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Judicial Round-and-Round: Persuasiveness, Presentation and Professionalism

Hon. Robert D. Berger

U.S. Bankruptcy Court (D. Kan.) | Kansas City

Hon. Dennis R. Dow

U.S. Bankruptcy Court (W.D. Mo.) | Kansas City

Hon. Mitchell L. Herren

U.S. Bankruptcy Court (D. Kan.) | Wichita

Hon. Janice D. Loyd

U.S. Bankruptcy Court (W.D. Okla.) | Oklahoma City

Hon. Cynthia A. Norton

U.S. Bankruptcy Court (W.D. Mo.) | Kansas City

Hon. Michael E. Romero

U.S. Bankruptcy Court (D. Colo.) | Denver

Hon. Bianca M. Rucker

U.S. Bankruptcy Court (W.D. & E.D. Ark.) | Fayetteville

Hon. Barry S. Schermer

U.S. Bankruptcy Court (E.D. Mo.) | St. Louis

Hon. Anita L. Shodeen

U.S. Bankruptcy Court (S.D. Iowa) | Des Moines

Hon. Kathy A. Surratt-States

U.S. Bankruptcy Court (E.D. Mo.) | St. Louis

Hon. Kimberley H. Tyson

U.S. Bankruptcy Court (D. Colo.) | Denver

AMERICAN BANKRUPTCY INSTITUTE

2022 ABI Midwestern Bankruptcy Institute

Judicial Roundtable – Friday, October 7, 11:15 am to 12:25 pm

Deadlines: Topics/Bios/Photos – August 11
Materials – Sept. 8
Final Materials – Sept. 22

Judges

Topics

Anita Shodeen (S.D. IA)

Estate Professionals: Getting Employed and Paid

Cynthia Norton (W.D. MO)

Professionalism & Civility

Kathy Surratt-States (E.D. MO)

Student Loans and Dischargeability Issues

Kimberly Tyson (CO)

Dos and Don'ts When Prosecuting Section
523 and/or 727 actions

Mitchell Herren (KS)

Avoid These Evidence Pitfalls at Trial

Michael Romero (CO)

Up in Smoke – the interplay between state
marijuana laws and the bankruptcy code

Michael Ridgway (MN)

Available Sanctions in the Bankruptcy Court

Bianca Rucker (Ark)

Compromise under Rule 9019, Sale Under § 363, or
Both

Janice Loyd (OK)

Who Gets the Benefit of Appreciation in Property
During the Case, the Estate or the Debtor?

Barry Schermer (EDMO)

Persuasiveness, Presentation, and Professionalism

Robert Berger (KS)

Chapter 13 Plan Length & the Kinney decision

Dennis Dow (WDMO)

Vicarious Liability for Non-Dischargeable Debt
Under §523(a)(2)

ABI Midwestern Bankruptcy Institute
Judicial Round-and-Round
October 7, 2022

Persuasiveness, Presentation, and Professionalism
Judge Barry S. Schermer

Materials included:

1. Rick Reilly, *On a Wing and a Prayer*, SPORTS ILLUSTRATED, Sept. 20, 1999, <https://vault.si.com/vault/1999/09/20/on-a-wing-and-a-prayer>.
2. *In re 38-36 Greenville Ave LLC*, No. 21-2164, 2022 WL 1153123, at *1 (3d Cir, 2022), *petition for cert. filed sub nom. Tung v. Forman*, 90 U.S.L.W. 3412 (U.S. June 23, 2022) (No. 21-1605).
3. *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186, 1187 (7th Cir. 1989).
4. MARK HERRMANN, THE CURMUDGEON'S GUIDE TO PRACTICING LAW 1-8 (ABA 1st ed. 2006).
5. Judge Schermer's "Examples of Words and Phrases to Avoid"



Now this message for America's most famous athletes: Someday you may be invited to fly in the backseat of one of your country's most powerful fighter jets. Many of you already have—John Elway, John Stockton, Tiger Woods to name a few. If you get this opportunity, let me urge you, with the greatest sincerity...

Move to Guam. Change your name. Fake your own death. Whatever you do, do not go. I know. The U.S. Navy invited me to try it. I was thrilled. I was pumped. I was toast!

I should've known when they told me my pilot would be Chip (Biff) King of Fighter Squadron 213 at Naval Air Station Oceana in Virginia Beach. Whatever you're thinking a Top Gun named Chip (Biff) King looks like, triple it. He's about six-foot, tan, ice-blue eyes, wavy surfer hair, finger-crippling handshake—the kind of man who wrestles dyspeptic alligators in his leisure time. If you see this man, run the other way. Fast.

Biff King was born to fly. His father, Jack King, was for years the voice of NASA missions. ("T-minus 15 seconds and counting..." Remember?) Chip would charge neighborhood kids a quarter each to hear his dad. Jack would wake up from naps surrounded by nine-year-olds waiting for him to say, "We have a liftoff."

Biff was to fly me in an F-14D Tomcat, a ridiculously powerful \$60 million weapon with nearly as much thrust as weight, not unlike Colin Montgomerie. I was worried about getting airsick, so the night before the flight I asked Biff if there was something I should eat the next morning.

"Bananas," he said.

"For the potassium?" I asked.

"No," Biff said, "because they taste about the same coming up as they do going down."

The next morning, out on the tarmac, I had on my flight suit with my name sewn over the left breast. (No call sign—like Crash or Sticky or Leadfoot—but, still, very cool.) I carried my helmet in the crook of my arm, as Biff had instructed. If ever in my life I had a chance to nail Nicole Kidman, that was it.

A fighter pilot named Psycho gave me a safety briefing and then fastened me into my ejection seat, which, when employed, would "egress" me out of the plane at such a velocity that I would be immediately knocked unconscious.

Just as I was thinking about aborting the flight, the canopy closed over me, and Biff gave the ground crew a thumbs-up. In minutes we were firing nose up at 600 mph. We leveled out and then canopy-rolled over another F-14. Those 20 minutes were the rush of my life. Unfortunately, the ride lasted 80.

It was like being on the roller coaster at Six Flags Over Hell. Only without rails. We did barrel rolls, sap rolls, loops, yanks and banks. We dived, rose and dived again, sometimes with a vertical velocity of 10,000 feet per minute. We chased another F-14, and it chased us. We broke the speed of sound. Sea was sky and sky was sea. Flying at 200 feet we did 90-degree turns at 550 mph, creating a G force of 6.5, which is to say I felt as if 6.5 times my body weight was smashing against me, thereby approximating life as Mrs. Colin Montgomerie.

And I egressed the bananas. I egressed the pizza from the night before. And the lunch before that. I egressed a box of Milk Duds from the sixth grade. I made Linda Blair look polite. Because of the G's, I was egressing stuff that did not even want to be egressed. I went through not one airsick bag, but two. Biff said I passed out. Twice.

I was coated in sweat. At one point, as we were coming in upside down in a banked curve on a mock bombing target and the G's were flattening me like a tortilla and I was in and out of consciousness, I realized I was the first person in history to throw down.

I used to know cool. Cool was Elway throwing a touchdown pass, or Norman making a five-iron bite. But now I really know cool. Cool is guys like Biff, men with cast-iron stomachs and Freon nerves. I wouldn't go up there again for Derek Jeter's black book, but I'm glad Biff does every day, and for less a year than a rookie reliever makes in a home stand.

A week later, when the spins finally stopped, Biff called. He said he and the fighters had the perfect call sign for me. Said he'd send it on a patch for my flight suit.


What is it? I asked.

"Two Bags."

Don't you dare tell Nicole.

SEPTEMBER 20, 1999

In re 38-36 Greenville Ave LLC, Not Reported in Fed. Rptr. (2022)
2022 WL 1153123

 KeyCite Blue Flag – Appeal Notification
Petition for Certiorari Docketed by KEVIN KERVENG TUNG, P.C. v.
CHARLES M. FORMAN, CHAPTER 7 TRUSTEE, ET AL., U.S., June
29, 2022

2022 WL 1153123

Only the Westlaw citation is currently available.
United States Court of Appeals, Third Circuit.

IN RE: 38-36 GREENVILLE AVE LLC, Debtor
Kevin Kerveng Tung, P.C., Appellant

No. 21-2164

Submitted Under Third Circuit L.A.R. 34.1(a)
April 14, 2022

(Filed: April 19, 2022)

On Appeal from the United States District Court For the
District of New Jersey (D.C. No. 2-20-cv-03563), District
Judge: Honorable Madeline C. Arleo

Attorneys and Law Firms

Kevin K. Tung, Esq., for Appellant.

Michael J. Connolly, Esq., Michael Holt, Esq., Erin J.
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Charles M. Forman, Chapter 7 Trustee.

Wendy Cox, Esq., Executive Office for United States
Trustee Office of General Counsel, Beth A. Levene, Esq.,
United States Department of Justice Executive Office for
United States Trustees, Washington, DC, Robert J.
Schneider, Jr., Esq., Office of United States Trustee,
Newark, NJ, for Andrew R. Vara, U.S. Trustee.

Before: AMBRO, JORDAN and SCIRICA, Circuit
Judges

OPINION*

* This disposition is not an opinion of the full court
and, pursuant to I.O.P. 5.7, does not constitute
binding precedent.

JORDAN, Circuit Judge.

*1 This case highlights the famous first law of holes:
when you're in one, stop digging. The appellant here, a
law firm representing a small, limited liability company in
a bankruptcy matter, ignored that law, and a few others, to
its shame. The U.S. Bankruptcy Court for the District of
New Jersey ordered the disgorgement of fees paid to the
firm, denied its request for further payment from the
bankrupt debtor's estate, and referred the firm's principal
to the District Court for possible disciplinary action. The
District Court upheld the Bankruptcy Court's order, and
so do we.

I. BACKGROUND

In March 2016, 38-36 Greenville Ave LLC (the "Debtor")
filed a petition for relief under Chapter 11 of the
Bankruptcy Code (the "Code") in the U.S. Bankruptcy
Court for the District of New Jersey. It did so with the aid
of its counsel, Kevin Kerveng Tung, and his law firm,
Kevin Kerveng Tung, P.C. ("KKT"). The Debtor is a
single-member limited liability company wholly owned
by Lingyan Quan. Aside from a few thousand dollars in
cash and accounts receivable, its only asset is a
multi-family dwelling in New Jersey, and its sole
creditors are Armando and Melinda Flores, who hold
approximately \$1.85 million in judgment liens arising out
of a state-court judgment.¹ Simultaneous with the
Debtor's petition, KKT filed a statement of compensation,
pursuant to § 329(a) of the Code and Rule 2016(b) of the
Federal Rules of Bankruptcy Procedure, disclosing receipt
of a \$3,000 retainer payment by the Debtor.

¹ Prior to the Debtor's bankruptcy, the Floreses
brought tort claims against the Debtor and its
employee, a non-party to this matter, in the
Superior Court of New Jersey. In November
2015, the jury found the Debtor jointly and
severally liable for the employee's tortious
conduct and awarded the Floreses approximately
\$1.85 million in compensatory damages. The
Debtor appealed in December 2015 but was
unable to post the bond necessary to stay
enforcement of the judgment pending appeal. *See*
N.J. R. Ct. 2:9-6. Instead, the Debtor "came to the
bankruptcy court for help as its last hope and
resort." (Opening Br. at 3.) The Debtor's petition
"automatically stay[ed], among other things, 'any
act to create, perfect, or enforce any lien against

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property of the estate[.]” ¹ *In re Linear Elec. Co.*, 852 F.3d 313, 317 (3d Cir. 2017) (quoting ² 11 U.S.C. § 362(a)(4)).

The Debtor then filed an application under § 327(a) of the Code (the “Retention Application”), seeking permission to retain KKT as counsel in the Chapter 11 proceedings. The Retention Application stated that KKT’s services were necessary because the Debtor had previously had KKT as its defense counsel in the state-court action brought by the Floreses, so KKT was “fully knowledgeable” of “the debtor’s situation.” (App. at 121.) It further represented that KKT had “rich experience in bankruptcy[.]” (App. at 121.)

Additionally, the Retention Application disclosed the parties’ compensation arrangement and declared that, other than the \$3,000 retainer, no other agreement had been made between KKT and the Debtor, or anyone acting on either party’s behalf. It also certified that KKT would comply with applicable bankruptcy laws and court procedures when applying for compensation. Lastly, it stated that KKT was disinterested and neither held nor represented an interest adverse to the Debtor or the Debtor’s estate under § 327(e) of the Code. The Bankruptcy Court approved the Retention Application and ordered that KKT be paid “in such amounts as may be allowed by the Court upon proper application(s) therefor.” (App. at 129.)

*2 Not long after, the Debtor asked the Bankruptcy Court to lift the automatic stay on its appeal of the state-court judgment and, in the meantime, to hold the bankruptcy proceeding in abeyance. The Court denied that request, concluding that the Debtor “was using the bankruptcy case as a substitute for posting a *supersedeas* bond ..., as required under state law[.]” without first “attempt[ing] to pay or obtain a waiver of the bond requirement.” (App. at 988-89.)

A year into the proceeding, the Debtor had yet to file a Chapter 11 disclosure statement and plan, so the Bankruptcy Court *sua sponte* ordered the parties to show cause why the proceeding should not be dismissed or converted into a Chapter 7 liquidation. The United States Trustee then became involved. The Trustee argued that the proceeding lacked a valid reorganizational purpose and should be dismissed entirely as a bad faith bankruptcy filing. [App. at 381-82 (citing 11 U.S.C. §§ 349, ³ 1112(b)(1)).] The Floreses argued for conversion into a Chapter 7 liquidation so that they could enforce their judgment liens. The Debtor admitted that “the only reason

[it] filed the instant bankruptcy [was] to secure a stay so that [it could] pursue its appeal in State Court without losing the property at issue.” (App. at 393.) Because it had not been successful in securing that relief, it sought dismissal of its Chapter 11 case.

At the hearing on the order to show cause, Tung, appearing on behalf of both the Debtor and his firm, KKT, “conceded that the Debtor failed to file a plan and disclosure statement and ... that it would be futile for the Debtor to do so.” (App. at 990.) The Bankruptcy Court refused to dismiss the case because it believed it was in the best interest of the creditors and the estate to instead convert the case to a Chapter 7 liquidation and appoint a trustee to manage the estate. The Court proceeded to take those steps, and soon the Chapter 7 Trustee moved to sell the Debtor’s only known asset, the multi-family house. The Court approved the property’s public sale for \$725,000 two months later.

It was not until after the Chapter 7 conversion, and over a year and half after the Debtor declared bankruptcy, that KKT filed its first and only fee application (the “Fee Application”). In the Fee Application, KKT sought payment of \$31,819 in fees and expenses from the Debtor. Notably, the Fee Application also disclosed that KKT, without Bankruptcy Court approval, had already received payments totaling \$19,400 from the “personal bank account” of Quan – the Debtor’s sole shareholder – as “pre-payment for the legal services rendered” to the Debtor. (App. at 481.) KKT thus requested that the Court approve its fees so that it could pay Quan back. Both the Chapter 7 Trustee and the Floreses objected to the Fee Application, arguing, among other things, that the previously undisclosed payments violated the Code and the Bankruptcy Rules.

At the Fee Application hearing, Tung repeatedly evaded the Bankruptcy Court’s questions regarding Quan’s undisclosed payments. At first, he attempted to characterize the payments as something other than an unauthorized loan incurred by the Debtor. When pressed, he admitted that the payments were indeed a loan, only to reverse course after the Bankruptcy Court reminded him that any debt incurred by the Debtor had to be pre-approved by the Court. He also conceded that KKT intentionally omitted the payments from the Debtor’s Monthly Operating Reports, in violation of §§ 704(a)(8) and 1106(a)(1) of the Code, because, if the Debtor had owed post-petition money for legal fees, then “the monthly operati[ng] report[s] most likely [would have] go[ne] negative[,] [a]nd at the time [they] were talking about reorganization[.]” (App. at 651.) In other words, KKT intentionally withheld required information and did

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so to mislead the Court and avoid either the conversion or the dismissal of the case.

*3 Rightly concerned, the Bankruptcy Court issued a second order for KKT and Tung, in his individual capacity, to show cause why the Court should not sanction them for violations of the New Jersey Rules of Professional Conduct, the Code, and the Bankruptcy Rules. It also asked, among other things, why it should not deny KKT's fee application in its entirety, require KKT to disgorge attorney's fees previously paid, and find that KKT was not disinterested in its representation. KKT and Tung responded that their conduct had not violated any legal or ethical obligations. KKT also contended, among other things, that acceptance of legal fees from Quan was not a per se violation of § 327(a) of the Code, that it made the appropriate disclosures in its Fee Application under Bankruptcy Rule 2016, and that there was no conflict of interest because the interests of Quan and the Debtor are united.

At the hearing on the second order to show cause, Tung, again speaking on behalf of both KKT and himself, first argued that the failure to timely disclose the payments was merely a "technical failure to disclose, ... [which] shouldn't warrant any sanctions." (App. 874.) He then changed his tune, saying he did not believe KKT needed to disclose anything about the payments until it filed the Fee Application. Even after he finally agreed that earlier disclosure was required, he gave a series of contradictory responses on how the undisclosed payments should be characterized.² The Bankruptcy Court said that Tung "really, really [did not] understand the laws that govern a bankruptcy proceeding," and, rather than show contrition for his mistakes, was "very defensive, flip flopping in [his] statements, ... and ... unhelpful[.]" (App. at 932-33.)

² Each time the negative implications of his proposed characterization became apparent, Tung would change his response: The undisclosed payments were "definitely not a loan" (App. at 879); they "could be characterized" as an infusion of capital (App. at 879); "the assumption should be [that they were] not [an] infusion of capital" (App. at 928); they were an "investment" (App. at 880); they "w[ere]n't treated as [an] investment" (App. at 890); they "could be" a gift to the debtor (App. at 889-90); "[n]obody said to me it was a gift" (App. at 890); "[i]t's a gift" (App. at 928); "I'm not saying it's a gift" (App. at 929); "I withdraw that statement [that it was a gift]" (App. at 929); "[i]t was money paid on behalf of the debtor ..., legally speaking, by a third party" (App. at 890); and "[a]nything could have happened" (App. at 892).

The Court denied with prejudice the Fee Application and ordered the payments to KKT to be disgorged to the estate (the "Fee Order"). It determined that KKT and Tung failed to make timely and adequate disclosures under Rules 2014 and 2016, and had "purposefully and strategically decided to omit pertinent information from the [Monthly Operating Reports.]" (App. at 1010.) The Court thus concluded they had violated their duty of candor under New Jersey Rule of Professional Conduct 3.3. In light of those violations, the Court found it unnecessary to decide whether an actual conflict of interest arose. Lastly, because of the egregiousness of counsel's conduct, the Court referred the case to the Chief Judge of the District Court for potential disciplinary action.

KKT appealed to the District Court, arguing that the Bankruptcy Court, as a non-Article III court, lacked jurisdiction to order disgorgement of KKT's fees and, even if it had the authority to do so, that it abused its discretion in issuing the Fee Order. The District Court rejected both arguments. It held that disgorgement was within the Bankruptcy Court's jurisdiction under *Stern v. Marshall*, 564 U.S. 462 (2011), as "these proceedings were core and flowed directly from the bankruptcy scheme[.]" (App. at 16.) And because KKT breached its disclosure obligations, the District Court said that the Bankruptcy Court was well within its discretion to order disgorgement and deny the Fee Application.³ Finally, the District Court struck from the record, as irrelevant and meritless, a supplemental letter filed by KKT alleging that the Bankruptcy Judge was improperly biased in the Debtor's bankruptcy. The basis of the allegation was a photograph taken of the Judge with the Chapter 7 Trustee at a New Jersey Bankruptcy Lawyers Foundation event.

³ The District Court also affirmed the Bankruptcy Court's holding that KKT violated New Jersey Rule of Professional Conduct 3.3 and, like the Bankruptcy Court, found it unnecessary to address whether there was an actual conflict of interest between KKT and the Debtor.

II. DISCUSSION⁴

⁴ The Bankruptcy Court had jurisdiction under 28 U.S.C. §§ 157(a) and (b) and

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¶1334(a). The District Court had jurisdiction to review the appeal under 28 U.S.C. § 158(a), and we have jurisdiction to review that final decision pursuant to 28 U.S.C. § 158(d)(1). In doing so, we “‘stand in the shoes’ of the District Court and ... review the Bankruptcy Court’s legal conclusions de novo and its factual findings for clear error.” *In re Glob. Indus. Techs., Inc.*, 645 F.3d 201, 209 (3d Cir. 2011) (en banc) (citations omitted).

*4 KKT raises the same arguments before us that have already been rejected. It says that the Bankruptcy Court lacked constitutional authority to order the disgorgement to the estate of fees paid by Quan, that the Bankruptcy Court abused its discretion in issuing the Fee Order, and that the District Court should not have struck KKT’s post-briefing filing accusing the Bankruptcy Judge of bias. None of that has the slightest merit.

KKT argued for the first time in the District Court that, under *Stern*, the Bankruptcy Court lacked authority to order disgorgement of the post-petition, unauthorized fee payments, because it is not an Article III court. It stated that the payments underlying the disgorgement were “non-core” because they were made by a third party and are not part of the estate. (Opening Br. at 17-18.) KKT’s reliance on *Stern* is misplaced.

In *Stern*, the Supreme Court determined that a bankruptcy court could not adjudicate state-law tort claims that were “in no way derived from or dependent upon bankruptcy law” because they “exist[] without regard to any bankruptcy proceeding.” 564 U.S. at 499. As we have since explained, “*Stern* made clear that non-Article III bankruptcy judges do not have the constitutional authority to adjudicate a claim that is exclusively based upon a legal right grounded in state law[.]” *In re One2One Comme’ns, LLC*, 805 F.3d 428, 433 (3d Cir. 2015). Unlike the tort claims at issue in *Stern*, the payment of legal fees is “based on a federal bankruptcy law provision with no common law analogue, so the *Stern* line of cases is plainly inapposite.” *In re Lazy Days’ RV Ctr. Inc.*, 724 F.3d 418, 423 (3d Cir. 2013); see also *In re Frazin*, 732 F.3d 313, 321 (5th Cir. 2013) (treating the award of fees as constitutionally within bankruptcy court’s jurisdiction). Violations thereof are thus appropriately policed through equitable remedies fashioned by the Bankruptcy Court. See *In re Lewis*, 113 F.3d 1040, 1046 (9th Cir. 1997) (“The bankruptcy

court may order the disgorgement of any payment made to an attorney representing the debtor in connection with a bankruptcy proceeding, irrespective of the payment’s source.”); *In re Walters*, 868 F.2d 665, 668 (4th Cir. 1989) (“[A]ny payment made to an attorney for representing a debtor in connection with a bankruptcy proceeding is reviewable by the bankruptcy court notwithstanding the source of payment.”). The fees paid by Quan were to the benefit of the estate and thus were core matters within the Bankruptcy Court’s purview. See 11 U.S.C. § 541(a)(7) (Property of the estate includes “[a]ny interest in property that the estate acquires after the commencement of the case.”).

