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Judicial Merry-Go-Round

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2023

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1. Sub V Eligibility Issues

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2. The Role of the Subchapter V Trustee

Subchapter V Trustee as Debtor in Possession

A debtor in possession may be removed for cause. 11 U.S.C. Section 1185(a).

This includes "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case." 11 U.S. Code § 1104(a)(1).

- Examples of the Court removing a debtor in possession for cause:
  - *In re Corinthian Commc'ns, Inc.,* 642 B.R. 224 (Bankr. S.D.N.Y. 2022)
  - *In re Dani Transport Service, Inc.,* No.6:20-bk-11234. Order at 2 (C.D. Cal. Feb. 23, 2021).
    - Both involved dishonesty in relation to and misuse of PPP loans.

If the debtor in possession is removed, the Subchapter V trustee steps into the shoes of the debtor, takes possession of the property of the estate and operates the debtor's business.

The Subchapter V trustee becomes a "fiduciary with an obligation of fairness to all parties in the case." U.S. Dep't of Justice, Handbook for Small Business Chapter 11 Subchapter V Trustees.

If the debtor ceases to be a debtor in possession, the Subchapter V trustee's duties include:

- Being accountable for all property received Section 704(a)(2);
- Examine proofs of claim and object to improper claims 704(a)(5);
- Unless the court orders otherwise, provide information regarding the estate as requested to parties in interest 704(a)(7);
- File reports of operations if the debtor is authorized to be operated 704(a)(8);
- Make a final report and file a final account of the administration of the estate 704(a)(9);
- Provide notice of the debtor's domestic support obligation 704(a)(10);
- Administer any employee benefit plan 704(a)(11);
- If debtor is a health care business, take reasonable steps to transfer patients704(a)(12).
- File the list, schedules and statements required under section 521(1).
- For any year for which the debtor has not filed a tax return required by law, furnish, without personal liability, such information as may be required by the governmental unit with which such tax return was to be filed, in light of the condition of the debtor's books and records and the availability of such information.

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- If there is a claim for domestic support obligation, provide the applicable notice to the holder of the claim and appropriate State child support enforcement agency, as set forth in § 704(c).
- Facilitate the development of a consensual plan of reorganization § 1183(b)(7).

U.S. Dep't of Justice, Handbook for Small Business Chapter 11 Subchapter V Trustees. *See also,*11 U.S.C. §§1106(a)(1) and 1106(a)(2), § 1106(a)(6), §1183(b)(6), §1183(b)(7).

Practical points:
- A Subchapter V trustee must follow certain banking and accounting practices;
- Must obtain a trustee bond;
- Must preserve certain business records;
- More involvement with creditor to reach a consensual plan;
- Must protect estate assets; and
- Must consult with the debtor and its employees to operate the business.

Discussion:
- Removal of the debtor-in-possession.
- Operating the debtor's business.

Subchapter V Trustee as Mediator

Is the Subchapter V trustee an adversary, neutral party, mediator or something else?

The Subchapter V trustee is not a true mediator, but rather is a facilitator.

- Communication with parties.
- Suggest alternative solutions or ideas.
- Assist the parties in analyzing issues in the case.
- Encourage and facilitate settlement negotiations between the parties.
- Assist in providing explanations to creditors or interested parties.
- Engage in private communications between adversarial parties to try to reach a resolution.
- Assist in keeping order of the case.

How does the Subchapter V trustee facilitate the development of a consensual plan?

A Subchapter V trustee must be a "disinterested person" within the meaning of § 101(14).
- The Subchapter V trustee must submit a verified statement of disinterestedness to the U.S. Trustee prior to appointment in a case.

Under 11 U.S. Code §101(14):
(14) The term "disinterested person" means a person that—

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and

(C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

The Subchapter V trustee is also a party in interest, with standing to take positions on issues.

Under 11 U.S. Code § 1109(b):
(b) A party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.

Such issues may include:

- Eligibility for Subchapter V relief;
- First day motions;
- Employment of professionals;
- Motions for adequate protection and relief from stay;
- Asset sales plan confirmation;
- Valuation of property;
- Objections to claims;
- Objection to discharge; and
- Dismissal, among other disputed issues in the case.

Discussion:

- How does the Subchapter V trustee's role as facilitator change if they take a position on an issue?
- What levels of Subchapter V trustee involvement as a facilitator have been successful/helpful?

Scope of Duties: Statutory and General Duties of a Sub V Trustee

- Statutory duties of a Subchapter V trustee are set forth in § 1183(b).
- Facilitation of the development of a consensual plan or reorganization is the role of the Subchapter v trustee.
- Trustee has a fiduciary responsibility to the bankruptcy estate.
- The Subchapter V's duties are largely supervisory unless the Court expands the Subchapter V's powers or the debtor-in-possession is removed.

Statutory Duties 11 U.S. Code § 1183(b):

1. Being accountable for all property received. §704(a)(2).
2. Examine proofs of claims and object if necessary. §704(a)(5).
3. Oppose the discharge of the debtor if warranted. § 704(a)(6).

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4. Furnish such information concerning the estate and the estate's administration as is requested by a party in interest. §704(a)(7).
5. Make a final report and file a final account of the administration of the estate with the United States Trustee and the court. §704(a)(9).
6. Perform the duties specified in §1106(a)(3) and §1106(a)(4) of this title if the court, for cause and on request of a party in interest, the trustee, or the United States Trustee, so orders. Pursuant to this provision, the trustee is required to:
    a. Investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan §1106(a)(3); and
    b. once the investigation is completed, file a statement of the investigation. § 1106(a)(4)(A).
7. File post-confirmation reports to the extent necessary. §1106(a)(7).
8. Appear and be heard at the status conference under §1188 and any hearing that concerns:
    a. The value of property subject to a lien;
    b. Confirmation of a plan filed under Subchapter V;
    c. Modification of the plan after confirmation; or
    d. The sale of property of the estate.

    §1183(b)(3).
9. Ensure that the debtor commences making timely payments required by a confirmed plan. §1183(b)(4).
10. If the debtor is no longer the debtor in possession, perform certain duties under § 704(a)(8) and § 1106(a) and be authorized to operate the business of the debtor. §1183(b)(5).
11. In regards to a domestic support obligation, perform the duties under § 704(c). §1183(b)(6).
12. Facilitate the development of the consensual plan. §1183(b)(7).

Practical Duties of the Subchapter V trustee:

- The Subchapter V trustee has the unique duty to facilitate the development of a consensual plan of reorganization.
- Assess the financial viability of the debtor.
- Communicate with the parties to make progress.
- Ensure the debtor meets filing requirements.
- Prepare and participate in Court hearings.
- Meet and confer with the debtor, creditors or U.S. Trustee when necessary.

Costs of Subchapter V Trustee involvement

Considerations:

- Hourly rate.
- Level of trustee involvement.
- Trustee background and professional expertise.

Ways to Maximize Efficiency:

- Provide the Subchapter V trustee an overview of the case early on in the case.
- Communicate the case goals, the players, and the big picture of the plan of reorganization to the Subchapter V trustee.
- Provide adequate financial documentation.
- Communicate regarding issues with plan confirmation, creditor objections or adversary proceedings.
- Do not ignore the Subchapter V trustee's emails, calls and basic requests.
- Keep the Subchapter V trustee updated.

11 U.S.C. § 330: Compensation
(a)(1)After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103—

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses.

Discussion: What approaches to case efficiency have worked for you?

What approaches to payment of subchapter V trustee fees has worked for you?

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3. Discharge Exceptions

Issue: Nondischargeability of Corporations?

11 USC § 1192 states:

> If the plan of the debtor is confirmed under section 1191(b) of this title, as soon as practicable after completion by the debtor of all payments due within the first 3 years of the plan, or such longer period not to exceed 5 years as the court may fix, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title, and all other debts allowed under section 503 of this title and provided for in the plan, except any debt-
>
> (1) on which the last payment is due after the first 3 years of the plan, or such other time not to exceed 5 years fixed by the court; or
>
> (2) of the kind specified in section 523(a) of this title.

BenShot, LLC v. 2 Monkey Trading, LLC (2 Monkey Trading, LLC), 2023 Bankr. LEXIS 1147 (Bankr. MD Fla. April 28, 2023)

> Based on Judge Burgess's decision in *Hall* [*Nutrien Ag Solutions, Inc. v. Hall, et al. (In re Hall), Ch. 11 Case No. 3:22-bk-01326-BAJ, Ch. 11 Case No. 3:22-bk-01341-BAJ, Adv. No. 3:22-AP-00062-BAJ, 2023 Bankr. LEXIS 1008, 2023 WL 2927164 (Bankr. M.D. Fla. Apr. 13, 2023)*] and the same conclusions reached by other bankruptcy courts, the Court agrees with Defendants that the Amended Complaint must be dismissed. *See GFS Indus., 647 B.R. at 344* ("[T]he statutory language along with the broader Chapter 11 statutory scheme mandate this **[*5]** Court's holding that corporate debtors proceeding under Subchapter V cannot be made defendants in *§ 523* dischargeability actions."); *Lapeer Aviation, No. 21-31500-JDA, 2022 Bankr. LEXIS 1032, 2022 WL 1110072, at *2* (holding that because a corporate defendant proceeding under Subchapter V is "not an individual debtor, actions under *§ 523(a)* are not applicable to it[]"); *Rtech Fabrications, 635 B.R. at 566*

(finding "that *§ 523(a)*'s discharge exceptions only apply to an individual debtor and *§ 1192(2)*'s reference to *§ 523(a)* does not expand its applicability to entity debtors[]"); *Satellite Rests., 626 B.R. at 873* (holding that *§ 523(a)* applies only to individuals, and not to corporations proceeding under Subchapter V).

In re Hall, 2023 Bankr.Lexis 1008 (MD Fla. April 13, 2023)

Although the Court finds that the Fourth Circuit's decision is well-written, the Court disagrees with the Fourth Circuit's reasoning and conclusion in ***Cleary Packaging, LLC***. Instead, the Court agrees with the five bankruptcy courts that have addressed this issue. Those courts concluded that the exceptions to discharge under *§ 523(a)* do not apply to corporate debtors receiving a discharge under *§ 1192*. *Avion Funding, 647 B.R. at 351-52*; *Jennings v. Lapeer Aviation, Inc. (In re LaPeer Aviation, Inc.), Adv. No. 22-03002, 2022 Bankr. LEXIS 1032, 2022 WL 1110072 (Bankr. E.D. Mich. Apr. 13, 2022)*; *Catt v. Rtech Fabrications, LLC (In re Rtech Fabrications, LLC), 635 B.R. 559 (Bankr. D. Idaho 2021)*; *Cantell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging, LLC), 630 B.R. 466 (Bankr. D. Md. 2021)*, rev'd ***36 F.4th 509 (4th Cir. 2022)***; *Gaske v. Satellite Rests. Inc. (In re Satellite Rests. Inc.), 626 B.R. 871 (Bankr. D. Md. 2021)*.

The Court reaches this conclusion primarily because the SBRA amended the language of *§ 523(a)* to add a reference to *§ 1192*. If Congress intended for *§ 523(a)* exceptions to apply to corporations receiving a discharge under *§ 1192*, then this addition was unnecessary. See *Avion Funding, 647 B.R. at 343*.

Synergetic Oil Tools, Inc. v. Relevant Holdings LLC (In re Relevant Holdings LLC), 2023 US Dist.LEXIS 53042 (D. Colo 2023)

Bankruptcy Court dismissed nondischargeability action against corporate debtor, but relied entirely on two decisions from the Maryland Bankruptcy Court, one of which was Cleary, which was subsequently reversed by the 4th Circuit.

District Court found that because the Bankruptcy Court's decision relied solely upon decisions from the United States Bankruptcy Court for the District of Maryland to determine that the limitations identified in *11 U.S.C. § 1192(2)* (i.e., the kind of debt specified within *§ 523(a)*) are only applicable to individual Subchapter V debtors, there has now been an intervening change

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in the law, which warrants reanalysis by the Bankruptcy Court. The Court finds the Fourth Circuit's analysis persuasive and reverses and remands the case back to the Bankruptcy Court to reanalyze the issue in light of ***In re Cleary Packaging, LLC, 36 F.4th 509, 518 (4th Cir. 2022)***.

Avion Funding, LLC v GFS Industries, LLC (In re GFS Industries, LLC), 647 BR 337 (Bankr. WD Tex. 2022)

For the reasons stated below, the Court determines that the interplay between *§§* ***1192(2)*** and *523(a)* compels the conclusion that in the Subchapter V context, only individuals, not corporations, can be subject to *§ 523(a)* dischargeability actions.

First, *§* ***1192(2)***'s reference to *§ 523(a)* only incorporates the list of nondischargeable debts, without expanding it. In other words, the language of *§* ***1192(2)*** does not intend to except from discharge any debts that *§ 523(a)* does not already except. Because *§ 523(a)* unequivocally applies only to individuals, the language of *§* ***1192(2)*** does not empower *§ 523(a)* to cast a wider net than the text of *§ 523(a)* permits. Had Congress included a phrase in *§* ***1192(2)*** explicitly stating that the list found in *§ 523(a)* applies to all debtors proceeding in Subchapter V, then the interpretation would be straightforward. Congress's choice not to insert this language is instructive.

Second, the inclusion of *§ 1192* in *§ 523(a)* would be rendered meaningless under any other interpretation. When Subchapter V was passed, Congress also amended *§ 523(a)* to add the newly enacted *§ 1192* to the list of discharge provisions incorporated in the scope of *§ 523(a)*'s discharge exceptions. *§ 523(a)* now reads, "[a] discharge under *section....1192....*does not discharge an individual debtor...." (emphasis added). *Section 1192*'s addition is vital to the analysis because it evinces Congress's intent. *Section* ***1192(2)*** as written makes *§ 523* discharge exceptions applicable to "debtors" without regard to whether the debtor is an individual or a corporation. Critically though, had Congress intended *§ 523(a)* exceptions to apply to entities as well, it would be unnecessary to add *§ 1192* to a statute that plainly applies to individual debtors only. The fact that Congress added *§ 1192* into *§ 523* demonstrates that Congress intended *§* ***1192(2)*** to limit the *§ 523* exceptions in Subchapter V to individuals only.

> Third, corporate debtors proceeding under Chapter 11 historically have been immune to dischargeability actions under *§ 523(a)*. It is well-settled law in this circuit that the *§ 523* exceptions to discharge apply only to individuals, not to corporations.

More compelling, the provisions governing Chapter 11 discharge imply that *§ 523(a)* should not apply to corporate debtors. *Section 1141(d)(2)* states, "[a] discharge under this chapter does not discharge a debtor *who is an individual* from any debt excepted from discharge under *section 523* of this title." (emphasis added). Had Congress intended that corporate debtors also be held to the provisions of *§ 523(a)*, then clarifying that only individuals under Chapter 11 are liable for *§ 523* exceptions to dischargeability makes little sense.

To date, four bankruptcy courts have decided this precise issue. All four bankruptcy courts have held that the *§ 523(a)* exceptions to discharge are applicable only to individuals, not corporations in Subchapter V. ***Jennings v. Lapeer Aviation, Inc. (In re LaPeer Aviation, Inc.)**, Adv. No. 22-03002, 2022 Bankr. LEXIS 1032, 2022 WL 1110072 (Bankr. E.D. Mich. Apr. 13, 2022)*; ***Catt v. Rtech Fabrications, LLC (In re Rtech Fabrications LLC)**, 635 B.R. 559 (Bankr. D. Idaho 2021)*; ***Cantell-Cleary Co., Inc., v. Cleary Packaging (In re Cleary Packaging, LLC)**, 630 B.R. 466 (Bankr. D. Md. 2021), rev'd 36 F.4th 509 (4th Cir. 2022)*; ***Gaske v. Satellite Rests. Inc. (In re Satellite Rests. Inc.)**, 626 B.R. 871 (Bankr. D. Md. 2021)*. All four decisions granted motions to dismiss under *Rule 12(b)(6)* for failure to state a claim upon which relief can be granted. The Court agrees with the rationales of the courts as explained below.

In re Lapeer Aviation, Inc., 2022 Bankr. LEXIS 1032; 2022 WL 1110072, 71 Bankr. Ct. Dec. 112 (April 13, 2022) (J. Applebaum)

> Although neither Plaintiff nor Defendant addressed the statutory language, the first sentence of § 523(a) clearly limits the denial of discharge to "an individual debtor." Because Defendant LAI is a corporation and not an individual debtor, actions under § 523(a) are not applicable to it. There are innumerable pre-SBRA cases which support this finding. *See, In re MF Glob. Holdings, Ltd.*, No. 11-15059(MG), 2012 WL 734175, at *3 (Bankr. S.D.N.Y. Mar. 6, 2012) (citing *Adam Glass Serv., Inc. v. Federated Dep't Stores*, Inc., 173 B.R. 840, 842 (E.D.N.Y. 1994)) (finding that § 523(a) "only applies to individual debtors" and "is not applicable to corporate debtors"); *Savoy Records Inc. v. Trafalgar Assocs. (In re Trafalgar Assocs.)*, 53 B.R. 693, 696 (Bankr. S.D.N.Y. 1985) (holding that § 523(a) "on its face applies only to

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> individual debtors"); *Williams v. Sears Holding Co.*, No. 06-PWG-455-M, 2008 WL 11424255, at *4 (N.D. Ala. Mar. 28, 2008) ("The discharge exception of 11 U.S.C. § 523(a)(2)(A) which applies only to an individual debtor, does not apply to Kmart, a corporate debtor."); *Garrie v. James L. Gray, Inc.*, 912 F.2d 808, 812 (5th Cir. 1990) ("Moreover, the 'willful and malicious injury' exception to discharge, like all of the exceptions to discharge found in section 523(a), applies only to individual, not corporate, debtors.").

Since the enactment of the SBRA, several courts that have considered the applicability of § 523(a) in the context of Subchapter V's discharge provisions governing non-consensual plans, 11 U.S.C. § 1192, have also found that § 523(a) does not apply to non-individual debtors. *In re Satellite Restaurants Inc. Crabcake Factory USA*, 626 B.R. 871 (Bankr. D. Md. 2021); *In re Cleary Packaging, LLC*, 630 B.R. 466 (Bankr. D. Md. 2021); *In re Rtech Fabrications, LLC*, 635 B.R. 559 (Bankr. D. Idaho 2021). This Court finds the reasoning in these opinions entirely persuasive and adopts and incorporates them here.

Cantwell-Cleary Co. v. Cleary Packaging, LLC (In re Cleary Packaging, LLC), 36 F.4th 509 (4th Cir. 2022)

> Fourth Circuit reversed and remanded bankruptcy court's dismissal of nondischargeability action against corporate debtor, ruling § 523 is applicable to corporate debtors.

*Section **1192(2)*** excepts from discharge "any *debt . . . of the kind* specified in *section 523(a)*." *11 U.S.C. § **1192(2)*** (emphasis added). The section's use of the word "debt" is, we believe, decisive, as it does not lend itself to encompass the "kind" of *debtors* discussed in the language of *§ 523(a)*. This is confirmed yet more clearly by the phrase modifying "debt"—i.e., "of the kind." Thus, the combination of the terms "debt" and "of the kind" indicates that Congress intended to reference only the *list of non-dischargeable debts* found in *§ 523(a)*. As the U.S. Government's amicus brief notes, this interpretation of "of the kind" is in line "with the ordinary meaning of the word 'kind' as 'category' or 'sort.'" (Citing American Heritage Dictionary of the English Language (online ed.) ("'[a] group of individuals or instances sharing common traits; a category or sort'"); Merriam-Webster Dictionary (online ed.) ("'a group united by common traits or interests: CATEGORY'")). In short, while *§ 523(a)* does provide that discharges under various sections, including *§ 1192* discharges, do not "discharge *an individual debtor* from any debt" of the kind listed, *§ **1192(2)***'s cross-reference to *§ 523(a)* does not refer to any *kind of debtor* addressed by *§ 523(a)* but rather to a *kind of debt* listed in *§ 523(a)*. By referring to the *kind of*

debt listed in *§ 523(a)*, Congress used a shorthand to avoid listing all 21 types of debts, which would indeed have expanded the one-page section to add several additional pages to the U.S. Code. Thus, we conclude that *the debtors* covered by the discharge language of ***§ 1192(2)*** — i.e., both individual and corporate debtors — remain subject to the 21 *kinds of debt* listed in *§ 523(a)*.

Interpretation of ***§ 1192(2)*** in Subchapter V makes particular sense when considering that subchapter's juxtaposition in Chapter 11 with traditional Chapter 11 provisions, reflecting its distinctive purpose within that Chapter. Congress enacted Subchapter V as part of the Small Business Reorganization Act of 2019 with the primary goal of simplifying Chapter 11 reorganizations for small businesses and reducing the administrative costs for those businesses. To do so, Congress deliberately altered the general provisions of traditional Chapter 11 proceedings by, among other things, eliminating the absolute priority rule and limiting the applicability of *§ 1141(d)* to Subchapter V proceedings. *Section 1141(d)*, in particular, sets forth debts that are eligible for discharge in a traditional Chapter 11 proceeding, making distinctions between individual debtors and corporate debtors. *See Breezy Ridge Farms, 2009 Bankr. LEXIS 1396, 2009 WL 1514671, at *2*; *cf. JRB Consol., 188 B.R. at 374*. In contrast, *§ 1192* provides benefits to small business debtors, regardless of whether they are individuals or corporations. Thus, an important purpose for Subchapter V would be frustrated were we to adopt Cleary Packaging's interpretation of *§§* ***1192(2)*** and *523(a)*, which would treat individuals and corporations differently.

