can a bankruptcy court order that a debtor's exempt assets be used to pay administrative expenses incurred as a result of the debtor's fraud?

Holding

In reversing and remanding the decision of the Ninth Circuit, the Supreme Court held that a bankruptcy court does not have the authority to contravene an express provision of the Bankruptcy Code by ordering that a debtor's exempt property be used to pay administrative expenses, even where those expenses are incurred to uncover and rectify the debtor's fraud. *Law*, 134 S. Ct. at 1198.

The Supreme Court's Ruling

In a unanimous opinion authored by Justice Scalia, the Supreme Court recognized that bankruptcy courts have statutory authority under § 105(a) to issue any order "necessary or appropriate to carry out the provisions" of the Bankruptcy Code. *Id.* (quoting § 105). But the Court also recognized that it is "hornbook law" that § 105 does not allow a bankruptcy court to override explicit mandates of the Bankruptcy Code. *Id.* The Court also acknowledged that bankruptcy courts may well possess inherent power to sanction abusive litigation practices. *Id.* But the bankruptcy court's inherent sanctioning powers "are likewise subordinate to valid statutory directives and prohibitions." *Id.* As the Supreme Court stated, "we have long held that whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Id.* (quotations omitted).

As the Court saw it, the Bankruptcy Court's surcharge was unauthorized if it contravened a specific provision of the Bankruptcy Code. In concluding that it did, the Court noted that Law was entitled to exempt the equity in his home by § 522, and that § 522(k) made the exempt property "not liable for payment of any administrative expenses." *Id.* at 1194-95; 11 U.S.C. § 522(k). The Trustee's legal fees were plainly administrative expenses. Thus, the Court held that the Bankruptcy Court exceeded the limits of its statutory authority and inherent powers by surcharging the debtor's homestead exemption to pay the Trustee's legal fees because the surcharge contravened the express terms of § 522.

The Court dismissed several arguments offered by the Trustee and the United States, appearing in support of the Trustee. The Court rejected the argument that a bankruptcy court's equitable power can coexist with § 522 because § 522 contains no directive requiring a court to allow exemptions. *Law*, 134 S. Ct. at 1195-96. The Supreme Court acknowledged that in certain instances a bankruptcy court may disallow a state-created exemption by applying state law, but held that neither federal law nor general equitable powers provide authority to deny an exemption on grounds not specified in the Code. *Id.* at 1196-97. The Court also rejected the argument that the surcharge was an outright denial of Law's homestead exemption, pointing out that the Trustee had not timely objected to the exemption claim and the Bankruptcy Appellate Panel concluded that the exemption became final before the surcharge was imposed. *Id.* at 1196. The Court explained that, even if Law's entitlement to the exemption were at issue, a bankruptcy court must have a valid statutory basis to refuse to honor a claimed exemption. *Id.* In denying an exemption, the bankruptcy courts must follow the "carefully calibrated exceptions and limitations" established by the statute and may not create additional exceptions. *Id.*

The Supreme Court explained that its decision in *Marrama*, on which the Trustee and the United States heavily relied, did not require a different result. In *Marrama*, the Court was faced with the question of whether a bankruptcy court could refuse to convert a chapter 7 case to one under chapter 13 based on the debtor's bad-faith conduct. The *Marrama* Court held that it could, because although § 706(a) gave the debtor a right to convert the case, that right was expressly conditioned in § 706(d) on the debtor's ability to qualify as a debtor under the applicable chapter. And § 1307(c) provides that a chapter 13 case can be dismissed for cause, which includes bad-faith conduct. The *Marrama* court held that because the debtor's bad-faith conduct could prevent him from qualifying as a debtor under Chapter 13, he failed to meet the express condition in § 706(d) for conversion.

As pertinent here, the Court in *Marrama* "also opined that the Bankruptcy Court's refusal to convert the case was authorized under § 105(a) and might have been authorized under the court's inherent power." *Id.* at 1197. The Court in *Law* stated that this dictum, at most, "suggests that in some circumstances a bankruptcy court may be authorized to dispense with futile procedural niceties in order to reach more expeditiously an end result required by the Code." *Id.* However, the Court in *Law* rejected the notion that the dictum of *Marrama* endorsed the notion that "equitable considerations would allow a bankruptcy court to contravene express provisions of the Code." *Id.*

The Court recognized that the outcome left the Trustee to shoulder the financial burden of litigation that resulted from debtor misconduct. In crafting § 522, however, "Congress balanced the difficult choices that exemption limits impose on debtors with the economic harm that exemptions visit on creditors." *Id.* at 1198 (quoting *Schwab v. Reilly*, 560 U.S. 770, 791, 130 S. Ct. 2652, 177 L. Ed. 2d 234 (2010)). The Supreme Court emphasized that it is not for the courts to alter that balance.