KKT next asserts that, even if the Bankruptcy Court possessed authority to order disgorgement, it abused its discretion by entering the Fee Order, which ordered disgorgement and denied KKT’s Fee Application. The word “chutzpah” comes to mind. KKT’s repeated violations of the Bankruptcy Rules and the Code, along with counsel’s lack of candor, more than justified entry of the Fee Order. See *In re Bressman*, 327 F.3d 229, 240 (3d Cir. 2003) (indicating that “a bankruptcy court may order the disgorgement of fees received by an attorney when he or she has ignored reporting and court approval duties imposed by the Code”); *In re Downs*, 103 F.3d 472, 479 (6th Cir. 1996) (holding that the bankruptcy court has inherent authority to “deny all compensation to an attorney who exhibits a willful disregard of his fiduciary obligations to fully disclose the nature and circumstances of his fee arrangement”).

*5 We reiterate that the Code and associated Rules impose a rigorous structure of oversight on a debtor, its professionals, and the estate. At the heart of that structure is a baseline presumption – and an expectation – of disclosure and candor. See, e.g., Fed. R. Bankr. P. 2014(a) (requiring counsel to disclose “any proposed arrangement for compensation”); Fed. R. Bankr. P. 2016(b) (requiring that compensation be disclosed “within 14 days after any payment or agreement not previously disclosed”); 11 U.S.C. § 329(a) (requiring comprehensive disclosure of payments in connection with bankruptcy); *id.* § 330(a) (requiring counsel to file fee applications when seeking payment for services rendered). KKT flouted those obligations, and we will not disturb the Bankruptcy Court’s well-justified response.

Lastly, though it is hardly worthy of response, we dispose of KKT’s argument that a photograph of the Bankruptcy Judge and the Chapter 7 Trustee, taken at a New Jersey Bankruptcy Lawyers Foundation event, somehow evidences judicial bias. It does not, and the District Court

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did not abuse its discretion by striking KKT's supplemental letter as "wholly irrelevant and without merit." (App. at 19.) See *Meditz v. City of Newark*, 658 F.3d 364, 367 n.1 (3d Cir. 2011) ("We review the District Court's decision denying the motion to strike for an abuse of discretion.").

Because there is no reason to question the Bankruptcy Court's handling of the sad situation created by KKT and its principal, Mr. Tung, we will affirm the order of the District Court, thus affirming the underlying Fee Order.

All Citations


Not Reported in Fed. Rptr., 2022 WL 1153123

III. CONCLUSION

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Levit v. Ingersoll Rand Financial Corp., 874 F.2d 1186 (1989)
 57 USLW 2677, 22 Collier Bankr.Cas.2d 36, 19 Bankr.Ct.Dec. 574...

 KeyCite Yellow Flag - Negative Treatment
 Disapproved of by *In re Arundel Housing Components, Inc.*,
 Bankr.D.Md., March 28, 1991

874 F.2d 1186
 United States Court of Appeals,
 Seventh Circuit.



Louis W. LEVIT, Trustee of V.N. Deprizio
 Construction Co., Plaintiff-Appellee,
 v.
 INGERSOLL RAND FINANCIAL
 CORPORATION, et al., Defendants-Appellants.

Nos. 88-3091, 88-3092 and 88-3093.

|
 Argued April 11, 1989.

|
 Decided May 12, 1989.




Synopsis

Trustee in Chapter 7 case sought to avoid payments as preferential transfers. The Bankruptcy Court,  58 B.R. 478, Robert L. Eisen, J., dismissed and appeal was taken. The United  States District Court for the Northern District of Illinois, 86 B.R. 545, Paul E. Plunkett, J., reversed and remanded. In separate appeal, the District Court, Harry D. Leinenweber, J., followed Judge Plunkett's opinion. Leave to appeal was granted and appeals were consolidated. The Court of Appeals, Easterbrook, Circuit Judge, held that: (1) delinquent taxes paid more than 90 days before filing could not be recovered; (2) trustee could not recover payments to pension and welfare trusts made more than 90 days before the filing, unless trusts negotiated for and received contractual guarantees from insiders; and (3) preference-recovery period for outside creditors is one year when payment produces benefit for inside creditor, including guarantor.


Judgments of the district court affirmed in part and reversed in part and cases remanded.

West Headnotes (6)






[1] **Bankruptcy ⇌ Insider Transferees;**
 Reasonable Cause to Believe Debtor Insolvent

Insiders, who were potentially subject to penalty as responsible persons for debtor's failure to remit withholding taxes, did not hold claim against debtor for the withholding tax liability; therefore, payments to the tax collector were not for benefit of insiders as creditors and bankruptcy trustee in Chapter 7 case could not recover funds from the United States for transfers more than 90 days before the bankruptcy filing. Bankr.Code,  11 U.S.C.A. §§ 101,  547,  547(b), 550, 701 et seq.; 26 U.S.C.A. § 6672(a).

44 Cases that cite this headnote

[2] **Bankruptcy ⇌ Insider Transferees;**
 Reasonable Cause to Believe Debtor Insolvent
 Pension and welfare trusts may recover from insiders only to the extent state law allows under rules for disregarding the corporate form, or the insiders make contractual commitments enforceable under the Employee Retirement Income Security Act. Employee Retirement Income Security Act of 1974, § 515, as amended,  29 U.S.C.A. § 1145.

9 Cases that cite this headnote

[3] **Bankruptcy ⇌ Insider Transferees;**
 Reasonable Cause to Believe Debtor Insolvent
 Payments to pension and welfare funds did not produce benefit to inside creditors, and thus, bankruptcy trustee in Chapter 7 case could not recover from the funds for transfers more than 90 days before bankruptcy filing; no insider guaranteed debts to pension and welfare funds, and trustee did not maintain that debtor was shell corporation or that other attributes allowing court to disregard corporate form were present. Bankr.Code,  11 U.S.C.A. §§ 101,  547,  547(b), 550, 701 et seq.; Employee Retirement Income Security Act of 1974, §§ 3(5, 9), 515, as amended,  29 U.S.C.A. §§ 1002(5, 9),  1145.

Levit v. Ingersoll Rand Financial Corp., 874 F.2d 1186 (1989)
 57 USLW 2677, 22 Collier Bankr.Cas.2d 36, 19 Bankr.Ct.Dec. 574...

96 Cases that cite this headnote

- [4] **Bankruptcy** ⇌ Insider Transferees;
 Reasonable Cause to Believe Debtor Insolvent
 Whether payments to pension and welfare funds produced avoidable benefit for inside creditor depended on terms of their agreements and had to be determined on remand, in bankruptcy proceeding wherein Chapter 7 trustee sought recovery of payments made to the funds within one year before filing on theory that insiders were secondarily liable. Bankr.Code, ¶11 U.S.C.A. §§ 101, ¶547, ¶547(b), 550, 701 et seq.; Employee Retirement Income Security Act of 1974, §§ 3(5, 9), 515, as amended, ¶29 U.S.C.A. § 1002(5, 9), ¶1145.

133 Cases that cite this headnote

- [5] **Bankruptcy** ⇌ Insider Transferees;
 Reasonable Cause to Believe Debtor Insolvent
 Bankruptcy trustee may not recover payments to pension and welfare trust made more than 90 days before bankruptcy filing, unless the trusts negotiated for and received contractual guarantees from insiders-in which event funds should be treated just like any other outside creditor. Bankr.Code, ¶11 U.S.C.A. §§ 101, ¶547, ¶547(b), 550; Employee Retirement Income Security Act of 1974, §§ 3(5, 9), 515, as amended, ¶29 U.S.C.A. §§ 1002(5, 9), ¶1145.

8 Cases that cite this headnote

- [6] **Bankruptcy** ⇌ Insider Transferees;
 Reasonable Cause to Believe Debtor Insolvent
 Preference-recovery period for outside creditors is one year when payment produces benefit for inside creditor, including guarantor. Bankr.Code, ¶11 U.S.C.A. §§ 101, ¶547, ¶547(b), 550.

80 Cases that cite this headnote

Attorneys and Law Firms

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Before BAUER, Chief Judge, and FLAUM and EASTERBROOK, Circuit Judges.

Opinion

EASTERBROOK, Circuit Judge.

We must decide a question no other appellate court has addressed: whether payments to creditors who dealt at arms' length with a debtor are subject to the year-long preference-recovery period that ¶11 U.S.C. § 547(b)(4)(B) provides for "inside" creditors, when the payments are "for the benefit of" insiders, ¶547(b)(1). The bankruptcy court in this case answered "no", ¶58 B.R. 478 (Bankr.N.D.Ill.1986), and the district court "yes", ¶86 B.R. 545 (N.D.Ill.1988). We agree with the district court for the most part, although we conclude that payments satisfying pension obligations ordinarily are not for the benefit of inside creditors, and payments of tax obligations never are.

I

In 1980 V.N. Deprizio Construction Co. was awarded contracts to do \$13.4 million of work on the extension of Chicago's subway system to O'Hare Airport. By 1982 the company was in financial trouble. Because Mayor Byrne wanted the line open before the primary election for that office in February 1983, the City made the firm extraordinary loans of \$2.5 million; the firm in turn donated \$3,000 to the Mayor's campaign fund. Neither outlay achieved its purpose. The line wasn't finished on time, and Byrne lost. These and other dealings by Richard N. Deprizio, the firm's president, including suspicions of affiliation with organized crime, led the United States Attorney to open an investigation. In April 1983 Deprizio Co. filed a petition under the Bankruptcy Code of 1978. Other firms finished the subway, which opened in 1984.

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As the investigation continued and Deprizio's indictment was imminent, word circulated that he might "sing". So in January 1986 Deprizio was lured to a vacant parking lot, where an assassin's gun and the obligations of a lifetime were discharged together. Corporations are not so easily liquidated.

Deprizio Co. had borrowed money from many sources other than the City of Chicago, including Ingersoll Rand Financial Corp., CIT Group/Equipment Financing, Inc., and Melrose Park Bank & Trust. Richard Deprizio co-signed the note to the Bank. Richard and his brothers, Robert and Edward, all insiders of the firm, also guaranteed its debts to other lenders. ("Insider", a term to which we return, includes officers of the debtor and the officers' relatives.) As the district court observed "the record is devoid of detail" concerning these guarantees. Details are potentially *1188 important, because CIT maintains on appeal that no insider guaranteed any of the firm's debts to it. The Trustee does not contest this but maintains that inside creditors received a benefit from payments to CIT because insiders had guaranteed debt secured by collateral in which CIT held the senior interest.

Deprizio Co. was party to collective bargaining agreements calling for payments to pension and welfare plans, for the benefit of the firm's employees. When it fell behind in making the required payments, the firm executed notes in favor of the plans, secured by junior interests in equipment in which Ingersoll and CIT held senior interests. Richard Deprizio co-signed the notes to several plans. The Central States Pension and Welfare Funds received only notes and security interests from Deprizio Co.; no insider guaranteed these notes.

Then there were tax obligations. Employers must remit to the government taxes withheld from wages. The Trustee believes that Deprizio Co. fell behind in making these payments but made substantial payments of delinquent withholding taxes in the year before bankruptcy. The United States, on the other hand, believes that Deprizio Co. did not remit any overdue taxes during the year before it filed its petition in bankruptcy.

Payments out of the ordinary course in the 90 days before filing a bankruptcy petition may be recovered for the estate under 11 U.S.C. §§ 547 and 550. Creditors then receive shares determined by statutory priorities and contractual entitlements rather than by their ability to sneak in under the wire. Payments to or for the benefit of an insider during a full year, not just 90 days, may be recovered by virtue of 11 U.S.C. §

547(b)(4)(B). The Trustee filed adversary proceedings against the lenders, the pension and welfare funds, and the United States—none of them insiders—seeking to recover payments made more than 90 days but within the year before the filing. The Trustee reasoned that the payments made to these outside creditors were "for the benefit" of inside co-signers and guarantors, because every dollar paid to the outside creditor reduced the insider's exposure by the same amount.

Without deciding whether any of the payments was preferential within the meaning of 11 U.S.C. § 547 or worked to the benefit of any insider, the bankruptcy judge denied the Trustee's request. Judge Eisen concluded that any transfer to an outside creditor for the benefit of an insider should be treated as two transfers: one being the money, and the other the benefit. A transfer may be recovered under § 550(a) only to the extent it is avoidable under 11 U.S.C. § 547. The monetary transfer to the outsider is not avoidable, Judge Eisen concluded, when made more than 90 days before the filing. Thus it may not be recovered from the outsider, even though the benefit to the insider may be recovered from the insider.

On an interlocutory appeal to the district court, Judge Plunkett reversed. He concluded that payment is only one transfer, although a transfer may create benefits for many persons. If the insider receives a benefit, then the transfer is avoidable under 11 U.S.C. § 547(b)(4)(B) if made within a year of the bankruptcy and does not qualify for the exclusions in 11 U.S.C. § 547(c). (These include payments in the ordinary course of business, payments for equivalent value received, and so on.) Section 550(a), as Judge Plunkett read it, allows the Trustee to recover the transfer from either the recipient or the indirect beneficiary, at the Trustee's option. The district court remanded the case so that the bankruptcy court could determine whether the payments identified by the Trustee occurred, whether an insider received a benefit from any particular payment, and whether any of them was protected by 11 U.S.C. § 547(c). Judge Plunkett certified the question under 28 U.S.C. § 1292(b), and we granted leave to appeal.¹

¹ One creditor's appeal from the bankruptcy court was assigned to Judge Leinenweber, who held the case in abeyance pending Judge Plunkett's opinion and followed his decision in a brief order. This court consolidated the appeals.

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II

Many bankruptcy and district judges *1189 have addressed the question we confront,² as have commentators.³ A majority of judges have concluded that insiders' guarantees do not expose outside lenders to an extended preference-recovery period, frequently because they believe that recovery would be inequitable when ordinarily outside creditors need restore only preferences received within the 90 days before bankruptcy. The commentators are evenly divided.

² Five cases answer "yes": the district court's decision here plus *In re Robinson Bros. Drilling, Inc.*, 97 B.R. 77 (W.D.Okla.1988), appeal pending, No. 88-8089 (10th Cir.); *In re Coastal Petroleum Corp.*, 91 B.R. 35 (Bankr.N.D. Ohio 1988); *In re W.E. Tucker Oil, Inc.*, 42 B.R. 897 (Bankr.W.D.Ark.1984); *In re Big Three Transportation, Inc.*, 41 B.R. 16 (Bankr.W.D.Ark.1983). These cases answer "no" on the ground that extended preference recovery would be inequitable: *In re T.B. Westex Foods, Inc.*, 96 B.R. 77 (Bankr.W.D.Tex.1989) (alternative holding); *In re Midwestern Companies Inc.*, 96 B.R. 224 (Bankr.W.D.Mo.1988); *In re C-L Cartage Co.*, 70 B.R. 928 (Bankr.E.D.Tenn.1987); *In re Aero Metals, Inc.*, 60 B.R. 77 (Bankr.N.D.Tex.1985); *In re R.A. Beck Builder, Inc.*, 34 B.R. 888 (Bankr.W.D.Pa.1983); *In re Duccilli Formal Wear, Inc.*, 8 Bankr.Ct. Dec. (CRR) 1180 (Bankr.S.D. Ohio 1982); *In re Cove Patio Corp.*, 19 B.R. 843 (Bankr.S.D.Fla.1982); *In re Church Buildings & Interiors, Inc.*, 14 B.R. 128 (Bankr.W.D.Okla.1981). Two answer "no" on the ground that insider and outsider receive different "transfers", only one of which may be recovered: the bankruptcy judge's opinion in our case and *In re Mercon Industries, Inc.*, 37 B.R. 549 (Bankr.E.D.Pa.1984). (*Midwestern* adopts this view as an alternative holding.)

³ Compare Lawrence P. King, 4 *Collier on Bankruptcy* ¶ 550.02 at 550-8 (15th ed. 1987), and Vern Countryman, *The Trustee's Recovery in Preference Actions*, 3 *Bankruptcy Developments* J. 449, 464 (1986), both saying "no" on grounds of equity, with Isaac Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1)*, 41 *Bus.Law.* 175, 186-99 (1985), and Thomas E. Pitts, Jr., *Insider Guaranties and the Law of Preferences*, 55 *Am.Bankr.L.J.* 343 (1981), both answering "yes". See also Phillip I. Blumberg, *The Law of Corporate Groups: Bankruptcy Law* § 9.03 (1985 & Supp.1988), contending that the answer should depend on whether the insider is solvent. A student note suggests still another approach. Note, *The Interplay Between Sections 547(b) and 550(a)(1) of the Bankruptcy Code*, 89 *Colum.L.Rev.* 530 (1989).

A

Six sections of the Bankruptcy Code supply the texts.

Section 547(b) says:

Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property-

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made-
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if-
 - (A) the case were a case under Chapter 7 of this title;

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(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

This is § 547(b) as amended in 1984. The version in force in 1983, when this case began (and thus the one applicable to it), applied the year-long period for insiders only if the insider "had reasonable cause to believe the debtor was insolvent at the time of such transfer", § 547(b)(4)(B)(ii), a qualification unimportant to this case.

Section 547(b) uses three terms of art: "creditor", "insider", and "transfer", and the definition of "creditor" brings in a fourth: "claim". Section 101 defines each.

(4) "claim" means-

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; ...

(9) "creditor" means-

*1190 (A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;

(B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; ...

(30) "insider" includes-

(B) if the debtor is a corporation-

(i) director of the debtor;

(ii) officer of the debtor;

(iii) person in control of the debtor;

(vi) relative of a general partner, director, officer, or person in control of the debtor;

(50) "transfer" means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption; ...

Finally there is § 550, which specifies who is liable for a transfer avoided under § 547:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section ... 547, ... the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from-

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.

(b) The trustee may not recover under section (a)(2) of this section from-

(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or

(2) any immediate or mediate good faith transferee of such transferee.

(c) The trustee is entitled to only a single satisfaction under subsection (a) of this section.

The Trustee's argument for extended recovery from outside creditors flows directly from these interlocked provisions.

Suppose Firm borrows money from Lender, with payment guaranteed by Firm's officer (Guarantor). Section 101(30)(B)(ii) renders Guarantor an "insider". Guarantor is not Firm's creditor in the colloquial sense, but under § 101(9) of the Code any person with a "claim" against Firm is a "creditor", and anyone with a contingent right to payment holds a "claim" under § 101(4)(A). A guarantor has a contingent right to payment from the debtor; if Lender collects from Guarantor, Guarantor succeeds to Lender's entitlements and can collect from Firm. So Guarantor is a

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“creditor” in Firm’s bankruptcy. A payment (“transfer”) by Firm to Lender is “for the benefit of” Guarantor under § 547(b)(1) because every reduction in the debt to Lender reduces Guarantor’s exposure.⁴ Because the payment to Lender assists Guarantor, it is avoidable under § 547(b)(4)(B) unless one of the exemptions in § 547(c) applies. Once the transfer is avoided under § 547, the Trustee turns to § 550 for authority to recover. “Section 547(b)(4) distinguishes according to [whether Guarantor is an “insider”], but § 550 does not. It says that if a transfer is recoverable by the trustee, it may be recovered from either the ‘initial transferee’ (Lender) or the ‘entity for whose benefit such transfer was made’ (Guarantor).” *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 894 (7th Cir.1988) (emphasis in original). So Lender may have to repay transfers received during the year before filing, even though Lender is not an insider.

⁴ This is even clearer when the insider is a co-maker on the note, as Richard Deprizio was on several. On the other hand, a co-maker may have no right to recover from the firm and therefore no “claim” in bankruptcy. The parties have not treated inside co-makers differently from inside guarantors, so neither shall we.

Judge Plunkett accepted this chain of reasoning. The creditors seek to break it *1191 at three links. First, they observe that § 550(a) allows the trustee to recover only “to the extent that a transfer is avoided under” § 547. Viewing each payment as two “transfers”—one to Lender, another to Guarantor—they insist that the only transfer avoidable under § 547 is the one to Guarantor. Second, several of the lenders say that the insiders are not “creditors” for particular debts. Third, CIT submits that payment of a non-guaranteed loan backed by a senior security interest does not produce a “benefit” for an inside guarantor of a junior secured creditor. The district court did not consider this third argument, and we do not pursue it (although we discuss it briefly at the close of this opinion); it should be resolved in the first instance by the bankruptcy court. The other two arguments we address in reverse order.

B.1

[1] The United States, as tax collector, did not receive a guarantee from any insider of Deprizio Co. There is no note; the debt is created by operation of law. The wrinkle is that 26 U.S.C. § 6672(a) potentially requires insiders to pay any tax the firm should have withheld and paid over. It provides:

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax ... shall ... be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over...

Because an “insider” may be liable under § 6672(a) when the firm does not pay over taxes, every dollar of tax paid reduces the insider’s exposure. Thus the insider receives a benefit from payment. Section 547(b)(1) speaks, however, of payments for the benefit of creditors, not benefits at large. A person is a “creditor” only to the extent he holds a “claim” against the debtor. So all turns on whether a “person required to collect, truthfully account for, and pay over any tax”—in the shorthand of tax law, a “responsible person”—has a contingent right to recover from the debtor in bankruptcy, the only basis for calling him a “creditor”.

Section 6672(a) does not authorize a responsible person to recover from the firm. Nothing in the text or structure of the statute suggests that the responsible person can seek compensation from anyone else. The law imposes a “penalty” on the defaulting responsible person. This is personal liability, standing apart from the firm’s tax debt. The government customarily collects the full tax only once, from the employer or the responsible person, see Policy Statement P-5-60, 1 CCH *Internal Revenue Manual* 1305-14; *Emshwiller v. United States*, 565 F.2d 1042, 1047 (8th Cir.1977), but nothing in the text of § 6672(a) prevents the Commissioner of Internal Revenue from collecting both the taxes withheld by the employer and the penalty from the responsible person. Because the responsible person owes his own debt to the government, *Monday v. United States*, 421 F.2d 1210, 1218 (7th Cir.1970), he does not hold a “claim” against the debtor and so is not a creditor. *In re FJS Tool & Mfg. Co.*,

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88 B.R. 866, 870 (Bankr.N.D.Ill.1988); *Arrigoni v. CIR*, 73 T.C. 792, 800-01 (1980).

The Trustee responds with an argument based on common law: the employer is liable for the tax, the responsible person has been vexed only to ensure collection, and so (the Trustee insists) the responsible person may get contribution or indemnity from the employer. That contingent claim would make the responsible person a creditor. Section 6672(a) does not define a tort, however, and federal courts no longer create private rights of action without support in either the statutory text or the legislative history. See *Karahalios v. Federal Employees Union*, 489 U.S. 527, 109 S.Ct. 1282, 103 L.Ed.2d 539 (1989). Rights of contribution and indemnity are no different in principle from other implied rights of action, see *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 101 S.Ct. 2061, 68 L.Ed.2d 500 (1981). The Trustee has not identified anything suggesting that Congress sought to create a private right of action by the responsible person against the employer to accompany the express right in favor of the Commissioner against the responsible person.

Analogies to indemnity at common law do not assist the Trustee. “[T]here can be no indemnity in favor of the intentional or reckless tortfeasor”, W. Page Keeton, et al., *Prosser and Keeton on Torts* 343 (5th ed.1984). Section 6672(a) imposes a penalty only when the responsible person has “willfully” failed to collect or pay over the tax. Willful is a term with many shadings, but its incarnation in § 6672(a) means at least reckless. “[T]he ‘responsible person’ is liable if he (1) clearly ought to have known that (2) there was a grave risk that withholding taxes were not being paid and if (3) he was in a position to find out for certain very easily.” *Wright v. United States*, 809 F.2d 425, 427 (7th Cir.1987). See also, e.g., *Snwyer v. United States*, 831 F.2d 755 (7th Cir.1987); *Ruth v. United States*, 823 F.2d 1091, 1094-95 (7th Cir.1987); *Purdy Co. v. United States*, 814 F.2d 1183, 1188-89 (7th Cir.1987). Cf. *United States v. Sotelo*, 436 U.S. 268, 274-75, 98 S.Ct. 1795, 1799-1800, 56 L.Ed.2d 275 (1978). Anyone who must pay a penalty under § 6672(a) also has the degree of involvement and the mental state that would prevent indemnity at common law.