And as to fairness and equity, it should be recognized that a Subchapter V proceeding involves a non-consensual plan — i.e., a "cram-down" proceeding — in which stakeholders in the bankruptcy estate are treated differently than they would be in traditional Chapter 11 proceedings under the absolute priority rule. Under a Subchapter V plan, owners of a debtor can retain ownership interests to continue conducting the reorganization at the expense of and over the objection of creditors. Given the elimination of the absolute priority rule, Congress understandably applied limitations on the discharge of debts to provide an additional layer of fairness and equity to creditors to balance against the altered order of priority that favors the debtor. To this end, *all Subchapter V debtors* are textually subject to the discharge limitations described in *§ 523(a)*, not just *individual* Subchapter V debtors. To make a distinction between individuals and corporations for how Subchapter V is applied would not only undermine that balance, but would also make no sense and indeed would create perverse incentives. But most importantly, it would violate the text of ***§ 1192(2)***.

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At bottom, while we recognize that the relationship between *§ 523(a)* and *§ 1192* might be a bit discordant — or perhaps more accurately, clumsy — we find more harmony from following a close textual analysis and contextual review of ***§ 1192(2)*** and thus conclude that it provides discharges to small business debtors, *whether they are individuals or corporations*, except with respect to the 21 kinds of debts listed in *§ 523(a)*.
In re Rtech Fabrications, LLC, 635 BR 559 (Bankr. D. Idaho 2021)

> § 523 nondichargeability provisions determined not applicable to corporate debtors. Court relied heavily on the Bankruptcy Court's decision in *Cleary Packaging,* which was later overturned by the 4th Circuit on appeal.

4. Plan Confirmation Issues

> **Issue: What constitutes "acceptance" of Sub V plan, and more specifically, is "deemed acceptance" sufficient?**

If the Subchapter V debtor obtains full consent for the plan (all impaired classes of claims or interests accept the plan), the plan is confirmed under § 1191(a).

If the Subchapter V debtor cannot obtain full consent for the plan (i.e. one or more impaired classes of claims or interests rejects the plan), then § 1191(b) states that the court shall confirm a Subchapter V plan that satisfies the confirmation requirements, other than the requirements of § 1129(a)(8) (providing that all classes vote to accept the plan or not be impaired by the plan), § 1129(a)(10) (requiring at least one impaired class to accept the plan), and § 1129(a)(15) (requiring payment of unsecured creditors in full or devoting allocated projected disposable income to the plan), so long as the plan does not discriminate unfairly against any impaired, non-consenting class and is fair and equitable regarding each class of impaired claims or interests that has rejected the plan.

In re Robinson, 632 BR 208 (Bankr. D. Kan. 2021)

> UST's second objection to confirmation, primarily based on Debtor's pre- and post-filing gambling. No creditor in any class returned a ballot on the amended plan. Court overruled UST Objections and confirmed as a consensual plan.

Section 1126(a) provides that a holder of an allowed claim *may* vote to accept or reject a plan of reorganization. Nothing in the Code requires the holder of an allowed

claim to vote. *Subsection (c)* addresses acceptance of the plan and applies in a subchapter V case. It applies the two-thirds in amount and more than one-half in number of allowed claims criteria for acceptance by a class of claims.

Chapter 11 debtors should be mindful that the IRS has a historical practice of not voting on plans. In Robinson's case, the IRS is the largest secured and largest priority creditor. Nothing in this Court's current review of the Internal Revenue Manual suggests that its policy has recently changed with respect to priority tax claims; for secured and general unsecured claims the IRS recognizes its "opportunity to vote to accept or reject a plan," and that authority is delegated to the Secretary of the Treasury.

Bankruptcy Rule 3018(c) governs the procedure and form for accepting or rejecting a plan. It provides, in relevant part: "An acceptance or rejection shall be in writing, identify the plan or plans accepted or rejected, be signed by the creditor . . . or an authorized agent, and conform to the appropriate Official Form." An objection to confirmation is distinct from casting a ballot to accept or reject the plan. Thus, an objection to confirmation does not constitute a vote to reject the plan and the lack of an objection to confirmation does not constitute a vote to accept the plan. *Rule 3018* suggests that the affirmative act of voting to accept or reject the plan (returning a completed ballot) is required in order for the vote to be counted. So, what is the effect if no creditor in any class casts a ballot as in the instant case?

Pre-SBRA case law holds that the failure to return a ballot cannot be deemed an acceptance of the plan. The bankruptcy court in *Trenton Ridge* recognized exceptions to the general rule. One exception is where the plan includes a provision that impaired classes in which no votes are cast are presumed to accept the plan. Thus, *Trenton Ridge* suggests a debtor may protect its plan from nonvoting creditors, by including language in the plan to the effect that failure to vote will be deemed an acceptance of the plan. No such language is included in Robinson's amended plan before the Court.

Adhering to *Sweetwater's* binding precedent that a nonobjecting and nonvoting creditor is deemed to have accepted a chapter 11 plan under *§ 1129(a)(8)*, I conclude that all of Robinson's creditors and all classes of creditors in this subchapter V case, none of whom voted, objected to confirmation, or appeared at the confirmation hearing, have accepted the amended plan. Therefore, all impaired classes have accepted the plan under *§ 1129(a)(8)* and the amended plan can and

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must be confirmed as a consensual plan under *§ 1191(a)*, if all other confirmation requirements are satisfied.

In re Jaramillo, 2022 Bankr. LEXIS 2620; 2022 WL 4389292 (Bankr. D. NM September 22, 2022)

> The Court took the order under advisement to determine whether, under Tenth Circuit law, a ***subchapter V*** plan can be confirmed as a consensual plan if some classes of creditors do not vote. The Court concludes that it can.

Recent cases have held that *Ruti-Sweetwater's* "***deemed acceptance***" rule for *§ 1129(a)(8)* applies in ***subchapter V***. *See, e.g., In re Robinson, 632 B.R. 208, 220 (Bankr. D. Kan. 2021)* (cited and applied "*Sweetwater's* binding precedent that a nonobjecting and nonvoting creditor is deemed to have accepted a chapter 11 plan under *§ 1129(a)(8)*"); *In re Olson*, 2020 WL 10111637, at *2 (Bankr. Utah) (same); and *In re Desert Lake Group, LLC*, no. 20-22496, doc. 114 (Bankr. D. Utah Sept. 30, 2020) (unpublished) (same). Here, an impaired class (Ms. Trei) voted to accept the plan, satisfying *§ 1129(a)(10)*. Under *Ruti-Sweetwater*, any remaining classes that did not vote are deemed to have accepted the plan. The plan therefore can be confirmed as a consensual plan under *§ 1191(a)* if the other plan confirmation requirements have been met.

Applying *Ruti-Sweetwater's* ***deemed acceptance*** rule to ***subchapter V*** cases is consistent with the realities of modern bankruptcy practice for individuals and small businesses, where many general unsecured creditors (e.g., credit card companies) do not vote. There is nothing wrong with not voting, but the confirmation process should not be derailed as a result.

In re Creason, 2023 Bankr. LEXIS 478; 2023 WL 2190623 (Bankr. WD Mich, February 23, 2023)(J. Dales).

> Parties requested confirmation as a consensual plan under § 1191(a). Court confirmed as a non-consensual plan under § 1191(b). Judge Dales' rationale:
>
> Congress provided a precise statutory definition of what constitutes acceptance in this area, complete with a dollar amount and numerosity requirement, but perhaps neglected to address what happens when a class of creditors fails to participate in balloting. Perceiving a gap, some courts adopt the concept of "***deemed acceptance***," a convenient though extra-statutory

response to the problem. *See, e.g., In re Ruti-Sweetwater, Inc., 836 F.2d 1263 (10th Cir. 1988)*. Here, because Dr. Creason put Everest Business Funding ("Everest") in its own class (Class III), and because Everest did not return its ballot, Class III did not formally accept the plan. In an effort to demonstrate compliance with *§ 1129(a)(8)*, Dr. Creason's counsel cites *Ruti-Sweetwater* and another case within the Tenth Circuit that, naturally, followed that circuit's "***deemed acceptance***" precedent. This court is not persuaded.

1. Although no interested party balked at counsel's citation **[*3]** to *Ruti-Sweetwater* and the concept of "***deemed acceptance***" by Everest — including Everest — the court is constrained by its independent duty to ensure that a debtor meets all statutory requirements as a condition of confirming a plan. *Cf. United Student Aid Funds, Inc. v. Espinosa, 559 U.S. 260, 277 n.14, 130 S. Ct. 1367, 176 L. Ed. 2d 158 (2010)* ("*Section 1325(a)* does more than codify this principle [that "courts have the discretion, but not the obligation, to raise on their own initiative certain nonjurisdictional barriers"]; it *requires* bankruptcy courts to address and correct a defect in a debtor's proposed plan even if no creditor raises the issue.") (original emphasis). The similarities in the language of *§ 1325(a)* at issue in *Espinosa* and *§ 1191(a)* at issue here, and the Supreme Court's relaxation of the principle of party presentation in the face of such language, are too hard to ignore.

2. *Ruti-Sweetwater* is an out-of-circuit case representing the minority position. Indeed, a leading bankruptcy commentator has described it as "an unfortunate decision...." 7 Collier on Bankruptcy ¶ 1129.02 (16th ed. 2022). In the thirty-five years since the Tenth Circuit rendered that decision, no reported decision within our circuit relied on the "***deemed acceptance***" holding, as far as this court's own research revealed.

3. *Ruti-Sweetwater* is an out-of-circuit case representing the minority position. Indeed, a leading bankruptcy commentator has described it as "an unfortunate decision...." 7 Collier on Bankruptcy ¶ 1129.02 (16th ed. 2022). In the thirty-five years since the Tenth Circuit rendered that decision, no reported decision within our circuit relied on the "***deemed acceptance***" holding, as far as this court's own research revealed.

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4. regarding Everest's non-acceptance, the court recognizes that today's approach vests considerable power in the hands of a non-participating creditor with control over an entire class. As a policy matter, it is probably unwise to allow a creditor such as Everest to, in effect, "cram down" on a debtor the consequences of a "cram down" confirmation under *§ 1191(b)*, where most of the creditors favor a consensual plan. Although the court might favor the Tenth Circuit's approach were it free to do so (especially in the small business (***subchapter V***) setting), "courts do not sit to assess the relative merits of different approaches to various bankruptcy problems." (citations omitted).

Buying Votes in Chapter 11

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According to § 1129 of the Bankruptcy Code, a court shall only confirm a chapter 11 plan if all of the requirements listed in (a)(1) through (a)(16) are met. Pursuant to (a)(3) therein, the plan must be proposed in good faith and not by any means forbidden by law. Furthermore, the plan must be accepted by at least one class of impaired claims, and the acceptance cannot include acceptance of the plan by an insider.[1]

With respect to confirmation requirements, confirmation is grounded in notions of fair dealing and disclosure by and among the debtor and the creditors within the bounds of the Code and the relief afforded therein to the debtor. The voting process is contemplated to provide some reasonable *indicia* of support following the review of the global circumstances by impacted creditors and to prevent confirmation where "side-dealing" is present.[2] When impaired creditors vote for or against a chapter 11 plan, the court presumes that they do so with free and informed consent to their altered treatment going forward. If support from at least one impaired creditor class were not required, the chapter 11 confirmation process would be changed technically as well as theoretically.[3] The fully and freely informed vote of the impaired creditor is essential to the spirit of chapter 11 and the Code. Therefore, it must follow that an inappropriately influenced vote cannot serve the purposes of chapter 11.

Artificial Impairment of Claims, Vote Manipulation and Gerrymandering

Cases that deal with inappropriately influenced voting through financial incentives often also deal with a number of related issues including artificial impairment of claims, vote manipulation and gerrymandering. Section 1129 could be characterized as providing a formula for calculating votes in the context of chapter 11 confirmation. By adjusting the membership makeup of any particular class, the value of individual claims, and/or the impaired characterization thereof, a party can formulate a calculation either for or against confirmation.

Section 1124 provides that a claim is truly impaired when the legal, equitable or contractual rights of the creditor are materially altered.[4] When claims are inappropriately grouped together or separated into classes for the sole purpose of engineering confirmation, this constitutes gerrymandering. Artificial impairment occurs where the change in a creditor's claim rights are quite minimal and where evidence establishes that the impairment was solely devised for the purpose of technical compliance with § 1129(a)(10) and obtaining confirmation of a plan.[5]

The cases reviewed in this article highlight that artificial impairment, gerrymandering and vote manipulation are more likely to come into play where numerous disclosure statements or plans have been filed and/or where there is a vast financial and/or practical dilemma facing the debtor (and a related entity) that has not been resolved over a significant period of time, whether in or outside of bankruptcy. The fine line between confirmation strategy and confirmation manipulation can blur in these instances.

Sole Corporate Shareholder Financially Incentivizing Vote Precludes Confirmation

In re Quigley presents a detailed discussion not only with regard to artificial impairment and gerrymandering, but also concerning the monetary incentivization of an impaired class to vote in favor of a chapter 11 plan.[6] In writing the *Quigley* decision, Hon. **Stuart M. Bernstein** of the Southern District of New York provided a treasure trove of legal material for any bankruptcy practitioner dealing with voting manipulation issues in a chapter 11.

The *Quigley* story begins in 1916, the year Quigley Co. was founded as a manufacturer of refractory products. From 1940-70, Quigley sold three asbestos-containing products that caused asbestos-related injuries. In 1968, Pfizer acquired Quigley and was Quigley's sole shareholder. In 1992, Quigley sold substantially all of its assets, did not operate any business thereafter and filed its chapter 11 petition on Sept. 3, 2004.

Despite the cessation of operations and sale of Quigley's assets, Quigley and Pfizer were named as defendants in 411,110 asbestos personal-injury cases. On top of that, a future claims representative estimated to the court that there were roughly 261,567 claims yet to be made. As Quigley was financially dependent on Pfizer, Pfizer was the only entity with any real ability to negotiate and pay tort claims. Pfizer also carried joint insurance.

Over a significant period of time, Quigley and Pfizer attempted numerous ways to address these tort claims. They utilized the services of a claims-handling nonprofit organization. They participated in a class-action settlement that was eventually overturned by the Supreme Court. They entered into various agreements and even tried to support favorable asbestos-litigation legislation. As time wore on, the financial outlook associated with these tort claims deteriorated for Pfizer and Quigley. Many of the asbestos producers, who were also named defendants in the various civil actions, filed for bankruptcy relief. Quigley's and Pfizer's potential exposure continued to grow.

As a result of the numerous failed attempts to resolve this situation outside of bankruptcy, Quigley and Pfizer developed a global strategy, wherein they would attempt to address and limit their liability using the bankruptcy court. The global strategy centered on

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1 11 U.S.C. § 1129(a)(10).
2 *In re Windsor on the River Assocs.*, 7 F.3d 127, 132 (8th Cir. 1993).
3 *Id.*
4 11 U.S.C. § 1124(1).
5 *See, e.g., In re Estate of Larosa*, 2009 Bankr. LEXIS 517 (Bankr. N.D. W.Va. March 25, 2009); *In re Gregory Rockhouse Ranch*, 2007 Bankr. LEXIS 4343 (Bankr. D. N.M. Dec. 21, 2007).
6 *In re Quigley*, 437 B.R. 102 (Bankr. S.D.N.Y. 2010), is a 50-page decision dated Sept. 8, 2010, with significant factual detail, which the authors attempted to summarize from a very general perspective.

Pfizer entering into agreements to settle and limit its own liability. These agreements would make Pfizer's final settlement payment contingent on the confirmation of Quigley's chapter 11 plan, among other things.[7]

For purposes of the fourth amended plan at issue, Quigley and Pfizer strategically formulated Quigley's classes in such a way that Quigley's chapter 11 plan confirmation was essentially assured, which contained additional protections for Pfizer.[8] They formulated an impaired class that included those who settled with Pfizer and those who had not in such a way that this impaired class would very predictably vote in favor of the plan. Specifically, those who settled with Pfizer were incentivized to vote for Quigley's plan, and those who had settled outnumbered and represented a greater value of claims than those who had not. Pfizer incentivized these claimholders to vote for the plan by conditioning a final Pfizer settlement payment on confirmation of the Quigley plan.

As a result, the Ad Hoc Committee of Tort Victims (AHC) and the U.S. Trustee objected to confirmation on the basis of lack of good faith pursuant to 11 U.S.C. § 1129(a)(3) and artificial impairment under § 1129(a)(10), among other issues. The AHC and U.S. Trustee also sought to designate (*i.e.*, disqualify from voting) these tainted claims pursuant to § 1126(e).

One of the most interesting things about the *Quigley* decision is that Judge Bernstein noted that there is more to § 1129(a)(3) than the content of the plan,[9] stating that (a)(3) must be "viewed in light of the totality of circumstances surrounding the establishment of a chapter 11 plan" and "including the debtor's pre-filing conduct."[10] It appears that for Judge Bernstein, past actions matter. It made particular sense for the court to include in the opinion a detailed historical account of the debtor and its attempts to deal with these asbestos-related personal injury claims over a significant period of time both in and outside of bankruptcy.

The court ultimately concluded that the impaired class was motivated to accept the plan by virtue of financial incentives, which were structured so as to manipulate the Quigley confirmation vote. As such, the plan was not proposed in good faith, and the court concluded that the bad-faith findings under § 1126(a)(3) buoyed its conclusion that the tainted votes should be disqualified. Confirmation of the fourth amended plan was denied by the court.

Impermissible Attempt to Incentivize Change of Vote

In *In re Featherworks Corp.*, Featherworks Corp. filed for chapter 11 relief.[11] The debtor was a subsidiary of Hudson Feather & Down Products Inc., which owned 100 percent of its common stock. Featherworks had essentially four significant creditors—namely, Hudson, Walter E. Heller & Co., Windsor Trading Company and Far West Garments Inc. Hudson was owned by Puro International Ltd., which was in turn owned by Windsor. Windsor belonged to the wife and daughter of the president of the debtor, Arthur Puro.

Hudson and Windsor were the debtor's largest creditors, and Far West was a former customer of the debtor with a breach-of-warranty judgment. Heller financed the debtor until the chapter 11 petition was filed. Among other things, the chapter 11 plan provided roughly $40,000 to unsecured creditors holding $12.5 million in claims; the funds were supplied by Windsor. The plan left Windsor and Puro in full ownership of Featherworks, free of all debts save the $40,000 to be paid.

Among other confirmation issues discussed, the court specifically looked at the voting process and, in particular, an attempt to change a vote by Heller. Heller voted against the plan, but subsequently filed a motion for authority to change its vote. In the motion, Heller stated that it initially decided to vote in favor of the plan until it took possession of the debtor's pre-petition inventory and determined it to be flawed. Heller decided to vote against the plan and to sue the debtor, Windsor and Puro.

To avoid litigation, Arthur Puro paid Heller $25,000 in exchange for certain releases for himself and Windsor, among other things. In its motion, Heller maintained that the receipt of the $25,000 was not the reason it changed its vote in favor of the plan, despite the fact that it changed its vote immediately upon receipt of the $25,000.

All things considered, the court did not find that the acceptance of the plan by Heller was given in good faith. The court held that a "change in vote by the Debtor's major unsecured creditor, coincidental with the receipt from the same source as the $40,000 funding the plan of an additional $25,000 over and above what other creditors are receiving, will not be allowed."[12]

Go with Your Gut

The cases summarized in this article generally suggest that financial incentive from parties related to the debtor in voting will raise red flags to the court. What is also apparent is that terms conditioning settlement relative to how votes must be cast are problematic. *In re Wiston XXIV* is an interesting case inasmuch as an admittedly inexperienced bankruptcy attorney had initial concerns about a voting agreement, but ultimately disregarded those initial concerns.[13]

Wiston was a single-asset real estate case in which the debtor moved to designate a creditor's claim based on alleged voting improprieties. If the court agreed with the debtor and disqualified the vote, the impaired class would be deemed to have accepted the plan. If it did not agree with the debtor, there was no impaired class that would be deemed to have voted in favor of the plan.