Finally, the Court emphasized that bankruptcy courts have substantial authority to respond to a debtor's misconduct. Chief among them is the authority to deny the dishonest debtor a discharge. The Court also pointed to Federal Rule of Bankruptcy Procedure 9011, which allows a court to award sanctions, including attorneys' fees, for bad-faith litigation. The Court stated a bankruptcy court also may possess further sanctioning authority under either § 105(a) or its inherent powers. And a debtor's fraudulent conduct may subject a debtor to criminal prosecution under 18 U.S.C. § 152. "But whatever other sanctions a bankruptcy court may impose on a dishonest debtor, it may not contravene express provisions of the Bankruptcy Code." *Id.*

United States v. Quality Stores, Inc., et al., 134 S. Ct. 1395 (2014)

Factual Background

An involuntary chapter 11 bankruptcy petition was filed against Quality Stores, Inc. on October 20, 2001. Quality Stores responded to the involuntary summons by consenting to the order for relief. Both before and after the commencement of the chapter 11 case, Quality Stores, an agricultural specialty retailer with over 300 stores in 26 states previously known as “Central Tractor Farm & Country,” terminated over 3,000 employees against their will and issued those employees severance pay. The plans under which the severance payments were made were not tied to any state unemployment benefits, were paid as part of reductions in force and operations closings, and were based on certain factors such as seniority and length of employment with the company. Certain “supplemental unemployment compensation benefits” (“SUB’s”) are exempt from taxation under the Federal Insurance Contribution Act, 26 U.S.C. § 2101 *et seq.* (“FICA”) based on policy reasons and largely because they are tied to and designed around state unemployment benefits. FICA is the federal payroll tax imposed on both the employer and employee to fund Social Security and Medicare.

Quality Stores paid its share of the taxes due under the FICA and reflected those wages and the income tax it withheld thereon on the employees’ IRS form W-2’s. Later concluding that the severance payments did not meet the legal definition of wages under FICA, Quality Stores sought a refund of the taxes it paid, and, as to certain employees who consented to Quality Stores’ refund efforts, the taxes on those employees’ wages totaling \$1,000,125. The IRS failed to either deny or allow the refund request.

Procedural Posture

After the IRS failed to act on the refund request, Quality Stores commenced an adversary proceeding against the IRS seeking the turnover of the \$1,000,125 by the filing of its Complaint for Turnover of Property of the Debtors’ Estate on June 1, 2005.

Quality Stores moved for summary judgment and the IRS filed a cross-motion for summary judgment. The United States Bankruptcy Court for the Western District of Michigan found in favor of Quality Stores and its former employees by holding that the payments that were made to the terminated employees were not “wages” subject to taxation under FICA. After stipulations between Quality Stores and the IRS as to the amount of the refund, the Bankruptcy Court granted judgment in favor of Quality Stores and its former employees in the amount of \$1,000,125. After the decision of the Bankruptcy Court, the United States Court of Appeals for the Federal Circuit reversed the lower court’s decision in *CSX Corp. Inc. v. United States*, 52 Fed. Cl. 208 (Fed. Cl. 2002) in which the Bankruptcy Court had relied upon (the Court of Federal Claims had ruled earlier that severance payments made as a lump sum amount were exempt from FICA). After the Federal Circuit’s ruling, the United States filed its motion for reconsideration. The Bankruptcy Court granted the motion for consideration, but on reconsideration, ratified and confirmed its prior ruling.

The United States appealed, but the United States District Court for the Western District of Michigan affirmed, and the United States appealed the District Court’s order.

The Court of Appeals for the Sixth Circuit affirmed the District Court finding that the severance payments were not “wages” for purposes of taxation under FICA. The Sixth Circuit’s holding that the severance payments were not wages created a circuit split. The United States filed its petition for *certiorari* on May 31, 2013 which was granted on October 1, 2013. 134 S. Ct. 49, 186 L. Ed. 2d 962 (2013).

MID-ATLANTIC BANKRUPTCY WORKSHOP 2014

After the Sixth Circuit's affirmance of the judgment, there were numerous requests for refunds filed with the IRS. In its Petition for Writ of Certiorari, the United States stated that "the amount at issue for this and other claims exceeds \$1 billion and is expected to grow."

Parties filing briefs *amicus curiae* were Professor Kristen E. Hickman of the University of Minnesota Law School, the American Payroll Association, the ERISA Industry Committee and the American Benefits Council.

Oral arguments were heard on January 14, 2014 and the decision rendered on March 25, 2014.

Question Presented

Whether payments made to employees who were terminated against their will both prior to and after the filing of a chapter 11 bankruptcy were "supplemental unemployment compensation benefits" and exempt from taxation under FICA, or whether those payments were "wages" subject to taxation under FICA.

Holding

In reversing and remanding the decision of the Sixth Circuit on an 8-0 vote, the Supreme Court unanimously⁵ held that FICA's definition of wages was broad enough to include the severance payments at issue and were taxable. "Under [FICA's] definition of wages, and as a matter of plain meaning, severance payments made to terminated employees are 'remuneration for employment.'" 134 S. Ct. at 1399.