An insider potentially subject to a penalty under § 6672(a) therefore does not hold a “claim” against the debtor and is not its creditor. *In re All Star Sports, Inc.*, 78 B.R. 281

(Bankr.D.Nev.1987); *In re Windsor Communications Group, Inc.*, 45 B.R. 770 (Bankr.E.D.Pa.1985). Payments to the tax collector, although to the benefit of the responsible person, are not to his benefit as creditor, and the Trustee may not recover funds from the United States for transfers more than 90 days before the filing.

B.2

[2] [3] [4] [5] Several of Deprizio Co.'s pension and welfare funds accepted notes co-signed by Richard Deprizio. Payments to the funds on these notes directly reduced his liability. These pension and welfare funds therefore must be treated just like the commercial creditors to the extent of these notes. The Central States pension and welfare funds, however, did not obtain Richard Deprizio's promise, and the other funds may have received payments on account of the firm's current obligations, which did not reduce the balances on the notes. The Trustee wants to recover payments made to all funds within the year before the filing on the ground that insiders of the firm are secondarily liable. The theory, as with the tax obligations, is that the insiders hold contingent claims against the debtor if they should be called on to satisfy its debts to the pension and welfare funds, making them “creditors”. Once again the potential benefit to the insiders is obvious but their status as “creditors” is not.

Pension funds look to the employer for payment. Section 515 of the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1145, requires “[e]very employer who is obligated to make contributions to a multiemployer plan under the terms of the plan or under the terms of a collectively bargained agreement [to] ... make such contributions in accordance with the terms and conditions of such plan or such agreement.” This statute, which we discussed in detail in *Central States Pension Fund v. Gerber Truck Service, Inc.*, 870 F.2d 1148 (7th Cir.1989) (en banc), requires strict adherence to the terms of the contribution agreement, unless those terms are inconsistent with law.

ERISA lacks, however, a provision such as § 6672(a) of the Internal Revenue Code. Nothing in ERISA requires insiders of the firm to stand behind its pension commitments. If this is the whole story, then payments to pension and welfare funds do not provide even a “benefit” to an inside creditor: because the plans are unable to recover from the insiders, payments do not reduce the insiders' exposure. More, the insiders who

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are not exposed to personal liability have no potential "claim" against the firm and could not be "creditors".

Things are not so simple, though. Section 3(5) of ERISA, 29 U.S.C. § 1002(5), defines "employer" as "any person acting directly as an employer, or indirectly in the interest of an employer", and § 3(9), 29 U.S.C. § 1002(9), adds that a "person" includes "an individual ... [or] corporation". Perhaps, then, an insider counts as an "employer" under ERISA to the extent he is acting "indirectly in the interest of an employer", and therefore is responsible for the firm's pension and welfare obligations. If the insider's obligation does not depend on wilful misconduct (thus avoiding the argument that defeated the Trustee's claims concerning tax payments), the insider's right to recover over against the firm would make the insider a "creditor".

Section 3(5) was derived from a similar provision in the Fair Labor Standards Act, and courts have allowed employees to collect from corporate investors and officers under the FLSA when they caused the firms to pay less than the minimum wage. See *Riordan v. Kempiners*, 831 F.2d 690 (7th Cir. 1987); *Donovan v. Agnew*, 712 F.2d 1509 (1st Cir. 1983). The analogy to the FLSA led Judge Shadur to conclude that a firm's managers are jointly and severally liable with the firm for pension obligations. *Gambino v. Index Sales Corp.*, 673 F.Supp. 1450, 1452-56 (N.D. Ill. 1987). Accord, *Elam v. Seng Truck Leasing Co.*, No. 87 C 8132, 1988 WL 139280 (N.D. Ill. Dec. 14, 1988); *West Virginia-Ohio Valley Area IBEW Welfare Fund v. Ball Electric Co.*, 685 F.Supp. 953 (S.D. Va. 1988). On this approach, payment to the funds yields a benefit for an inside creditor. *Gambino* gives a thoughtful and plausible account of managers' liability under ERISA. At the end of the day, however, we remain unpersuaded, for two reasons.

First, we must take account of § 515. Only an "employer who is obligated to make contributions to" a plan under an agreement need do so. Such an employer must make contributions "in accordance with the terms and conditions of such plan or such agreement." Even if a manager or other officer is an "employer" under § 3(5), the plan or other agreement still governs what each must do, for not all "employers" are "obligated to make contributions" under the "terms and conditions" of a plan or agreement. *Gerber Truck Service* holds that these documents will be strictly

enforced. Exactitude works both ways. Just as pension and welfare plans get no less than the agreements provide, so they get no more. The parent corporation of an employer under the act is an "employer" itself—may even have its own pension plan—but the parent would not be liable under § 515 for its subsidiary's pension debts in the absence of a promise running from the parent. So it is with other investors and managers. Several plans obtained Richard Deprizio's personal commitment, as co-maker of notes with Deprizio Co. Other plans had only Deprizio Co.'s commitment to pay. Section 515 requires us to honor the difference between these engagements. *Massachusetts Laborers' Health and Welfare Fund v. Starrett Paving Corp.*, 845 F.2d 23 (1st Cir. 1988) (Breyer, J.).

Second, the General Counsel of the Pension Benefit Guaranty Corp., which insures multi-employer pension funds and accordingly has a strong interest in seeing that they collect their due, has concluded that ERISA does not address "shareholder or officer liability". Opinion Letter 82-38 (Dec. 14, 1982), states: "With regard to your question as to individual shareholder responsibility for withdrawal liability, we note that ERISA has no special rules regarding shareholder or officer liability. Accordingly, this issue is usually determined by State law, which generally provides that shareholders are not liable for the debts of a corporation." Opinion Letter 82-38 does not go into detail, but even so we owe it some respect. *Gerber Truck Service*, 870 F.2d at 1153-54. The approach of this letter has been adopted widely. Courts routinely rebuff efforts to collect pension debts from managers and investors unless the officer or investor would be liable for the firm's other debts under state law—in other words, unless courts would "pierce the corporate veil" in light of the structure and operation of the particular firm. *Scarborough v. Perez*, 870 F.2d 1079 (6th Cir. 1989); *International Brotherhood of Painters v. George A. Kracher, Inc.*, 856 F.2d 1546 (D.C. Cir. 1988); *Solomon v. Klein*, 770 F.2d 352 (3d Cir. 1985); *Operating Engineers Pension Trust v. Reed*, 726 F.2d 513 (9th Cir. 1984) (Kennedy, J.). It would take a compelling argument to persuade us to depart from an interpretation of the law adopted by a responsible agency and followed by so many courts. Inferences from the importation into ERISA of a few words from the FLSA do not satisfy that standard.

An officer who does not make a contractual commitment to a pension or welfare plan still could be personally liable, to

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the extent he is liable for general corporate debts under state corporate law, ⁴ *Starret Paving*, 845 F.2d at 26. But when state law recognizes the separate identity of manager and firm, liability under ERISA depends on the contents of the plan and related agreements.⁵ No insider guaranteed Deprizio Co.'s debts to the Central States pension and welfare funds. Because the Trustee does not maintain that Deprizio Co. is a shell corporation or that the other attributes allowing a court to disregard the corporate form are present, cf. ⁶ *Secon Service System, Inc. v. St. Joseph Bank & Trust Co.*, 855 F.2d 406, 412-16 (7th Cir.1988), payments to the Central States funds did not produce a benefit to an inside "creditor". Whether particular payments to the other funds produced such an avoidable benefit depends on the terms of their agreements, a topic that must be explored on remand.

5

Section 502(a)(3)(B)(ii), ⁷ 29 U.S.C. § 1132(a)(3)(B)(ii), adds nothing to § 515. It authorizes a plan's trustee to bring suit to "enforce any provisions of this subchapter or the terms of the plan." This returns us to the question whether the "terms of [a] plan" require managers and investors to stand behind the employer's pension commitments, the same question to which § 515 directs us.

III

[6] Now for the principal question: whether the Trustee may recover from an outside creditor under § 550(a)(1) a transfer more than 90 days before the filing that is avoided under ⁸ § 547(b) because of a benefit for an inside creditor. The textual argument, which we have already given, is simple. ⁹ Section 547(b) defines which transfers are "avoidable". No one doubts that a transfer to Lender produces a "benefit" for Guarantor. After ¹⁰ § 547 defines which transfers may be avoided, § 550(a) identifies who is responsible for payment: "the initial transferee of such transfer or the entity for whose benefit such transfer was made" (emphasis added). This gives the trustee the option to collect from Lender, Guarantor, or both, subject only to the proviso in § 550(c) that there can be but one satisfaction.

More than language lies behind this approach. The trustee's power to avoid preferences (the "avoiding power") is essential to make the bankruptcy case a *collective* proceeding for the determination and payment of debts. Any individual

creditor has a strong incentive to make off with the assets of a troubled firm, saving itself at potential damage to the value of the enterprise. Many a firm is worth more together than in pieces, and a spate of asset-grabbing by creditors could dissipate whatever firm-specific value the assets have. Like fishers in a common pool, creditors logically disregard the fact that their self-protection may diminish aggregate value-for if Creditor A does not lay claim to the assets, Creditor B will, and A will suffer for inaction. All creditors gain from a rule of law that induces each to hold back. The trustee's avoiding powers serve this end in two ways: first, they eliminate the benefit of attaching assets out of the ordinary course in the last 90 days before the filing, so that the rush to dismember a firm is not profitable from a creditor's perspective; second, the avoiding powers assure each creditor that if it refrains from acting, the pickings of anyone less civil will be fetched back into the pool. See Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 Stan.L.Rev. 725, 727-31, 756-68 (1984).

How long should this preference-recovery period be? If one outside creditor knows that the firm is in trouble, others will too. Each major lender monitors both the firm and fellow lenders. If it perceives that some other lender is being paid preferentially, a major lender can propel Firm into bankruptcy. Reasonably alert lenders ¹¹ can act with sufficient dispatch to ensure that the perceived preference is recoverable even when the preference period is short. ¹² Section 547(b) makes 90 days the rule, time enough (Congress concluded) for careful creditors to protect themselves (and when one does, small unsecured trade creditors get the benefits too).

Insiders pose special problems. Insiders will be the first to recognize that the firm is in a downward spiral. If insiders and outsiders had the same preference-recovery period, insiders who lent money to the firm could use their knowledge to advantage by paying their own loans preferentially, then putting off filing the petition in bankruptcy until the preference period had passed. Outside creditors, aware of this risk, would monitor more closely, or grab assets themselves (fearing that the reciprocity that is important to the pooling scheme has been destroyed), or precipitate bankruptcy at the smallest sign of trouble, hoping to "catch" inside preferences before it is too late. All of these devices could be costly. An alternative device is to make the preference-recovery period for insiders longer than that for outsiders. With a long period for insiders, even the prescient managers who first see the end coming are unlikely to be able to prefer themselves in distribution.

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Loans from insiders to their firms are not the only, or even the most important, concern of outside creditors. Insiders frequently guarantee other loans. If the firm folds while these loans are outstanding, the insiders are personally liable. So insiders bent on serving their own interests (few managers hold outside lenders' interests of equal weight with their own!) could do so by inducing the firm to pay the guaranteed loans preferentially. If the preference-recovery period for such payments were identical to the one for outside debts, this would be an attractive device for insiders. While concealing the firm's true financial state, they would pay off (at least pay down) the debts they had guaranteed, while neglecting others. To the extent they could use private information to do this more than 90 days ahead of the filing in bankruptcy, they would make out like bandits. The guaranteed loans would be extinguished, and with them the guarantees. True, it is logically possible to recover from the insider the value of the released guarantee, even if the trustee could not reach the proceeds in the hands of the outside lender. But it is hard to determine the value of a released guarantee, and anyway insiders might think that they would be more successful resisting the claims of the trustee than the hounds of the outside creditors. So an extended recovery period for payments to outside creditors that benefit insiders could contribute to the ability of the bankruptcy process to deter last-minute grabs of assets. The outsiders who must kick into the pool when the trustee uses the avoiding powers retain their contractual entitlements; all the trustee's recovery does is ensure that those entitlements (as modified by any statutory priorities)-rather than the efforts of insiders to protect their own interests, or the cleverness of outsiders in beating the 90-day deadline-determine the ultimate distribution of the debtor's net assets.

A

The bankruptcy court bridled at the extended preference period for outside creditors. Treating each payment as two transfers, one to Lender and the other to Guarantor, Judge Eisen concluded that § 550(a) limits the trustee to recovery from Guarantor. Section 550(a) allows recovery only "to the extent that a transfer is avoided" under § 547, and the two-transfer approach implies that the transfer to Lender has not been "avoided" at all. Judge Plunkett disagreed with this approach; so do we.

The two-transfer approach equates "transfer" with "benefit received". Both Lender and Guarantor gain from payment, and each receives a "transfer" to the extent of the gain. The Code, however, equates "transfer" with payments made. Section 101(50), which we quoted above, says that a transfer is a disposition of property. Sections 547 and 550 both speak of a transfer being avoided; avoidability is an attribute of the transfer rather than of the creditor. While the lenders want to define transfer from the recipients' perspectives, *1196 the Code consistently defines it from the debtor's. A single payment therefore is one "transfer", no matter how many persons gain thereby.⁶

6

The creditors contend that *In re Air Conditioning, Inc.*, 845 F.2d 293, 296-97 (11th Cir.1988), and *In re Compton Corp.*, 831 F.2d 586, 591-94 (5th Cir.1987), modified on other grounds, 835 F.2d 584 (1988), take a different view. These two cases do not consider the relation between §§ 547 and 550 of the Code or mention § 101(50). Identifying multiple "transfers" was an heuristic device to explain how recoveries could be had from indirect beneficiaries under the 1898 Act, which on the surface did not allow such recoveries. See note 9 below. In summarizing this approach, the Fifth and Eleventh Circuits did not thereby resolve a question that was not before them. (The *holding* of each case was that a recoverable preference had taken place.)

Section 550(a) allows recovery "to the extent that a transfer is avoided" not because a single payment may be many "transfers" but because on occasion less than all of a given transfer is "avoided". Section 547(b)(5) provides that a transfer is avoidable only to the extent it gives the creditor more than it would have received in a liquidation under Chapter 7. Several portions of § 547(c) also contemplate avoiding part of a transfer. Section 547(c)(1), for example, excludes from recovery the portion of a transfer supported by contemporaneous new value. So if Lender receives an asset worth \$100 and infuses \$80 of new capital, only \$20 of the transfer is avoidable. The "to the extent that a transfer is avoided" language in § 550(a) ensures that the trustee recovers only the \$20 and not the \$100 in such a case.⁷

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⁷ The legislative history supports this understanding. See, e.g., H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 375-76 (1977); S.Rep. No. 95-989, 95th Cong., 2d Sess. 90 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5876, 5963, 6331, 6332.

There is no greater support for the two-transfer approach in the legislative history than in the text and structure of the Code. The features of the Code important to us were substantially revised by the Conference Committee, which did not issue a report. Managers of the legislation read into the Congressional Record identical statements explaining the Conference Committee's work, but these statements do not address the subject at hand.

The parties agree that there is no helpful legislative history. They draw different inferences from this, however. The creditors say that we must infer that Congress meant to preserve the practice, under the Bankruptcy Act of 1898, of recovering payments only from those to whom the transfer represented a preference, see *Dean v. Davis*, 242 U.S. 438, 443, 37 S.Ct. 130, 131, 61 L.Ed. 419 (1917) (dictum), on the theory that if Congress made a change as momentous as this, surely someone would have said so. Frequently the pre-1978 practice will be informative. *United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 108 S.Ct. 626, 634, 98 L.Ed.2d 740 (1988); *Kelly v. Robinson*, 479 U.S. 36, 44-47, 107 S.Ct. 353, 358-60, 93 L.Ed.2d 216 (1986); *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494, 501, 106 S.Ct. 755, 759-60, 88 L.Ed.2d 859 (1986). Yet "[i]t is not the law that a statute can have no effects which are not explicitly mentioned in its legislative history". *Pittston Coal Group v. Sebben*, 488 U.S. 105, 109 S.Ct. 414, 420-21, 102 L.Ed.2d 408 (1988). See also, e.g., *United States Railroad Retirement Board v. Fritz*, 449 U.S. 166, 101 S.Ct. 453, 66 L.Ed.2d 368 (1980); *Harrison v. PPG Industries, Inc.*, 446 U.S. 578, 591-92, 100 S.Ct. 1889, 1897, 64 L.Ed.2d 525 (1980); *Swain v. Pressley*, 430 U.S. 372, 378-79, 97 S.Ct. 1224, 1228-29, 51 L.Ed.2d 411 (1977). When Congress makes wholesale changes in the text and structure of the law, it is fatuous to pretend that a silent legislative history means that existing practices should continue unchanged. The 1978 Code separates the identification of avoidable transfers (§ 547) from the identification of those who must

pay (§ 550), a structural change with no antecedents in the 1898 Act.⁸ It also creates for the first time the principle that transfers may be recoverable from either transferee or beneficiary-something introduced *1197 to § 550(a)(1) in the Conference Committee, too late for comment in the usual committee reports.⁹ Changes of this character show that the pre-1978 practice is not a useful guide to interpreting the relation between §§ 547 and 550. See *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S.Ct. 1026, 1031-33, 103 L.Ed.2d 290 (1989).

⁸ This separation was well thought out and discussed at length in the legislative history, although without discussing all of its consequences. See the references in note 7 above.

⁹ And obviously too late for comment in the Report of the Commission on the Bankruptcy Laws of the United States, H.R.Doc. No. 137, 93d Cong., 1st Sess. (1973). This Report has influenced the interpretation of the many features of the 1978 Code it proposed and discussed in detail. As the creditors observe, the Report does not mention the possibility that outside lenders could be subject to an extended preference-recovery period on account of insiders' guarantees. The Report discussed (and discarded) a proposal to make transfers avoidable on account of benefits to insiders, reasoning that this was implicit under current law. Report pt. II at 170; see *National Bank of Newport v. National Herkimer County Bank*, 225 U.S. 178, 184, 32 S.Ct. 633, 635, 56 L.Ed. 1042 (1912). The creditors ask us to infer that the "benefit" language in the Code did not change the law. But it is not the "benefit" language of § 547(b)(1), the possibility discussed by the Report, that makes the change; it is the novel text of § 550(a)(1), allowing recovery from either transferee or beneficiary, that underlies the Trustee's claim. Because that change did not happen until five years after the Report, its silence on the subject is not informative.

Applying the longer preference-recovery period to outside creditors would not put the Code in conflict with fundamental policies reflected in both state and federal law—in *Kelly* the policy denying discharge to criminals seeking to avoid penalties for their crimes, in *Midlantic* the policy of requiring those who discharge hazardous wastes to clean them up.

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The Court thought it fantastic to suppose that Congress would provide for the discharge of criminal restitution orders when it expressly forbade discharge of penal sanctions, or that Congress would allow polluters to leave the mess to someone else (technically, allow unsecured creditors to obtain larger shares of the debtor's assets even though the clean-up obligation passed through bankruptcy as a charge against the firm's assets). It therefore resolved ambiguities in the Code in a way harmonious with the structure of the rest of bankruptcy law and non-bankruptcy entitlements. See *Butner v. United States*, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979). There is no similarly enduring policy concerning the length of the preference-recovery period for outside creditors or the relation between insiders' guarantees and the preference-recovery period. An extended recovery period is consistent with the structure of the Code and does not subvert any of its functions. A longer period when insiders reap benefits by preferring one outside creditor over another facilitates the operation of bankruptcy as a collective process and ensures that each creditor will receive payment according to the Code's priorities and non-bankruptcy entitlements. Silence in the legislative history therefore does not require or authorize a court to depart from the text and structure of the Code.

Chan v. Korean Air Lines, Ltd., 490 U.S. 122, ----, 109 S.Ct. 1676, 1683-85, 104 L.Ed.2d 113 (1989); *Ron Pair*, 109 S.Ct. at 1030.

B

The creditors do not argue that even if the Code extends the preference period, the extension should not be enforced because "inequitable". Perhaps our rebuff to "equity" arguments in other bankruptcy cases is responsible. See *Bonded Financial*, 838 F.2d at 894-95, and, e.g., *In re Iowa R.R.*, 840 F.2d 535, 536 (7th Cir.1988); *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 791 F.2d 524, 528 (7th Cir.1986); *Boston & Maine Corp. v. Chicago Pacific Corp.*, 785 F.2d 562, 566 (7th Cir.1986). See also, e.g., *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963, 968-69, 99 L.Ed.2d 169 (1988) ("whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code"); *Official Committee v. Mabey*, 832 F.2d 299, 301-02 (4th Cir.1987); *Guerin v. Weil, Gotshal & Manges*, 205 F.2d 302, 304 (2d Cir.1953) (A. Hand, J.). "There is

a basic difference between filling a gap left by Congress' silence and rewriting rules that Congress has affirmatively and specifically enacted." *Mobil Oil Corp. v. *1198 Higginbotham*, 436 U.S. 618, 625, 98 S.Ct. 2010, 2015, 56 L.Ed.2d 581 (1978). Bankruptcy laws are not special cases, as *Ahlers* demonstrates.¹⁰ See also *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 455-57, 60 S.Ct. 1044, 1053-54, 84 L.Ed. 1293 (1940).

10

Whatever force the assertion in *Bank of Marin v. England*, 385 U.S. 99, 103, 87 S.Ct. 274, 277, 17 L.Ed.2d 197 (1966), that "equitable principles govern the exercise of bankruptcy jurisdiction" may have had under the 1898 Act, this approach has no place under the Code to the extent the statute addresses the question.

Nonetheless, "equity" arguments have captivated a majority of the bankruptcy judges and several of the commentators who have spoken on this subject (see notes 2 and 3 above). So it is worth pointing out that even if equity arguments were admissible, they would not help the creditors' cause. Rules of law affecting parties to voluntary arrangements do not operate "inequitably" in the business world—at least not once the rule is understood. Prices adjust. If the extended preference period facilitates the operation of bankruptcy as a collective debt-adjustment process, then credit will become available on slightly better terms. If a longer period has the opposite effect, creditors will charge slightly higher rates of interest and monitor debtors more closely. In either case creditors will receive the competitive rate of return in financial markets—the same risk-adjusted rate they would have received with a 90-day preference-recovery period. A rule may injure debtors and creditors by foreclosing efficient business arrangements and increasing the rate of interest low-risk borrowers must pay, see *In re Thompson*, 867 F.2d 416, 419 (7th Cir.1989); *In re Patterson*, 825 F.2d 1140, 1142 (7th Cir.1987); *In re Erickson*, 815 F.2d 1090, 1094 (7th Cir.1987), but inefficiency is not inequity. At all events, in what sense is it "inequitable" to recapture payments to creditors that may have been favored only because payment reduced insiders' exposure (recall that the insiders select which debts to pay first), then distribute these monies according to statutory priorities and contractual entitlements? In what sense is it "inequitable" to require the outside lenders to pursue the inside guarantors for any shortfall, when they bargained for exactly that recourse? See also *86 B.R.* at 552-53.