Essentially, two creditors of the debtor negotiated and entered into an agreement related to foreclosure of real estate, possession of personal property collateral therein and promises to refrain from seeking recovery of improper post-petition payments. Acceptance of the settlement agreement was conditioned on the creditors' voting to reject the debtor's plan, although this term was not expressly stated in the creditors' agreement. Counsel for one of the creditors expressed concern that his client's vote would be designated but was assured by the other counsel that everything would be fine. The settlement agreement was held for signature until it was clear that the rejection vote was, in fact, filed. The court concluded that the agreement was made primarily for defeating the plan and, in reaching its decision, highlighted that one of the attorneys to the agreement questioned the appropriateness of the voting condition at the outset.[14]

Conclusion

These cases strongly suggest that conditioning a financial incentive to a

7 In the past, the court noted, Pfizer and Quigley would settle their claims jointly.
8 The court's decision concerns the fourth amended plan submitted by the debtor.
9 *Quigley*, 437 B.R. at 125 (referring to *In re Bush Indus. Inc.*, 315 B.R. 292, 304 (Bankr. W.D.N.Y. 2004)).
10 *Id.* (referring to, among others, *In re Greate Bay Hotel & Casino Inc.*, 251 B.R. 213, 240 (Bankr. D. N.J. 2000); *In re Madison Hotel Assocs.*, 749 F.2d 410, 425 (7th Cir. Wis. 1984); *In re Jasik*, 727 F.2d 1379, 1383 (5th Cir. Tex. 1984).
11 In re Featherworks Corp., 25 B.R. 634 (Bankr. E.D.N.Y. 1982).
12 *Id.* at 641.
13 *In re Wiston XXIV Ltd. Part.*, 153 B.R. 322 (Bankr. D. Kan. 1993).
14 *Id.* at 325.

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creditor in exchange for a pre-determined plan vote is inappropriate under § 1129. Whether or not that condition is expressly set forth in the agreement does not appear to make much difference. If settlement is conditioned on voting, it presents a problem.

In addition to considering the understandings or written agreements of the parties relative to the vote, a court may also look to the past historical dealings of the involved parties and insider relationships. Where there is essentially a sweetheart deal for a related entity and a motive to financially incentivize others to vote similarly, look for the court not only to find a lack of good faith but also to consider designating the vote under § 1126(e). Simply put, good faith in the voting process is the backbone of the chapter 11 reorganization and confirmation process. ■

Problems in the Code

By Stephen W. Sather and Barbara M. Barron

Voting and the Apathetic Creditor

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Voting by creditors and equity securityholders is one of the key features of chapter 11 reorganization. It determines whether a plan may be confirmed consensually[1] or by cramdown.[2] In order for a plan to be considered for confirmation, it must be accepted by at least one class of impaired creditors without reference to votes by insiders.[3] Voting in chapter 11 is defined by acceptance or rejection.[4] However, what happens when no creditor within a class casts a ballot? Is that an acceptance, a rejection or something else? The answer is unclear.

The subject of this article is the "apathetic creditor." Assume that a debtor proposes a plan with 10 classes of creditors, with each class containing one creditor. Creditors in nine classes vote to accept the plan. However, one class of creditors fails to cast a vote at all, and efforts to reach this creditor are unsuccessful. It could be that the debt is simply too small for a large organization to care about. It could be that the creditor is too busy to open any mail. It could also be that a grieving child has inherited the claim from his/her deceased parent. For whatever reason, voting upon the plan is not a priority for this creditor. Should this creditor's failure to vote affect how all of the other creditors who like the plan will fare? Courts have disagreed as described below, and the Bankruptcy Code is not clear.

The Statutory Language

The starting point for this question is the statutory language. The Code states that a creditor may vote to accept or reject a plan.[5] Whether a class accepts is set forth in 11 U.S.C. § 1126(c), which states:

> (c) A class of claims has accepted a plan if such plan has been accepted by creditors ... that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors ... that have accepted or rejected such plan.

If no creditors vote within a class, it makes for a difficult math problem. In that case, the fraction is 0/0, an equation that mathematicians struggle to solve.[6] Since bankruptcy law should not require an advanced degree in mathematics, a more practical approach is thus required.

The Code provides an express answer to the case of the apathetic creditor *within* a class of claims. Because only creditors who vote are counted in determining acceptance or rejection, a non-voting creditor *within* a class does not affect the outcome. Assume that in a class of 10 creditors, only one creditor votes. That creditor's vote will control whether the class assumes or rejects the plan.

The former Bankruptcy Act also provided an express answer, by requiring that a majority of the creditors in a class accept the plan.[7] Therefore, failure to vote constituted rejection of the plan.

Thus, there is a clear answer to what happens if a creditor within a multicreditor class fails to vote, as well as an answer as to what would have happened under the Bankruptcy Act. However, there is not a clear answer to what happens when an *entire class* fails to vote under the Bankruptcy Code, which has led to disparate results among the courts to have considered the issue.

Judicial Approaches to the Null Class

Courts have dealt with the problem of the apathetic creditor since the early days of the Bankruptcy Code. One approach, established by *Heins v. Ruti-Sweetwater Inc. (In re Ruti-Sweetwater)*,[8] holds that a class that neither votes to accept or reject is deemed to have accepted the plan. Because *Ruti-Sweetwater* provides the backdrop for many of the cases that follow, it is worth spending some time on its particulars.

The *Ruti-Sweetwater* entities were in the vacation time-sharing business. They filed a plan with 123 separate classes of creditors. One class of creditors was a judgment creditor, the Heins. They failed to vote, object to confirmation or appear at the confirmation hearing. All told, 20 separate classes of secured creditors failed to vote. The bankruptcy court ruled that these creditors were deemed to have accepted the plan.

When the property on which the Heins owned a timeshare was sold and they did not receive the sales proceeds, they realized that the plan had transferred their lien to other property. They figured this out in time to appeal the confirmation order. The Tenth Circuit affirmed the lower court opinions, which found that the plan had been properly confirmed. The debtors argued that the Heins were deemed to

1 11 U.S.C. § 1129(a)(8).
2 11 U.S.C. § 1129(b).
3 11 U.S.C. § 1129(a)(10).
4 11 U.S.C. § 1126(a).
5 11 U.S.C. § 1126(a).
6 Patrick Suppes, *Introduction to Logic* (Dover Publications Inc. 1959) (1999 Dover Edition), § 8.7. Formulations include that the answer is infinite, that it is undefined and that it cannot be answered.
7 11 U.S.C. § 762(a) (repealed), Bankruptcy Act of 1898 § 362.
8 836 F.2d 1263 (10th Cir. 1988).

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have accepted the plan based on their failure to both vote and object to the plan. The Tenth Circuit agreed, finding that creditors should be expected to take "an active role in protecting their claims."[9] The court ruled for the debtors on both grounds, stating:

> Since the Heins did not object to the Plan at any time prior to its confirmation and because the Heins unilaterally opted not to vote on the confirmation of the Plan, the bankruptcy court did not err in presuming their acceptance of the Plan for purposes of § 1129(b).[10]

Ruti-Sweetwater had several facets upon which later courts have seized. First, it was a complicated plan with many classes of creditors. Second, the non-voting class contained a single secured creditor, but there were other classes that accepted the plan. Third, the creditor committed the "trifecta" of not voting, not objecting and not appearing at the confirmation hearing.

While *Ruti-Sweetwater* remains the law in the Tenth Circuit, there has been a backlash among lower courts in other circuits, as well as commentators, concluding that failure to vote constitutes a rejection of the plan.[11] These courts claim to read the Bankruptcy Code as written to require an affirmative acceptance.

Other courts have taken intermediate approaches, such as finding that failure to vote constitutes deemed acceptance, but cannot satisfy the requirement of 11 U.S.C. § 1129(a)(10), which requires that a plan be accepted by at least one class of impaired claims.[12] Courts have also relied on the specific circumstances of *Ruti-Sweetwater* in which a single creditor class failed to vote on a complicated plan, which had overwhelming support from other creditors.[13]

No courts of appeals outside of the Tenth Circuit have addressed this issue. As a result, plan proponents and opponents have both a wide choice of authority to cite, but little clarity.

What Is the Purpose for Voting?

Voting serves multiple functions under the Bankruptcy Code. First, it requires that at least one class of impaired creditors has accepted the plan,[14] which serves a gatekeeping function to ensure that before a plan is considered for confirmation, it has some minimal level of support from parties whose rights are being altered.[15] Second, it encourages negotiation, which is one of the main goals of chapter 11.[16] When a debtor knows that its creditors will be voting on a plan, it will be more likely to engage in negotiations to make sure that positive ballots will be received. This may occur prior to the plan being filed, or alternatively receipt of a negative ballot may motivate the debtor to call or email to find out what the creditor would be willing to accept. Finally, plan voting determines how the confirmation hearing will proceed. If all classes of impaired creditors vote to accept the plan, it might be approved on a consensual basis.[17] Otherwise, the more stringent requirements of cramdown will apply.[18]

So, how are these purposes implicated in the case of the apathetic creditor? A failure to vote should not be sufficient to satisfy the gatekeeping function of 11 U.S.C. § 1129(a)(10), because the purpose of this subsection is to ensure that someone with some stake in the outcome approves the plan, and therefore a case in which no one votes does not accomplish this goal. This result is consistent even with the cases that follow *Ruti-Sweetwater*.[19]

It is harder to tell whether counting non-voting classes as an acceptance or a rejection will encourage negotiation. Some creditors will simply not engage. While the threat of a rejecting class may motivate a debtor to attempt to negotiate, it takes two parties to talk. As stated in *Ruti-Sweetwater*, creditors should be expected to take an active role in protecting their claims. The creditors that actively participate in the process should reasonably be expected to receive treatment more closely designed to fit their particular needs.

Finally, in setting up the requirements of proof for a confirmation hearing, it makes a big difference whether the class is secured or unsecured. If a secured class fails to vote, the debtor stands a good chance of proving the elements of 11 U.S.C. § 1129(b)(2)(A)[20] without an opposing party there to object. However, if the silent class is unsecured, counting silence as rejection invokes the absolute-priority rule,[21] which a debtor might not be able to satisfy. Is it fair to the creditors who voted to accept the plan if confirmation is denied due to apathy? The answer should be "no."

Based on the policies involved in voting, the authors believe that a non-voting class should be treated the same as a non-voting creditor within a class. Assuming that creditors receive proper notice and an opportunity to vote, silence should be treated as acquiescence, with one important caveat. Having at least one impaired accepting class under 11 U.S.C. § 1129(a)(10), by its nature, requires that someone care about a plan. If a debtor cannot obtain even one class of creditors to affirmatively support a plan, the plan probably does not deserve to be confirmed.

9 *Id.* at 1267.
10 *Id.* at 1267-68.
11 *In re M. Long Arabians*, 103 B.R. 211 (B.A.P. 9th Cir. 1989); *In re Vita Corp.*, 380 B.R. 525 (C.D. Ill. 2008); *HUD v. Westwood Plaza Apartments (In re Westwood Plaza Apartments)*, 192 B.R. 693 (E.D. Tex. 1996); *In re Augusto's Cuisine Corp.*, 2017 Bankr. LEXIS 833 (Bankr. D.P.R. 2017); *In re Jim Beck Inc.*, 207 B.R. 1010 (Bankr. W.D. Va. 1997); *In re Higgins Slacks Co.*, 178 B.R. 853 (Bankr. N.D. Ala. 1995). An influential treatise adopts this position as well. Alan N. Resnick & Henry J. Sommer, 7 *Collier on Bankruptcy*, ¶ 1126.04 (16th ed. 2016).
12 *SLC Inc. v. Nollkamper*, 1989 U.S. App. LEXIS 24464 (9th Cir. 1989); *In re Abkari-Shamirzadi*, 2015 U.S. Dist. LEXIS 164737 (D.N.M. 2015).
13 *In re Adelphia Commc'ns Corp.*, 368 B.R. 140 (Bankr. S.D.N.Y. 2007).
14 11 U.S.C. § 1129(a)(10).
15 *In re Combustion Eng'g Inc.*, 391 F.3d 190 (3d Cir. 2004); *In re A & B Assocs. LP*, 2019 Bankr. LEXIS 988 (Bankr. S.D. Ga. 2019).
16 *In re Cajun Elec. Power Coop.*, 230 B.R. 715 (Bankr. M.D. La. 1999).
17 11 U.S.C. § 1129(a).
18 11 U.S.C. § 1129(b).
19 *In re Abkari-Shamirzadi, supra.*
20 These include that the creditor is receiving the present value of its lien, that the property is being sold free and clear of liens, that the property will be surrendered to the creditor or that the creditor is receiving the indubitable equivalent of its interest.
21 11 U.S.C. § 1129(b)(2)(B).

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One possible controversy is whether a debtor should escape application of the absolute-priority rule due to the failure of creditors to vote. However, in that situation, all it would have taken is one creditor to vote "no" to cause the class to reject. Creditors that do not care should not receive the protections afforded to dissenting creditors or classes.

A Statutory Fix

One solution is to do nothing and insist that debtors create classes in which creditors will vote. This is unsatisfactory, though, since secured claims must generally be placed in separate classes because they have their own unique priorities. Instead, the authors suggest two alternative fixes, both of which arrive at the same result. The first is to amend 11 U.S.C. § 1126 to add subsection (h) as follows:

> (h) If no creditors or interest-holders within an impaired class of claims or interests casts a vote upon the plan, the class shall not be counted as either an accepting or rejecting class.

This formulation breaks out of the binary choice between acceptance or rejection to recognize that an abstaining class is a class that elects not to be counted, and therefore forfeits its right to influence whether the plan will be confirmed, unless there is no one to affirmatively raise their hand in support of the plan. An alternate formulation would allow an abstaining class to count as an acceptance for all purposes, except for § 1129(a)(10):

> (h) If no creditors or interest holders within an impaired class of claims or interests casts a vote upon a plan, the class will be deemed to have accepted the plan for all purposes, except for satisfying 11 U.S.C. § 1129(a)(10).

This solution would avoid sending a case to cramdown based on a class of apathetic creditors, while preserving the requirement that some impaired class must have affirmatively voted to approve the plan. Either one of these solutions would avoid the need to resort to cramdown based on a class that, when given the opportunity to vote, does not take an interest. abi

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JANUARY 11, 2023

Adverse Plan Amendment Requires a Disclosure Statement and More Voting, Circuit Says

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> The Eleventh Circuit stated the obvious: A class that gets something under a chapter 11 plan is entitled to a disclosure statement and to vote again if an amendment takes it away, even if the class was entitled to nothing in the first place.

The Eleventh Circuit laid down a strict rule requiring a class to receive a new disclosure statement and another opportunity to vote whenever the debtor amends a chapter 11 plan before confirmation that materially and adversely affects that class compared to the treatment in the prior plan.

The corporate debtor filed a chapter 11 reorganization plan to be financed with a $500,000 equity contribution and a $1.6 million line of credit, both to be supplied by existing equity holders. The plan said that existing stock would be extinguished and that new stock would be distributed in proportion to the new financing provided by the existing stockholders.

The existing stock was held by the chief executive and a group of shareholders. The formula meant that the shareholder group would receive two-thirds of the new shares, while the CEO would receive the remaining third. The plan also said that the new financing would be provided on the plan's effective date.

The bankruptcy court approved the disclosure statement, and creditors voted. The CEO and the shareholder group were in the same class, but none voted.

Two weeks before the confirmation hearing, the CEO notified the shareholder group that the company needed the new equity and credit line three days before the confirmation hearing, ostensibly to prove feasibility at the confirmation hearing. The shareholder group objected to the demand but worked with the debtor to advance the infusion before the confirmation hearing.

When the shareholder group missed the three-day-before confirmation deadline, the CEO put up all of the new financing. When the group missed the deadline, the debtor filed an amended plan giving the CEO all of the new stock in return for posting all of the new financing. The debtor did not serve the emergency motion to amend the plan on the shareholder group.

The shareholder group deposited their required share of the new financing into the debtor's escrow account the day before the confirmation hearing. The nature of the group's knowledge about the amended plan is unclear from the Eleventh Circuit's opinion, but the Court of Appeals said that the majority "had no reason to believe they would lose their equity interests at the confirmation hearing."

The shareholder group did not appear at the confirmation hearing to object to the amended plan, which the bankruptcy court confirmed after granting the motion to modify the plan.

Two days after confirmation, the shareholder group filed a motion to reconsider confirmation of the modified plan. The bankruptcy court denied the motion.

The shareholder group appealed, but the district court affirmed. The CEO wanted the district court to dismiss the appeal as equitably moot, but the district court denied the motion, believing it was possible to grant effective relief.

The group appealed to the circuit. The debtor did not raise equitable mootness on the second appeal.

The Shareholder Group Wasn't Deemed to Reject

Circuit Judge Britt C. Grant reversed in an opinion on January 5. She began her legal analysis by noting how a plan amendment under Section 1127(a) must comply with the requirements of a plan under Section 1123.

Of significance to the case on appeal, Section 1127(a)(4) requires a plan to "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." In this case, of course, the other shareholders were not receiving the same treatment as the CEO under the amended plan.

Procedurally speaking, Judge Grant said that an amendment must comply with the requirement in Section 1125 about providing "adequate information" in a disclosure statement.

Stitching the statutes together, Judge Grant held that a debtor must provide a new disclosure statement and another round of voting if a modification is made after the votes are cast and the modification materially and adversely changes how the class is treated.

Applying the principles to the case, Judge Grant said that the "sole purpose" of the amendment was to "strip" the other shareholders of the new equity. Therefore, she said, the amendment was materially adverse and entitled the other shareholders "to a new disclosure statement and a second chance to cast a ballot."

The CEO argued that the other shareholders had equity in an insolvent company, were entitled to nothing under the plan and were not entitled to vote because they were deemed to oppose confirmation. Having "rejected" the plan, the other shareholders were not entitled to vote a second time, the CEO contended.

Judge Grant found flaws in the argument. First, the other shareholders were to receive property under the original plan, thus making Section 1126(g) inapplicable. That section says that a class is deemed to have rejected the plan if the class receives nothing under the plan.

Second, Judge Grant said they were entitled to vote on the amendment and receive a disclosure statement because they were treated adversely, even if the other shareholders were deemed to have rejected the original plan.

Judge Grant therefore held that the bankruptcy court could not have deemed the majority to have rejected the amended plan. If there were any doubt, Judge Grant noted how the plan said several times that shareholders were entitled to vote.

Judge Grant held that the bankruptcy court "could not have granted the modification or confirmed the modified plans because the [CEO] was treated more favorably than the rest of [the shareholder class]."

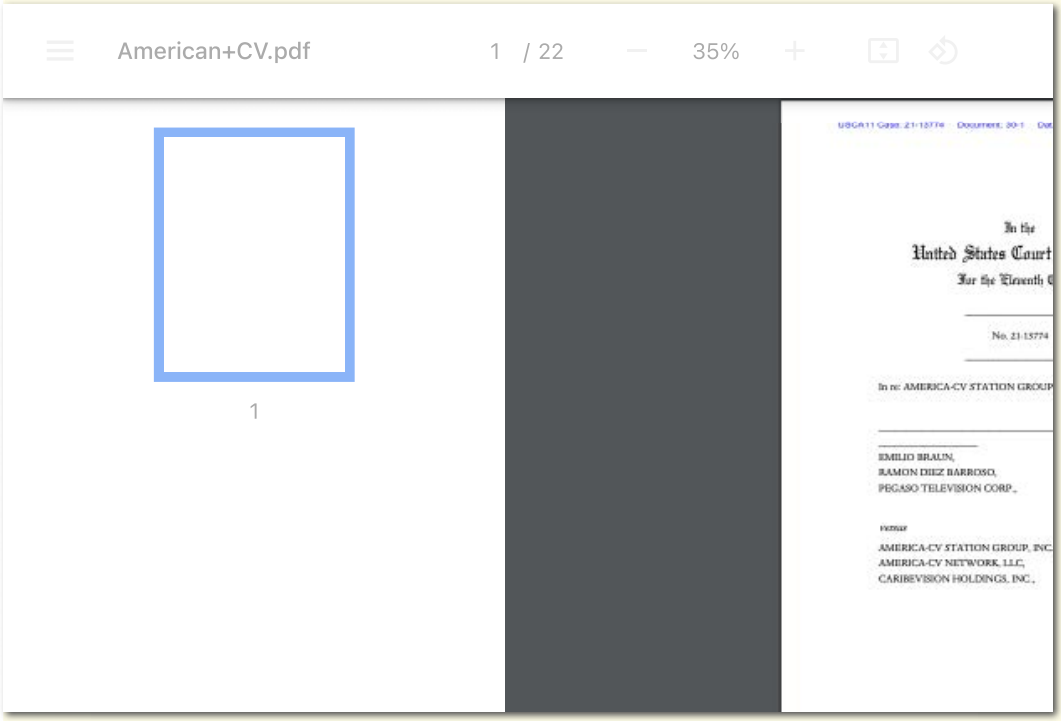
Remedy

The circuit court "assumed" that the appeal was not equitably moot because the CEO did not raise the argument in the court of appeals. The appeals court also assumed that relief could be granted, based on the finding by the district court.

Judge Grant left "the exact contours of that relief to the bankruptcy court in the first instance [and remanded for] the bankruptcy court to fashion an equitable remedy."

Opinion Link

PREVIEW



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Case Details

Case Citation	Braunn v. America-CV Station Group Inc. (In re America-CV Station Group Inc.), 21-13774 (11th Cir. Jan. 5, 2023).