The Supreme Court's Ruling

In the March 25, 2014 decision written by Justice Kennedy, the Supreme Court reversed and remanded the circuit court's ruling that the payments made to the terminated employees were not taxable "wages" within the meaning of the FICA.

In its ruling applying FICA to the severance payments, the Court started with the imposition of taxes on "wages" under FICA and the statutory definition of wages. 26 U.S.C. § 3121(a) defines "wages" under FICA as "all remuneration for employment." Section 3121(b) provides that "employment encompasses 'any service, of whatever nature, performed . . . by an employee for the person employing him.'"

Another section of the Internal Revenue Code, 26 U.S.C. § 3402(o), however, provides that "[f]or purposes of this chapter . . . any supplemental unemployment compensation benefit paid to an individual shall be treated *as if* it were a payment of wages by an employer to an employee for a payroll period." 26 U.S.C. § 3402(o)(1)(A). (Emphasis supplied).

Quality Stores argued, and the lower courts agreed, that since the supplemental unemployment compensation benefit were to be treated "as if they are wages" under § 3402(o), they were not "wages" for the purpose of taxation under 26 U.S.C. § 3121(a). The Court reviewed the history of the IRS treatment of SUB's and the public policy concern of treating the SUB's as income on the employee side so that taxpayers would not have to confront large unpaid tax payments at the time the returns are due.

⁵ Justice Kagan recused herself and did not participate in this case.

In reaching its decision, the Court disagreed with the Sixth Circuit’s interpretation of 26 U.S.C. § 3402(o). The Court pointed out that the Internal Revenue Code’s withholding provisions are generally governed by a separate, broad definition of “wages” (26 U.S.C. § 3401(a)), and that the provisions of section 3402(o) were not meant to narrow this definition or to suggest that no severance payments come within the definition of “wages.” Rather, section 3402(o) was enacted to ensure that all supplemental unemployment payments were subject to withholding, regardless of whether they were deemed wages. The Court found that this was intended to address other types of ongoing unemployment compensation under certain supplemental unemployment benefit agreements with unions that the IRS had already deemed were excluded from the definition of “wages.”

After the Court addressed the “plain meaning” of the definition of “wages” under FICA, the Supreme Court also reviewed *Rowan Cos. v. United States*, 452 U.S. 247 (1981), and its directive that the FICA tax and withholding statutes are to be construed “co-extensively with each other to avoid ‘[c]ontradicting interpretations of substantially identical definitions.’” *Rowan*, 452 U.S. at 257. In addition, the Internal Revenue Code was amended after *Rowan* by addition language to § 3121(a) to address regulatory variances between exclusions of “wages” for income tax withholding and other taxes. Section 3121(a) provides that “[N]othing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion for ‘wages as used in such chapter shall be construed to require a similar exclusion from ‘wages’ in the regulations prescribed for purposes of this Chapter” “[W]ere the Court to rule that the severance payments made here are exempt from FICA taxation but not from withholding under § 3402 for income tax purposes, it would contravene the holding in *Rowan* which held that there should be congruence in the rules for FICA and income tax withholding.” 134 S. Ct. at 1398.

The court attacked the indirect negative inference sought by Quality Stores that since SUB’s were treated “as if” they were wages in an exception entitled, in part, as “certain payments other than wages” in § 3402(o), by highlighting the other exceptions to taxable wages in § 3121. Section 3121 provides numerous statutory exceptions to the definition of “wages” and the Supreme Court highlighted section (a)(13)(A) that provides an express exception from FICA’s definition of wages for payments made because of “retirement of disability.” “The specificity of these exceptions reinforces the broad nature of FICA’s definition of wages.” 134 S. Ct. at 1400. The itemized list of exceptions for items not to be considered as wages under § 3121 enforced the ruling that the SUB’s were “wages” subject to FICA.

Quality Stores also argued that the bolded heading of IRC § 3402(o), “**Extension of Withholding to Certain Payment Other Than Wages**” supported its indirect inference that the types of payments, including the severance payments at issue, are “other than wages.” Stating that “[c]aptions, of course, can be ‘a useful aid in resolving’ a text’s ‘ambiguity’”, the Court found there was no ambiguity permitting an analysis of the caption. “The heading stated that withholding is extended to ‘certain payments.’ This falls short of a declaration that all payments listed in § 3402(o) are not wages.” 134 S. Ct. at 1402.

In the Court’s final paragraph of the opinion, the Court noted “that the IRS still provides that severance payments tied to the receipt of state unemployment benefits are exempt not only from income tax withholding but also from FICA taxation.” “Because the severance payments here were not linked to state unemployment benefits, the Court does not reach the question whether the IRS’ current exemption is consistent with the broad definition of wages under FICA.” This parting shot was viewed as a “thinly veiled warning to the government” by the Court by Professor Bradley Joondeph, the Inez Mable Distinguished Professor and Associate Dean for Academic Affairs at the Santa Clara University School of Law. “Opinion analysis: Severance Payments are wages – at least in most instances – for purposes of FICA.”