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Our creditors press a cousin to “equity” arguments: “policy” arguments. According to the creditors, an extended preference period will force lenders to precipitate bankruptcy filings at the slightest sign of trouble in order to prevent erosion of their positions. The lenders paint a bleak picture of firms driven under when the problems could have been worked out-if only the lenders knew that they would keep what they receive in the “workout”. Workouts often involve guarantees, and if these mean longer preference periods, then workouts may become less common (and formal bankruptcy more common). It is not clear to us that bankruptcy proceedings are more costly than workouts. See *Olympia Equipment Leasing Co. v. Western Union Telegraph Co.*, 786 F.2d 794, 802-03 (7th Cir.1986) (concurring opinion). It's not as though the filing of a bankruptcy petition closes the firm and heaves its workers into the streets. A firm with positive cash flows will continue operating in bankruptcy; the court simply sorts out the financial claims to the enterprise. Creditors are free to compromise their claims inside of bankruptcy, just as they are outside it.¹¹ So the fear of bankruptcy replacing some workouts does not lead us to shy away from an ordinary reading of the statute.

¹¹ To a substantial extent a corporate bankruptcy is nothing but an orderly forum for private adjustments. Often these adjustments could be made at least cost if the firm were sold intact and the proceeds divided according to contractual and statutory entitlements, see Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. Legal Studies 127 (1986), but even when the court rather than an auction market resolves questions of valuation, it is serving a function equally important in a private workout.

For what it may be worth, we doubt that an extended preference-recovery period will cause a stampede from workouts to bankruptcies. Unless there is a “preference”, there is nothing for the trustee to avoid. Most of the tales of woe presented by the *1199 creditors do not involve preferences in light of § 547(b)(5), which says that a transfer is a preference only to the extent the creditor got more than it would have received in a liquidation, and § 547(c), which specifies situations that do not create avoidable preferences.

§ 547(c) The trustee may not avoid under this section a transfer-

- (1) to the extent that such transfer was-
 - (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
 - (B) in fact a substantially contemporaneous exchange;
- (2) to the extent that such transfer was-
 - (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
 - (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
 - (C) made according to ordinary business terms;
- (3) that creates a security interest in property acquired by the debtor-
 - (A) to the extent such security interest secures new value [in the nature of a purchase-money security interest] ...
 - (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor-
 - (A) not secured by an otherwise unavoidable security interest; and
 - (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;
 - (5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction ... to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on [one of three defined dates] ...
 - (6) that is the fixing of a statutory lien that is not avoidable under section 545 of this title; or

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(7) [aggregate transfers of less than \$600 for an individual debtor].

This is the current version of § 547(c), as amended in 1984 to eliminate the former requirement in § 547(c)(2) that the payment come within 45 days of the debt to count as one in due course, a qualifier that at least potentially allowed the trustee to recover all installment payments, because the contract had been signed and credit extended more than 45 days before a given payment. Cf. *In re Xonics Imaging Inc.*, 837 F.2d 763 (7th Cir.1988). We need not decide whether installment payments before 1984 may be recovered even though made within 45 days of their due date, because this appeal does not present for decision the Trustee's effort to recoup any particular transfer. It is enough to observe that § 547(b)(5) and § 547(c), both before and after amendment, exclude from recovery the bulk of ordinary commercial payments.

Consider some of the transactions the lenders use to illustrate what they view as pernicious consequences of an extended preference-recovery period:

- A fully-secured creditor with an insider's guarantee to boot is paid off nine months before bankruptcy and releases its security interest. The debtor uses the property as security for a new loan. The trustee recovers the payment as a preference, and the creditor has been stripped of its security.

The trustee confronts two obstacles in such a case. First, if the creditor was fully secured, then payment does not produce a benefit for the inside guarantor, whose exposure was zero. The preference-recovery period therefore would be only 90 days. Second, under § 547(b)(5) a transfer is avoidable only to the extent the creditor received more than it would have in a Chapter 7 liquidation. A fully-secured creditor will be paid in full under Chapter 7, so there is no avoidable preference in this case with or without a guarantee by an insider. If, on the other hand, the security covered only 90% of the debt, then only the remaining 10% of the payment is avoidable as a preference.

- A creditor financing the debtor's inventory and receivables makes many loans and receives many payments during the year before the filing. The trustee

seeks to recover all of these. Under § 547(c)(5), however, the trustee must show that the lender improved its position relative to other creditors during the preference period. See *In re Ebbler Furniture & Appliances, Inc.*, 804 F.2d 87 (7th Cir.1986). Ordinary financing arrangements do not produce such an effect.

- A creditor makes an unsecured loan guaranteed by an insider and requires monthly payments over a number of years. The trustee seeks to recover all of the payments during the year before the filing. To the extent the debtor paid on time, the creditor is protected by the current version of § 547(c)(2), the "ordinary course" rule. (The state of things for payments before the amendment is less clear, as we have mentioned.)
- Lender # 1 extends credit and takes security. It is so over-secured that Lender # 2 is willing to make a second loan and take a junior security interest. This second loan (but not the first) is backed up by an insider's guarantee. Every payment to Lender # 1 increases the amount of security available for Lender # 2, which produces a benefit to Guarantor by reducing his exposure. Cf. *In re Prescott*, 805 F.2d 719, 731 (7th Cir.1986). The trustee seeks to recover all payments to Lender # 1 during the year before the filing, even though Lender # 1 did not negotiate for an insider's guarantee.

This appears to be the Trustee's position vis-à-vis CIT. If the payments had been made after the 1984 amendments, then § 547(c)(2) would prevent recovery. Even under the pre-1984 law that applies to this case, we have substantial doubt that the payments to Lender # 1 are avoidable transfers. By assumption Lender # 1 is over-secured, so its position has not been improved relative to a Chapter 7 liquidation, § 547(b)(5). The benefit in such a case is negligible at best, so the case for recapture is weak. *Bonded Financial*, 838 F.2d at 895. Because neither the bankruptcy court nor the district court considered this question in detail, we do not resolve it, but the Trustee has an uphill battle.

In light of these exclusions, there is no reason to use ambulatory arguments of "equity" or "policy" to defeat the Trustee's claims in this case. Congress has considered and addressed specifically the situations that most concern lenders. If these exclusions and exemptions are not "enough", creditors should complain to Congress.

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IV

To sum up: We hold in Part II.B.1 that insiders who may be liable on account of the firm's failure to pay taxes are not "creditors" because they do not hold "claims" against their firms. Accordingly, delinquent taxes paid more than 90 days before the filing may not be recovered under § 550(a). We conclude in Part II.B.2 that pension and welfare trusts may recover from insiders only to the extent state law allows that under rules for disregarding the corporate form, or the insiders make contractual commitments enforceable under § 515 of ERISA. When state law supports "veil piercing" it does so on the ground that the investor and the firm are a single entity, which precludes the insider from holding a "claim" against the firm. The Trustee therefore may not recover payments to

pension and welfare trusts made more than 90 days before the filing, unless those trusts negotiated for and received contractual guarantees from insiders-in which event the funds should be treated just like any other outside creditor. We hold in Part III that the preference-recovery *1201 period for outside creditors is one year when the payment produces a benefit for an inside creditor, including a guarantor.

The judgments of the district court are affirmed in part and reversed in part. The cases are remanded for further proceedings consistent with this opinion.

All Citations

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How to Write:

A Memorandum from a Curmudgeon

To: New Associate

From: Curmudgeon

Welcome to the firm.

To work at this firm, you must know how to write. Here are the rules. Follow them.

I make three assumptions about all of your written work. First, it will contain no typographical errors. Second, it will contain no grammatical errors. Third, all citation forms will be correct. Please review your written work before you hand it to me to be sure that my assumptions hold true.

Style

Here are the rules of style. Follow them.

First, write in short sentences. If a sentence runs on for more than three and one-half typed lines, break the sentence in half. Make it two sentences.

Second, put two or three paragraphs on a typed page. If a single paragraph fills the whole page, break the paragraph in half. Make it two paragraphs.

Third, use only the active voice. At this firm, we write: "Jim threw the ball." Not: "The ball was thrown by Jim."

Fourth, when you have a choice, always use an action verb instead of the verb "to be" and an adjective. At this firm, we write: "The rule applies here." Not: "The rule is applicable here."

Fifth, start each paragraph with a topic sentence. This is important. Few people do it. You will do it. If you don't know what a topic sentence is, look it up. Now.

Sixth, use many headings and sub-headings to break up your memorandum or brief. Little pieces are easier to read.

Seventh, when you have a choice between using the word "which" and using the word "that," the word "that" is correct. (There are exceptions to this rule. Do not worry about them. If you follow my rule, you will be right 95 percent of the time. If I think that an exception applies, I will make the change.)

Eighth, do not start a sentence with the word "however." Re-write the sentence to put the word "however" in the middle of the sentence. (Again, there are exceptions to this rule. Do not worry about them. If you follow my rule, you will be right 95 percent of the time. If I think that an exception applies, I will make the change.)

Ninth, do not use the phrase "in order to." Use "to" instead.

Finally, it is *your* obligation to follow these rules. It is not my obligation to find your mistakes and fix them. You must develop the self-discipline to read your final work with an eye

How to Write: A Memorandum from a Curmudgeon

toward finding and correcting each of the nine errors listed above.

I have a great deal of self-discipline. I will read your work and fix your mistakes. This, however, is not my job. It is better for your career if you fix your own mistakes; I do not enjoy fixing them for you.

Discussing a Case

When you are writing a legal memorandum for internal use, there is only one proper way to discuss a case. This is the way:

In *Smith v. Jones*,

1. Somebody sued somebody for something.
2. The trial court held something. (The trial court did not “discuss” something or “analyze” something or “believe” something; it *held* something. Ordinarily, a trial court grants or denies a motion, or enters a judgment. Use the proper verb to describe the holding.)
3. The appellate court held something. (Ordinarily, an appellate court will affirm, reverse, vacate, or remand. Use the proper verb to describe the holding.)
4. Now, you can say anything else about the case that you care to.

If you start chatting about the case before you have covered items 1, 2, and 3, I will notice your error. I will change your memorandum and make it right. I will know that you lack self-discipline.

Why do I insist on a rigid formula for discussing cases? Because my clients prefer to win.

When I discuss a case in a brief, I think carefully about the persuasive force of the precedent. I prefer to cite cases where the trial court did what my *opponent* is seeking here, and the appellate court *reversed*. By discussing the holding of that case in my brief, I tell my trial judge that he could do what the other guy wants him to do, but that the appellate court would reverse. Judges do not like to be reversed. Accordingly, if a precedent contains the implicit threat of reversal, I will use that threat (gently, of course) when I discuss the case in a brief.

The second most persuasive precedent is a case in which the trial court did what I am asking the trial court to do in my case, and the appellate court affirmed. In that situation, I am able to tell my trial judge that if he does what I am asking him to do, he will not be reversed. There is no implicit threat here, but there is at least a guarantee of affirmance.

The least helpful case is one in which a court simply discusses an issue in *dictum*. If that is the best case that you can find, I will cite that case in my brief. Beggars can't be choosers.

Your memorandum, however, *must* tell me the holding of the case first. If you do not tell me the holding in your memo, then I will not believe that you read and understood the holding. I will be forced to go to the library and read the case. I will not like this.

The Structure of a Brief

Any child can write a persuasive brief. Here's the magic formula. Follow it.

I. *Introduction*

An introduction contains one or two short paragraphs. It has no footnotes. It says something sexy about the case.

II. *Allegations of The Complaint* (in a motion to dismiss) *or*

Undisputed Facts (in a summary judgment motion)
or

Facts (for most other briefs):

In short sentences, bring the reader up to speed. Include in your statement of facts every fact that you will later mention in your argument. Do not include facts that are unnecessary for your argument.

III. *Argument*

Our client is entitled to win for [three] reasons. First, [reason one]. Second, [reason two]. Third, [reason three].

A. *Our Client Should Win for Reason One*

The other guy falls prey to reason one. Our client therefore wins for reason one.

In this state, the rule is that litigants win for reason one. For example, in *Smith v. Jones* [discuss case, as per the formula above].

The Curmudgeon's Guide to Practicing Law

Similarly, in *Doe v. Doe*, [discuss case, as per the formula above].

[One sentence or paragraph explaining why our situation is indistinguishable.]

Therefore, our client wins for reason one.

B. *Our Client Should Win for Reason Two*

Etc.

When writing your argument, remember that we are practitioners, not academics. Your professors discussed cases because they found cases to be interesting. We prefer statutes or rules to cases. If there is a statute or rule on point, discuss it before you begin discussing the case law.

IV. *Conclusion*

For these reasons, this court should [grant our motion *or* deny the other guy's motion].

Put a date on it here. Otherwise, the certificate of service will get torn off sometime, and you (or some other person using the brief as a model in the future) will regret not knowing when the brief was written.

The Style of a Brief

There are matters of style unique to writing a brief. First, when writing a brief, avoid alphabet soup. Judges read many briefs every day. Most lawyers use alphabetical short forms for the

How to Write: A Memorandum from a Curmudgeon

names of parties, statutes, and agencies. Those alphabetical short forms become meaningless after a judge has read the first twenty or thirty briefs. If ABC Co. thinks FDA regulation triggers MDA preemption in the U.S., then ABC Co. will lose. In this firm, we use words, not gibberish.

This rule applies in particular to selecting short forms for parties' names. Use words, not letters, as a short form. For example, "National Superior Fur Dressing & Dying Company" does *not* become "NSFDDC." This is gibberish.

There are exceptions to this rule. They include IBM, AT&T, GM, and VW. If I think that an exception applies, I will make the change. You use words, not letters.

When selecting the words to be used as the short form, think about the persuasive force of the words. For example, National Superior Fur Dressing & Dying Company could be shortened to "National Superior" if you would like the company to sound like a large corporation. On the other hand, the short form should be "Superior Fur" if you want the company to sound like a Ma-and-Pa outfit.

Second, unless court rules require otherwise, use the parties' names, not their status in litigation. Thus, we represent "Superior Fur;" we do not represent "the defendant." (Once again, there may be rare exceptions to this rule. We might represent "the defendant" rather than "Saddam Hussein." Again, you do not decide to use an exception. If one is appropriate, I will make the change.)

Third, use block quotations rarely, if at all. Your judge is busy. The judge's eye will naturally jump over a block quotation and go on to the next line of text. By including a block

quotation, you are inviting the judge not to read the critical quotation.

You can avoid block quotations by using quotations of fewer than fifty words. If necessary, use a quotation that is forty-nine words long. Then say: "The Court went on" Then use another forty-nine-word quotation. This will trick the judge into reading the quotation. This trick is not simply permitted; it is required at this law firm.

If you feel compelled to include a block quotation in a brief, assume that the judge will not read it. You must trick the judge into learning the content of the block quotation. You do this by summarizing the substance of the block quotation in the sentence immediately preceding it.

Thus, do not introduce a block quote: "In *Smith v. Jones*, the Court held: . . ." Rather, introduce the quote: "In *Smith v. Jones*, the Court held that our client wins and the other guy loses: . . ." By using this form, the judge will get your point even when he does not read the block quotation.

Fourth, use argumentative headings. "This Court Should Grant Summary Judgment Because There Is No Private Right of Action under the Federal Food, Drug and Cosmetic Act." Not: "The Relevant Provisions of the FFDCA."

Finally, keep the brief as short as humanly possible.

Those are the rules. Follow them.

We'll get along just fine.

Curmudgeon

EXAMPLES OF WORDS OR PHRASES TO AVOID

1. Herewith, herein, and hereinafter
2. Therewith, therein, and thereof
3. Wherefore, whereof
4. Forwith
5. Aforementioned
6. And/or
7. "On or about"
8. Dates in the form 01/02/03. Instead, write January 2, 2003.
9. "In the instant case"
10. "The undersigned"
11. The word "same" as a pronoun
12. The word "said" as a substitute for "the"

STUDENT LOANS AND DISCHARGEABILITY ISSUES



Hon. Kathy A. Surratt-States

United States Bankruptcy Court for the Eastern District of Missouri

Student Loans and Dischargeability Issues

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Student Loans and Dischargeability Issues¹

A. Tests for undue hardship to discharge student loans under § 523(a)(8)

a. *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987)

Brunner Test. *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987). To discharge student loans a debtor must establish by a preponderance of the evidence that: (1) the debtor cannot maintain a minimal standard of living; (2) additional circumstances exist to show that the debtor's financial condition is likely to persist for a significant portion of the repayment period; and (3) the debtor made a good faith attempt to repay the loan.

Case Summary

Facts: Marie Brunner, pro se debtor (hereinafter "Brunner"), appealed from a decision of the United States District Court for the Southern District of New York, which held that it was an error for the Bankruptcy Court to discharge her student loans based on "undue hardship."² The District Court determined that Brunner did not establish her eligibility for a discharge of her student loans based on undue hardship. The record demonstrates no "additional circumstances" indicating a likelihood that her current inability to find any work will extend for a significant portion of the loan repayment period. Brunner is not disabled, nor elderly, and she has—so far as the record discloses—no dependents. No evidence was presented indicating a total foreclosure of job prospects in her area of training. At the time of the hearing, only ten months had elapsed since Brunner's graduation from her master's degree program. Finally, as noted by the District Court, Brunner filed for the discharge within a month of the date the first payment of her loans came due. Moreover, she did so without first requesting a deferment of payment, a less drastic remedy available to those unable to pay because of prolonged unemployment. Such conduct does not evidence a good faith attempt to repay her student loans.³

Holding: The Second Circuit Court of Appeals affirmed, holding that:

- (1) for a debt to be dischargeable on basis of "undue hardship," debtor must show an inability to maintain a "minimal" standard of living for self and dependents if forced to repay loans, that additional circumstances exist indicating that state of affairs is likely to persist for a significant portion of the repayment period of student loans, and that debtor has made good-faith efforts to repay loans,⁴ and
- (2) Chapter 7 debtor failed to establish that her current inability to find work would extend for a significant portion of the student loan repayment period or that she had made a good-faith attempt to repay student loans, and thus failed to establish "undue hardship" as required for a discharge of loans.⁵

¹ The *Brunner* test is generally followed by the Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth, and Eleventh Circuits.

² *Brunner*, 831 F.2d at 396 (citing *In re Brunner*, 46 B.R. 752 (S.D.N.Y. 1985)).

³ *Brunner*, 831 F.2d at 396-97.

⁴ *Brunner*, 831 F.2d at 396.

⁵ *Id.*

b. *Long v. Educ. Credit Mgmt. Corp.*, 322 F.3d 549 (8th Cir. 2003)

Totality of Circumstances Test. The Eighth Circuit developed a totality of the circumstances test in *Long v. Educ. Credit Mgmt. Corp.*, 322 F.3d 549, 554 (8th Cir. 2003), where the court must consider (1) debtor's future financial condition, (2) debtor's and dependent's reasonable and necessary living expenses, and (3) other relevant facts and circumstances surrounding each particular bankruptcy case.

Case Summary

Facts: Educational Credit Management Corporation (hereinafter "ECMC") appealed the Bankruptcy Appellate Panel's (hereinafter "BAP") decision affirming the Bankruptcy Court's discharge of Nanci Long's student loan debt. This case required the Eighth Circuit Court of Appeals to address the undue hardship provision found in 11 U.S.C. § 523(a)(8)(B). ECMC argues that the Bankruptcy Court erred in its determination that repayment of the debt would impose an undue hardship on appellee. ECMC also contends that the BAP relied on an incorrect review standard to reach its decision.⁶ The Eighth Circuit Court of Appeals reversed and remanded to the BAP.

Nanci Long (hereinafter "Appellee"), was a thirty-nine-year-old, single-mother. In 1987, she passed her state-board examination. Until 1990, she worked as a chiropractor in various clinics. Appellee owned and operated a successful chiropractic practice from 1990 until 1993. At some point in 1993, Appellee began to experience extreme fatigue, depression, and diminution of her mental faculties. These symptoms increasingly affected her work, causing a substantial drop in her clientele. In 1995, Appellee terminated her chiropractic practice altogether, citing an inability to handle life changes. She continued in a downward economic and emotional spiral. At one point, she attempted suicide. At the time of the trial, she was gainfully employed and was pursuing an additional college degree. According to Appellee, her symptoms included severe, short-term memory loss, persistent ache, dramatic weight gain, and anxiety about being in public places. In order to treat her condition, appellee takes various prescription drugs and sleeps in excess of twelve hours per day.⁷

The Bankruptcy Court found that Appellee's medical condition will persist into the future and will interfere with her future earning potential. The Bankruptcy Court concluded that the severity and historical intensity of Appellee's illness and overall prognosis would prevent Appellee from earning enough money to "dig herself out of these ... loans."⁸ After conducting a review for clear error, a divided BAP summarily affirmed the Bankruptcy Court's decision. On appeal, ECMC argues that the BAP should have used the de novo standard in its review of the Bankruptcy Court's undue hardship determination. ECMC also contends that Appellee's student loans were not dischargeable under § 523(a)(8)(B), because the loans did not impose an undue hardship.⁹

Holding: The Eighth Circuit Court of Appeals held that:

⁶ *In re Long*, 322 F.3d at 551.

⁷ *Id.*

⁸ *In re Long*, 322 F.3d at 551-552.

⁹ *Id.*

A less restrictive approach to the “undue hardship” inquiry is preferred.¹⁰ The Eighth Circuit Court of Appeals is convinced that requiring bankruptcy courts in the Eighth Circuit to adhere to the strict parameters of a particular test would diminish the inherent discretion contained in § 523(a)(8)(B). “Therefore, we continue—as we first did in *Andrews*—to embrace a totality-of-the-circumstances approach to the ‘undue hardship’ inquiry.”¹¹ “We believe that fairness and equity require each undue hardship case to be examined on the unique facts and circumstances that surround the particular bankruptcy.”¹²

In evaluating the totality-of-the-circumstances, reviewing bankruptcy courts in the Eighth Circuit should consider: (1) debtor's past, present, and reasonably reliable future financial resources; (2) a calculation of debtor's and her dependent's reasonable necessary living expenses; and (3) any other relevant facts and circumstances surrounding each particular bankruptcy case.¹³

Simply put, if 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 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.¹⁴

c. *In re Gerhardt*, 348 F.3d 89 (5th Cir. 2003)

Brunner plus “Total Incapacity” to Repay Test. The Fifth Circuit added to the *Brunner* test by holding that discharging student loans requires the debtor to specifically prove “a total incapacity ... in the future to pay [his] debts for reasons not within [his] control.”¹⁵ In other words, the debtor must show that circumstances out of her control have resulted in a ‘total incapacity’ to repay the debt now and in the future.

Case Summary

Facts: Chapter 7 debtor sought discharge of his student loans. The Bankruptcy Court for the Eastern District of Louisiana entered judgment in favor of debtor, and creditor appealed. The District Court reversed.¹⁶

Over a period of years, Jonathon Gerhardt (hereinafter “Gerhardt”) obtained over \$77,000 in government-insured student loans to finance his education at the University of Southern California, the Eastman School of Music, the University of Rochester, and the New England Conservatory of Music. Gerhardt is a professional cellist. He subsequently defaulted on each loan owed to the United States Government. In 1999, Gerhardt filed for Chapter 7 bankruptcy and thereafter filed an adversary proceeding seeking discharge of his student loans pursuant to 11 U.S.C. § 523(a)(8). The Bankruptcy Court discharged Gerhardt's student loans as causing undue hardship. On appeal, the District Court reversed, holding that it would not be an undue

¹⁰ *Andrews v. S.D. Student Loan Assistance Corp. (In re Andrews)*, 661 F.2d 702, 704 (8th Cir. 1981).