Case Name	Braunn v. America-CV Station Group Inc. (In re America-CV Station Group Inc.)
Case Type	Business
Court	11th Circuit
Bankruptcy Tags	Plan Confirmation Business Reorganization

A Way to a Stay That Can Pay

Committee: Bankruptcy Litigation

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Real estate debtor principals who guaranty a debtor's debts often face uphill battles to obtain stays pursuant to § 105 of the Bankruptcy Court of guaranty actions against them by secured creditors of the debtor. The bankruptcy court in *In re Chicora Life Center, LC*[1] recently issued such a stay. That court applied traditional § 105 analysis to a guarantor with very favorable facts, making *Chicora Life Center* unlikely to be a harbinger of real estate mortgage guarantors obtaining stays more readily.

The key facts can be summarized briefly. UCF 1 Trust 1 (UCF) held a first-priority mortgage on the commercial retail center owned by the debtor Chicora Life Center, LC (the debtor). A guarantor ("Durbano" or "guarantor") sought to enjoin UCF from pursuing a post-petition guaranty action.

UCF was owed approximately $15.6 million. The debtor offered property valuation testimony of $35-$37 million. UCF's appraisal at the time of incurring the loan also showed a large equity cushion. UCF, according to the bankruptcy court, did not offer competing evidence of value.

The guarantor testified that the debtor would submit a plan of reorganization to provide a personal contribution from him of no less than $1 million to pay operating expenses and necessary pre-occupancy tenant improvements for the property. At this point, the debtor still held exclusivity. In addition, the debtor acknowledged that it was a "single-asset real estate" entity that would have to start making monthly payments in August 2016 on account of the UCF debt absent filing a plan with a reasonable likelihood of successful confirmation.

The guarantor further testified that he was also a guarantor on a line of credit at Zions First National Bank. Zions was to be the source of the $1 million contribution through a line of credit outstanding to a guarantor affiliate. The debtor offered testimony from both the duarantor and a third-party credit expert that the filing of an action against the guarantor by UCF would materially impede the guarantor's ability to renew the Antion credit line and use it to fund the debtor's plan.

Significantly, UCF contended that the debtor's indirect members could fund the $1 million through other capital contributions, but the bankruptcy court appeared to reject that contention in its analysis (but not its factual findings).

The bankruptcy court also noted debtor testimony of its efforts to negotiate a takeout loan for $31 million, an amount sufficient to pay in full the secured claims and the unsecured claims that were less than $170,000.

Against this factual background, the bankruptcy court applied the traditional four-element test for injunctions to the § 105 request: (1) Was the debtor likely to succeed on the merits; (2) would the debtor likely suffer irreparable harm in the absence of injunctive relief; (3) what was the balance of equities; and (4) was an injunction is in the public interest? The bankruptcy court cited *Willis v. Celotex Corp.*,[2] quoting *A.H. Robins Co. v. Piccinin (In re A.H. Robins Co.)*, 788 F.2d 994, 1003 (4th Cir. 1986), as authority for a § 105 injunction against a guaranty action to avoid either the detrimental influence and pressure of the debtor through the third party or an adverse impact on the debtor's ability to formulate a chapter 11 plan. The bankruptcy court further concluded, despite another case in the district ruling otherwise, that

the Fourth Circuit does not separately require "unusual circumstances" to issue a § 105 injunction. The court also disposed of UCF's claim that the guarantor had waived in its guaranty its right to seek a § 105 injunction, pointing out that the debtor had not waived *its* right to such an injunction for the guarantor.

Applying these standards, the court found that an action against the guarantor would impede renewal of the credit line funding the $1 million anticipated plan contribution. Filing the plan shortly was necessary, since the impending expiration of the 90-day single-asset real estate and lack of sufficient property income to permit § 362(d)(3) payments would otherwise have entitled UCF to stay relief.

Because the court found that commencement of the lawsuit would imperil renewal of the letter of credit and thus jeopardize the plan's funding source, it was crucial that the court had concluded that UCF had not brought forth sufficient evidence to show other equity owners' potential sources of capital contributions to pay the needed $1 million. Otherwise, perhaps the court could not have concluded that the injunction was necessary to prevent irreparable harm.

The substantial equity cushion helped the debtor satisfy the balance-of-equities test. The court then strained to find that all four factors favored the debtor by concluding that promoting confirmed plans of reorganization is more in the public interest than upholding the contractual rights of third parties. This seems puzzling, since the bankruptcy court could have found simply that the public interest would not be affected one way or another by its decision, as this was purely a private-party dispute. That would have left all of the other factors favoring the injunction in any event.

Of interest is the court's conclusion that the debtor was likely to be able to confirm a plan. This is not so clear. Based on the debtor's schedules, lack of liens in favor of any non-insider creditors other than UCF and the minimal amounts of priority and unsecured claims, the $1 million infusion likely would have sufficed to pay all non-insider creditors in full other than UCF.

This would have left UCF as the only unimpaired creditor. This would leave the debtor with no impaired noninsider accepting class, meaning that the debtor would not have satisfied 11 U.S.C. § 1129(a)(10). Hence, the debtor's testimony of proposed takeout financing became critical. It could facilitate full takeout of UCF, eliminating UCF's veto.

Indeed, a hint of this takeout financing's significance on the court's thinking can be gleaned from the scope of its actual order. The § 105 injunction was put in place until Aug. 1, 2016, with a conference to take place three days before. By that time, the court expressed its expectation that the debtor would "formulate with specificity its plan of reorganization and report to the Court on its efforts to obtain a takeout loan that is sufficient to pay UCF's claim in full."

To summarize, *Chicora Life Center* is a case where the debtor ably mustered evidence to justify a § 105 injunction against the secured creditor's commencement of an action on a guaranty. The large equity cushion, lack of harm that UCF could show were the injunction granted, lack of evidence to counter the debtor's contention that the guarantor was the sole source of the needed $1 million infusion, and the prospect that the debtor could obtain takeout financing created a powerful case for a § 105 injunction. This case should not, however, be seen as a radical alteration of the standards by which bankruptcy courts assess § 105 injunction requests. The debtor in this case, armed with very favorable facts, mustered them effectively in support of an injunction that existing case law justifies.

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[1] 553 B.R. 61 (Bankr. D.S.C. 2016).

[2] 978 F.2d 146, 149 (4th Cir. 1992).

Rochelle's Daily Wire

ABI EXCLUSIVE

MAY 25, 2023

Do Debtors Get to Keep Post-Confirmation Windfalls in Chapter 13?

> Chapter 13 scholar Keith Lundin believes that debtors retain inheritances acquired more than 180 days after filing.

A chapter 13 debtor ties the score in the top half of the ninth inning in a game against the trustee. In the bottom half of the ninth inning, the trustee loads the bases with two outs. The batter for the trustee hits a long fly ball. Will it be caught to end the inning and win the game for the debtor, or will it go over the fence, with the trustee beating the debtor on a walkoff homer?

The case involves an inheritance the debtor received almost three years after confirming a chapter 13 plan. Will the debtor get to keep the inheritance or not?

Former Bankruptcy Judge Keith Lundin, the author of the treatise *Lundin on Chapter 13*, predicts that the debtor will win the game, perhaps in extra innings (that is to say, on appeal or after converting the case from chapter 13 to chapter 7).

The Inheritance

The debtor confirmed a 36-month chapter 13 plan with nothing for unsecured creditors on their $25,000 in claims. The debtor paid $140 a month over the life of the plan, for a total of $5,040.

In the 31st month of the plan, the debtor received a $72,000 inheritance on the death of her mother. After completing payments in the 37th month of the plan, the debtor informed the trustee about the inheritance and amended her schedules.

The debtor still had a wildcard exemption that could be applied to the inheritance. After the exemption, the trustee calculated that the $58,000 net was estate property.

The chapter 13 trustee insisted that the debtor either pay 100% of filed claims or modify her plan to pay 100%. After the debtor declined, the chapter 13 trustee filed a motion asking Bankruptcy Judge Mary Jo Heston of Tacoma, Wash., to modify the plan under Section 1329(a) by increasing payments and extending the life of the plan.

The Seven Questions

In her May 18 opinion, Judge Heston marched through a string of questions to decide whether the debtor could keep the entire inheritance or part of it. First, she tackled the issue of whether the inheritance was property of the chapter 13 estate.

Two statutory provisions come into play. Section 541(a)(5) tells us that an inheritance becomes property of the estate if the debtor "acquires" the inheritance within 180 days of the filing date. In this case, the debtor acquired the inheritance long after the 180-day period.

"[I]n addition to the property specified in section 541," Section 1306(a)(1) provides that estate property in chapter 13 includes "all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title, whichever occurs first."

Judge Heston refined the first question by asking "whether § 1306 extends the time frame under which inheritances become property of a chapter 13 bankruptcy estate beyond 180 days or whether § 541 sets a fixed time frame for the receipt of an inheritance under any chapter of the Code."

Courts differ on the answer. Judge Heston elected to follow the majority of courts, citing the Fourth Circuit and the Ninth Circuit Bankruptcy Appellate Panel. *See Carroll v. Logan*, 735 F.3d 147, 152 (4th Cir. 2013) (holding that Section 1306 extends time frame set by Section 541 beyond 180 days in chapter 13 cases), and *Dale v. Maney (In re Dale)*, 505 B.R. 8, 13 (B.A.P. 9th Cir. 2014) (same).

Judge Heston found the BAP to be most persuasive and held that the post-petition inheritance became property of the estate under Section 1306(a)(1). In other words, Section 1306(a)(1) overrules or modifies the 180-day limitation in Section 541(a)(5).

Second, Judge Heston analyzed Section 1329 and decided that the trustee had the ability to modify the plan. Pointing to the debtor's delay in notifying the trustee about receipt of the inheritance, she next concluded that equitable estoppel barred the debtor from relying on Section 1329(a) by claiming that the trustee could not modify the plan, since she had already made the last payment under her plan.

Fourth, Judge Heston asked whether a modified plan would satisfy the best interests test in Section 1325(a)(4). "[A]s of the effective date of the plan," the section requires that distributions be not less than what unsecured creditors would receive in chapter 7. But what's the effective date? Is it the date of confirmation of the original plan or the confirmation date of the amended plan?

Although she found no controlling authority, Judge Heston said that "most courts" believe that the "effective date" refers to the modified plan, meaning that the liquidation analysis must be "reapplied" when the plan is modified. She said that "the majority approach ensures that the plan as modified accurately reflects what creditors might hope to receive in a chapter 7 liquidation if the debtor were to convert the case to chapter 7 today."

For the fifth question, Judge Heston asked "whether the value of the non-exempt portion of the inheritance is included in a hypothetical liquidation, known as the best interest of

the creditors test."

Again, two sections were in competition. Section 1306 brings post-petition property into the estate, but what about Section 348(f)(1)(A)? When a case is converted from chapter 13, Section 348(f)(1)(A) says that "property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion." If conversion was in bad faith, subsection (f)(2) says that "the property of the estate in the converted case shall consist of the property of the estate as of the date of conversion."

Naturally, the trustee contended that Section 1306 brought the inheritance into the estate. Judge Heston disagreed, handing the debtor an apparent victory under Section 348(f)(1)(A).

Judge Heston followed *In re Taylor*, 631 B.R. 346 (Bankr. D. Kan. 2021). She described the opinion by Bankruptcy Judge Dale L. Somers of Topeka, Kan., to mean that "the hypothetical chapter 7 estate does not include [the recovery on a post-petition personal injury claim] pursuant to § 348(f)." *Taylor* appears to mean that chapter 13 debtors retain post-petition inheritances, lottery winnings and other windfalls that have no connection to pre-petition assets. To read ABI's report on *Taylor*, **click here**.

If Section 1306 were to control, Judge Heston said that "liquidation value would be subject to constant upwards and downwards adjustments during the pendency of the case to account for any postconfirmation asset or liability acquired." She also said that the adoption of Section 348(f) in 1994 "expressly overruled *In re Lybrook*, 951 F.2d 136 (7th Cir. 1991)," and removed a disincentive for filing in chapter 13.

Saying there were unresolved facts to govern whether conversion to chapter 7 would be in bad faith, Judge Heston identified a sixth question but did not decide whether Section 348(f)(2) would bring the inheritance into the estate.

Yogi Berra Precedent

At this point, the score was tied, or the debtor might have had a leg up, because Judge Heston's ruling on Section 348(f)(1)(A) meant that the inheritance would not be included in the new liquidation analysis absent bad faith. But as Yogi Berra allegedly said, "It ain't over 'til it's over."

On the penultimate page of her opinion, Judge Heston raised a seventh issue and dropped a bombshell when she said, without statutory authority:

In determining whether modification is warranted, the Court may in its discretion consider whether a debtor experienced a substantial and unanticipated change in her financial condition. *In re Mattson*, 468 B.R. 361, 370 (B.A.P. 9th Cir. 2012).

Citing the Fourth Circuit's *Carrroll* opinion, Judge Heston found, "as a matter of its discretion, that the inheritance is a significant improvement in the Debtors' financial condition that warrants increasing the distribution to unsecured creditors." She therefore directed the debtor to "propose a modified plan that increases the distribution to unsecured creditors that meets the good faith requirements of § 1325(a)(3)."

Commentary

Former Bankruptcy Judge Lundin told ABI that "post-confirmation change in assets/income is probably the hottest topic going in the chapter 13 world, because post-petition assets and income are badly managed by the Code."

Judge Lundin said that Judge Heston "correctly excluded the inheritance from the best-interests-of-creditors test analysis because of Section 348(f)." But then, he said, the opinion "jumps to 'unforeseen, changed circumstances' to allow a section 1329 modification without telling us what provision of Section 1329 captures the inheritance."

Judge Lundin said that "1325(b) doesn't apply at modification after confirmation under section 1329. So where is the hook? Is the inheritance 'future income' of some sort?"

Judge Lundin answered his own question by saying that "it can't be the projected disposable income test in Section 1325(b) because an inheritance is not a substitute for wages or salary." He cited the Ninth Circuit for having "rejected the notion that liquidation of an asset produces income for Section 1329 modification purposes."

"Once the inheritance is excluded from the asset calculation in Section 1325(a)(4)," Judge Lundin said, "it doesn't come back in through the income door."

Judge Lundin's analysis suggests that the debtor might succeed on appeal. To do so, she could modify her plan to satisfy Judge Heston and then appeal, asking the trustee to hold her extra payments pending appeal.

Or, the debtor might covert her case to chapter 7 as of right under Section 1307(b), if she were confident that conversion would not be in bad faith under Section 348(f)(2). Were she to convert, Judge Lundin said that the "debtor would keep the entire inheritance on a good faith conversion to chapter 7."

Opinion Link

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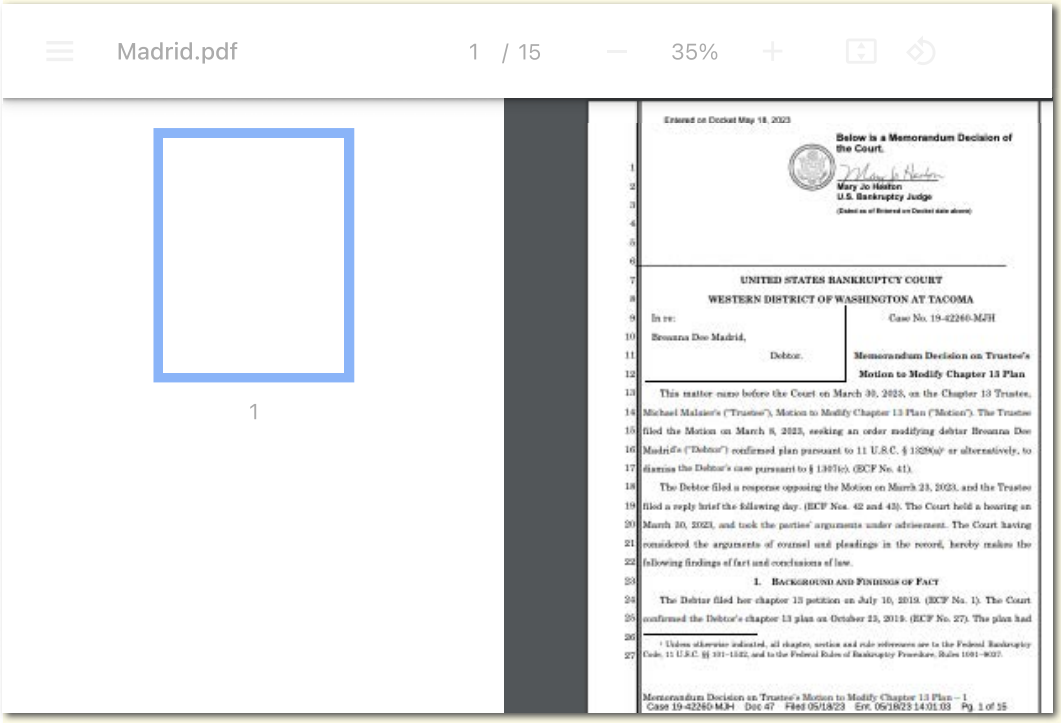

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Case Details

Case Citation	In re Madrid, 19-42260 (Bankr. W.D. Wash. May 18, 2023)
Case Name	In re Madrid
Case Type	Consumer

Court	9th Circuit Washington Washington Western District
Bankruptcy Tags	Plan Confirmation Consumer Bankruptcy

Trustee Talk

By Maria Joyner

Post-Confirmation Plan Modification and Income Changes

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The nature of a chapter 13 case, as a long-term repayment plan, results in a high likelihood that chapter 13 debtors will experience changes in income and/or expenses, or will acquire additional assets after plan confirmation. The Bankruptcy Code deals with such post-petition acquired assets in § 541 (limiting property of the estate to was acquired within 180 days of filing) and in § 1306 (expanding property of the estate in for chapter 13 cases). While there is a large body of case law that addresses whether assets acquired post-petition are property of the estate in chapter 13 cases,[1] there is only one circuit decision on the specific interplay of §§ 541 and 1306.

In *Carroll v. Logan*,[2] the Fourth Circuit held that a $100,000 inheritance received three years after the filing of the chapter 13 petition was property of the estate. The court declined to limit the time period under § 541, even though an inheritance is one of the types of property of the estate enumerated in that section. The court held that even the asset types enumerated in § 541 were property of the estate past the 180-day limitation pursuant to a reading of that section in conjunction with a reading of § 1306. The majority of lower court holdings appear to be in line with the Fourth Circuit in *Carroll*, but the issue is far from settled. In fact, in the Northern District of Georgia, there are two recent opinions: *In re Gilbert*, which follows the majority, and *In re McAllister*, which aligns with the minority position.[3]

The incongruity of post-petition property and its impact as property of the estate is mentioned to show that this area of law is still developing. Increases in a debtor's post-petition income (the focus of this article) are more clearly property of the estate because § 1306(a)(2) specifically states that property of a chapter 13 estate includes "earnings from services performed by the debtor, after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 ... whichever occurs first."

Despite clear identification as estate property, the Bankruptcy Code is less clear on how increases in employment income affect a debtor's confirmed plan. A hotly litigated topic is whether a change of circumstance after plan confirmation is necessary to modify the plan. For those courts that answer in the affirmative, the question then becomes: What type of change of circumstance is necessary to modify a plan due to increased income?

What Is Substantial and Unanticipated?

In *In re Matusak*, the U.S. Bankruptcy Court for the Eastern District of North Carolina reviewed an unsecured creditor's request to modify the confirmed plan when the creditor became aware of the debtor's increased annual income of approximately $35,000, and the debtor's subsequent objection to that modification request.[4] In order to determine whether the modification was warranted, the court used a three-part test: (1) determine whether a substantial and unanticipated change in the debtor's financial condition has occurred; (2) if such a change is established, then ensure that the modification is for one of the purposes enumerated in § 1329(a); and (3) determine whether the modification complies with § 1329(b).[5]

Without much discussion, the court determined that the approximately $35,000 gross income increase was substantial. A more robust analysis was made for determining whether the change was "unanticipated." The debtor was a commission-based salesman, thus his income fluctuated throughout the year. The creditor was the debtor's former spouse and worked in the same field as he did. Based on the known variation of his income, the court found that a post-petition increase of income could have been anticipated by all parties, and thus found that the first prong of the test was not met. The court ultimately did rule that the plan would be modified, but on different grounds. However, the court found that the debtor was precluded from objecting to modification of his plan due to litigation that commenced pre-confirmation, whereby the ex-spouse withdrew her objection to confirmation of his plan based on the debtor's statement that his

1 For several lower court decisions on the topic, *see In re Taylor*, 523 B.R. 915, 2014 WL 7246122 (Bankr. S.D. Ga. 2014); *In re Roberts*, 514 B.R. 358, 361-63 (Bankr. E.D.N.Y. 2014); *In re Castillo*, 508 B.R. 1, 6 (Bankr. W.D. Tex. 2014); *In re Ormiston*, 501 B.R. 303, 307-08 (Bankr. E.D.N.C. 2013); *In re Stillwaggon*, No. 9:10-bk-12289-FMD, 2014 Bankr. LEXIS 1085 (Bankr. M.D. Fla. March 19, 2014); *In re Key*, 465 B.R. 709, 712 (Bankr. S.D. Ga. 2012); *In re Schlottman*, 319 B.R. 23, 25 (Bankr. M.D. Fla. 2004).

2 *Carroll v. Logan*, 735 F.3d 147 (4th Cir. 2013).