¹¹ *In re Long*, 322 F.3d at 554.

¹² *Id.*

¹³ *In re Long*, 322 F.3d at 554 (citing *Andresen v. Neb. Student Loan Program, Inc. (In re Andresen)*, 232 B.R. 127, 132 (8th Cir. B.A.P. 1999).

¹⁴ *In re Long*, 322 F.3d at 554-555.

¹⁵ *In re Gerhardt*, 348 F.3d 89, 92 (5th Cir. 2003) (citing *In re Faish*, 72 F.3d 298, 307 (3d Cir.1995)).

¹⁶ *In re Gerhardt*, 348 F.3d at 91.

hardship for Gerhardt to repay his student loans.¹⁷ Finding no error, the Fifth Circuit Court of Appeals affirmed the District Court's judgment.

Holding: The Fifth Circuit Court of Appeals affirmed, holding that:

To justify discharging debtor's student loans, the *Brunner* test requires a three-part showing:

- (1) that debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for [himself] and [his] dependents if forced to repay the loans;
- (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
- (3) that debtor has made good faith efforts to repay the loans.¹⁸

Because the Second Circuit presented a workable approach to evaluating the undue hardship determination, the Fifth Circuit Court of Appeals *expressly* adopted the *Brunner* test for purposes of evaluating a Section 523(a)(8) decision.¹⁹

"The second prong of the *Brunner* test asks if 'additional circumstances exist indicating that this state of affairs is likely to persist [for a significant period of time].'"²⁰ "Additional circumstances' encompass 'circumstances that impacted on the debtor's future earning potential but which [were] either not present when the debtor applied for the loans or [have] since been exacerbated.'"²¹

Thus, the Fifth Circuit ultimately held that "proving that the debtor is 'currently in financial straits' is not enough."²² "Instead, the debtor must specifically prove "a total incapacity ... in the future to pay [his] debts for reasons not within [his] control."²³

d. ***In re Matter of Thomas*, 931 F.3d 449 (5th Cir. 2019)**

Brunner plus "Intolerable Difficulties" Test. The Fifth Circuit also tightened the *Brunner* test by ruling that a debtor may not discharge a student loan unless repayment would impose intolerable difficulties on the debtor.

Case Summary

Facts: Chapter 7 debtor brought adversary proceeding against the Department of Education seeking determination that she was entitled to undue hardship discharge of \$7,806.45 student loan debt. The United States Bankruptcy Court for the Northern District of Texas denied

¹⁷ *In re Gerhardt*, 348 F.3d at 90-91.

¹⁸ *In re Gerhardt*, 348 F.3d at 91 (quoting *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, 831 F.2d 395, 396 (2d Cir. 1987)).

¹⁹ *Id.*

²⁰ *In re Gerhardt*, 348 F.3d at 92 (quoting *Brunner*, 831 F.2d at 396).

²¹ *In re Gerhardt*, 348 F.3d at 92 (quoting *In re Roach*, 288 B.R. 437, 445 (Bankr. E.D. La. 2003)).

²² *In re Gerhardt*, 348 F.3d at 92 (quoting *In re Brightful*, 267 F.3d 324, 327 (3d Cir.2001)).

²³ *In re Gerhardt*, 348 F.3d at 92 (quoting *In re Faish*, 72 F.3d 298, 307 (3d Cir.1995) (quoting *In re Rappaport*, 16 B.R. 615, 617 (Bankr.D.N.J.1981)).

discharge of student loan debt. Debtor appealed and the District Court affirmed. Debtor appealed again.²⁴

Vera Frances Thomas, the Appellant (hereinafter “Thomas”), is over 60 years old and had to file a Chapter 7 bankruptcy case in 2017. Thomas suffers from diabetic neuropathy, a degenerative condition that causes pain in her lower extremities. Thomas is now unemployed and subsists on a combination of public assistance and private charity. In February 2012, however, Thomas worked for eight years at a call center in Southeastern Virginia and was earning \$11.40 per hour with benefits. That year, Thomas decided to enroll at a local community college to improve her career prospects (she had a high school diploma, but no higher education credits). Thomas obtained two \$3,500 loans through the Department of Education, the first on February 14, 2012, and the second on September 21, 2012, to finance her first two semesters of courses. Thomas did not return for a third semester, and her loans went into repayment in December 2013. In spring 2014, Thomas made payments of \$41.24 and \$41.61 on the loans.²⁵

Thomas’ health began to decline significantly in 2014 when she was diagnosed with diabetic neuropathy. The condition, which often reduces circulation in patients’ lower extremities, caused muscle weakness, numbness, and pain in her legs and feet after prolonged standing. Thomas frequently took unpaid leave from work at the call center to manage her symptoms and incurred significant medical expenses. In 2016, her employer was acquired by another company, and the new employer fired her for violating company policies. Because she was terminated for cause, Thomas was ineligible for unemployment benefits.²⁶

To defray costs, Thomas moved to Texas to live with her then-boyfriend. Thomas obtained work with Perfumania, then Whataburger, and finally UPS. But each job required her to be on her feet, and she could not maintain these positions. Since quitting UPS in 2017, Thomas has not obtained employment that comports with her need for sedentary work. Unable to make payments on her student loans and other significant debts, Thomas filed Chapter 7 bankruptcy in Dallas and received a general discharge of her debts. Seeking a discharge of her student loan debt as well, Thomas initiated an adversary complaint in Bankruptcy Court against the Department of Education.²⁷

Holding: The Fifth Circuit Court of Appeals affirmed, holding that:

Thomas’ inability to pay her student loans and maintain a minimal standard of living was not likely to persist throughout a significant portion of the loans’ repayment period. The plain meaning of the words chosen by Congress is that student loans are not to be discharged unless requiring repayment would impose intolerable difficulties on the debtor.²⁸ The threshold by definition must be greater than the ordinary circumstances that might force one to seek bankruptcy relief.²⁹

²⁴ *In re Matter of Thomas*, 931 F.3d at 449.

²⁵ *In re Matter of Thomas*, 931 F.3d at 450.

²⁶ *In re Matter of Thomas*, 931 F.3d at 450.

²⁷ *In re Matter of Thomas*, 931 F.3d at 450.

²⁸ *In re Matter of Thomas*, 931 F.3d at 454.

²⁹ *Id.*

e. *Educ. Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302 (10th Cir. 2004)

Brunner plus “Acting in Good Faith” Test. Tenth Circuit adopted a narrower version of the *Brunner* test.

Case Summary

Facts: Plaintiff/Appellee Nancy Jane Polleys (hereinafter “Polleys”) sought a bankruptcy court discharge of federally guaranteed student loans. Defendant/Appellant Education Credit Management Corporation (hereinafter “ECMC”) is a non-profit company and fiduciary of the Department of Education that is charged with collecting such loans. ECMC was the holder of the loans at the time of filing. Polleys initiated an adversary proceeding in bankruptcy, contending that the loans were dischargeable because payment of them would impose an undue hardship within the meaning of 11 U.S.C. § 523(a)(8). The Bankruptcy Court agreed and discharged the loans. The District Court affirmed. ECMC appealed.³⁰

At the time of trial, Polleys was a 45-year old single mother of a teenaged girl. In 1993, Polleys obtained a degree in accounting financed with student loan funds. Polleys has not repaid any amount on these loans. Her loans were later consolidated, and at the time of trial had a balance of approximately \$51,000 with repayment requiring \$420 per month over a period of 20 years. Polleys was previously employed as an accountant. In 1994, she worked for one year in that capacity and earned \$33,000. She had a job in public accounting in 1997, earning \$13,771. According to Polleys, she was laid off from that job when the employer realized she was taking antidepressant medication and she asked for too much help. Polleys also tried self-employment but could only get small bookkeeping jobs that paid less than \$400 per month. Since 1997, Polleys' annual income has been as high as \$16,000 and as low as \$3,000.³¹

Polleys and her daughter live in a rental property owned by her parents and pay no rent or utilities. Polleys has a 1993 Subaru, which has significant body damage, but owns very little other property and no real property. Her budget contains no funds for emergencies. Polleys qualifies for food stamps, and her income is below the federal poverty guidelines, as it was in the year before trial. Although her daughter is eligible for Medicaid, Polleys herself has no health insurance. Polleys is apparently in good physical health, but she has been diagnosed with and continues to suffer from a psychological condition known as ‘cyclothymic disorder’.³²

Holding: The Tenth Circuit Court of Appeals affirmed, holding that:

- (1) showing of a certainty of hopelessness was not required to demonstrate inability to maintain minimum standard of living if forced to repay loans;
- (2) whether debtor has made good faith efforts to repay loans should depend on the legitimacy of the basis for seeking a discharge;
- (3) debtor had inability to maintain minimum standard of living if forced to repay student loans which was likely to persist for significant portion of loan repayment period;
- (4) debtor sought discharge in good faith; and

³⁰ *Educ. Credit Mgmt. Corp.*, 356 F.3d at 1304.

³¹ *Educ. Credit Mgmt. Corp.*, 356 F.3d at 1304-1305

³² *Educ. Credit Mgmt. Corp.*, 356 F.3d at 1305.

(5) debtor demonstrated undue hardship, entitling her to discharge.³³

B. Recent Cases

a. *Tingling v. Educ. Credit Mgmt. Corp. et al.*, 990 F.3d 304 (2d Cir. 2021)

Recent reaffirmance of the *Brunner* undue hardship test by the Second Circuit.

Case Summary

Facts: Chapter 7 debtor filed an adversary complaint seeking [a] determination that her educational loans were dischargeable and subsequently moved to seal the case and for a default judgment against the United States Department of Education (hereinafter “DOE”). After loan guarantor’s motion to intervene was granted and debtor’s default motion was denied, trial was held. The Bankruptcy Court for the Eastern District of New York determined that debtor failed to satisfy the *Brunner* test and, accordingly, that her student loans were not dischargeable. Debtor, proceeding pro se, appealed. The District Court affirmed. Debtor appealed.³⁴

In August 2016, Debtor/Appellant Janet Tingling (hereinafter “Tingling”) sought relief from her student debt by filing a complaint against student loan holder United States Department of Education and others. On consent of the parties, the Bankruptcy Court granted the motion of Educational Credit Management Corporation to intervene as the assignee of eight of the loans. On April 15, 2019, the Bankruptcy Court entered a final judgment, holding that Tingling’s student loans were non-dischargeable and that Tingling had failed to prove undue hardship. Tingling appealed to the District Court, which affirmed the Bankruptcy Court’s judgment. The District Court further held that the Bankruptcy Court did not abuse its discretion when it adopted the July 31, 2018, joint pretrial memorandum as the basis for its Pretrial Order and declined to incorporate Tingling’s later unilateral revisions.³⁵

Holding: The Second Circuit Court of Appeals affirmed, holding that:

- (1) The Bankruptcy Court did not abuse its discretion in basing its Pretrial Order on the joint pretrial memorandum dated July 31, 2018. Nor was it an abuse of discretion for the Bankruptcy Court to not permit Tingling to unilaterally modify that joint pretrial memorandum, as the interests of justice in this case did not so require.³⁶
- (2) Tingling failed to make the factual showing to establish “undue hardship” under *Brunner*, as would be required to discharge her educational loans.³⁷

Appeal: Tingling’s petition to the United States Supreme Court for writ of certiorari was denied.³⁸

³³ *Educ. Credit Mgmt. Corp.*, 356 F.3d at 1310-1312.

³⁴ *In re Tingling*, 990 F.3d at 306-307.

³⁵ *In re Tingling*, 990 F.3d at 307-308.

³⁶ *In re Tingling*, 990 F.3d at 309.

³⁷ *Id.* at 310.

³⁸ *Tingling v. Educ. Credit Mgmt. Corp.*, 142 S. Ct. 1367, 212 L. Ed. 2d 326, 90 U.S.L.W. 3290 (2022).

b. ***Educ. Credit Mgmt. Corp. v. Goodvin*, 2021 WL 1026801 (D. Kan. 2021)**

Compare the following to *Tingling* to *Educ. Credit Mgmt. Corp. v. Goodvin*, 2021 WL 1026801 (D. Kan. 2021), which the district court determined the debtor could satisfy the *Brunner* test because the debtor could not pay accruing interest on the student loan and still maintain a minimal standard of living.

Case Summary

Facts: After filing chapter 7 bankruptcy, Debtor Jeffrey Goodvin (hereinafter “Goodvin”) initiated an adversarial proceeding against the United States Department of Education (hereinafter “DOE”) and defendant Educational Credit Management Corporation (hereinafter “ECMC”) seeking discharge of certain student loans held by DOE and ECMC pursuant to 11 U.S.C. § 523(a)(8).³⁹ At the time of trial, Goodvin was 57, single, and had no dependents. In total, Goodvin owed \$77,000 on his student loans, which are accruing interest at a rate of \$503 per month.⁴⁰ On July 15, 2020, the Bankruptcy Court conducted a trial at which the parties offered documentary evidence and stipulations of fact and at which Goodvin testified. On September 1, 2020, the Bankruptcy Court issued a written opinion in which it made various findings of fact; concluded Goodvin had shown the necessary undue hardship; and partially discharged the student loan debt, specifically discharging Goodvin's debt on a 1992 consolidation loan held by ECMC but excepting from discharge the debt on ECMC's other loan and on DOE's loans.⁴¹

ECMC appealed that decision to the United States District Court for the District of Kansas. ECMC challenged particular findings of fact relating to Goodvin's expenses, and it argued that the Bankruptcy Court erred in concluding that Goodvin satisfied the undue hardship standard. ECMC also argued that, if that standard is deemed satisfied, the Bankruptcy Court abused its discretion in discharging only the debt on one loan instead of spreading the partial discharge among all debts on a pro rata basis. The Court rejected ECMC's arguments, and it therefore affirmed the Bankruptcy Court's partial discharge.⁴²

Holding: The United States District Court for the District of Kansas held that:

- (1) disposable income insufficient even to pay accruing interest can prove “undue hardship” under 11 U.S.C. § 523(a)(8); and
- (2) the availability of an income-based repayment program will not automatically preclude the discharge of student loans.⁴³

c. ***Parvizi v. U.S. Dep’t of Educ., et al., (In re Parvizi)*, 2021 Bankr. LEXIS 1283 (Bankr. D. Mass. May 12, 2021)**

Bankruptcy Court in Massachusetts discharged part of debtor’s student loans under Section 105(a) after finding that in Massachusetts the bankruptcy courts use the totality of the circumstances test.

³⁹ *Educ. Credit Mgmt. Corp.*, 2021 WL 1026801, at *1.

⁴⁰ *Id.* at *2.

⁴¹ *Id.* at *1-2.

⁴² *Educ. Credit Mgmt. Corp.*, 2021 WL 1026801, at *2.

⁴³ *Educ. Credit Mgmt. Corp.*, 2021 WL 1026801, at *23-26. See Bill Rochelle, *Inability to Cover Accruing Interest Was Pivotal on Discharging Student Loans*, AMERICAN BANKRUPTCY INSTITUTE (Mar. 22, 2020).

Case Summary

Facts: As of the trial date, Debtor Tamara Parvizi (hereinafter “Parvizi”) was 51 years old, had no physical or mental conditions that impede her ability to work, and did not have any dependents. From 1997 through 2012, Parvizi received various student loans to fund her extensive education. As a result of that education, Debtor has obtained multiple degrees and is fluent in at least four languages. In 1990, Parvizi obtained a bachelor’s degree in philosophy and biochemistry from Clark University. Thereafter, she attended medical school but voluntarily left before receiving a degree. In 2007, Parvizi received \$100,000 from her father and offered to compromise her extant \$123,000 student loan balance for \$45,000. The United States Department of Education (hereinafter “DOE”) rejected the offer because, based on Parvizi’s financial statement, the DOE believed that Parvizi had an ability to pay the loan. In 2008, Parvizi returned to medical school at St. George’s University School of Medicine (financed by additional student loans) and graduated with a Doctor of Medicine in 2012. In June 2012, Parvizi began a four-year residency program in psychiatry at the University of Vermont, earning \$50,000 per year. However, Parvizi did not complete the residency program and left in January 2013. Parvizi testified that, as a result of a conflict with her supervisor, she was put on a remediation plan and was then placed on leave pending an appeal. Parvizi admitted that she decided not to pursue the appeal and, instead, chose to resign. Despite her many attempts, Parvizi was never offered an interview for, nor admitted to, another residency program. Since 2014, Parvizi has primarily obtained employment in the education field. For tax years 2016 through 2019, Parvizi annual income was \$21,588, \$20,876, \$41,336, and \$28,668, respectively. Debtor estimated that she earned \$2,500 per month in early 2020.⁴⁴

The DOE holds two types of Parvizi’s student loans - federal government funded loans through the William D. Ford Federal Direct Loan Program (hereinafter the “Direct Loans”) and privately funded student loans that are guaranteed and held by the federal government through the Federal Family Education Loan Program (hereinafter the “FFELP Loans”). As of September 10, 2020, the outstanding total balance of the Direct and FFELP Loans totaled \$653,843.22, comprised of \$478,070.53 in unpaid principal and \$175,772.80 in interest. Parvizi has not made any payments toward the student loans with the exception of offsets of her income tax refunds in the amount of \$3,960.95, which were credited to her student loan account. The parties have stipulated that the Direct Loans are currently eligible for participation in the Revised Pay As You Earn (hereinafter “REPAYE”) income driven repayment plan, and that the FFELP Loans would also be eligible upon consolidation.⁴⁵

Holding: The United States Bankruptcy Court for the District of Massachusetts held that:

“Although ‘undue hardship’ is not defined in the Bankruptcy Code, the parties have stipulated that the test to be applied in this case is the totality of the circumstances’ test, which this Court, along with the other bankruptcy courts in this district, has previously adopted.”⁴⁶ “[T]he totality of the circumstances analysis is aimed at determining the answer to the question: ‘Can the debtor now, and in the foreseeable future, maintain a reasonable, minimal standard of living for the

⁴⁴ *Parvizi*, 2021 Bankr. LEXIS 1283, at *2-6.

⁴⁵ *Parvizi*, 2021 Bankr. LEXIS 1283, at *9-10.

⁴⁶ *Parvizi*, 2021 Bankr. LEXIS 1283, at *14. See *Schatz v. U.S. Dep’t. of Educ. (In re Schatz)*, 584 B.R. 1, 7 (Bankr. D. Mass. 2018), *vacated and remanded on other grounds*, 602 B.R. 411 (B.A.P. 1st Cir. 2019).

debtor and the debtor's dependents and still afford to make payments on the debtor's student loans?"⁴⁷

Based on the totality of the circumstances, Parvizi has not proven by a preponderance of the evidence that excepting her student loans from discharge would impose an undue hardship pursuant to § 523(a)(8). However, the Court does find that to the extent Parvizi is unable to repay the student loans in full by the end of any applicable income-contingent repayment program, the negative amortization of the debt and accrued interest would undoubtedly constitute an undue hardship to Parvizi at that time. Parvizi was 51 years old at the time of trial and will be in her mid to late 70's by the time she completes an income-based repayment plan. Judgment was entered for DOE, except that pursuant to § 105(a), the Court will order that any student loan debt remaining unpaid upon Parvizi's completion of the REPAYE program, or any comparable program is deemed discharged as an undue hardship pursuant to § 523(a)(8).⁴⁸

Update: The United States Bankruptcy Appellate Panel for the First Circuit affirmed holding there was no clear error in the court's ruling.⁴⁹

d. ***Randall v. Navient Sols. (In re Randall)*, 628 B.R. 772 (Bankr. D. Md. 2021)**

In applying the *Brunner* test, the Maryland Bankruptcy Court granted a partial discharge of student loans.

Case Summary

Facts: Terry Lucille Randall (hereinafter "Plaintiff") is 68 years old. She received her first college degree, a bachelor's degree in psychology, in 2004 from Morgan State University. She then received a master's degree in human services and public policy in 2008 from Sojourner-Douglass College. Plaintiff further pursued, but did not complete, a master's degree in business administration from Strayer University. Plaintiff financed her education with assistance from her parents and with loans from, among others, Defendant. Plaintiff testified that she is currently employed as a community medical technician, earning approximately \$13 per hour with some opportunity for overtime. Plaintiff explained that she has worked an exceptional number of overtime hours during the past year primarily due to the global COVID-19 pandemic and a shortage of workers. Plaintiff stated that she did not believe her current level of overtime pay would continue after the pandemic recovery.⁵⁰

Plaintiff did not deny receiving student loans to finance her education, including student loans from Defendant in an amount now due and owing of \$190,800.35. Plaintiff further acknowledged that, with respect to the amounts due to Defendant, she has only been able to repay

⁴⁷ *Parvizi*, 2021 Bankr. LEXIS 1283, at *15 (quoting *Hicks v. Educ. Credit Mgmt. Corp. (In re Hicks)*, 331 B.R. 18, 31 (Bankr. D. Mass. 2005)) The court in *In re Hicks* ruled –

In answering this question, the Court should consider all relevant evidence—debtor's income and expenses, debtor's health, age, education, number of dependents and other personal or family circumstances, the amount of the monthly payment required, the impact of the general discharge under Chapter 7 and debtor's ability to find a higher-paying job, move or cut living expenses. In addition, other factors not listed here may impact a particular debtor's case.

331 B.R. 18, 31 (Bankr. D. Mass. 2005).

⁴⁸ *Parvizi*, 2021 Bankr. LEXIS 1283, at *18-19.

⁴⁹ *Parvizi v. U.S. (In re Parvizi)*, 2022 Bankr. LEXIS 2128, at *46 (B.A.P. 1st Cir. July 29, 2022)

⁵⁰ *In re Randall*, 628 B.R. at 778.

approximately \$3,764.43. Plaintiff lists approximately \$516,918.04 of total student loan debt in her bankruptcy schedules.⁵¹

Holding: The United States Bankruptcy Court for the District of Maryland held that:

Plaintiff, within her limits, made good faith attempts to repay or otherwise address her student loan debt. The Court concluded that requiring Plaintiff to repay Defendant in full would impose an undue hardship on Plaintiff. The Court based this conclusion on, among other factors, Plaintiff's earning capacity, nominal assets, minimal existing expenses, limited opportunities for decreasing expenses or increasing wages, age, fluctuation in overtime hours and income generally, and past attempts to repay her debt given her limitations.⁵² Therefore, the Court supported a finding of undue hardship. That said, "the Court did not ignore that Plaintiff has some ability to repay some portion of her student loan debt."⁵³ "The Code does not directly address, however, the scenario when some resources might be available to repay some of the debt but repayment of the entire debt is not possible at all, or at least not without an undue hardship."⁵⁴ "Although some courts have determined that any ability to repay requires a complete denial of discharge, the Court did not read the Code in that manner. Rather, the Court agreed with those decisions allowing a partial discharge of student loan debt when debtor has established undue hardship."⁵⁵

Balancing all of the evidence and considering the language and purpose of the Code, the Court determined that Plaintiff should be required to pay a total of \$12,000.00 (plus interest at the federal judgment rate) to Defendant on account of the student loan debt. Plaintiff does not have to pay that amount all at once; rather, the Court found that Plaintiff should have an ability to make monthly payments towards that amount over a ten-year period. The Court recognized that such monthly payments are likely feasible for Plaintiff now but may not be so in a few years depending on Plaintiff's circumstances. As such, the Court expressly noted that Plaintiff may prepay some or all of the non-dischargeable debt she will owe to Defendant under the terms of this Court's ruling without penalty or additional interest charges. In sum, the Court ultimately held that \$12,000 of Defendant's debt is non-dischargeable under Section 523(a)(8) of the Code and that such debt shall accrue interest at the federal judgment rate until paid in full. Repaying that amount plus the remaining balance that would be due on those student loans would impose an undue hardship on Plaintiff under Section 523(a)(8) of the Code and the *Brunner* test.⁵⁶

e. ***Homaidan v. Sallie Mae, Inc.*, 3 F.4th 595 (2d Cir. 2021)**

The Second Circuit Court of Appeals held that private student loans were not excepted from discharge.

Case Summary

Facts: The issue in this case is whether the private educational loans that Plaintiff/Appellee Hilal K. Homaidan (hereinafter "Homaidan") took out from Defendant/Appellants Sallie Mae Inc.,

⁵¹ *In re Randall*, 628 B.R. at 779.

⁵² *In re Randall*, 628 B.R. at 785.

⁵³ *In re Randall*, 628 B.R. at 785 (citing *In re Nitcher*, 606 B.R. 67, 79 (Bankr. D. Or. 2019)).

⁵⁴ *In re Randall*, 628 B.R. at 785-786 (citing *Mosko v. Am. Educ. Servs.*, No. 04-52834, 2005 WL 2413582, at *8 (Bankr. M.D.N.C. Sept. 29, 2005)).

⁵⁵ *In re Randall*, 628 B.R. at 786 (citing *In re Alderete*, 412 F.3d 1200, 1206-1207 (10th Cir. 2005)).

⁵⁶ *In re Randall*, 628 B.R. at 787-88.

Navient Solutions, LLC, and Navient Credit Finance Corporation (hereinafter collectively, “Navient”) were dischargeable.⁵⁷

Homaidan received the loans (hereinafter “Navient loans”), graduated from Emerson College, and later filed for Chapter 7 bankruptcy. The Bankruptcy Court’s 2009 discharge order was ambiguous as to whether the Navient loans were discharged. Navient pursued repayment after the discharge order was issued, and Homaidan complied. Among them were two direct-to-consumer Tuition Answer Loans, totaling \$12,567, from Sallie Mae Inc., a corporation to which Navient is the successor. Although the loans helped underwrite Homaidan’s college education, they were not made through Emerson’s financial aid office, nor—Homaidan alleges—were they made solely to cover Emerson’s cost of attendance. They went straight to Homaidan’s bank account, and the loan proceeds exceeded the cost of Emerson’s tuition. Soon after graduating, Homaidan filed for Chapter 7 bankruptcy in the Bankruptcy Court for the Eastern District of New York. The petition listed the Navient loans as liabilities. Homaidan eventually obtained a discharge order from the Bankruptcy Court, but the order did not specify which debts were discharged.⁵⁸

After paying off the loans in full, Homaidan reopened the bankruptcy case and commenced this adversary proceeding against Navient seeking, among other things, actual damages for Navient’s alleged violation of the discharge order. The Bankruptcy Court for the Eastern District of New York determined that the Navient loans were not excepted from discharge under 11 U.S.C. § 523(a)(8)(A)(ii) and therefore denied Navient’s motion to dismiss.⁵⁹

Navient maintains that § 523(a)(8)(A)(ii) prevented the loans from being discharged in Homaidan’s bankruptcy. That provision excepts from discharge “obligation[s] to repay funds received as an educational benefit, scholarship, or stipend.” 11 U.S.C. § 523(a)(8)(A)(ii). Under Navient’s reading of that provision, the term “educational benefit” would encompass virtually all private student loans. But that reading cannot be reconciled with the text and structure of § 523(a)(8), both of which confirm that § 523(a)(8)(A)(ii) excepts from discharge a far narrower category of debt.⁶⁰

Holding: The Second Circuit Court of Appeals, affirmed holding that:

- (1) lenders were not estopped from advancing their interpretation of the subsection of the Bankruptcy Code at issue simply because they had unsuccessfully advanced that interpretation of the provision in other cases, and
- (2) as a matter of apparent first impression for the Court, debtor’s private student loans did not constitute “funds received as an educational benefit” and so were not excepted from discharge.⁶¹

“Educational benefit” is therefore best read to refer to conditional grant payments similar to scholarships and stipends. The Reserve Officer Training Corps and the National Health Service Corps, for example, pay tuition in exchange for a promise to serve in the military after

⁵⁷ *Homaidan*, 3 F.4th at 598.

⁵⁸ *Homaidan*, 3 F.4th at 598.

⁵⁹ *Homaidan*, 3 F.4th at 598.

⁶⁰ *Homaidan*, 3 F.4th at 599.

⁶¹ *Homaidan*, 3 F.4th at 600-604.

graduation or to practice medicine in an underserved region.⁶² A recipient who breaks that promise incurs an “obligation to repay [the] funds” that they previously received “as an educational benefit.” Per § 523(a)(8)(A)(ii), that obligation cannot be discharged in bankruptcy.⁶³

f. **McCoy v. U.S., 810 Fed. Appx. 315 (5th Cir. 2020)**

Chapter 7 debtor appealed the district court’s decision affirming denial of her student loan discharge under § 523(a)(8).

Case Summary

Facts: After trial, the Bankruptcy Court for the Southern District of Texas declared that loans were not discharged. Debtor appealed and the United States District Court for the Southern District of Texas affirmed. Debtor appealed to the Fifth Circuit Court of Appeals.⁶⁴

Thelma McCoy (hereinafter “McCoy”) incurred a large amount of student loan debt (currently totaling over \$345,000.00) in pursuit of advanced degrees, beginning when she was in her forties. She consolidated her loans and entered into an income-based repayment plan. When her degrees did not yield the well-paying jobs she hoped for, she filed for bankruptcy seeking relief from the consolidated student loan debt. At the time of her bankruptcy filing, and throughout this litigation, her repayment plan has required zero dollars per month due to her low income. If her income does not improve, McCoy will continue to have a zero-dollar repayment obligation. Under the structure of the repayment plan, her debt may be forgiven twenty-five years following her first payment under the plan.⁶⁵ However, under current law, such forgiveness has tax implications unless McCoy were to qualify for an employment-based exception; any forgiven amount will be subject to whatever taxation laws are in effect at the time the debt is forgiven. See 26 U.S.C. §§ 61(a)(11), 108(f)(1). Student loan debt is usually not dischargeable in bankruptcy. 11 U.S.C. § 523(a)(8). However, there is an exception, which McCoy asserted, for circumstances where failure to discharge would impose an undue hardship on Debtor. The Bankruptcy Court found no undue hardship, and the district court affirmed.⁶⁶

Holding: The Fifth Circuit Court of Appeals affirmed, holding that:

The Bankruptcy Court did not clearly err in its determination that debtor’s inability to pay her student loans was not likely to persist, and thus debtor was not entitled to “undue hardship” discharge of student loan debt.⁶⁷

The impact of a zero-dollar monthly payment under an income-based repayment plan on the first prong of *Brunner* has not been decisively determined by our court previously, and we conclude that we need not address it because McCoy has failed to establish that the bankruptcy court (as affirmed by the district court) erred in its findings on the second prong.⁶⁸

Under the Fifth Circuit precedent, “[a]dditional circumstances encompass circumstances that impacted on the debtor’s future earning potential but which were either not present when the

⁶² *Homaidan*, 3 F.4th at 605 (citing Jason Iuliano, *Student Loan Bankruptcy and the Meaning of Educational Benefit*, 93 AM. BANKR. L.J. 277, 292 (2019)).

⁶³ *Homaidan*, 3 F.4th at 605.

⁶⁴ *McCoy*, 810 Fed. Appx. at 315-16.

⁶⁵ See 34 C.F.R. §§ 685.221(f)(1), (f)(3)(ii)(D) (2013).

⁶⁶ *McCoy*, 810 Fed. Appx. at 316.

⁶⁷ *McCoy*, 810 Fed. Appx. At 316.

⁶⁸ *McCoy*, 810 Fed. Appx. at 316-18.

debtor applied for the loans or have since been exacerbated.”⁶⁹ McCoy argued that “[a]t least two major additional circumstances” demonstrate that the state of affairs is likely to persist: “(1) she is elderly—at 62 she is less than three years away from the minimum retirement age; and (2) she suffers from severe mental and physical disabilities, which are not likely to recede or resolve.”⁷⁰

The Bankruptcy Court determined that McCoy did not satisfy the second prong because, “although her payments [were] set at zero dollars per month, [McCoy] had not shown additional circumstances demonstrating her inability to pay a higher monthly amount would persist. Therefore, McCoy failed to meet her burden of proof.”⁷¹

In affirming the Bankruptcy Court’s determination that McCoy failed to satisfy the second prong, the District Court noted that Bankruptcy Courts have considered the timing of additional circumstances.⁷² The District Court correctly determined that the Bankruptcy Court did not clearly err in its determination about the second prong of the *Brunner* undue hardship test. Accordingly, the Fifth Circuit Court of Appeals found no need to reach the third prong.

Update: McCoy’s petition to the United States Supreme Court for writ of certiorari was denied.⁷³

g. ***In re Rosenberg*, 610 B.R. 454, 456 (Bankr. S.D.N.Y. 2020)**

Chapter 7 debtor-attorney brought adversary proceeding for determination that he was entitled to ‘undue hardship’ discharge of his \$221,385.49 in consolidated student loan debt. Both parties cross-moved for summary judgment.

Case Summary

Facts: Debtor/Plaintiff, Kevin Jared Rosenberg (hereinafter “Rosenberg”), asked the Court to declare the debt owed to Educational Credit Management Corporation (hereinafter “ECMC”) dischargeable, pursuant to § 523(a)(8) in a summary judgment motion. The Bankruptcy Court for the Southern District of New York granted Rosenberg’s motion for summary judgment. However, ECMC’s cross-motion for summary judgment was denied.⁷⁴

Rosenberg filed a petition for relief under Chapter 7 of the Bankruptcy Code on March 12, 2018. On June 18, 2018, Rosenberg filed an adversary proceeding to have his student loan debt declared dischargeable, pursuant to 11 U.S.C. § 523(a)(8). “On November 14, 2018, the parties entered into a consent order, which authorized ECMC to intervene in this adversary proceeding as the ‘holder [] of one ... federal consolidation loan owed by Plaintiff’ (hereinafter the “Student Loan”).”⁷⁵

⁶⁹ *McCoy*, 810 Fed. Appx. at 316-17 (quoting *In re Gerhardt*, 348 F.3d 89, 92 (5th Cir. 2003)).

⁷⁰ *McCoy*, 819 Fed. Appx. At 317.

⁷¹ *McCoy*, 810 Fed. Appx. at 317.

⁷² See *In re Thoms*, 257 B.R. 144, 149 (Bankr. S.D.N.Y. 2001) (stating that a pertinent additional circumstance would be one “which was either not present when the debtor applied for the loans or has since been exacerbated” because “[o]therwise, the debtor could have calculated that factor into its cost-benefit analysis at the time the debtor obtained the loan”).

⁷³ *McCoy v. U.S.*, 141 S. Ct. 2794, 210 L. Ed. 2d 927, 89 U.S.L.W. 3426 (2021).

⁷⁴ *In re Rosenberg*, 610 B.R. at 456.

⁷⁵ *In re Rosenberg*, 610 B.R. at 456-57.

Rosenberg received a discharge of his debts on July 26, 2019. ECMC filed a Cross Motion for Summary Judgement and opposition to Rosenberg’s motion (hereinafter the “Cross Motion”) on October 8, 2019. The parties agree that there are no genuine issues of material fact and that this issue is ripe for summary judgment. The Court held a hearing on October 29, 2019, and asked the parties to provide the Court with evidence as to the current promissory note, the current terms of the loan, the current principal balance, and a payment history. ECMC filed a response which contained the payment history since consolidation of the loan.⁷⁶

Rosenberg began borrowing money to fund his education in August 1993. From 1993 until 1996, Rosenberg continued to borrow money to pay for his undergraduate education at the University of Arizona. After obtaining a Bachelor of Arts degree in History, Rosenberg served in the United States Navy on active duty for five years. After completing his tour of duty, Rosenberg attended Cardozo Law School at Yeshiva University where he applied for and received additional student loans to cover his tuition and board from 2001 through 2004. After graduating from law school, Rosenberg consolidated his Student Loan on April 22, 2005, in the original principal amount of \$116,464.75. The total outstanding balance of this Student Loan as of November 19, 2019, was \$221,385.49 with an interest rate of 3.38% per annum.⁷⁷

Holding: The United States Bankruptcy Court for the Southern District of New York held that:

Rosenberg has a negative income each month, he has no money available to repay his Student Loan and maintain a “minimal” standard of living. This prong of the *Brunner* test is met.⁷⁸

The repayment period has ended. Rosenberg is in default and his loan was accelerated. As of November 19, 2019, Debtor is responsible for the repayment of the full amount of \$221,385.49. His circumstances will certainly exist for the remainder of the repayment period as the repayment period has ended and the loan is due and payable in the full amount. The second prong of the *Brunner* test is, therefore, satisfied.⁷⁹

Lastly, Rosenberg made 10 payments, in varying amounts, during the 26 months that he was responsible for making payments, which is approximately a 40% rate of payment over a thirteen-year period. Additionally, Rosenberg did not sit back for 20 years but made a good faith effort to repay his Student Loan. Rosenberg actively called and requested forbearance on at least five separate occasions, all of which were granted by the servicer.⁸⁰

Therefore, Rosenberg has demonstrated a good faith effort to repay the loan and has satisfied the “undue hardship” standard of 11 U.S.C. § 523(a)(8).⁸¹

h. *Wolfson v. United States Dep’t of Educ., et al., (In re Wolfson), 2022 Bankr. LEXIS 103 (Bankr. Del. Jan 14, 2022)*

Chapter 7 debtor brought an adversary proceeding for determination that his student loan debt totaling \$95,137.02 was dischargeable under 11 U.S.C. § 523(a)(8).

⁷⁶ *Id.* at 457.

⁷⁷ *In re Rosenberg*, 610 B.R. at 457.

⁷⁸ *In re Rosenberg*, 610 B.R. at 460-61.

⁷⁹ *In re Rosenberg*, 610 B.R. at 461.

⁸⁰ *In re Rosenberg*, 610 B.R. at 462.

⁸¹ *In re Rosenberg*, 610 B.R. at 462.

Case Summary

Facts: Ryan Wolfson (hereinafter “Wolfson”) was diagnosed with epilepsy including petit mal seizures at 12 years old. Wolfson was prescribed medication for his seizures but due to the risk of liver disease substituted the medication for medical cannabis at age 23.⁸²

Wolfson obtained financing to fund his college education from a Federal Family Education Loan on August 12, 2005, and Direct Loan Master Promissory Note on May 5, 2013 (hereinafter, the “Student Loans”). Wolfson’s father cosigned on several of the Student Loans and made minimal payments. Wolfson did not make payments on the Student Loans while in college. Wolfson graduated in 2010 with a Bachelor of Science degree in Business from Penn State.⁸³

After college, Wolfson was involved in two business ventures that deemed unsuccessful by 2014. For two years beginning in 2014, Wolfson provided full time care to his grandmother. From 2016 to 2019, Wolfson worked at a cannabis dispensary, then for a home renovation company, and finally as a truck driver. At the time, Wolfson’s monthly living expenses were \$2,475.00 and his monthly income was \$1,137.39. Wolfson’s father contributed \$1,335.00 per month to cover the remainder of Wolfson’s living expenses. In August 2019, Wolfson had a seizure while driving as a truck driver resulting in his truck being totaled. Wolfson’s epilepsy limited his job search in that he could only work between the hours of 9:30 a.m. and 8:00 p.m. Wolfson remained unemployed following the accident and through trial.⁸⁴

Wolfson filed a voluntary petition under Chapter 7 on July 20, 2019. On October 22, 2019, Wolfson was granted a chapter 7 discharge. On October 23, 2019, Wolfson filed an adversary proceeding against Betsey DeVos in her capacity as Secretary of the Department of Educations (hereinafter “DOE”), Pennsylvania Higher Education Assistance Agency (hereinafter “PHEAA”), d/b/a Fedloan Servicing, Navient Solutions, Inc. (hereinafter “Navient”), and American Education Services seeking a determination that his Student Loans were dischargeable under § 523(a)(8). On November 26, 2019, Navient and Wolfson filed a stipulation agreeing to discharge Navient’s portion of Wolfson’s student loans. Education Credit Management Corporation (hereinafter “ECMC”) moved to intervene as a defendant, in that it now owns the interests PHEAA formerly held in Wolfson’s student loans. Trial was held on December 7, 2020.⁸⁵

Holding: The United States Bankruptcy Court for the District of Delaware held that:

Wolfson established under *Brunner* by a preponderance of the evidence that his Student Loans would impose an undue hardship and should be excepted from discharge.

Under the first prong, the court determined that Wolfson did not meet a minimal standard of living because he did not have disposable income to pay his Student Loans. The court ruled that third party charitable contributions are not considered income under *Brunner* because the primary inquiry is whether the debtor can support himself individually. Thus, the court found that Wolfson’s father’s monthly contributions are not included as Wolfson’s income. Without the

⁸² *In re Wolfson*, 2022 Bankr. LEXIS, at *4.

⁸³ *In re Wolfson*, 2022 Bankr. LEXIS, at *5, 10-12.

⁸⁴ *In re Wolfson*, 2022 Bankr. LEXIS, at *5-8.

⁸⁵ *In re Wolfson*, 2022 Bankr. LEXIS, at *3-4.

father's contributions and despite Wolfson's efforts to obtain employment, the court determined that Wolfson's income was insufficient to maintain a minimal standard of living.⁸⁶

Under the second prong, the court determined that Wolfson demonstrated additional circumstances exist causing him to be unable to pay the Student Loans during the repayment period. Because the Student Loans' repayment periods expired, the court followed the bankruptcy courts in *In re Rosenberg* and *In re Nitcher* and ruled that the repayment period is the contractual repayment term in the loan and not a hypothetical repayment period.⁸⁷ Thus, the court found that Wolfson satisfied this component because the Student Loans' repayment period expired.⁸⁸ In terms of the additional circumstances, the court found that Wolfson's past and current employment failures are indicative of his inability to repay the Student Loans. As the court notes, "[Wolfson's] work history shows that he is unlikely to ever receive an income sufficient to pay his student loan debt."⁸⁹ Though rejecting the retributive dicta of the phrase "certainty of hopelessness," the court states that "viewing [Wolfson's] situation with unwarranted optimism will only do him a disservice."⁹⁰

Under the third and final prong, the court determined that Wolfson in good faith was not able to make payments on the Student Loans because of his job history, which was limited due to his medical condition.⁹¹ "Despite his apparent best efforts to maximize income and minimize expenses, [Wolfson] has never had the discretionary income to make meaningful payments on his [Student] Loans."⁹²

C. Law Review Articles

a. ***How the Courts Have Gone Astray in Refusing to Discharge Student Loans: The Folly of Brunner, of Rewriting Repayment Terms, of Issuing Partial Discharges and of Considering Income-Based Repayment Plans*, 95 Am. Bankr. L.J. 53, 54 (2021).**

Author: Hon. Alan M. Ahart, Retired Bankruptcy Judge for the Central District of California.

Law Review Synopsis

To determine whether undue hardship exists, nine federal circuits have adopted a specious test that was promulgated in 1985 by the federal district in *Brunner v. N.Y. State Higher Educ. Services Corp.* (*In re Brunner*) and affirmed and adopted by the Second Circuit...This paper demonstrates how the *Brunner* undue hardship test misconstrues 11 U.S.C. § 523(a)(8) and how the courts ought to interpret this section when determining whether educational loans should be discharged in bankruptcy. Some courts have concluded that an educational loan can be partially discharged and/or restructured. This article further explains how these courts have

⁸⁶ *In re Wolfson*, 2022 Bankr. LEXIS, at *15.

⁸⁷ *In re Wolfson*, 2022 Bankr. LEXIS, at *18-19. See *Rosenberg v. Educ. Credit. Mgmt.*, 610 B.R. 454, 461 (Bankr. S.D.N.Y. 2020). See *Nitcher v. Educ. Credit Mgmt. Corp. (In re Nitcher)*, 606 BR 67, 78 (Bankr. D. Ore. 2019).

⁸⁸ *In re Wolfson*, 2022 Bankr. LEXIS, at *19.

⁸⁹ *Id.* at *23.

⁹⁰ *Id.* at *21, 24.

⁹¹ *In re Wolfson*, 2022 Bankr. LEXIS at *25-26.

⁹² *Id.* at *29.

erred. Building from different laws in two other federal circuits, this article provides the framework for determining whether an educational loan should be discharged.⁹³

The article concludes by pointing out that: “[t]he Courts of Appeals in all, but two federal circuits have adopted the *Brunner* test to determine whether an educational loan should be discharged under § 523(a)(8).”⁹⁴ The article further indicates the [t]hree elements of the *Brunner* test are wide of the mark: a bankruptcy court should not be required to demonstrate a “certainty of hopelessness,” “extraordinary circumstances,” or that her situation will persist for a long time, or that she has made good faith efforts to repay the loan. Many courts in these *Brunner* circuits have rewritten the repayment terms and/or ordered these loans partially discharged. Other courts in various federal circuits have considered the debtor’s eligibility to participate in an income-based repayment plan when deciding whether an educational loan should be discharged.⁹⁵ Judge Ahart asserts these actions are mistaken.

According to Judge Ahart, “a bankruptcy court must decide whether the debtor’s reasonable future financial resources would [adequately] cover payment of the student loan debt over the remaining term of the loan, while still permitting for a minimal standard of living.”⁹⁶ However, if the court does not find “undue hardship” then the student loan should not be discharged.⁹⁷ Thus, a money judgment must be entered in favor of the creditor.⁹⁸ On the other hand, if the court determines that “undue hardship” is established then the court ought to simply order a discharge of the entire balance of the student loan.⁹⁹

b. *Illness and Inability to Repay: The Role of Debtor Health in the Discharge of Educational Debt*, 35 Fla. St. U. L. Rev. (2008).

Author: Rafael I. Pardo, Associate Professor of Law, Washington University in St. Louis

Law Review Synopsis

In 2005, Michelle Lacey and Rafael Pardo presented the results from their empirical study.¹⁰⁰ Over a period of ten years, Lacey and Pardo analyzed how bankruptcy courts considered a bankruptcy debtor’s health and income status in making undue hardship determinations. The study derived its data from 261 published and unpublished opinions issued between October 1993 and October 2003. The primary objective was to determine what circumstances courts considered when discharging student loan debt. The study concluded that “the law had been inconsistently applied to relatively similarly situated debtors” because of “varying judicial perceptions of the meaning of undue hardship.”¹⁰¹

⁹³ Alan M. Ahart, *How the Courts Have Gone Astray in Refusing to Discharge Student Loans: The Folly of Brunner, of Rewriting Repayment Terms, of Issuing Partial Discharges and of Considering Income-Based Repayment Plans*, 95 Am. Bankr. L.J. 53, 54 (2021).

⁹⁴ *Id.* at 78-79.