3 *See In re Gilbert*, 526 B.R. 414 (Bankr. N.D. Ga. 2015); *In re McAllister*, 510 B.R. 409 (Bankr. N.D. Ga. 2014), *aff'd on other grounds*, *Townson v. McAllister*, No. 4:14-CV-00106-HLM, 2014 U.S. Dist. LEXIS 182651 (N.D. Ga. Oct. 14, 2014).

4 *In re Matusak*, 571 B.R. 176 (Bankr. E.D.N.C. 2017).

5 The three-part test and standards utilized in *Matusak* originate from *In re Fitak*, 92 B.R. 243 (Bankr. S.D. Ohio 1988), and *In re Arnold*, 869 F.2d 240 (4th Cir. 1989).

plan could later be modified to capture increases of income. The court specifically noted in a footnote that they were not deciding whether commission-derived income can ever be modified under § 1329.

The same bankruptcy court looked at another plan modification based on additional wage income in *In re Ripley*.[6] In this case, the chapter 13 trustee moved to modify the debtor's plan payment due to an increase of income from $66,705.64 annually to $105,747.24 annually. Again, the court quickly determined that the increased income was "substantial," but also struggled with whether the change of income was "unanticipated." The debtor was also a commission-based salesman whose income fluctuated. The debtor testified that the main reason for the change of his income was due to an expansion of his sales territory.

The court found that no evidence was presented, prior to confirmation of the debtor's plan, that would have allowed the creditor and/or the trustee to reasonably anticipate the increase in income for the debtor. Therefore, the court found that the increased income did meet the "unanticipated" prong of the three-part test. From these cases, it appears that determining whether increased income is anticipated is heavily fact-driven and a possible point of contention, especially for commission-based or non-traditional wage earners. For those who practice in districts where this type of "unanticipated" change is necessary to modify the plan, it might be advisable to request an order of the court at the time of plan confirmation that clarifies the debtor's duty to disclose income changes post-confirmation and clarifies what types of income changes will warrant modification of the plan.

Who Can Modify?

Even assuming that the debtor has a substantial and unanticipated income change (or you practice in a district where a change of circumstance is not required), more questions remain. For example, who has the duty to bring a post-confirmation modification when a change of income occurs? The starting point for this inquiry, § 1329, is hardly helpful to determine which party has the duty to bring a post-confirmation modification for a debtor's increased income, but it does narrow the possible parties who are allowed to file a post-confirmation plan modification. The statute states that "the plan may be modified, upon request of the debtor, the trustee, or the holder of an allowed unsecured claim."[7] While this statute gives equal rights to these three parties, these parties have wide discrepancies in their ability and motivation to file a modification of the plan.

On one hand, the debtor is in the best position to know when there has been an increase in income, but this is contrasted with the debtor having the lowest motivation to come before the court due to the ultimate result of a plan payment being increased. On the other hand, unsecured creditors are highly motivated to modify the debtor's plan to increase a plan payment, but unsecured creditors are often not in a position where it makes financial sense to monitor each debtor's post-petition income.

In the middle is the chapter 13 trustee. While the chapter 13 trustee has no better knowledge of a debtor's post-petition income than an unsecured creditor, the trustee is, in most cases, better positioned to utilize the Bankruptcy Code to acquire income information from the debtor.

Although out of the three the trustee is often the party seeking modification of the plan, this might be an inefficient solution. The party seeking modification of a confirmed plan bears the burden to prove the circumstances supporting the modification.[8] Individual trustees determine their own criteria to analyze the amount of increased income that warrants a request to modify the plan. As the debtor rarely files updated schedules prior to the trustee filing a motion to modify, the trustee's decision to file the motion to modify is often based only on gross income figures. This will typically be a comparison of the income listed on a debtor's tax return from year to year and the debtor's filed Schedule I. The obvious disadvantage in this endeavor is that the trustee might not be aware of any revised circumstances of the debtor, such as changes in household size, increased medical expenses, increased transportation costs and other various expenses. This could lead to an inefficient use of a bankruptcy court's resources if motions are filed and hearings are held only to discover, through updated schedules, that there was also an increase in the debtor's expenses that effectively rendered the income increase moot. Based on this analysis, it appears that the debtor should be the party responsible for modification of the plan and the best candidate to know changes of income and expenses, but the reality remains that it will often be the trustee upon whom this burden falls.

Duty to Disclose or Discover?

Before a court can consider any party's request to modify a plan, the change of post-petition income has to be either disclosed or discovered. This leads to the following question: Who has the duty to disclose or discover income changes post-confirmation? The Bankruptcy Code does not expressly confer a duty on the debtor to notify the parties of changes in income and expenses, although some districts specifically place this responsibility on debtors and their attorneys through general orders or rights and responsibilities statements.[9] Outside of any local provisions, in order to receive a debtor's updated income information, the trustee will utilize § 521(f)(1), which provides that "at the request of the Court, the United States Trustee, or any party-in-interest ... a debtor ... shall file with the Court ... a copy of each Federal Income Tax Return ... with respect to each tax year of the Debtor ending while the case is pending." Further, § 521(f)(4) provides that a chapter 13 debtor, at the request of the court, the trustee or other party-in-interest, must file annual statements disclosing "the income and expenditures of the debtor during the tax year ... and ... the monthly income of the debtor that shows how income, expenditures, and monthly income are calculated."

6 *In re Ripley*, No. 14-01265-5-DMW, 2018 Bankr. LEXIS 311 (Bankr. E.D.N.C. Feb. 6, 2018).
7 11 U.S.C. § 1329(a).
8 *In re Brown*, 332 B.R. 562 (Bankr. N.D. Ill. 2005).
9 *See* Northern District of Georgia General Order 18-2015, *available at* ganb.uscourts.gov/content/general-order-18-2015 (last visited on March 26, 2019).

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Trustee Talk: Post-Confirmation Plan Modification and Income Changes

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One way, albeit indirectly, that the Bankruptcy Code instills a duty on the debtor to disclose increased income during the pendency of their bankruptcy case is the inclusion of the confirmation requirements of § 1325(a) in § 1329 — specifically, the inclusion of the good-faith test under § 1325(a)(3). However, the good-faith test for post-confirmation modifications has been viewed differently across the courts and might be a more difficult issue when a request to modify the plan is brought by the trustee. In analyzing the good-faith test, some courts have held that the good faith applies only to the proponent of the modification.[10] In cases where the motion to modify was brought by the trustee or an unsecured creditor, these courts have held that the debtor's good faith was determined at the time the court confirmed the debtor's plan.[11]

For example, in the *Pautin* case, the court stated that it was "deeply troubled" by the actions of the debtor that caused "an absence of accountability and transparency," but denied the trustee's motion to modify.[12] The *Pautin* ruling is contrasted by the ruling in the *Deal* case, where Hon. Robert Brizendine found that the debtor's "pattern of conduct ... reveals a persisting reluctance of candor ... inconsistent with the good faith expected" of debtors.[13] In *Deal*, the court held that the actions of the debtor rose to the level of dismissal, which was the alternative relief sought by the trustee when undisclosed income was discovered.[14]

When to Request a Modification?

One last question is this: When does a modification have to be requested for a post-confirmation income change? It is common for trustees to require debtors to submit tax returns to them each year pursuant to § 521. This allows the trustee to monitor the debtor's income and identify cases where increased income might warrant a motion to modify. The process of requesting, logging and reviewing tax returns is not a small task.

In the Northern District of Georgia, there are more than 24,000 active chapter 13 cases among the three trustee's offices. The sheer volume of cases and their related tax returns can lead to issues that cause delays in filing motions to modify. A significant delay could render success on a motion to modify problematic based on § 1329 providing two temporal requirements for timely modifications: (1) a modified plan may not provide for payments over a period that expires after the applicable commitment period;[15] and (2) the plan may only be modified before the completion of payments under such a plan.[16] Courts will consider modifications timely if they are filed prior to the completion of the applicable commitment period and before the debtor completes payments due under the plan.[17] The best practice for parties proposing modifications is to file the modifications as soon as they become aware of the increased income, preferably after an annual review of income, and avoid unnecessary delay.

Conclusion

There are certainly many other questions on this topic, and there are not a lot of concrete answers that can be applied nationwide. However, here are some takeaways for debtor attorneys to help circumvent or at least mitigate the increased-income issue: Prepare debtors for the potential effects that income changes will have on their bankruptcy case; review debtor's income and expenses annually; review a debtor's tax returns before forwarding to the trustee; and file amended schedules and/or modifications, if necessary. From the author's experience in the trustee's office, many cases have been seen where the filing of amended schedules of income and expenses have pre-empted a trustee's motion to modify. However, just as many cases have been seen where tax returns are forwarded to the trustee without proper attorney review, which has led to unexpected litigation for the attorney and debtor.

Also, consider the need for orders at the time of plan confirmation that clarify the burden of the debtor to disclose income changes and/or modify their plan to account for income changes; create an efficient manner to collect and review tax returns each year; and ensure your income review process allows for prompt requests to modify the plan when necessary. One thing is certain: If you practice chapter 13, these issues will likely come up in a case you are involved in. Hopefully, the "who, what, when and how" will be in your favor. abi

10 *In re Self*, 2009 Bankr. LEXIS 2880 (Bankr. D. Kan. Sept. 11, 2009).
11 *Id.* at 9.
12 *In re Pautin*, 521 B.R. 754 (Bankr. W.D. Tex. 2014) (debtor did not disclose post-petition pawn payments, became delinquent on plan payments, did not disclose increase in income and did not disclose tax refunds).
13 *In re Deal*, 2014 Bankr. LEXIS 2303 (Bankr. N.D. Ga. March 11, 2014) (debtor failed to disclose substantial increases in income and failed to update business records).
14 *Id.* at 10.
15 11 U.S.C. § 1329(c).
16 11 U.S.C. § 1329(a).
17 *Germerand v. Powers*, 826 F.3d 962, 969 (7th Cir. 2016); *In re Meza*, 467 F.3d 874, 879-880 (5th Cir. 2006); *In re Jacobs*, 263 B.R. 39, 43 (Bankr. N.D.N.Y. 2001) (denying chapter 13 trustee's motion to modify plan after completion of temporal terms and final payment of plan).

November 17, 2022

GUIDANCE FOR DEPARTMENT ATTORNEYS REGARDING STUDENT LOAN BANKRUPTCY LITIGATION

I. Introduction

This memorandum provides guidance (Guidance) to Department of Justice (Department) attorneys regarding requests to discharge student loans in bankruptcy cases. Developed in coordination with the Department of Education (Education), this Guidance will enhance consistency and equity in the handling of these cases. In accordance with existing case law and Education policy, the Guidance advises Department attorneys to stipulate to the facts demonstrating that a debt would impose an undue hardship and recommend to the court that a debtor's student loan be discharged if three conditions are satisfied: (1) the debtor presently lacks an ability to repay the loan; (2) the debtor's inability to pay the loan is likely to persist in the future; and (3) the debtor has acted in good faith in the past in attempting to repay the loan.

To assist the Department attorney in evaluating each of these factors, a debtor will typically be asked to provide relevant information to the government by completing an attestation form (Attestation). The Attestation requests information about the debtor's income and expenses to enable the Department attorney to evaluate the debtor's present ability to pay. The Attestation also seeks information that will help the Department attorney evaluate the other two factors. In the following sections, this Guidance provides more detail about the Attestation that a debtor will be asked to complete, and how the information provided in the Attestation will be considered by the Department attorney. In Appendix A, this Guidance provides a sample attestation form. In addition, in Appendix B, this Guidance provides a concrete example of how a debtor's request for discharge of a student loan will be evaluated.

II. Objectives of the Guidance and Education's Role in Supporting Discharge Cases

In cases where a debtor seeks the discharge of a student loan in bankruptcy, the Department shares with Education the responsibility to represent the interests of the United States in accord with existing law and in the interests of justice. This responsibility includes recommending that a bankruptcy court grant full or partial discharge of student loan debts in appropriate cases. To fulfill that responsibility, Department attorneys should stipulate to facts necessary to demonstrate undue hardship and recommend discharge where the debtor provides information in the Attestation (or otherwise during the adversary proceeding) that satisfies the elements of the analysis below. Some debtors have been deterred from seeking discharge of student loans in bankruptcy due to the historically low probability of success and due to the mistaken belief that student loans are ineligible for discharge. Other student loan borrowers have been dissuaded from seeking relief due to the cost and intrusiveness entailed in pursuing an

adversary proceeding. This Guidance is intended to redress these concerns so that discharges are sought and received when warranted by the facts and law. In addition, Department attorneys are expected to consult proactively with Education to evaluate the specific circumstances of each case.

In collaborating in the preparation of this Guidance, the Department and Education have sought to promote three goals in particular:

1. To set clear, transparent, and consistent expectations for discharge that debtors understand regardless of representation;
2. To reduce debtors' burdens in pursuing an adversary proceeding by simplifying the fact-gathering process. This includes use of an Attestation, and where feasible, information provided through prior submissions to the bankruptcy court and available student loan servicing records;
3. Where the facts support it, to increase the number of cases where the government stipulates to the facts demonstrating a debt would impose an undue hardship and recommends to the court that a debtor's student loans be discharged.

Education is committed to supporting Department attorneys handling these cases. Department attorneys should expect that, for each adversary proceeding, Education will provide to the Department attorney a record of the debtor's account history, loan details, and—where available—educational history, which the Department attorney will share with the debtor. This information will be provided with the Education litigation report.

The Department attorney is expected to consult with Education in each case; consultation includes sharing the completed Attestation and conferring on an appropriate course of action. In its initial litigation report, Education will advise on matters including whether it has data relating to the presumptions in this Guidance regarding assessment of future circumstances and whether it considers the debtor made good faith efforts to repay their student loans. This process will ensure the final decision is informed by Education's experience administering student loans and its role as creditor. Once the Department attorney reaches a recommendation in accordance with this Guidance, the Department attorney shall submit their recommendation or approval, as appropriate, along with Education's recommendation, under the standard procedures applicable in that attorney's component.

III. Applicable Law

Under Section 523(a)(8) of the Bankruptcy Code, certain student loans may not be discharged in bankruptcy unless the bankruptcy court determines that payment of the loan "would impose an undue hardship on the debtor and the debtor's dependents." 11 U.S.C. § 523(a)(8); *United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260, 278 (2010) ("the bankruptcy court must make an independent determination of undue hardship . . . even if the creditor fails to object or appear in the adversary proceeding.").[1] This inquiry is undertaken through a formal adversary proceeding in the bankruptcy court. *United Student Aid Funds*, 559 U.S. at 263-64; Fed. R. Bankr. P. 7001(6). The parties in that proceeding may stipulate to the existence of certain facts and recommend that the bankruptcy court find, based on such facts, that repayment of the student loan would cause the debtor an undue hardship.

The most common framework for assessing undue hardship is the so-called *Brunner* test, emanating from *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395 (2d Cir. 1987). To discharge a student loan under the *Brunner* test, a bankruptcy court must find that the debtor has established that (1) the debtor cannot presently maintain a minimal standard of living if required to repay the student loan, (2) circumstances exist that indicate the debtor's financial situation is likely to persist into the future for a significant portion of the loan repayment period, and (3) the debtor has made good faith efforts in the past to repay the student loan. *Id.* at 396.

Other courts have employed a "totality of circumstances" test (Totality Test) to determine whether repayment of student loan debt would cause an undue hardship. *See, e.g.*, *In re Long*, 322 F.3d 549, 553 (8th Cir. 2003). The Totality Test looks to: (1) the debtor's past, present, and reasonably reliable future financial resources; (2) a calculation of the debtor's and their dependents' reasonably necessary living expenses; and (3) any other relevant facts and circumstances surrounding each particular bankruptcy case. *Id.*

This Guidance applies in both *Brunner* and Totality Test jurisdictions. Courts have recognized the *Brunner* and Totality Tests "consider similar information—the debtor's current and prospective financial situation in relation to the educational debt and the debtor's efforts at repayment." *In re Polleys*, 356 F.3d 1302, 1309 (10th Cir. 2004); *see also In re Jesperson*, 571

[1] Section 523(a)(8) requires the debtor to demonstrate an undue hardship to discharge nearly all federal student loans, excluding Health Education Assistance Loans, as well as private education loans that meet the definition of qualified education loans under the Internal Revenue Code. *See* 26 U.S.C. § 221(d)(1).

F.3d 775, 779 (8th Cir. 2009).[2] Both tests require assessment of the debtor's income and reasonable expenses to determine whether the debtor has the present and future ability to maintain a "minimal standard of living" while making student loan payments. *See, e.g.*, *In re Hurst*, 553 B.R. 133, 137 (B.A.P. 8th Cir. 2017) ("[I]f the debtor's reasonable financial resources will sufficiently cover payment of the student loan debt—while still allowing for a minimal standard of living—then the debt should not be discharged.") (citing *In re Jesperson*, 571 F.3d at 779). Finally, both tests direct the court to review the debtor's past efforts at repayment. *In re Polleys*, 356 F.3d at 1309; *see also In re Bronsdon,* 435 B.R. 791, 797 (B.A.P. 1st Cir. 2010).

IV. Discussion of the Applicable Factors

As explained above, consideration of student loan debt discharge requires an evaluation of a debtor's present, future, and past financial circumstances. This Guidance offers a framework for Department attorneys to apply each of these factors.

With respect to the first factor, the Guidance relies upon the Internal Revenue Service Collection Financial Standards (the IRS Standards) to assess whether a debtor can presently maintain a "minimal standard of living" if required to repay student loan debt. In particular, the Department attorney is advised to use the IRS Standards to evaluate a debtor's expenses, and then to compare those expenses to the debtor's income, to determine whether the debtor has a present ability to pay the loan.

With respect to the second factor, the Guidance uses presumptions for determining whether inability to repay is likely to persist in the future. The Guidance recognizes, however, that even in the absence of such presumptions a debtor may be able to establish that their inability to pay will continue in the future.

With respect to the third factor, the Guidance identifies certain objective criteria that evidence a borrower's good faith. In addition, the Guidance discusses how to evaluate a debtor's

[2] The Eighth Circuit has described the Totality Test as "less restrictive" than the *Brunner* framework, *In re Long*, 322 F.3d at 554, but it has also recognized that the distinction between the standards "may not be that significant." *Jesperson*, 571 F.3d at 779 n.1, 782. *See, e.g.*, *In re Long,* 322 F.3d at 554-55 ("Simply put, if the debtor's reasonable future financial resources will sufficiently cover payment of the student loan debt—while still allowing for a minimal standard of living—then the debt should not be discharged. Certainly, this determination will require a special consideration of the debtor's present employment and financial situation—including assets, expenses, and earnings—along with the prospect of future changes—positive or adverse—in the debtor's financial position"); *see also Jesperson*, 571 F.3d at 782 (the totality approach also requires consideration of "evidence of a less than good faith effort to repay . . . student loan debts"). The Guidance does not supersede applicable case law in the circuits. Department attorneys should advance the principles and goals described in this Guidance consistent with that case law.

payment history and decision to participate in an income-driven repayment plan, and clarifies that neither of these factors are dispositive evidence where other evidence of good faith exists.

Finally, the Guidance also provides direction to Department attorneys regarding the treatment of a debtor's assets and the availability of partial discharge.

The Attestation provided with this Guidance will assist in the assembly of the information needed to assess these factors.[3] Department attorneys are expected to review completed Attestations in consultation with Education.

A. Assessment of Present Circumstances

The first factor relevant to whether a student loan debtor can meet the statutory undue hardship standard requires the debtor to prove an inability to presently maintain "a minimal standard of living" while making student loan payments. To address this factor, the Department attorney should complete two steps. First, the Department attorney should use the IRS Standards to determine the debtor's "allowable" expenses. Second, the attorney should compare those allowable expenses to the debtor's income to determine whether the debtor has income after expenses with which to make student loan payments. If the debtor's allowable expenses exceed their gross income, this element of the analysis is satisfied. If the debtor's financial circumstances changed since filing the initial bankruptcy petition, the Department attorney can look to the debtor's actual financial circumstances when making an undue hardship determination. *Cf. In re Walker* 650 F.3d 1227, 1232 (8th Cir. 2011).

1. Assessment of the Debtor's Expenses

The Attestation solicits expense information from debtors in categories corresponding to the IRS Standards, particularly the portions of the IRS Standards described as "National and Local Standards" and "Other Necessary Expenses."[4] The IRS Standards are a useful guide to assess a debtor's expenses for purposes of the "minimal standard of living" inquiry. Use of these standards will ensure more consistent and equitable treatment of debtors seeking discharge. The IRS has established and updated the IRS Standards to determine appropriate collection actions where taxpayers have outstanding unpaid tax obligations. The IRS Standards evaluate what

[3] As discussed in more detail below, the Attestation requires a debtor to present information relevant to the Department attorney's analysis in an efficient, organized manner. If the debtor's satisfaction of the requirements for discharge are clearly demonstrated by the complaint or other facts available outside the Attestation, then upon verification of those facts, a Department attorney may recommend discharge without requiring that the debtor complete the Attestation.