⁹⁵ *Id.* at 79

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge of Education Debt*. Rafael I. Pardo & Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge of Education Debt*, 74 U. Cin. L. Rev. 405 (2005).

¹⁰¹ *Id.* at 486-509.

From the 2005 study¹⁰², Pardo presents his results using statistical modeling to show whether debtors were granted a undue hardship discharge based on their monthly household income, monthly household expenses, or health status.¹⁰³ The data indicates that a debtor's health status has more of a significantly statistical relationship than the debtor's financial status.¹⁰⁴ Pardo suggests that if a debtor has a medical condition there is a 140% chance of the debtor's student loan debt getting discharged. For instance, if two debtors have the same average monthly household income and expenses of \$2,018 and \$2,158, the debtor with the medical condition is 57% more likely at getting a student loan debt discharged versus the healthy debtor (with a 35% probability of discharge).¹⁰⁵

¹⁰² Rafael I. Pardo, *Illness and Inability to Repay: The Role of Debtor Health in the Discharge of Educational Debt*, 35 Fla. St. U. L. Rev. (2008).

¹⁰³ *Id.* at 510.

¹⁰⁴ *Id.* at 511.

¹⁰⁵ *Id.* at 512-13.

RETROACTIVE ORDERS: Getting employed and paid¹

ABI Midwest 2022
Judge Anita L. Shodeen
Southern District of Iowa

Based upon the U.S. Supreme Court’s holding in *Roman Catholic Archdiocese of San Juan, Puerto Rico v. Acevedo Feliciano* discussion ensued as to whether requesting nunc pro tunc orders related to the effective date of employment applications in bankruptcy cases could still be obtained. These materials highlight relevant case law, and statutory authority related to the issue of getting employed and paid when seeking retroactive employment.²

1. Background

Roman Catholic Archdiocese of San Juan, Puerto Rico v. Acevedo Feliciano, 140 S.Ct. 696 (2020)

The Catholic Church of Puerto Rico was sued in the Court of First Instance (the equivalent of state court) related to termination of pension benefits involving Catholic School employees. The disputes in the case, and multiple appeals, focused upon what Church related entities were obligated to fund the benefits owed. In 2018, the case was removed to federal court under related to jurisdiction resulting from the Archdiocese’s chapter 11 filing. The federal court eventually dismissed the removed actions and five months later it remanded the cases back to the state court. In the meantime, the state court entered orders: that the Church deposit \$4.7 million in a court account, seizure of Church assets in Puerto Rico and a nunc pro tunc stating that the remand order was effective as of the dismissal date of March 13, 2018.

After granting cert on the case, SCOTUS concluded that the state court lacked jurisdiction to order the deposit and seizure of assets. The opinion noted that the notice of removal left the state court without jurisdiction and any orders after that point were “absolutely void”. *Roman Cath. Archdiocese of San Juan, Puerto Rico v. Acevedo Feliciano*, 140 S.Ct. 696, 700 (2020). An order nunc pro tunc cannot overcome that jurisdictional deficiency.

Federal courts may issue nunc pro tunc orders, or “now for then” orders to reflect the reality of what has already occurred. Such a decree presupposes a decree allowed, or ordered, but not entered, through inadvertence of the court. Put colorfully, [n]unc pro tunc orders are not some Orwellian vehicle for revisionist history—creating ‘facts’ that never occurred in fact. Put plainly, the court “cannot make the record what it is not.” Jenkins,

¹Acknowledgement and appreciation to Alexandria Quinn-Hanse, Career Law Clerk and Claire Davison, Term Law Clerk for their contributions in producing these materials.

² The written materials contain only selected cases and does not include all decisions rendered by the courts on this issue. Practitioners should independently conduct research on a specific legal issue to obtain all relevant opinions.

Id. at 700-701 (citations and internal quotations omitted).

Post-*Acevedo* most courts evaluate retroactive employment under three prevalent themes: Language, Timing and Circumstances.

1. Language

In re Millinckrodt, PLC, 2022 WL 906462 (D. Del 2022)

Do not ask for “nunc pro tunc” relief because some courts have concluded that the use of nunc pro tunc orders are not available after *Acevedo*, but that does not preclude a request for *retroactive* relief.

In re Williams, 631 B.R. 398 (Bankr. D.S.C. 2021)

Court approval of post-petition employment of an attorney by a Chapter 13 debtor is not required by § 327 because that section applies only to a trustee.³ In this case post-petition personal injury proceeds used to pay attorney with balance turned over to the estate.

In re Moore, No. 6:21-bk-70299, 2021 WL 3777538 (Bankr. W.D. Ark. Aug. 25, 2021)

Nothing in § 327 dictates a time within which an application for employment must be filed thus the Court has authority to grant it retroactively.

In re Oaktree Medical Centre, LLC, 634 B.R. 465 (Bankr. D.S.C. 2021); *In re Ramirez*, 633 B.R. 297 (Bankr. W.D. Texas 2021)

Addressing the holding of *Acevedo* directly, some courts dismissed its applicability entirely because nunc pro tunc orders of employment does not “create facts or rewrite history” of the case.

2. Timing

Pursuant to local rule, some courts identify the time within which an employment application must be filed to be considered “contemporary” which eliminates the need for retroactive employment. Other courts have analyzed specific facts of timing.

In re Hunanyan, 631 B.R. 904 (Bankr. C.D. Cal. 2021)

An order nunc pro tunc may not be appropriate when there is a lengthy delay. *Acevedo* is not applicable to a retroactive employment request of two weeks.

Smith v. Meredith (In re Smith), 637 B.R. 758 (Bankr. S.D. Ga. 2022)

³ Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title. 11 U.S.C. §327(a).

Request for court approval of employment and settlement three years after proceeds disbursed by personal injury counsel resulted in a sanction for violation of disclosure requirements under 11 U.S.C. §329 and Fed. R. Bankr. Pro. 2016(b) resulting in all fees ordered disgorged.

David v. King, 638 B.R. 561 (E.D. Va. 2022)

Counsel properly employed by chapter 7 trustee. Case converted and the same trustee was appointed trustee in the chapter 11 case where law firm continued to provide services. When case converted employment of the law firm ceased which would require a new application to employ in the converted case to be paid for post-conversion services.

3. Circumstances

In re Bear Communications, LLC, No. 21-10495-11 2021 WL 4256161 (Bankr. D. KS Sept. 21, 2021)

Creditor's Committee requested retroactive employment to cover approximately 30 days of pre-employment services. Court stated that "post-facto or retroactive employment" is a request for relief, not a request for a "nunc pro tunc" order. Failure to obtain contemporaneous employment does not preclude compensation to counsel but it does require heightened scrutiny of fee request. Extraordinary circumstances must be present to justify fees for the pre-employment period.

In re Wellington, 628 B.R. 19 (Bankr. M.D. N.C. March 9, 2021)

The Court applied the the non-exclusive list of factors enumerated in § 330(a)(3) to examine the fees. But also considered the additional factor of whether some or all the fees sought were for work performed prior to the effective date, and whether the professionals had a reasonable justification for the delay. Using the well-developed caselaw on nunc pro tunc employment orders for guidance on the issue the court concluded that those cases did not only come from limiting language in the Bankruptcy Code or Rules, but also through policy concerns. Thus, the Court's analysis of the reasonable justification for pre-employment compensation rested on the following considerations:

1. The reason for the delay in filing an application to employ;
2. Whether the applicant or some other person bore responsibility for applying for approval;
3. Whether the applicant was under time pressure to begin service without approval;
4. The amount of delay after the applicant learned that initial approval had not been granted;

5. The extent to which compensation to the applicant will prejudice innocent third parties; and
6. Other relevant factors.

The Court concluded that the work was reasonable and necessary. The delay in filing the application could justifiably be attributed to the emergency nature of the work performed, including litigation and responses to inquiry by state court entities. Further, there was no prejudice to any creditors evident and the payment to the Special Counsel would not impact any creditors. A 10% reduction in fees was imposed for the length of delay.

4. Relief Denied

In re Grinding Specialists, LLC, 625 B.R. 6 (Bankr. D. S.C. February 3, 2021)

The Court interpreted Acevedo as not entirely prohibiting nunc pro tunc orders, but rather allowing them only to reflect events that actually took place. Here, a Motion to clarify Settlement Order (on whether professional had been hired to represent trustee) or requesting a nunc pro tunc order for start of employment. No facts supported granting the relief, thus counsel's effective employment date can only be effective as to the date of the current Motion.

In re Duvall, 2020 WL 1492769, Slip Copy (Bankr. W.D. KY March 25, 2020)

Successful recovery of assets for the estate lacked sufficient evidence to determine if the work done was necessary or reasonable considering the results obtained. Retroactive Motion to Retain was denied.

In re Owsley, 2021 WL 1270833, Slip Copy (Bankr. S.D. TX April 5, 2021)

Court concluded Special Counsel was not entitled to pre-employment fees and disallowed the requested amount. Special Counsel did not file an application for a nunc pro tunc employment order, and rather simply requested the fees. The only explanation provided was that the urgent family matters required advice. However, this is undercut by the amount of time that lapsed between the initial consultation with Debtor and the date that the employment application was filed (5 weeks).

In re Roberts, 618 B.R. 213 (Bankr. S.D. Ohio 2020) (No requirement that professional be employed prior to providing services or requesting/receiving compensation. Order nunc pro tunc denied on failure to disclose compensation arrangement in original application).

For purposes of comparison, prior to the holding in Acevedo courts strictly applied standards of extraordinary circumstances.

In re Sugar Loaf Holdings, LLC, 2019 WL 1494544 (Bankr. D. Utah 2019) (Judge Kevin Anderson) (10th Circuit has concluded that a professional merely acts as a volunteer on behalf of the estate and must demonstrate “most extraordinary circumstances” to be compensated for pre-employment services which were not present in this case)

In re Kearney, 581 B.R. 644 (Bankr. D. N.M. 2018) (movant failed to meet its burden to establish employment application would have been approved and extraordinary circumstances). See also, *Matter of Arkansas Co., Inc.*, 798 F.2d 645 (3d Cir. 1986); *In re Twinton Properties P'ship*, 27 B.R. 817 (Bankr. M.D. Tenn.), report and recommendation approved, 33 B.R. 111 (M.D. Tenn. 1983).

AVOID THESE EVIDENCE PITFALLS AT TRIAL!

Discussion Topics

- Failing to determine if you have the burden of proof and providing evidence in support of each element
 - Confusing arguments with evidence
 - Failing to determine what is relevant
 - Discovering your trial plan/theme during trial
 - Fed. R. Evid. 401 - 402
- Failing to properly object, or proffer
 - Not offering objection basis
 - Not waiting for judge to rule
 - Forgetting to make an offer of proof
 - Fed. R. Evid. 103
- Overestimating or underestimating the scope of judicial notice relating to:
 - Facts generally known in the jurisdiction
 - Court filings
 - Contents of schedules
 - Proofs of claim and amounts due to others who have not filed POC
 - See Fed. R. Evid. 201
- Failing to distinguish self-authenticating from non-self-authenticating items
 - Emails
 - Certified copies of public records
 - Certified domestic records of a regularly conducted activity
 - Fed. R. Evid. 901 – 902
- Failing to properly plan and manage exhibits
 - Burying the Court with unnecessary and unused exhibits
 - Failing to admit exhibits
- Over-thinking or under-thinking hearsay
 - Failing to determine before trial if it is or is not hearsay
 - Expert valuation reports
 - Fed. R. Evid. 801 - 807
- Failing to have a plan to admit a business record
 - Confusing authentication with hearsay exceptions
 - Failing to remember the elements of the business records exception
 - Forgetting that the burden to show a lack of trustworthiness of the record (if otherwise shown to satisfy Fed. R. Evid. 803(6)) is now on the party opposing admission
- Fearing the Rules of Evidence
- Failing to have a trusted Rules of Evidence summary to carry with you

DISCUSSION POINTS FOR UP IN SMOKE

Background

- 38 States and DC have legalized marijuana to some extent. 18 + DC have fully legalized marijuana both for medical and recreational use
- However, in bankruptcy, a federal proceeding, these state immunization schemes are not protected. In the 2005 Supreme Court case of *Gonzales v. Raich*, 545 U.S. 1 (2005), the Court upheld the constitutionality of the federal government's regulation of marijuana under the Controlled Substances Act and held Congress has the prerogative to regulate controlled substances and this supersedes any less strict state law regulating them under the Supremacy Clause.

The Controlled Substances Act, 21 USC 801, et seq.

- Marijuana is a Schedule 1 controlled substance under that act.
- Thus, activities such as using, selling, and manufacturing marijuana, financing businesses that sell or manufacture marijuana, leasing property to those types of businesses and selling related drug paraphernalia are all deemed illegal.
- There is a section of the Act referred to as Prohibited Acts C is particularly broad. Specifically, under that section, it is “unlawful for any person knowingly or intentionally . . . to manufacture a controlled substance or listed chemical, knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance.”
- As a result, whether and under what circumstances a federal bankruptcy case can proceed in bankruptcy despite connections to the locally “legal” marijuana industry remains on the cutting-edge of federal bankruptcy law.
- Despite the extensive development of caselaw, significant gray areas remain. Unfortunately, the courts find themselves in a game of whack-a-mole, each time an issue is addressed, another will arise with a novel spin dressed in a new shade of gray.

Marijuana and Bankruptcy

- Article 1 of the Constitution grants Congress the power to “establish uniform laws on the subject of bankruptcies throughout the United States.”
- Congress codified bankruptcy law in Title 11 of the US Code
- The Code is divided in several chapters, the key ones for our discussion are Chapter 7, typically thought of as liquidation, and Chapters 11 and 13,

considered to involve relief in the form of rehabilitation and reorganization for corporations and individuals, respectively.

- Bankruptcy cases involving marijuana are typically divided into two categories generally described as “upstream” and “downstream.”
 - An upstream case occurs when the debtor and/or their business is directly and purposefully involving marijuana or the marijuana industry.
 - Downstream operations are those which the debtor and/or their business transacts with a marijuana-related industry or provides to a marijuana-related operation a good or service that is available in the general stream of commerce.

Case Law - The Upstream Cases

Since Colorado was one of the first states to fully legalize pot, not surprisingly, many of the earliest cited cases came from there.

In re Arenas, 514 B.R. 887(Bankr. Colo. 2014):

- United States Trustee moved to dismiss chapter 7 case filed by Colorado marijuana growers. Debtors moved to convert to Chapter 13.
- First, the court held the debtors could not be in chapter 7 because the chapter 7 trustee could not legally liquidate its marijuana assets: Here, the Debtors' chapter 7 trustee (the “Trustee”) could not take control of the Debtors' Property without himself violating § 856(a)(2) of the CSA. Nor could he liquidate the inventory of marijuana plants Mr. Arenas possessed on the petition date because that would involve him in the distribution of a Schedule I controlled substance in violation of § 841(a) of the CSA. The Court found administration of this case under chapter 7 would be impossible without inextricably involving the Court and the Trustee in the Debtors' ongoing criminal violation of the CSA. . . . To allow the Debtors to remain in a chapter 7 bankruptcy case under circumstances where their Trustee would be unable to administer valuable assets for the benefit of creditors would allow them to receive discharges without turning over their non-exempt assets to the Trustee. That would give the Debtors all of the benefits of a chapter 7 bankruptcy discharge while allowing them to avoid the attendant burdens. The impossibility of lawfully administering the Debtors' bankruptcy estate under chapter 7 constituted cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a).
- The court then denied the debtors' motion to convert to chapter 13. The court reasoned the debtors' plan payments would necessarily be funded by proceeds of a criminal enterprise under federal law, and therefore, conversion was not in good faith. The court reasoned the plan could not be administered by a Chapter

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13 trustee who would be prohibited from distribution funds derived from violation of federal law.

- Finally, the court rejected the debtors' argument the CSA violates the 10th Amendment to the United States Constitution. The court concluded the CSA was properly enacted under the Commerce Clause, and therefore the CSA did not violate the 10th Amendment.
- The court dismissed the case pursuant to § 707(a).

In re Arenas, 535 B.R. 845 (10th Cir. BAP 2015)

- On appeal, the 10th Circuit BAP affirmed Judge Tallman's opinion dismissing the Debtors' bankruptcy case. The question presented to the BAP was whether "a debtor in the marijuana business [can] obtain relief in the federal bankruptcy court?" The BAP answered this question with a resounding "No." The BAP agreed with the bankruptcy court "that while the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes."
- The BAP applied the eleven factors set forth by the 10th Circuit Court of Appeals in *Flygare v. Boulden*, 709 F.2d 1344 (10th Cir. 1983). The BAP agreed the debtors could not show an employment history to support future income unrelated to marijuana; the trustee could not legally administer and distribute marijuana derived assets; and the debtors' motives were not improper, but nonetheless the debtors were not in good faith according to an objective standard. That is, the inability to propose a confirmable plan made it "objectively unreasonable" for the debtors to seek chapter 13 relief.
- Finally, the BAP addressed the debtors' argument the case should not be per se dismissed or converted, but rather, the Trustee should simply abandon the marijuana assets: "It is not clear that a bankruptcy court may order a trustee to abandon assets *sua sponte*. And even if the court can do that, this bankruptcy estate, shorn of its marijuana assets, would likely yield no dividend to the creditors. The debtors would get a discharge and get to keep (via abandonment) their marijuana assets while being protected from collection activities. This also strikes us as prejudicial delay that amounts to cause for dismissal."

In re McGinnis, 453 B.R. 770 (Bankr. Ore. 2011):

- Debtor proposed chapter 13 plan to be funded by: 1) business leasing warehouse to marijuana grower, 2) the debtor's own marijuana operation and 3) rental income from property housing tattoo artists.
- The court held the plan was to be funded through operations dependent "on a product the cultivation and sale of which violates federal law[.]" As a result, the

plan was proposed by means forbidden by law and could not be confirmed pursuant to § 1325(a)(3).

- Further, due to the federal illegality of the operations, the court could not “find that the predicted income stream from the marijuana operations is reasonably certain to produce sufficient income to fund the Plan” and therefore concluded the plan failed the feasibility requirement of § 1325(a)(6)

In re Johnson, 532 B.R. 53 (Bankr. W.D. Mich. 2015)

- The court didn't dismiss
- Debtor received the majority of his income from social security benefits; but got some income from growing and selling marijuana as a licensed caregiver.
- Ct enjoined debtor from continuing the pot business, ordered the trustee to abandon all pot related assets and ordered the debtor to destroy all the pot related assets
- Said the debtor could finance his plan thru just the SS income

Case Law - The Downstream cases

In re Rent-Rite Super Kegs West Ltd., 484 B.R. 799 (Bankr. Colo. 2012):

- One of the earliest cases
- Creditor moved to dismiss Chapter 11 case of debtor which derived 25% of its revenue from leasing warehouse space to marijuana grow business. The court first found the debtor's business operations violated the federal Controlled Substances Act (“CSA”), and therefore the Debtor was engaged in ongoing criminal violation of Federal law. The court then noted Colorado's marijuana laws “make it clear that their provisions apply to state law only. Absent from either enactment is any effort to impede the enforcement of federal law.” Accordingly, the court concluded “even if the Debtor is never charged or prosecuted under the CSA, its conduction operations in the normal course of its business that violate federal criminal law. Unless and until Congress changes that law . . . a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime.”
- As additional grounds for dismissal, the court further concluded the debtor was barred from bankruptcy relief by the unclean hands doctrine. “The Debtor freely admits that it leases space to those who are engaged in the cultivation of marijuana. Even if the Debtor's holds a good faith—albeit misguided—belief that Colorado state law would prevail over the federal law or that the federal law is unlikely to be enforced, that is quite beside the point. The Debtor has knowingly

and intentionally engaged in conduct that constitutes a violation of federal criminal law and it has done so with respect to its sole income producing asset.”

- The court concluded cause existed for dismissal or conversion under § 1112(b).

In re ARM Ventures LLC, 564 B.R. 77 (Bankr. S.D. Fla 2017)

- Single asset debtor whose case filed on the eve of a foreclosure.
- Prospects for success depended on a highly speculative possibility that its tenant would be approved for sale of medical marijuana.
- Case not dismissed due to the presence of a significant non insider unsecured claim
- Chose to grant relief to the secured party which could be stayed if the debtor could come up w/ a plan that didn't depend on pot income.
- Landlord cases fact driven – can a plan be confirmed w/o pot contributions

In re Way to Grow, Inc., 597 B.R. 111 (Bankr. Colo. 2018), *aff'd* 610 B.R. 338 (D. Colo. 2019)

- Classic downstream business
- WTG and related companies sold hydroponics and gardening equipment for consumer use.
- The court held that selling products that can be used to cultivate marijuana didn't make the debtors liable for directly manufacturing, distributing, or dispensing controlled substances. Merely offering advice and selling products to customers involved in the pot industry did not violate the specific CSA provision prohibiting such activities
- But intent to violate isn't critical to violate the CSA. Prohibited Act C under the act provides if the seller knew the equipment would be used to manufacture a controlled substance is the critical factor
- In this case it was clear such knowledge existed as Debtors admitted its business plan and majority of its income was an aimed sale of these products to the marijuana growing industry.

The Garvin Conundrum – *Garvin v. Cook Investments NW, SPNWY, LLC*, 922 F.3d 1031 (9th Cir. 2019)

- First and only time to date that an appellate court has tackled whether a pot related business can file for bankruptcy
- 5 real estate holding companies owned and managed by a man named Michael Cook were in financial straits and filed a Chapter 11 bankruptcy petition.
- The joint plan was drafted that paid all creditors in full and allowed Cook to continue to operate
- But one of the holding companies leased properties to a company who used them exclusively for the production of marijuana.
- The US Trustee moved to dismiss under the Dismissal for Cause provision of 1112 due to alleged gross mismanagement of the estate. This was denied w/ leave to renew the argument at the confirmation hearing. At the confirmation hearing, the Trustee failed to renew the argument and the plan was confirmed.
- On appeal, the UST raised 2 issues 1/the Dismissal for Cause argument and 2/ that the lessee's agreement violated federal law
- The 9th Cir. held the UST waived its first argument and then turned to the Legal Means provision issue of whether the plan was "proposed ... not by any means forbidden by law."
- It held that provision requirement applies only to the method of the plan proposal as opposed to the substance of the plan itself.

The Garvin Conundrum – the aftermath

In re Basrah Custom Design, Inc., 600 B.R. 368 (Bankr. E.D. Mich. 2019)

- Debtor filed so as to allow it and its sole shareholder to either lease commercial space to a pot related business or enter into a pot related business themselves
- Court found there was cause to dismiss as a federal court cannot be used to "assist [a debtor] in obtaining a result that is contrary to federal criminal law under the [CSA], and therefore contrary to federal public policy."

- Court went out of its way to criticize and distinguish *Garvin*, even though the court was not in the 9th Circuit

In re CWNevada LLC, 602 B.R. 717 (Bankr. Nev. 2019)

- a 9th Circuit court case
- distinguished *Garvin* within a month after its issuance
- Debtor was a debtor who was in the business of cultivating, producing, and distributing medical and recreational marijuana legally under Nevada state law.
- acknowledged *Garvin* binding when an objection was made to a proposed Ch 11 plan under the “Legal Means” provision; but noted the 9th Circuit didn’t consider the “For Cause” provision as it held the argument had been waived by the US Trustee
- Also indicated that unlike in *Garvin*, the debtor in that case was directly violating the CSA

Discussion points:

- What is the ultimate influence of *Garvin*
- Downstream issues cause the most concern . . . How far do you extend the bankruptcy filing bar:
 - janitor at a dispensary or a grow house
 - Delivery services
 - Employees of landlord - one further step removed.

Judicial Round and Round

1. Mutual Settlement Does Not Require Evaluation as § 363 Sale. *Spark Factor Design, Inc. v. Hjelmeset (In re Open Med. Inst., Inc.)*, 639 B.R. 169 (B.A.P. 9th Cir. 2022) (Faris, J.).

The chapter 11 trustee filed a motion to approve a compromise with the debtor corporation's former principal, who had filed a concurrent chapter 11 case. Under the terms of the compromise, the trustee sold causes of action to a different company belonging to the former principal, settled breach of fiduciary duty claims against the former principal, and withdrew the trustee's proof of claim in the former principal's bankruptcy case. In exchange, the former principal and the company that purchased the causes of action paid the trustee \$200,000, agreed to fund the litigation of the purchased causes of action, and agreed to deliver to the trustee fifty-five percent of the recovery in the purchased causes of action. The bankruptcy court determined (1) the compromise satisfied the Ninth Circuit test for approving settlement agreements, and (2) the sale of the causes of action was proper under § 363.

The Bankruptcy Appellate Panel of the Ninth Circuit affirmed. The BAP first determined the bankruptcy court correctly applied the Ninth Circuit test for approving settlement agreements. Second, the court wrote further "to clarify that bankruptcy courts do not always need to examine a compromise as a sale under § 363." Bankruptcy courts have "the discretion to apply § 363 procedures to a sale of claims pursuant to a settlement approved under Rule 9019" and must evaluate a settlement of claims under § 363 when "the claims r[un] in only one direction," such that the settlement amounts to "a one-way sale." But "it is not always necessary for a bankruptcy court to treat a compromise of claims as a sale under § 363." When the trustee and the other party to the settlement have claims against each other and the settlement resolves those mutual claims, the "requirement that the bankruptcy court examine a compromise as a sale or conduct an auction is inapplicable." Because the settlement in this case resolved mutual claims, "the bankruptcy court did not need to analyze whether the compromise transaction comported with § 363."

Rule 9019 Compromise and Arbitration

(a) Compromise

On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement. Notice shall be given to creditors, the United States trustee, the debtor, and indenture trustees as provided in Rule 2002 and to any other entity as the court may direct.

(b) Authority to compromise or settle controversies within classes

After a hearing on such notice as the court may direct, the court may fix a class or classes of controversies and authorize the trustee to compromise or settle controversies within such class or classes without further hearing or notice.

(c) Arbitration

On stipulation of the parties to any controversy affecting the estate the court may authorize the matter to be submitted to final and binding arbitration.

The *Mickey Thompson* Rule

“[I]n some circumstances, a settlement agreement transferring estate assets must be evaluated both as a compromise under Rule 9019 and a sale under § 363.” *In re Open Med. Inst., Inc.*, 639 B.R. 169, 181 (B.A.P. 9th Cir. 2022).

ABI Midwestern Bankruptcy Institute

October 6-7, 2022

Vicarious Liability in a Discharge Context in Light of *Bartenwerfer*

The Honorable Dennis R. Dow
Bankruptcy Court for the Western District of Missouri

Sharon Loftspring
Law Clerk

Bartenwerfer v. Buckley

860 Fed. Appx. 544 (9th Cir. 2021), *cert. granted.*, 2022 WL 1295707
(U.S. May 2, 2022)(No. 21-908)

Issue: Can an individual be subject to liability for the fraud of another that is barred from discharge under §523(a)(2)(A), by imputation, without any act, omission, intent or knowledge of her own?

Background: Husband and wife renovated a house and then sold it. The buyer alleged that there were defects in the house, and sued the couple in state court for nondisclosure of material facts. The court found in favor of the buyer and awarded him damages. The husband and wife filed for bankruptcy.

The judgment creditor initiated an adversary proceeding against the debtors, arguing that the state court judgment was nondischargeable under §523(a)(2)(A) as a debt obtained through fraud. The bankruptcy court agreed. It found that Mr. Bartenwerfer had actual knowledge of the false representations made to the creditor and that his fraudulent conduct could be imputed to Mrs. Bartenwerfer (the “Petitioner”) based on their partnership relationship. On appeal, the Ninth Circuit BAP remanded the imputed liability finding for a determination as to whether Mrs. Bartenwerfer “knew or should have known” of her husband’s fraud. On remand, the bankruptcy court held that Mr. Bartenwerfer’s fraud could not be imputed to his wife because she didn’t know about it. The BAP affirmed, and the creditor appealed.

Citing *Strang v. Bradner*, 114 U.S. 555 (1885), the Ninth Circuit applied partnership principles to hold that the bankruptcy court applied the incorrect legal standard for imputed liability in a partnership. It concluded that Mrs. Bartenwerfer’s debt was non-dischargeable regardless of her knowledge of the fraud, and remanded the case.

Mrs. Bartenwerfer’s Petition for Writ of Certiorari has been granted.

Discussion: The circuit courts are split on this issue. Some require at least a minimal level of scienter on the part of the debtor in question and others impose vicarious liability on “innocent debtors.”

The leading case applying the approach requiring scienter is *In re Walker*, 726 F. 2d 452 (8th Cir. 1984). In *Walker*, the Eighth Circuit concluded that more than the mere existence of an agent-principal relationship is required to charge the agent’s fraud to the principal. *Id.* at 454. It held that §523(a)(2)(A) requires that a debtor-principal “knew or should have known” of his agent’s fraud before the liability can be rendered nondischargeable, citing *In re Lovich*, 117 F.2d 612 (2d Cir. 1941). *Id.* The *Lovich* court justified the scienter requirement this way:

On principle we think that more should be shown to justify withholding a discharge that an agent made a fraudulent statement within the scope of a general authority to transact the bankrupt's business. A discharge is a privilege accorded to bankrupts by the statute unless they are chargeable with conduct showing some lack of personal business morality. *Lovich*, 117 F.2d at 615.

See also In re Huh, 506 B.R. 257 (9th Cir. BAP 2014) (en banc) (adopting *Walker*’s “knew or should have known” standard); *In re Treadwell*, 637 F.3d 855 (8th Cir. 2011) (same); *In re Reuter*, 427 B.R. 727 (Bankr. W.D. Mo. 2010) (finding that debtor should be held vicariously liable for his partner’s fraud because debtor should have known that his partner was engaged in fraudulent conduct). The Eighth Circuit stated that the requisite knowledge could be imputed when the principal is recklessly indifferent to his agent’s acts. *Walker*, 726 F. 2d at 454, citing *David v. Annapolis Banking & Tr. Co.*, 209 F.2d 343, 344 (4th Cir. 1953) (finding that a wife who allows her husband to do business in her name and signs without question or examination any paper that he presents to her is not

entitled to a discharge). Interestingly, neither *Walker* nor the cases on which the Eighth Circuit relies mentions *Strang*.

Several courts have criticized the *Walker* decision as contrary to the legislative history and proper statutory interpretation of § 523. *See, e.g., In re Calhoun*, 131 B.R. 757, 760-62 (Bankr. D.C. 1991); *BancBoston Mortgage Corp. v. Ledford*, 127 B.R. 175, 180-85 (M.D.Tenn.1991), *aff'd*, 970 F.2d 1556 (6th Cir.1992), *cert. denied*, 507 U.S. 916 (1993); *In re Paolino*, 75 B.R. 641, 645-50 (Bankr.E.D.Pa.1987). One court put it this way: “Granted, the *Walker* standard is a bit mushy; if it's enough to deny the discharge that the principal ‘should have known of the agent's fraud,’ there will never be an occasion for requiring proof of reckless indifference.” *Sullivan v. Glenn*, 782 F.3d 378, 382 (7th Cir. 2015).

The leading case imposing liability without knowledge is *Strang v. Bradner*, 114 U.S. 555 (1885). The question in *Strang* was whether the debtors could be held liable for the fraudulent representations of their business partner when the representations were not made under their direction nor with their knowledge. The Supreme Court held that the “innocent” partners were barred from discharging their debt in bankruptcy, reasoning that since each partner was an agent and representative of the firm, one partner’s fraud was to be imputed to all the members of his firm. *Id.* at 561. It stated further that the wrongdoer’s partners “cannot escape pecuniary responsibility” on the ground that the misrepresentations were made without their knowledge. *Id.* *See also In re Palilla*, 493 B.R. 248 (Bankr. D. Colo. 2013) (applying *Strang* to hold debtor liable for partner’s felonious conduct despite the fact that he was unaware of it); *In the matter of M.M. Winkler & Associates*, 239 F. 3d 746, 751 (5th Cir. 2001) (“[I]f a debt arises from fraud and the debtor is liable for that debt under state partnership law, the debt is nondischargeable under §523(a)(2)(A).”). The court noted that this is especially true when the innocent partners “received and appropriated the

fruits of the fraudulent conduct.” *Strang*, 114 U.S. at 561. *But see Winkler*, 239 F.3d at 751-2 (concluding that the receipt of benefits is irrelevant to this inquiry).

The Petitioner in *Bartenwerfer* contends that *Strang* is inapposite or an aberration, and that requiring scienter is consistent with the legislative history of §523(a)(2)(A). Courts grappling with the conflicting *Walker* and *Strang* standards have likewise pointed to the historical background of the statute – noting that while *Strang* has not been overruled, it constitutes part of the background to the adoption of the statute and its amendments by Congress. *See, e.g., In re Huh*, 506 B.R. 257, 264 (9th Cir. BAP 2014). In *Huh*, the BAP explains that, unlike the current Bankruptcy Code, the provisions of the Bankruptcy Act of 1867 (in effect when *Strang* was decided) were not liberally construed in favor of debtors and included exceptions to discharge that were broader than the subsequent Bankruptcy Act. *Id.* The BAP also distinguished *Strang* on the grounds that it relied on partners and partnership law, and was decided before agency law was well-developed. *Id.*

The Petitioner also points out that there is no analysis or discussion of dischargeability in *Strang*; it simply focuses on the liability of the firm’s partners for another partner’s fraud. While that is true, other courts applying the *Strang* standard have recognized the distinction between liability and dischargeability. *See, e.g., Palilla*, 493 B.R. at 256 (commenting that §523 has compensatory objectives which aim to protect certain types of creditors regardless of the debtor’s culpability); *Winkler*, 239 F. 3d at 749 (noting that §523 focuses on the character of the debt, not the culpability of the debtor).

In addition, the Petitioner asserts that *Strang* is inconsistent with other Supreme Court precedent on the mental state required in dischargeability litigation. For example, in *Bullock v. BankChampaign, N.A.*, 569 U.S. 267 (2013), the Supreme Court considered the question of whether excepting a debt for fiduciary defalcation from discharge under

§ 523(a)(4) required a showing of the debtor's subjective bad or extremely reckless state of mind. Relying, in part, on statutory context and policy considerations, the Supreme Court interpreted the term “defalcation” to require a showing of the debtor’s intentional state of mind. *Id.* at 273-74. *See also Neal v. Clark*, 95 U.S. 704 (1877) (interpreting “fraud” under §523(a)(4) to mean intentional wrong, and not implied fraud); *Field v. Mans*, 516 U.S. 59 (1995) (finding that statutory history of §523(a)(2)(A) and (B) did not support stripping fraud exception of scienter requirement). These decisions weigh against imputing fraud under §523(a)(2) in the absence of some showing of culpability on the debtor’s part.

Note that the issue of vicarious liability has been addressed in the context of the dischargeability of debt resulting from securities law violations: Does §523(a)(19)(A)(i) encompass debts arising from violations committed by third parties, or is it limited to those committed by the debtor? For a discussion of the split of authority, *see In re Reefer*, 2022 WL 1295935 (Bankr. S.D. Fla. April 29, 2022).

Faculty

Hon. Robert D. Berger was appointed as a U.S. Bankruptcy Judge for the District of Kansas in Kansas City on Oct. 16, 2003, and was reappointed on Oct. 16, 2017. Prior to his appointment, Judge Berger practiced law as a bankruptcy and insolvency specialist representing debtors and creditors, and was among the first group of attorneys in Kansas and Missouri to be certified by the American Board of Certification in both consumer and business bankruptcy law. Judge Berger is a member of ABI and the National Conference of Bankruptcy Judges, and a founding member of the Kansas Chapter of the Federal Bar Association. He also is a chapter author for *Collier on Bankruptcy*, *Collier Bankruptcy Practice Guide*, *Kansas Bankruptcy Handbook* and *Practitioner's Guide to Kansas Family Law*. Judge Berger is a frequent lecturer and he has authored articles for various publications, including *The Washburn Law Journal*, *ABI Journal* and the *Journal of the Kansas Bar Association*. He received his B.A. in history and political science from the University of Kansas in 1983 and his J.D. from Washburn University School of Law in 1986.

Hon. Dennis R. Dow is a U.S. Bankruptcy Judge for the Western District of Missouri in Kansas City, appointed on Nov. 10, 2003, by the Eighth Circuit Court of Appeals. Prior to taking the bench, he was a partner with the firm of Shook, Hardy & Bacon LLP, where he represented trustees in chapter 7 cases involving significant assets, individual and corporate debtors in proceedings under chapters 7 and 11, and secured, unsecured and priority creditors and lessors in chapter 7, 11, 12 and 13 cases, and had been listed in *The Best Lawyers in America* in the area of bankruptcy law every year since 1995. He also tried numerous adversary proceedings and contested matters, including preference actions, objections to discharge, dischargeability complaints and objections to confirmation of chapter 11 plans. Judge Dow is a member of ABI, the Missouri Bar and the Kansas City Metropolitan Bar Association. He is a Fellow of the American College of Bankruptcy, inducted in March 2013, and was selected in November 2014 to become a conferee of the National Bankruptcy Conference. He also is a member of the National Conference of Bankruptcy Judges. Judge Dow is a member of the Bankruptcy Appellate Panel and was appointed in October 2014 to the Judicial Conference Advisory Committee on Bankruptcy Rules, then appointed in 2018 to chair the committee. He has authored and co-authored several articles, including "ERISA-Related Claims in Bankruptcy," *Journal of Bankruptcy Law and Practice*, Vol. 3, No. 1 (Nov/Dec 1993), "Rent to Own Agreements in Bankruptcy: Sales or Leases?," *ABI Law Review*, Vol. 2, No. 1 (Spring 1994), and "Gramm-Leach-Bliley and the Bankruptcy/Collection Attorney," *Norton Bankruptcy Law Advisor* (Feb 2002). Judge Dow received his B.A. with honors from the University of Wyoming and his J.D. from Washburn University School of Law, where he was notes editor of the *Washburn Law Journal*.

Hon. Mitchell L. Herren is a U.S. Bankruptcy Judge for the District of Kansas in Wichita, appointed in July 2020. His 33 years prior to the bench included practice with a litigation firm in Kansas City, serving as in-house litigation counsel for a large energy company, then returning to private practice for 18 years with a Wichita-based firm, where he served for seven years as managing member and represented clients ranging from individuals to large companies, with a focus on commercial litigation. Judge Herren is a Fellow of the Litigation Counsel of America and the American Bar Foundation. He received his J.D. from the University of Missouri at Kansas City School of Law.

Hon. Janice D. Loyd is a U.S. Bankruptcy Judge for the Western District of Oklahoma in Oklahoma City, sworn in on Dec. 12, 2014. Prior to her swearing in, she was an officer, director and shareholder with the Oklahoma City law firm of Bellingham & Loyd, P.C. Prior to taking the bench, Judge Loyd's practice emphasized the areas of bankruptcy, reorganization and commercial litigation. She also was a member of the Chapter 7 Trustee Panel for the U.S. Bankruptcy Court for the Western District of Oklahoma for 22 years, handling over 20,000 cases. Judge Loyd is a member of the Oklahoma County Bar Association, the Oklahoma Bar Association, the Federal Bar Association, ABI and the National Conference of Bankruptcy Judges. She has chaired both the Bankruptcy Section of the Oklahoma County Bar Association and the board of directors for the Bankruptcy and Reorganization Section of the Oklahoma Bar Association. She also has served on the Mediation Advisory Board Committee and is a Permanent Member of the Standing Local Rules Committee for the U.S. Bankruptcy Court for the Western District of Oklahoma. In 2019, Judge Loyd was appointed to the Tenth Circuit Bankruptcy Appellate Panel. In 2006, she received the Oklahoma Bar Association Award for Outstanding Pro Bono Service, and she is a two-time recipient of the Mona Salyer Lambird Service to Children Award for services provided as a volunteer for Lawyers for Children. Judge Loyd received her B.A. in political science in 1983 from the University of Oklahoma and her J.D. in 1986 from the University of Oklahoma College of Law.

Hon. Cynthia A. Norton is a U.S. Bankruptcy Judge for the Western District of Missouri in Kansas City. Prior to her appointment on Feb. 1, 2013, she was a founding partner of Grimes & Rebein, LC in Lenexa, Kan., where she focused on consumer and business bankruptcy, creditors' rights, commercial workouts and related fields. She also clerked for Hon. John E. Rees of the Kansas Court of Appeals and Hon. James A. Pusateri of the U.S. Bankruptcy Court in Topeka, Kan., and was previously an associate with Stinson, Mag & Fizzell, an associate and then partner with Lewis, Rice & Fingers, and Of Counsel with Levy & Craig, and established her own law firm in 1995. She has published an annual column reviewing Eighth Circuit bankruptcy cases of interest for *Norton's Bankruptcy Law Advisor* and has authored numerous articles, book chapters and seminar papers on bankruptcy-related topics, is a Fellow in the American College of Bankruptcy and a member of various bankruptcy organizations. She also is the recipient of the Michael R. Roser Excellence in Bankruptcy Award and the Robert L. Gernon Award for Outstanding Contribution to CLE, as well as the NCBJ Excellence in Education Award. Judge Norton received her B.A. in French and art history Phi Beta Kappa and *summa cum laude* from Kansas University in 1981, and her J.D. from the Kansas University Law School in 1984, where she was associate editor of its law review.

Hon. Michael E. Romero is a U.S. Bankruptcy Judge in the District of Colorado in Denver, initially appointed in 2003 and appointed Chief Judge from July 2014-June 2021. He is also Chief Judge of the Tenth Circuit Bankruptcy Appellate Panel. Since becoming a judge, Judge Romero has served on numerous committees and advisory groups for the Administrative Office of the U.S. Courts, is the past chair of the Bankruptcy Judges Advisory Group and has served as the sole bankruptcy court representative/observer to the Judicial Conference of the United States, the governing body for the federal judiciary. He is a past president of the National Conference of Bankruptcy Judges and actively participates in several of its committees. He also serves on the Executive Board of Our Courts, a joint activity between the Colorado Judicial Institute and the Colorado Bar Association that provides programs to further public understanding of the federal and state court systems. Judge Romero is a member of the Colorado Bar Association, ABI, the Historical Society of the Tenth Circuit and the

Colorado Hispanic Bar Association. He received his undergraduate degree in economics and political science from Denver University in 1977 and his J.D. from the University of Michigan in 1980.

Hon. Bianca M. Rucker was appointed U.S. Bankruptcy Judge for the Eastern and Western Districts of Arkansas in Fayetteville on April 26, 2021. Prior to her judicial appointment, she was a chapter 7 panel bankruptcy trustee and attorney representing creditors and debtors in consumer and business bankruptcy matters at Rucker Law PLLC, in Fayetteville. Before working as a trustee, Judge Rucker was a partner at Wright, Lindsey & Jennings, LLP (WLJ), where her practice focused on bankruptcy, commercial litigation and insurance defense. She also served as a staff attorney to Hon. Richard D. Taylor (2006-07) and Hon. Ben T. Barry (2007-11) of the U.S. Bankruptcy Court for the Eastern and Western Districts of Arkansas. Judge Rucker has served as president of the Northwest Arkansas Debtor and Creditor Bar Association, and she is an adjunct professor at the University of Arkansas School of Law, where she teaches alcohol beverage law. She received her B.A. in political science in 2003 from the University of Arkansas at Little Rock and her J.D. with honors in 2006 from the William H. Bowen School of Law.

Hon. Anita L. Shodeen is a U.S. Bankruptcy Judge for the Southern District of Iowa in Des Moines, appointed in 2009. She also serves on the Eighth Circuit Bankruptcy Appellate Panel, is a member of the Judicial Resources Committee of the Judicial Conference, and is a Fellow in the American College of Bankruptcy. Judge Shodeen is an associate editor for the *American Bankruptcy Law Journal*. Prior to her appointment, she focused her practice on representing both debtors and creditors in workouts, bankruptcy and litigation in the state and federal courts. She also served as a chapter 7 panel trustee and chapter 12 standing trustee. Judge Shodeen received her J.D. in 1985 from Drake University.

Hon. Kathy A. Surratt-States is a U.S. Bankruptcy Judge for the Eastern District of Missouri in St. Louis, initially appointed on March 17, 2003, and named Chief Judge from Feb. 1, 2013, to June 30, 2022. She began her legal career as law clerk to now-retired Bankruptcy Judge James J. Barta. In 1993, Judge Surratt-States was an associate at Campbell & Coyne, P.C., where her work focused on bankruptcy, commercial litigation and foreclosures. She then moved to Ziercher & Hocker, P.C. in 1998, where she became partner. The firm later merged with Husch Blackwell, where she was a partner in its insolvency practice group until her appointment to the bankruptcy court. In 1997, Judge Surratt-States was appointed to the Panel of Bankruptcy Trustees for the Eastern District of Missouri, and in 1999, she served as the chapter 7 trustee for Family Company of America, then the third-largest grocery store chain in St. Louis. Judge Surratt-States serves on the Board of Catholic Charities of St. Louis and is a member of Altrusa International, Inc. of St. Louis, an international association of professionals dedicated to serving their community. She also is a member of the Missouri Bar, the Bar Association of Metropolitan St. Louis, the Mound City Bar Association, the National Conference of Bankruptcy Judges, ABI and the International Women's Insolvency & Restructuring Confederation (IWIRC). Judge Surratt-States received her B.A. *cum laude* from Oklahoma City University in 1988 and her J.D. from Washington University School of Law in 1991.

Hon. Kimberley H. Tyson is Chief U.S. Bankruptcy Judge for the District of Colorado in Denver, initially appointed to the bench in May 2017. Previously she was a director of Ireland Stapleton Pryor & Pascoe, PC, where her practice focused on bankruptcy and related litigation. She represented

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secured and unsecured creditors, creditors' committees, trustees and purchasers in bankruptcies, as well as clients in contested foreclosure proceedings and lender-liability cases. She also pursued hidden or improperly transferred assets. In March 2011, she was appointed to the panel of chapter 7 trustees by the U.S. Trustee. Ms. Tyson is a former chair of the Colorado Bar Association's Bankruptcy subcommittee and is a frequent lecturer on bankruptcy issues, co-authors the bankruptcy chapter of the *Annual Survey of Colorado Law*, and has been named in *Colorado Super Lawyers*. She is an active member of ABI, having served on its Rocky Mountain Bankruptcy Conference advisory board since 2003. Ms. Tyson clerked for Hon. John K. Pearson of the U.S. Bankruptcy Court for the District of Kansas and Hon. Jerry G. Elliot of the Kansas Court of Appeals. She earned her B.A. at Smith College and her J.D. at the University of Kansas School of Law.