[4] Links to the IRS Standards are found at https://www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards.

expenses are "necessary to provide for a taxpayer's health and welfare[,]"[5] or, as described in the IRS Collection Manual, "the *minimum* a taxpayer and family needs to live."[6] Courts have recognized the IRS Standards as useful objective criteria in assessing "undue hardship" under Section 523(a)(8). *See, e.g.*, *In re O'Hearn*, 339 F.3d 559, 565 (7th Cir. 2003); *In re Cota*, 298 B.R. 408, 415 (Bankr. D. Ariz. 2003). The IRS Standards list certain expenses (the National and Local Standards) for which they provide a recommended maximum allowance, but also recognize other potential expenses (Other Necessary Expenses) that are potentially necessary for an individual's health and welfare.

Allowance of Expenses in National Standard Categories: The IRS National Standards consist of tables of allowable expense amounts in the following categories: food; housekeeping supplies; apparel and services; personal care products and services; and miscellaneous. Where the debtor's expenses are below the amount allowed under the IRS National Standards, no further inquiry into the debtor's actual expense amount is needed and the debtor is allowed the full National Standards amount. If a debtor's reported expenses exceed the IRS National Standard amount, a debtor's reasonable explanation for why particular actual expenses exceed the standard should be considered carefully by the Department attorney, in consultation with Education, and may be accepted if allowing the additional expenses is warranted by the debtor's circumstances and would comport with a "minimal standard of living."[7]

Allowance of Expenses in Local Standards Categories: The Local Standards provide expense standards for the categories of housing, utilities, and transportation. Unlike the expenses in the National Standards category, for the Local Standards categories, the Department attorney should limit the debtor to their *actual* expenses. To the extent such expenses do not exceed the amount prescribed in the Local Standards for the debtor's location and household size, Department attorneys should consider the debtor's actual expenses in these categories to be consistent with a minimal standard of living and treat such amount as allowed. If the debtor's actual expense exceeds the Local Standards amount, Department attorneys should generally limit the debtor's allowable expense to the standard amount. However, as with those expenses categorized as National Standards expenses, the Department attorney should, in consultation

[5] IRS, *Collection Financial Standards*, https://www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards.

[6] IRS, Internal Revenue Manual: Part 5.15.1.8 (July 24, 2019), https://www.irs.gov/irm/part5/irm_05-015-001#idm139862108264304 (emphasis added).

[7] The decision whether to allow expenses in excess of the National and Local Standards will necessarily be fact-intensive, but allowable excess expenses could, for example, include specific health-related costs, costs for special dietary needs, unique commuting requirements, or other needs of the debtor or dependents.

with Education, carefully consider and accept a debtor's reasonable explanation for the need for the additional expenses.

Allowance of Other Necessary Expenses: The IRS Standards recognize "Other Necessary Expenses" in addition to the National and Local Standards expenses. The Attestation requests that debtors list expenses in these "Other Necessary Expense" categories. For example, the IRS Standards allow expenses for alimony and child support payments if they are court-ordered and actually being paid, as well as for baby-sitting, day care, nursery and preschool costs where reasonable and necessary. These Other Necessary Expenses are consistent with a "minimal standard of living," so long as they are necessary and reasonable in amount.[8]

Allowance for Reasonable Expenses Not Incurred: In addition to the comparison of expenses and income described above, Department attorneys should also recognize there may be circumstances in which a debtor's actual expenditures fall below the expenses required to maintain a minimal standard of living and to meet basic needs. For example, a debtor may be living in housing that the debtor is not paying for (e.g., the debtor is staying with a family member) or living in substandard or overcrowded housing but should not be required to remain there indefinitely. Likewise, a debtor may be forgoing spending on childcare, dependent care, technology, or healthcare that would otherwise be expenses one would reasonably expect to maintain a minimal living standard. A simple comparison of present expenses and income could unduly assess the debtor's financial situation against a standard that is below a minimal standard of living. In such circumstances, it would be inappropriate to conclude a debtor possesses income with which to make student loan payments and ignore the debtor's actual living standard. To address these situations, the Attestation provides an opportunity for a debtor to identify and explain expenses the debtor would incur if able to address needs that are unmet or insufficiently provided for. The Department attorney should use those projected expenses in assessing the debtor's present and future financial circumstances. Unless the amount of the projected expenses exceeds the Local Standards, it is not necessary to probe the debtor's calculation.

Appendix B includes specific examples of the recommended analysis of expenses.[9]

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[8] The Department attorney may consult the IRS Standards themselves to assist in determining whether these expenses are necessary to a debtor's minimal standard of living.

[9] The Attestation process is intended to be distinct from the bankruptcy "means test," which is used to determine a debtor's eligibility for Chapter 7 relief. Although the means test also uses the IRS Standards as part of its calculation of a debtor's household disposable income for the purpose of establishing bankruptcy eligibility, courts have recognized that the means test is not a test of a "minimal standard of living." *See In re Miller*, 409 B.R. 299, 319–320 (Bankr. E.D. Pa. 2009) (means test not appropriate to determine whether the "undue hardship" standard is met) (citing *In re Savage*, 311 B.R. 835, 840 n.7 (1st Cir. B.A.P. 2004). Moreover, the means test calculation differs from the Attestation in specific ways, including that (1) the means test (unlike

2. *Comparison of Expenses with the Debtor's Gross Income*

After determining the debtor's allowable household expenses using the National and Local Standards and Other Necessary Expenses, the Department attorney should compare the debtor's expenses to the debtor's household gross income. Gross income includes income from employment of the debtor and other household members, as well as unemployment benefits, Social Security benefits and other income sources. Debtors normally provide this information in the Schedule I filing. Where debtors filed this form less than 18 months prior to the adversary proceeding, the debtor may use the information on Schedule I to complete the Attestation. Where Schedule I was filed more than 18 months prior to the adversary proceeding or the debtor's circumstances have changed, the Attestation directs the debtor to provide the new income information.

Using the expense and income information provided in the Attestation, the Department attorney should determine whether the debtor possesses income with which to make student loan payments. If the debtor's allowable expenses exceed the debtor's income, the minimal standard of living requirement is satisfied and the debtor may be eligible for a student loan discharge, subject to consideration of the additional factors below. If, however, after considering the analysis described above, the debtor has sufficient discretionary income to make full student loan payments as required under their loan agreement, the debtor has not satisfied the test for undue hardship.[10] Where a debtor's income allows for payment toward the student loan debt but in an amount insufficient to cover the required monthly student loan payment, the Department attorney

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the Attestation) is required only for "consumer" debtors whose income exceeds a state "median," and (2) in practice, the means test often allows expenses regardless of their necessity to the debtor's basic or minimal standard of living, such as payments on multiple vehicles or for real property other than the debtor's residence.

[10] Department attorneys are expected to consult with Education to determine the monthly repayment amount. Generally, where permitted in a given jurisdiction, the Department attorney should use the monthly payment amount due under a "standard" repayment plan for the student loan in question when determining whether the debtor has the ability to make payments. The standard repayment amount is the payment amount required to pay the student loan within the remaining term of the loan, as determined by Education. *See* 34 C.F.R. § 685.208. Where the account includes unpaid interest, Department attorneys should take care to ensure that the monthly payment amount would be sufficient to pay the loan obligation in full. Except as required by controlling law, the Department attorney should not use the monthly payment amount available through income-driven repayment plan options as the comparator. Finally, where a student loan has been accelerated, whether based on a debtor's payment default or otherwise, the Department attorney should, following consultation with Education, determine the standard repayment amount either prior to default or as calculated if the loan were removed from default status.

should consider the potential for a partial discharge (discussed more fully in Section IV.E. below).

B. Assessment of Future Circumstances

The second factor for discharge is whether the debtor's current inability to repay the debt while maintaining a minimal standard of living will likely persist for a significant portion of the repayment period. This showing is required in both *Brunner* Test and Totality Test jurisdictions. *See In re Thomas,* 931 F.3d 449, 452 (5th Cir. 2019); *In re Long*, 322 F.3d at 554.

A presumption that a debtor's inability to repay debt will persist is to be applied in certain circumstances, including: (1) the debtor is age 65 or older; (2) the debtor has a disability or chronic injury impacting their income potential;[11] (3) the debtor has been unemployed for at least five of the last ten years; (4) the debtor has failed to obtain the degree for which the loan was procured; and (5) the loan has been in payment status other than 'in-school' for at least ten years.[12] The Attestation is designed to identify any such circumstances, and it advises the debtor to disclose all of the circumstances applicable to their situation and not rely exclusively on a single presumptive basis for claiming a continuing inability to repay.

The presumptions identified in this Guidance are rebuttable. Although circumstances supporting rebuttal of a presumption will likely be uncommon, the Department attorney need not apply a particular presumption if the debtor's attestation nonetheless indicates a likely future ability to pay. Such a rebuttal must be based on concrete factual circumstances. Mere conjecture about the borrower's future ability is not enough. For example, the presumption in favor of a

[11] The debtor may, but is not required to, submit information from a treating physician indicating that the debtor suffers from a disability or chronic injury impacting their income potential, and when provided, that information should be considered carefully. The presumption may be applied even in the absence of a formal medical opinion.

Education offers Total and Permanent Disability (TPD) discharge for qualifying borrowers with certain severe disabilities. Because TPD discharge has its own requirements, the existence of that potential administrative relief generally should not foreclose the debtor from showing a future inability to pay. If, in the view of the Department attorney, the debtor may qualify for TPD discharge, the attorney can provide information to the debtor about the program. Finally, Education's denial of a TPD discharge request is not dispositive of the future circumstances analysis: a prior denial for TPD discharge only implies that Education determined the borrower is likely to have some ability to earn income at the time of the application based on the information provided and evaluation criteria in place, but does not otherwise suggest that the debtor's income is sufficient to service student loan debt or that future circumstances are likely to change.

[12] In the case of consolidation loans, the length of time the debtor has been in repayment includes periods in repayment on the original underlying loans.

debtor who failed to obtain a degree may be rebutted by evidence that the debtor has received employment offers with salaries significantly higher than their current income. In sum, a presumption may be rebutted by evidence that a debtor's future financial circumstances render them able to pay their outstanding debt.

The presumptions identified above are not the sole bases upon which a future inability to pay may be found. A debtor may attest to any facts the debtor believes are relevant to future inability to pay, and the Department attorney should review the Attestation to determine whether the facts presented by the debtor satisfy the standards for proof of likely persistence of inability to pay. A Department attorney may find, for example, that a debtor's financial circumstances are unlikely to improve in the future where the debtor has a significant history of unemployment, even if the debtor's unemployment does not meet the criteria for a presumption. A stipulation may also be appropriate, even absent a particular presumption, where the institution that granted the debtor's degree has closed, and that closure has inhibited a debtor's future earning capacity.[13] Education has indicated that closure of a school after completion of the debtor's degree may affect a debtor's future ability to pay where the debtor incurs reputational harm from such closure or where the debtor's lack of access to records hampers employment efforts.[14]

C. Assessment of Good Faith

Whether a debtor has demonstrated good faith with regard to repayment of student loan debt depends upon the debtor's actions relative to their loan obligation.[15] Good faith may be demonstrated in numerous ways and the good faith inquiry "should not be used as a means for courts" or Department attorneys "to impose their own values on a debtor's life choices." *Polleys*, 356 F.3d at 1310. A debt should not be discharged if the debtor has "willfully contrive[d] a hardship in order to discharge student loans," *id.*, abused the student loan system, *In re Coco*, 335 Fed. App'x 224, 228-29 (3rd Cir. 2009), for example, by committing fraud in connection with obtaining the loans, or otherwise demonstrated a lack of interest in repaying the debt, *id*.

[13] Education offers a loan discharge for students attending a school that closed while the borrower was in attendance or shortly after withdrawal. As with a TPD discharge, the availability of this administrative relief should have limited influence on the analysis discussed in this Guidance. Debtors may not receive the "closed-school" discharge for a range of reasons that do not implicate their financial status.

[14] The presumptions discussed in this Guidance are intended to direct a Department attorney's assessment of the debtor's situation and do not shift any burden of proof in undue hardship litigation. Before the court in the adversary proceeding, the debtor retains the burden of proof on all elements of the undue hardship claim.

[15] In discussing good faith, this Guidance intends to encompass satisfaction of both Prong Three of the *Brunner* test and good faith as considered under the Totality Test in evaluating the debtor's past efforts at repayment.

Where the debtor has taken at least one of the following steps and in the absence of countervailing circumstances as discussed below, the steps demonstrate good faith. We would normally expect the Department attorney to be able to determine the presence of any countervailing circumstances based on the information contained in the Attestation and provided by Education or that is publicly available.

Evidence of good faith: The following steps evidence good faith:

- making a payment;
- applying for a deferment or forbearance (other than in-school or grace period deferments);
- applying for an IDRP plan;
- applying for a federal consolidation loan;
- responding to outreach from a servicer or collector;
- engaging meaningfully with Education or their loan servicer, regarding payment options, forbearance and deferment options, or loan consolidation; or
- engaging meaningfully with a third party they believed would assist them in managing their student loan debt.

The good faith standard also assesses criteria such as "the debtor's efforts to obtain employment, maximize income and minimize expenses." *In re Mosko*, 515 F.3d 319, 324 (4th Cir. 2008) (citing *In re O'Hearn*, 339 F.3d at 564); *see, e.g.*, *In re Jesperson,* 571 F.3d at 780. A debtor's handling of finances in a manner that suggests responsible management of their debts, including student loan debts, also suggests good faith. A debtor has minimized expenses if their expenses fall within the IRS Standards as discussed in this Guidance.[16] Good faith can be satisfied where debtors' personal or family obligations significantly reduce their employment opportunities or increase their expenses." Issues concerning employment, income, and expenses are case-specific and may be highly dependent on a debtor's family, community, and individual circumstances. Debtors may provide an explanation of those circumstances, and the Department attorney should weigh the explanation in consultation with Education.

Actual payment history and IDRP enrollment: Department attorneys should consider the following two issues that frequently arise and deserve additional attention: a debtor's actual payment history and a debtor's enrollment or non-enrollment in an IDRP. Department of Education studies have shown that the servicing of student loan debt has been plagued at times

[16] By contrast, a debtor whose expenses exceed the IRS Standards should not be foreclosed from showing they have minimized expenses, and the Department attorney and Education should carefully assess any explanations debtors may provide for exceeding the standard expenses.

by administrative errors and dissemination of confusing and inaccurate information, and that these issues may have affected debtors' responses to their loan obligations. In addition, the Consumer Financial Protection Bureau has found that debtors have been wrongfully denied IDRP enrollment and that monthly payments have been inaccurately calculated. *See* Consumer Financial Protection Bureau, *Supervisory Highlights* Fall 2022, Summer 2021, and Fall. The Bureau has also found that servicers falsely but affirmatively represented to borrowers that loans were never dischargeable in bankruptcy. *See* Consumer Financial Protection Bureau, *Supervisory Highlights*, Fall 2014 & Fall 2015. These problems have also given rise to a lack of trust by debtors in the repayment process. As a result, the good faith inquiry should not disqualify debtors who may not have meaningfully engaged with the repayment process due to possible misinformation, wrongful IDRP determinations, or a lack of adequate information or guidance. When considering a debtor's attempts to engage with their student loan, attorneys should look at the entire life of the loan rather than merely considering the recent history.

Department attorneys should consider payment history within the broader context of the debtor's financial means and personal circumstances. Where other evidence of good faith exists, including evidence that the debtor lacked financial means to pay or that the debtor made meaningful contact with Education or the servicer to explore repayment options, the failure to repay (or inconsistent or limited repayment) does not indicate a lack of good faith. In some circumstances, the Department of Education may not have records or have incomplete records about a debtor. The absence of ED data should not reduce the weight of the borrower's evidence.[17]

Department attorneys should also exercise caution in assessing IDRP enrollment. IDRPs are intended to provide a means through which debtors may respond to difficult financial circumstances, and the model Attestation asks a debtor to identify if they enrolled in an IDRP and to offer an explanation if they did not. Where a debtor participated in an IDRP, this factor is evidence of good faith.[18]

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[17] Between March 2020 and December 2022, borrowers were placed into an automatic COVID-related forbearance. The vast majority of borrowers remained in that forbearance for the duration of the period because it included a zero percent interest rate and eligibility toward IDRP and PSLF forgiveness. Due to this extended period, many debtors may not have taken any action toward their loans. This period of inactivity is not evidence of bad faith and actions taken prior to March 2020 should not be discounted because they are not recent.

[18] *See, e.g.*, *In re Tingling*, 990 F.3d 304, 309 (2d Cir 2021); *In re Krieger*, 713 F.3d 882, 884 (7th Cir. 2013); *In re Coco*, 2009 WL 1426757, at *228–229; *In re Mosko*, 515 F.3d at 323; *In re Barrett*, 487 F.3d 353, 363-64 (6th Cir. 2007); *In re Mosley*, 494 F.3d 1320, 1327 (11th Cir. 2007); *In re Jesperson*, 571 F.3d at 782-83; *In re Nys*, 446 F.3d 938, 947 (9th Cir. 2007); *In re Alderete*, 412 F.3d 1200, 1206 (10th Cir. 2005); *In re Bronsdon*, 435 B.R. at 802.

However, where a debtor has not enrolled in an IDRP, the Department attorney should give significant weight to the fact that, as noted, Education has found widespread problems with IDRP servicing. In particular, Education has advised that IDRPs have not always been administered in ways that have been effective for, or accessible to, student loan debtors. In some cases, borrowers may not have been aware of their IDRP options. At times, servicers failed to inform borrowers about these options in favor of other repayment plans or nonpayment options like forbearance. Likewise, many schools have failed to advise prospective borrowers about IDRPs, despite being legally obligated to do so. *See* 20 U.S.C. § 1092(d). Thus, non-enrollment alone does not show a lack of good faith.

Where a debtor did not enroll in an IDRP, the Department attorney is expected to look first to the debtor's Attestation response and to accept any reasonable explanation or evidence supporting the debtor's non-enrollment in an IDRP. Acceptable explanations or evidence could include, for example:

- that the debtor was denied access to, or diverted or discouraged from using, an IDRP, and instead relied on an option like forbearance or deferment;
- that the debtor was provided inaccurate, incomprehensible, or incomplete information about the merits of an IDRP;
- that the debtor had a plausible belief that an IDRP would not have meaningfully improved their financial situation;
- that the debtor was unaware, after reasonable engagement, of the option of an IDRP and its benefits; or
- where permitted under controlling case law, that the debtor was concerned with the potential tax consequences of loan forgiveness at the conclusion of an IDRP.

Where these explanations are based in part on contact or attempted contact with Education, servicers, or trusted third parties, they evidence good faith.

If a debtor provides an explanation that lacks sufficient detail or is not otherwise acceptable (or fails to provide any explanation), the debtor may still demonstrate good faith through other actions such as making payments, responding to outreach from a servicer or collector, enrolling in deferment or forbearance, making contact with Education or their servicer about their loan, or otherwise taking professional or financial steps that indicate a good-faith attempt to meet their loan obligations. In sum, we would expect Department attorneys not to oppose discharge for lack of good faith where there is a basis to conclude that the debtor's IDRP non-enrollment was not a willful attempt to avoid repayment.

D. Consideration of a Debtor's Assets

A debtor's assets must also be considered in the undue hardship analysis. Department attorneys, however, should not give dispositive weight to the existence of assets that are not easily converted to cash or are otherwise critical to the debtor's well-being, and should be cautious in concluding that the existence of real property or other financial assets demonstrates a lack of undue hardship.[19]

The Attestation facilitates this inquiry by seeking information regarding the debtor's assets. It may be appropriate to suggest that a debtor consider liquidating an asset where the asset is unnecessary to the debtor's and dependents' support and welfare. Residential real property and funds in retirement accounts are often exempt from collection under federal or state exemption laws. Although the exempt status of property may not be dispositive of whether that property is necessary for a minimal standard of living, the Department attorney should be careful in considering such property in the undue hardship analysis. *In re Marcotte*, 455 B.R. 460, 471 (Bankr. D.S.C. 2011).[20] The Department recognizes that liquidating a primary residence or retirement account is an extreme measure and therefore requests to liquidate those assets should be exceptionally rare.

E. Partial Discharge.

Where appropriate and permissible under governing case law, Department attorneys may recognize the availability of partial discharge. Partial discharge occurs where the bankruptcy

[19] The debtors' assets may be liquidated by a bankruptcy trustee to fund payments to creditors of the estate. Such property, if liquidated by the trustee, would not be available for the payment of student loan debt and thus should not be considered.

[20] The question of how exempt property should be considered under the "undue hardship" analysis has generated disagreement among courts. Generally, courts find that "the exempt character of an asset does not necessarily preempt its relevance to a hardship evaluation." *In re Armesto*, 298 B.R. 45, 48 (Bankr. W.D.N.Y. 2003); *see also In re Nys*, 446 F.3d at 947 (recognizing courts must consider availability of assets "whether or not exempt, which could be used to pay the loan"); *In re Gleason*, 2017 Bankr. LEXIS 3455, at *14 (Bankr. N.D.N.Y. Oct. 6, 2017) (allowing consideration of IRA or 401K account, regardless of exemption status). Other courts, however, have noted the necessity to weigh the policies underlying certain exemptions, for example, the homestead exemption in the debtor's residence, before considering such assets in assessing undue hardship. *Schatz v. Access Grp., Inc. (In re Schatz)*, 602 B.R. 411, 427-28 (1st Cir. B.A.P. 2019) (reversing bankruptcy court's treatment of exempt equity in homestead as dispositive of a lack of undue hardship). Notably, the *Schatz* opinion states that the bankruptcy court failed to make any finding whether the equity in the debtor's home could be liquidated without imposing an undue hardship on the debtor. *Id.* at 428.

court discharges a portion of the outstanding student loan debt while requiring payment of the remainder.[21]

Department attorneys may consider recommending partial discharge based upon a determination that the debtor has the ability to make some payments on the loan while maintaining a minimal standard of living, but an inability to make the full standard monthly repayment due. A partial discharge should not result in a remaining (undischarged) balance larger than what a debtor's discretionary income (as determined under the Prong One analysis) permits them to pay off in monthly payments over the remaining loan term. In practice, a full discharge is appropriate for debtors whose expenses are equal to or greater than their income where they meet the other elements of the analysis. Partial discharge may also be available to a debtor who is able to liquidate assets to pay a portion of the debt but remains unable to pay the remainder while maintaining a minimal standard of living. *See In re Stevenson*, 463 B.R. 586, 598-99 (Bankr. D. Mass. 2011); *In re Clavell*, 611 B.R. 504, 531-32 (Bankr. S.D.N.Y. 2020).

V. Procedures

Although the process for soliciting and reviewing the Attestation may vary from case to case, Department attorneys should generally observe the following procedures in soliciting Attestations.

A. Submission of the Attestation

Upon a debtor's commencement of an adversary proceeding seeking discharge pursuant to 11 U.S.C. § 523(a)(8), the Department attorney should provide a debtor the opportunity to complete and submit the Attestation. The Department attorney is encouraged to contact the debtor or debtor's counsel as soon as practicable after service of process in an adversary

[21] Section 523(a)(8) is silent with respect to whether bankruptcy courts may discharge part of a student loan based on undue hardship. The concept, however, has been recognized by several courts of appeals. *See generally In re Miller*, 377 F.3d 616, 622 (6th Cir 2004); *In re Saxman*, 325 F.3d 1168, 1173-1174 (9th Cir. 2003); *In re Alderete*, 412 F.3d at 1207; *In re Cox*, 338 F.3d 1238, 1243 (11th Cir. 2003). In most jurisdictions where no circuit level authority exists, lower courts have permitted partial discharges. *See, e.g.*, *In re Rumer*, 469 B.R. 553, 564 n.12 (Bankr. M.D. Pa. 2012) (recognizing majority rule is to allow partial discharges); *In re Gill*, 326 B.R. 611, 644 (Bankr. E.D. Va. 2005) (recognizing lower courts have generally allowed partial discharges); *but see, e.g.*, *In re Conway*, 495 B.R. 416, 423 (B.A.P. 8th Cir. 2013) (explaining that the general rule prevents discharging parts of individual loans). Prior to any partial discharge, a debtor must have established all elements necessary for an undue hardship determination. *See In re Saxman*, 325 F.3d at 1175; *Hemar Ins. Co. of Am. v. Cox (In re Cox)*, 338 F.3d 1238, 1243 (11th Cir. 2003).

proceeding, advising the debtor of the opportunity to submit the Attestation for review by the United States. Any Attestation should be submitted by a debtor under oath by signing under penalty of perjury pursuant to 28 U.S.C.§ 1746. The Attestation requests that a debtor provide documents corroborating the debtor's stated income (tax returns, or where appropriate, paystubs or other documents proving income). The Department attorney may seek additional evidence where necessary to support representations in the Attestation.

Education will provide debtors' account history and loan details to the Department and that information will be provided to the debtor with the Attestation form.

B. Time for Attestation

Ideally, the Department attorney would solicit the Attestation from the debtor at the outset of the case to permit early consideration whether to stipulate to facts relevant to undue hardship. The Department attorney is not required to impose any strict time limit for the Attestation.

C. Bankruptcy Court Authority

The Department attorney should advise debtors that although the United States may stipulate to facts relevant to undue hardship and recommend to the bankruptcy court that a finding of undue hardship is appropriate, the United States' position is not binding on the bankruptcy court, which will render its own determination whether a debtor has met the standard for an undue hardship discharge. Department attorneys and debtors should cooperate to file appropriate documents to enable the court to consider whether to issue an order to discharge student loan debt based upon undue hardship.

VI. Conclusion

The goal of this Guidance is to provide Department attorneys with a consistent and practical approach for handling student loan discharge litigation. Because of the fact-specific nature of such litigation, questions may arise about how the Guidance should be applied in particular cases. For assistance in interpreting and implementing the Guidance, Department attorneys are invited to contact the Commercial Litigation Branch, Corporate/Financial Litigation Section of the Civil Division.[22]

[22] This memorandum applies only to future bankruptcy proceedings, as well as (wherever practical) matters pending as of the date of this Guidance. This Guidance is an internal Department of Justice policy directed at Department components and employees. Accordingly, it is not intended to and does not create any rights, substantive or procedural, enforceable at law by any party in any matter.

The Difficult Client (Ethics)

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"The Difficult Client"

ABI 2015 Northeast Conference

Flying Saucer Burgers, Inc. operates a chain of approximately 100 fast-casual restaurants located in multiple states. For a period of time, it successfully rode the wave of "gourmet", high-priced burgers and grew rapidly. The business was started by the Meyer Family, which owned 100% of its capital stock. Three years ago, the business was acquired by Rainbow Capital Partners, a well- known private equity firm. Rainbow, as it often did with new investments, financed more than 75% of the acquisition price through a credit facility provided by Acme Bank. The Meyer Family, after driving a hard bargain, sold all of its shares to Rainbow and realized an excellent return on its investment.

Flying Saucer has struggled mightily since the Rainbow acquisition. Rising beef and vegetable prices squeezed profit margins just as a number of well-financed competitors rushed into the gourmet burger market. The resulting decrease in cash flow and some other operational hiccups resulted in Flying Saucer failing to satisfy various financing covenants in its credit facility, although no payment defaults have occurred. Acme responded by issuing a series of increasingly belligerent Notices of Default.

Rainbow in turn became increasingly dissatisfied with the company's management team, which Rainbow believed was still loyal to the Meyer Family, and has become directly involved in the day-to-day operations of the company. In fact, Rainbow's representatives on the Board of Directors have made clear that management must seek Board approval before any material business decision or cash expenditure can be executed. The Board, after multiple discussions with management, recently approved a reduction-in-force that resulted in the immediate layoff of approximately 120 employees. The Board also directed the management team not to make the most recent monthly rent payments owed to Flying Saucer's various landlords (which aggregated more than $3 million), although company representatives had previously assured many landlords via email that the rent would be paid.

Paul Gleeson of Hooks, Snow & Ladder, LLP is serving as Flying Saucer's primary restructuring and bankruptcy counsel. It became clear to Paul that a Chapter 11 filing was necessary. A number of angry unpaid vendors had filed suit and were threatening to file an involuntary petition. Further, Acme had full dominion over all of the company's bank accounts and insisted that it would not extend additional credit unless Flying Saucer agreed to various conditions. Among other things, Acme demanded that Flying Saucer retain a "chief restructuring officer" acceptable to the bank and that the company file bankruptcy to effect a sale under Section 363 of the Bankruptcy Code. The company's Board consulted at length with Paul and ultimately agreed to substantially all of the Bank's conditions, including the appointment of a CRO, Sally Jones of Triple AAA Advisory Group, a nationally known firm.

Paul and his team worked feverishly to file the Chapter 11 case and, after an uneventful first day hearing, were hopeful that the case would proceed smoothly. Unfortunately, Paul is now growing very concerned both about the case and his own role in it. His firm, HS&L, had

represented Rainbow for years in numerous matters and one of his most powerful partners, Carla Smith, managed the overall relationship. The managing director of Rainbow contacted Carla soon after the Ch. 11 petition was filed to make sure that Paul was "on board with the program" and was making sure to look out for Rainbow's interests. About a year earlier, Rainbow had taken a pummeling in the press after it chose to liquidate one of its portfolio companies following a lengthy labor dispute; Rainbow believed that the law firm which had represented the portfolio company was not appropriately loyal to Rainbow and had ceased using that firm on other matters. Further, Rainbow had told Paul and Carla that it was going to submit a bid for Flying Saucer's assets and that it expected to receive a general release from the Debtor's estate as a condition to closing.

Acme was also proving to be a challenge. Although it had agreed to provide DIP Financing, Acme was concerned that the Debtor's results were trending below plan and was threatening to cease funding unless the sale process was accelerated. Paul believed that the Debtor could survive on cash collateral and that a longer sale process likely would generate more value, but was meeting opposition from both Rainbow and Sally Jones, the CRO. Rainbow regularly obtained financing from Acme for other investments and was not eager to be part of a contested cash collateral fight. Further, Acme is one of Sally's most important referral sources and she had expressed great concern to Paul about "going to war" with the Bank even if the DIP Financing was not needed. A workout officer at Acme had gone so far as to tell Sally, in an off-the-record conversation, that she would never get another referral if the Debtor became uncooperative. Paul had raised serious concerns with Acme's counsel about the workout officer's behavior, but was told that this was "business as usual" for a tough Chapter 11 case.

Paul also immediately found himself at odds with the Creditors' Committee. The Committee was made up of four landlords and three vendors. Its counsel had advised Paul that the landlords on the Committee were apoplectic about the Debtor's failure to pay pre-petition rent and were demanding that the estate file a lawsuit against the Board and management team even if it derailed the sale process. The vendors on the Committee, meanwhile, had stated that they were most interested in having a customer to sell to after the case ended even if no value was generated for the estate's creditors. The vendors were urging the Debtor to sell its assets back to the Meyer Family, who had expressed interest is regaining control of the business. But Rainbow had advised Paul that the Meyer Family could not be trusted and directed Paul not to engage them in negotiations.

As he prepared for an important all-hands' meeting with Acme and the Committee in advance of the case's second-day hearing (at which, among other things, Paul's retention application would be heard by the Court), Paul was torn about how to proceed. While he was not eager to take any action that would upset Rainbow or his partner Carla Smith, Paul knew that Rainbow's actions were troubling. His first instinct was to ally himself more closely with Sally, who was known as a significant force in the restructuring world. But Paul was not confident that Sally was fully on the Debtor's side. He was also frustrated that counsel to Acme and the Committee were doing little to rein in their clients. Paul was starting to wonder if he could continue to represent the Debtor under these circumstances.

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THE DIFFICULT CLIENT – SELECTED ETHICAL AND FIDUCIARY ISSUES IN BANKRUPTCY CASES

A. Concurrent Representations Outside of Bankruptcy

1. Under general principles of corporate law and the Rules of Professional Conduct (the "Rules"),[1] an organization and the person or persons who own and operate it are considered separate clients. When a lawyer represents an organization, she should distinguish between the organization and the various constituents of the organization. The client is the organization, not the officers or owners of the organization. See, generally, Rule 1.13.

2. A lawyer employed or retained by an organization represents the organization through its duly authorized constituents. See Rule 1.13(a).

3. In dealing with an organization's constituents, a lawyer should explain the identity of the client when a lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituent with whom the lawyer is dealing. See Rule 1.13(f).

4. Outside of the bankruptcy context, it generally is permissible for a lawyer to concurrently represent an organization and its owner(s). Indeed, Rule 1.13(g) expressly permits such concurrent representations subject to Rule 1.7 regarding conflicts of interest. When dealing with a closely held entity, there usually should be no conflicts between the interests of the organization and its owner(s) because the legal and economic interests of the organization and the owners ordinarily are aligned.

5. Outside of the bankruptcy context, this general principle would remain true even if the organization is insolvent. However, the insolvency of an organization can affect who may have standing to assert derivative claims on behalf of the organization against its fiduciaries. See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

B. Concurrent Representation of Organization and Its Owner(s) in Bankruptcy

1. Concurrent representations that are generally permissible outside of the bankruptcy context may be impermissible in a bankruptcy case. See, generally, 11 U.S.C. §§ 327(a) and 101(14).

2. Generally, counsel for the debtor-in-possession cannot represent the owner(s) of the debtor in the same bankruptcy case. Counsel for a d-i-p must qualify under §327(a) of the Code which requires that counsel be "a disinterested person." Section 101(14) defines "disinterested person." Among other things, a "disinterested person" cannot have "an interest materially adverse to the interest ...of any class of creditors... for any... reason." In a bankruptcy case, it is foreseeable that there will be instances in which the interests of creditors

[1] References are to the Massachusetts Rules of Professional Conduct (Mass. R. Prof. C.), which are largely derived from and the similar to the American Bar Association's Model Rules of Professional Conduct.

will be adverse to the interests of equity security holders. In addition, under §327(a), counsel for the debtor-in-possession also may not "hold or represent an interest adverse to the estate." Counsel for the debtor-in-possession also owes a fiduciary duty of loyalty to her client; that duty could be compromised by conflicting loyalties to other parties, such as shareholders, if they are also clients in the case.

3. The foregoing, however, does not mean that in representing the debtor-in-possession, counsel might not often take actions that are beneficial to the interests of the owners of the debtor, e.g., drafting a plan that preserves the interests of shareholders.

4. The potential adversity between d-i-p counsel's duties to the d-i-p and her duties to the debtor's owners, if they are also concurrent clients, may be most apparent in the case of a closely-held debtor company where the nondebtor owner is a guarantor or co-obligor of the debtor's debts as compared to a case in which a parent corporation and its subsidiaries are debtors represented by a single counsel.

5. In contrast to the general prohibition of the concurrent representation of the debtor-in-possession and the owners of the debtor in the same case, there is no per se prohibition of representing the debtor-in-possession and concurrently representing the owners of the debtor in matters unrelated to the bankruptcy case provided that counsel's relationship with the owners does not cause counsel to be not disinterested or otherwise impair counsel's ability to zealously carry out her duties to the debtor-in-possession.

6. As demonstrated by *In re Project Orange Assoc., LLC,* 431 B. R. 363 (Bankr. S. D. N. Y. 2010), obtaining a conflict waiver from the non-debtor client may be insufficient to enable counsel to satisfy the requirements of §§327(a) and 101(14). In Project Orange, the court held that, where d-i-p counsel represented the debtor's largest creditor in other matters; the conflict waiver precluded counsel from suing or threatening to sue that creditor; and the resolution of disputes with that creditor were central to the possible success of the reorganization, counsel could not satisfy the requirements of §327(a) of the Code.

7. In *In re Kendavis Industries, Int'l., Inc.,* 91 B. R. 742 (Bankr. N.D. Tex. 1988), the bankruptcy court required a firm which acted as d-i-p counsel to disgorge compensation because the court found that the firm had acted to protect the interests of the debtor's shareholders.

8. In *In re Amdura Corp.,* 121 B. R. 862 (Bankr. D. Col. 1990), the bankruptcy court refused to approve the employment of a firm as d-i-p counsel where the firm had in the past and continued to represent the debtor's principal lender (owed $215 million) in matters unrelated to the debtor. The firm indicated that it could not undertake an investigation of the relationship between the debtor and the lender nor could the firm initiate or prosecute any claims against the lender if they were found to exist. Under these circumstances, the court determined that the firm was not disinterested.

C. **Disinterestedness and the Receipt of Payments for Prepetition Services**

1. If proposed d-i-p counsel has received payment for its prepetition services within 90 days prior to the filing of the petition, an issue may arise with regard to counsel's

disinterestedness. See *United States Trustee v. First Jersey Sec., Inc. (In re First Jersey Sec., Inc.),* 180 F.3d 504 (3rd Cir. 1999); *Staiano v. Pillowtex, Inc. (In re Pillowtex, Inc.),* 304 F.3d 246 (3rd Cir. 2002).

2. Whether the payment was in the form of cash, which were the facts in *Pillowtex*, or securities, which were the facts in *First Jersey Securities*, a payment received within the 90-day period will be subject to scrutiny as a possible voidable preference.

3. In *First Jersey Securities*, the proposed d-i-p counsel argued that the payment it received was not voidable for several reasons. First, counsel argued that there was no antecedent debt because (i) no debt came into existence until it sent out its invoice for the services rendered and (ii) assuming there was debt, that debt did not become antecedent debt until the invoice was deemed overdue. Counsel also argued that if there was an antecedent debt, the payment was not voidable because it was made in the ordinary course of business. The Third Circuit rejected all of these arguments. The court held that a debt would be deemed to arise as soon as legal services were rendered. The court also held that the payment was not in the ordinary course of business for a couple reasons, including the fact that it was made by a transfer of restricted securities.

4. In *Pillowtex*, counsel also argued that several payments received within the 90-day period were within the ordinary course of business. Counsel argued that it was not disqualified because it had agreed that, if it was found to have received a preference, it would immediately return the funds to the estate and waive any claim that would result in its favor. This was acceptable to the lower court but the Third Circuit held that it was error for the court to approve the employment of counsel while the issue of the potential voidable transfer was unresolved. This unresolved issue rendered counsel unqualified under § 327(a) of the Code.

5. As a result of these decisions, it is now standard practice in certain circuits for prospective d-i-p counsel, in anticipation of a Chapter 11 filing, to obtain an advance payment retainer for services to be rendered within the 90-day period and to waive any fees which remain outstanding and unpaid as of the filing date.

D. **Insider Guaranties and Conflicts**

1. D-i-p counsel may accept a guaranty of payment for her services so long as she makes full disclosure and the terms of the guaranty don't restrict her professional independence in representing the d-i-p.

2. Rule 1.7(b) provides that a lawyer holds a conflict of interest if there is a significant risk that her representation of a client will be materially limited by her responsibilities to another client or a third person or by her own personal interests.

3. Rule 1.8(f) provides that a lawyer may not accept compensation for representing a client from someone other than the client unless three conditions are met: (i) the client must give its informed consent; (ii) there must be no interference with the lawyer's

independent professional judgment or with the client-lawyer relationship; and (iii) information relating to the representation of the client is protected as required by Rule 1.6.

4. In order for the debtor-in-possession to give its informed consent, the terms of the guaranty would have to be fully disclosed in the engagement letter and in the retention papers filed with the court.

5. In addition, the terms of the guaranty should not impose any restrictions on the lawyer's independence as counsel for the debtor-in-possession. Thus, for example, the guaranty should not preclude counsel from taking actions in the case adverse to the guarantor.

E. **Potential Conflict Presented By Acceptance of Security for Post-Petition Fees**

1. The First Circuit's decision in *In re Martin,* 817 F.2d 175 (1st Cir. 1987), bears upon this question. In that case, the First Circuit held that the grant of a mortgage on property of the estate to d-i-p counsel as security for payment of its post-petition fees was not impermissible per se.

2. However, the court was careful to note that whether such a security arrangement would render counsel disqualified has to be determined on the facts of each case; and there must always be full and timely disclosure to parties-in-interest and the court of the details of any given arrangement.

3. It is noteworthy that in *Martin*, the mortgage was granted on property that was not the debtor's principal residence nor was it used for any business purposes associated with the debtor's business; and it appears that the property was not essential to any potential reorganization.

4. Therefore, *In re Martin* probably would not support d-i-p counsel's receipt of a security interest on property of the estate that is essential to the business where there could be a conflict between the need to use the property in the reorganization and counsel's reliance upon the property as a source of payment.

F. **D-I-P Counsel's Disclosure Obligations**

1. See generally 11 U.S.C. § 327(a); Fed. R. of Bankr. P. 2014(a). But see Rule of Professional Conduct 1.6(b).

2. Proposed d-i-p counsel has a duty to disclose all "connections." See Fed. R. Bankr. P. 2014; *In re Leslie Fay Cos.,* 175 B. R. 525 (Bankr. S.D.N.Y. 1994).

3. Rule 1.6's requirement that a lawyer preserve the confidentiality of client information may limit what counsel can disclose regarding existing or prior representations of nondebtor parties in counsel's effort to comply with the disclosure requirements applicable to d-i-p counsel, but Rule 1.6(b)(4) does permit a lawyer to reveal client information "when permitted under these rules or required by law or court order."

G. **Fiduciary Duties Owed by D-I-P Counsel**

1. It has been held that the debtor-in-possession's counsel's client is the d-i-p, not the estate or creditors; while d-i-p counsel owes fiduciary duties of loyalty and care to the d-i-p, counsel does not owe fiduciary duties directly to the estate or creditors. See *Hansen, Jones & Leta, P.C. v. Segal*, 220 B. R. 434 (D. Utah 1998).

2. *Hansen* contains an excellent analysis and discussion of the legal and ethical duties of d-i-p counsel by the federal district court.

3. *Hansen* holds that d-i-p counsel's client is the debtor-in-possession, not the estate and not creditors.

4. *Hansen* also holds that d-i-p counsel, like any other attorney, owes professional duties of loyalty and care to her client. *Hansen* holds that the sources of these duties for d-i-p counsel are the Rules of Professional Conduct and the Bankruptcy Code. Another source may be the common law.

5. *Hansen* holds that d-i-p counsel does not owe a fiduciary duty to the estate or to creditors. The court holds that courts should not impose upon d-i-p counsel the fiduciary duties owed by the d-i-p itself, as a trustee, to the creditors. In determining professional compensation, the court should consider whether the services provided by counsel satisfied the statutory standard, including benefit to the estate, not whether counsel fulfilled or breached fiduciary duties to the estate or creditors.

H. **Duties of D-I-P Counsel When Learning of Misconduct**

1. Rule 1.6(a) requires a lawyer to maintain the confidentiality of information relating to the representation of her client, unless (i) the client gives informed consent to disclosure or (ii) disclosure is permitted under other parts of Rule 1.6. Rule 1.6(b) permits disclosure of client information to third parties without the client's consent under certain circumstances. Moreover, disclosure is required if necessary to comply with Rules 3.3 (dealing with a lawyer's duty of candor toward the tribunal), 4.1(b) (dealing with a lawyer's duty to be truthful in statements to others); or 8.3 (dealing with a lawyer's duty to report professional misconduct).

2. As an officer of the court, counsel owes a duty of candor to the court. See Rule 3.3. Rule 3.3(a) provides that a lawyer shall not, inter alia, knowingly: (1) make a false statement of material fact or law to a tribunal; (2) fail to disclose a material fact to a tribunal when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client, except for certain special rules applicable in criminal cases; (3) offer evidence that the lawyer knows to be false, except for special rules applicable in criminal cases. A lawyer is also required to take reasonable remedial measures if a lawyer has offered, or the lawyer's client or witnesses testifying on behalf of the client have given, material evidence that the lawyer comes to know is false. See Rule 3.3(a)(4). A lawyer is also permitted to refuse to offer evidence that the lawyer reasonably believes is false. See Rule 3.3(c). The disclosure obligations under Rule 3.3(a) apply "even if compliance requires disclosure of information otherwise protected by Rule 1.6."

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3. However, Rule 4.1(b) provides that a lawyer shall not knowingly fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

4. The obligation to report lawyer misconduct under Rule 8.3 does "not require disclosure of information otherwise protected by Rule 1.6." See Rule 8.3(c).

5. Rule 1.6 does not preclude a lawyer from disclosing client information to other people within the organizational structure of the client.

6. If the persons in control of the d-i-p propose to take action that would violate the law or otherwise prejudice the interests of the d-i-p, then d-i-p counsel should consider whether, pursuant to Rule 1.13, he should refer the matter to the d-i-p's board of directors.

7. If, notwithstanding d-i-p's counsel's bringing the matter to the attention of the highest corporate authority in control of the d-i-p, the client continues to proceed with an unlawful action, then d-i-p counsel should consider whether doing so would likely result in substantial injury to the debtor. Arguably, causing the debtor to knowingly violate the law would substantially harm the debtor. The lawyer should also consider her duties under Rule 3.3 and as an officer of the court. The lawyer should probably threaten to resign as d-i-p counsel pursuant to Rule 1.16. Such resignation would require counsel to file an application with the court on notice. The threat of counsel filing such an application might be sufficient to induce the officers not to proceed with the unlawful action.

I. Representing Client in "Zone of Insolvency"

1. See *Quadrant Structured Prods. Co. v. Vertin,* (Del. Ch. 2014), rehearing denied, 2014 Del. Ch. LEXIS (Del. Ch. Oct. 28, 2014). In that case, a corporation (the "parent") held a controlling interest in the equity of a Delaware corporation (the "subsidiary"). The parent also held junior debt securities of the subsidiary. The parent also caused members of its board to be appointed to a majority of the seats on the board of the subsidiary. The board of the subsidiary caused it to change its business strategy in a manner that significantly increased the risk that senior creditors of the subsidiary would not collect all of their claims while, on the upside, increasing the chance that the parent would recover on the junior notes and retain its ownership interest.

2. The Delaware Chancery Court reaffirmed recent holdings of the Delaware courts that directors owe no direct fiduciary duties to creditors but owe their fiduciary duties only to the corporation.

3. When a Delaware corporation is insolvent, however, creditors obtain standing to assert derivative claims for breach of fiduciary duty against the officers and directors of the corporation.

4. *Quadrant* holds that, regardless of the financial condition of the corporation, the directors and officers are permitted to cause the corporation to take actions that have the potential to maximize the value of the business even if those actions expose creditors to

a greater risk that they will not recover the full amount of their claims. So long as the directors and officers act reasonably in doing so, the adoption of a more risky business strategy will be protected by the Business Judgment Rule.

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Selected First Circuit Decisions on Retention of Professionals

1. In the first opinion – Rome v. Braunstein, 19 F.3d 54 (1st Cir. 1994) – the First Circuit denied debtor's counsel's fee request due to an impermissible conflict of interest caused by his (undisclosed, simultaneous) representation of: (i) the debtor's sole shareholder, and (ii) the purchaser of the debtor's assets.

The court began its analysis by noting that "section 328(c) expressly empowers the bankruptcy court to disallow compensation if court-appointed counsel, 'at any time,' is either not a 'disinterested' person '**or** represents or holds an interest adverse to the interest of the estate with respect to the matter on which [counsel] is employed.'" Id. at 60 (emphasis added). And, when considering whether an impermissible conflict exists, "the bankruptcy court must determine whether any competing interest of a court-appointed professional created either a meaningful incentive to act contrary to the best interests of the estate and its sundry creditors – an incentive sufficient to place those parties at more than acceptable risk – **or the reasonable perception of one**." Id. at 58 (citation and internal quotations omitted) (emphasis added). Importantly, "[t]he test is neither subjective, nor significantly influenced by the court-appointed professional's 'protestations of good faith' . . . but[,] [rather,] contemplates an objective screening for even the 'appearance of impropriety.'" Id.

Regarding the attorney's representation of the shareholder, the court concluded that because the debtor "held claims of alleged preferential and fraudulent transfers" against the shareholder there was "a clear conflict of interest".

Similarly, in concluding that the attorney had a disqualifying conflict with respect to his representation of the asset purchaser, the court noted that:

> [S]imultaneous representation of the buyer and the seller in the same transaction is a prototypical disqualifying conflict of interest even if it is not invariably disqualifying in all circumstances. Even if [the purchaser] was the highest bidder for these [] assets, or even the only one, [the attorney's] longtime position as corporate clerk and counsel to [the debtor], both prepetition and postpetition, presumably afforded him unique access to inside information concerning the nature and value of its assets, information that [the attorney] could have used (or been tempted to use) to enable his other client [the purchaser] to submit a better calibrated bid than arm's-length bidders could venture, thereby potentially chilling bidding at the expense of [the debtor] and its creditors.

Id. at 61-62 (citations omitted).

2. In the second opinion – Parker v. Frazier (In re Freedom Solar Center, Inc.), 776 F.2d 14, 15 (1st Cir. 1985) – the First Circuit held "that the debtor's counsel may not also represent the debtor's sole shareholder when that sole shareholder is attempting to purchase some of the debtor's assets and may be liable for preferential transfers."

The relevant rule at issue in Freedom Solar Center was Maine Bar Rule 3.4, pursuant to which "[a] prima facie case for disqualification is made out if the moving party shows that an attorney

is representing: (a) multiple clients; (b) with differing interests; and (c) absent full disclosure and consent." Id. at 16.

Below is a summary of the court's findings regarding these three issues:

(a) The fact that the attorney represented multiple clients was not disputed. Id.

(b) The court concluded that there was a differing (adverse) interest because the shareholder's "interest was in purchasing the assets for the lowest possible price, while the debtor's interest was in selling the assets for the highest possible price." Id.

(c) Although there was "full disclosure to all concerned parties of the multiple representations", "[a]ll concerned parties . . . did not consent to the multiple representation" because "[a]ssuming that [the shareholder] and [its new corporation] consented, it is clear that the debtor has not consented [because] . . . [o]nce a trustee has been appointed in bankruptcy, all functions traditionally handled by the debtor's management are subsumed by the trustee." Id. at 17.

3. In the third opinion – In re Filene's Basement, 239 B.R. 850 (Bankr. D. Mass. 1999) – the Bankruptcy Court for the District of Massachusetts vacated a prior order appointing a law firm as debtor's counsel.

In Filene's Basement, debtor's counsel disclosed that it represented a creditor of the debtor called "T.A.C." in connection with "discrete financing and corporate matters entirely unrelated to the Debtors." Id. at 856. However, T.A.C. was a plaintiff in a lawsuit naming the Debtors as defendants. Although the law firm did not represent "either party in such lawsuit" and stated that it would "not provide representation to T.A.C. in connection with any matters or dealings in the[] Chapter 11 cases", the Court found that the law firm was not disinterested and represented an interest adverse to the debtor's estate based on, *inter alia*, its over 18-year relationship with T.A.C., "resulting in the payment by T.A.C. to the Firm of over $1,5000,000 in fees". Id. at 856.

Regarding the existence of an actual conflict of interest, the court noted:

> Stated most simplistically, the Firm is regularly engaged by T.A.C. to handle legal matters of various kinds, and has been for almost a score of years. T.A.C. is now engaged in litigation against the Debtors, whom [the Firm] serve as general counsel. While it is true that the Firm is technically aloof from the conflict, in that it represents neither of the antagonists, it is a part of the proceedings, as the litigation will involve contracts drawn by [the Firm] for both sides; the interpretation of those contracts; and possible testimony of partners in the Firm regarding various related matters . . . Under these circumstances, I find that there is an actual adverse interest in the Firm's continued representation of T.A.C. while it seeks to represent the Debtors. When there is an actual conflict of interest, disqualification is mandatory."

Id. at 857-58.

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Furthermore, the court noted that "[e]ven if there is no present adverse interest, both the potential for a conflict and the perception that there might be such are clear to me [and] [a] potential conflict constitutes a ground for disqualification under § 327." Id. at 858.

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Faculty

Hon. Denise E. Barnett is a U.S. Bankruptcy Judge for the Western District of Tennessee in Memphis, appointed on Nov. 8, 2021. Prior to her appointment, she was a trial attorney with the U.S. Trustee Program in Tampa, Fla., from 2002-21. Judge Barnett also was an attorney in private practice from 1997-2002 in Jacksonville, Fla., where she represented consumer debtors, chapter 11 debtors, trustees and creditors. From 1995-97, she clerked for Hon. George L. Proctor, Chief Judge Emeritus of the U.S. Bankruptcy Court for the Middle District of Florida in Jacksonville. Judge Barnett taught as an adjunct professor from 1996-2000 in Jacksonville. She is a member of the State Bars of Florida and Minnesota. Prior to her appointment, Judge Barnett served on the board of directors of the Tampa Bay Bankruptcy Bar Association (TBBBA), specifically working with its Judicial Liaison Committee from 2016-21. She also served on the District Wide Steering Committee (MDFL) for several terms from 2013-19, and was a frequent speaker for several continuing legal education seminars. Since 2021, Judge Barnett has been a guest lecturer teaching bankruptcy law at the University of Memphis Cecil C. School of Law. She also has helped prepare law students for the Duberstein Moot Court Competition, and welcomed high school and law students as interns in her judicial chambers. Judge Barnett received her B.S. in legal studies in 1990 from City University of New York John Jay College of Criminal Justice and her J.D. from William Mitchell College of Law (now known as Mitchell Hamline School of Law) in St. Paul, Minn., in 1995, where she was a member and an editor of the *William Mitchell Law Review*.

Hon. Jeffery W. Cavender is a U.S. Bankruptcy Judge for the Northern District of Georgia in Atlanta, sworn in on March 2, 2018. Prior to his appointment to the bench, he was a partner in the financial restructuring practice of Troutman Sanders LLP, where he primarily represented corporate debtors and secured lenders in chapter 11 cases and mortgage servicers in consumer-related litigation and bankruptcy matters. Judge Cavender previously was a partner in the bankruptcy group of McKenna Long & Aldridge LLP (n/k/a Dentons LLP) and served as the general counsel for a national mortgage company. He chaired the Bankruptcy Section for the Atlanta Bar Association from 2017-18 and was a member of its board of directors from 2012-18. During Judge Cavender's tenure as chair, the Atlanta Bar Bankruptcy Section was named the national CARE chapter of the year and received the *Pro Bono* Award for Excellence and the Small Section of the Year Award from the Atlanta Bar. He is an active member of the National Conference of Bankruptcy Judges, the Turnaround Management Association and ABI, having previously served on the advisory board for ABI's Southeast Bankruptcy Workshop. Judge Cavender received his undergraduate degree in history *summa cum laud*e in 1990 from Berry College, and his J.D. *cum laud*e from the University of Georgia School of Law in 1993, where he was a member of the *Georgia Law Review* and was inducted into the Order of the Coif.

Hon. Elisabetta G. M. Gasparini is a U.S. Bankruptcy Judge for the District of South Carolina in Charleston, appointed on June 27, 2022, after an extensive career as a trial attorney with the Office of the U.S.Trustee in both Region 4 (2012-22) and Region 2 (2009-12). During her tenure with Region 4 in Columbia, S.C., she served as chapter 11 regional coordinator in complex chapter 11 cases. In 2019, Ms. Gasparini received the Director's Award for Excellence in Chapter 11 Complex Issues. While serving as a trial attorney for Region 2 in New York, she worked on numerous high-profile cases, including American Airlines, Blockbuster and Lehman Brothers. Prior to her service with the

UST, Judge Gasparini was a member of the corporate restructuring groups for several firms in New York from 2001-09, where she worked on complex chapter 11 cases and mass-tort bankruptcies, and represented various defendants to preference actions. She previously clerked for her predecessor, Hon. John E. Waites, from 1999-2001. Judge Gasparini was born in Milan, Italy, and immigrated to the U.S. with her family in 1987. She received her B.A. in 1996 from Wake Forest University and her J.D. in 1999 from the University of South Carolina School of Law.

Hon. Tiffany Payne Geyer is a U.S. Bankruptcy Judge for the Middle District of Florida in Orlando, appointed by the Eleventh Circuit Court of Appeals on March 25, 2022. Previously, she was a partner with BakerHostetler in Orlando and practiced primarily in the areas of bankruptcy and creditors' rights. Judge Geyer represented both corporate and individual debtors in chapter 11 cases and individuals in chapter 7 cases, and her clients included health care businesses and medical professionals, investment bankers and financial advisors. She also represented clients in the hospitality sectors, assisted in representing debtors in the energy sectors, and negotiated multiple settlements of guarantor liability and assignments for the benefit of creditors. She also represented secured creditors, unsecured creditors, landlords and panel trustees. Judge Geyer has been listed in *Chambers USA* for Bankruptcy/Restructuring in Florida and in *The Best Lawyers in America* in 2020 for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law. She began her legal career in Orlando clerking for Bankruptcy Judge Karen S. Jennemann, whose vacancy she filled upon her retirement, and she volunteered at a Florida nonprofit organization devoted to housing and educating young adults struggling with homelessness. Judge Geyer received her B.A. with honors in political science and public administration in 1998 from the University of Central Florida, and her J.D. in 2000 from the University of Florida Levin College of Law, where she received the Book Award for Legal Drafting and was a member of a trial competition team.

Hon. Martin Glenn is Chief U.S. Bankruptcy Judge for the Southern District of New York in New York, initially sworn in on Nov. 30, 2006, and appointed Chief Judge on March 1, 2022. Previously, he was a law clerk for Hon. Henry J. Friendly, Chief Judge of the U.S. Court of Appeals for the Second Circuit, from 1971-72, and he practiced law with O'Melveny & Myers LLP in Los Angeles from 1972-85 and in New York from 1985-2006, where he focused on complex civil litigation including securities, RICO, financial and accounting fraud, and unfair competition. Judge Glenn is a Fellow in the American College of Bankruptcy and a member of the American Law Institute, International Insolvency Institute, New York Federal-State Judicial Council, New York City Bar, National Conference of Bankruptcy Judges and ABI. He is a past member of the Committee on International Judicial Relations of the U.S. Judicial Conference and the Bankruptcy Judge Advisory Group of the Administrative Office of the U.S. Courts. In addition, he is an adjunct professor at Columbia Law School, a contributing author to *Collier on Bankruptcy* and a frequent lecturer on bankruptcy-related issues. Judge Glenn received his B.S. from Cornell University in 1968 and his J.D. from Rutgers Law School in 1971, where he was an articles editor of the *Rutgers Law Review*.

Hon. Jennifer H. Henderson is Chief U.S. Bankruptcy Judge for the Northern District of Alabama in Tuscaloosa, initially sworn in on Feb. 16, 2015,and named Chief Judge on Oct. 1, 2022. Previously, she was a partner with Bradley Arant Boult Cummings LLP's Bankruptcy, Restructuring and Distressed Investing Practice Group in Birmingham, Ala., where she represented debtors and creditors in bankruptcy cases, out-of-court workouts and restructurings and bankruptcy- related litigation. Judge

Henderson clerked for Hon. Thomas B. Bennet and is listed as a 2014 Alabama Super Lawyers "Rising Star." She received her B.A. *magna cum laud*e from Birmingham-Southern College in 2001 and her J.D. *summa cum laud*e form the University of Alabama School of Law in 2004, where she was a member of the Order of the Coif and a special works editor for the *Alabama Law Review*.

Hon. Benjamin A. Kahn is a U.S. Bankruptcy Judge for the Middle District of North Carolina in Greensboro, sworn in on Feb. 3, 2014. He also is the chair of the Advisory Committee on Bankruptcy Judge Education for the Federal Judicial Center, for which he serves as one of the instructors for Phase I and Phase II Orientation for Newly Appointed Bankruptcy Judges. Judge Kahn is a member of the U.S. Judicial Conference Advisory Committee on the Bankruptcy Rules, and is chair of its Forms Subcommittee. In addition, he is a conferee of the National Bankruptcy Conference, for which he previously served on the Executive Committee and currently serves as chair of the Committee on the Court System and Bankruptcy Administration and on the Nominating Committee. Judge Kahn is a contributing author and member of the board of editors for *Collier on Bankrup cy* and has served as the judicial chair of ABI's Southeast Bankruptcy Workshop. Prior to his appointment, he was a member of Nexsen Pruet PLLC and clerked for Bankruptcy Judge Jerry G. Tart of the Middle District of North Carolina. Judge Kahn is certified as a specialist in business and consumer bankruptcy law by the American Board of Certification, for which he served as a member of its board of directors until his appointment to the bench. Prior to joining the bench, Judge Kahn was a certified mediator in North Carolina and was recognized as among the Top 10 North Carolina *Sup r Lawyers* across all practice areas for the two years immediately preceding his appointment, elected to the Legal Elite Hall of Fame by *Business North Carolina Magazine* in 2014 as the category winner in North Carolina for Bankruptcy, and was included among Band 1 bankruptcy practitioners in North Carolina in *Cham bers and Partners USA*. He received his B.A. in political science and history in 1990, and his J.D. with honors in 1993, from the University of North Carolina at Chapel Hill.

Hon. Christopher M. Lopez is a U.S. Bankruptcy Judge for the Southern District of Texas in Houston, appointed on Aug. 14, 2019. He previously was a member of the Business, Finance & Restructuring Group of Weil, Gotshal & Manges LLP and focused on representations ranging from top global corporations in mega-restructurings to middle-market debtor and creditor representations. Judge Lopez lectures across the country on bankruptcy issues. He also serves as an adjunct professor at Thurgood Marshall School of Law. Judge Lopez currently serves as a council member of the State Bar of Texas Bankruptcy Law Section, an advisor to the State Bar of Texas Young Lawyers Committee, a member of the Nominations Committee for the National Conference of Bankruptcy Judges, and a member of the National Bankruptcy Conference. He received his B.A. in psychlogy in 1996 from the University of Houston, his M.A. in religion in 1999 from Yale Divinity School and his J.D. from the University of Texas School of Law in 2003.

Hon. Pamela W. McAfee is a U.S. Bankruptcy Judge for the Eastern District of North Carolina in Raleigh, appointed on Jan. 7, 2022. Prior to taking the bench, she was a creditors' rights attorney, commercial litigator and mediator for 13 nonconsecutive years and served as a law clerk or career law clerk for four bankruptcy judges over 14 nonconsecutive years. Judge McAfee has spoken and written on a variety of bankruptcy topics, served on the Local Rules Committee for the bankruptcy court and the Local Civil Rules Subcommittee for the district court, and was an adjunct professor of bankruptcy law and a moot court coach at Campbell Law School. In 2016, she was recognized

by the North Carolina Bar Association with the Citizen Lawyer Award for her work with HopeLine, a suicide prevention hotline, and for her mentoring activities with law students and young lawyers. Judge McAfee received her undergraduate degree from the University of Pennsylvania and her J.D. with honors from the University of North Carolina School of Law.

Hon. Sage M. Sigler is a U.S. Bankruptcy Judge for the Northern District of Georgia in Atlanta, appointed in March 2018. She succeeded Hon. Mary Grace Diehl, for whom she clerked after graduating from law school. Prior to her appointment to the bench, Judge Sigler was a partner in Alston & Bird LLP's Bankruptcy Group. She is an active member of ABI, IWIRC and the Bankruptcy Section of the Atlanta Bar Association, and she enjoys being a volunteer presenter for the Credit Abuse Resistance Education (CARE) program. Judge Sigler was an honoree in ABI's inaugural class of "40 Under 40" in 2017. She received her B.A. in political science from the University of Florida in 2001 and her J.D. in 2006 from Emory University School of Law, where she was the executive symposium editor of the *Emory Bankruptcy Developments Journal*.